

PRIVATELY HELD STOCK WITHIN A PRIVATE FOUNDATION

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Special considerations must be taken into account when investing a foundation's assets in or funding a foundation with privately held stock.

One of the most appealing qualities of a private foundation is the tremendous degree of flexibility it provides to its Board for making investment decisions. This quality is greatly prized by savvy investors and entrepreneurs who have developed the knack for making shrewd and lucrative investments. These successful investors find great satisfaction in applying their skills to benefit their foundations and in growing foundation assets in a dynamic and effective way. Often, a sophisticated investor's strategy includes investments in privately held stock. Following is a brief synopsis of key points to bear in mind when a foundation's portfolio includes investments in such stock.

Tips for holding privately held stock

Excise Tax: Upon a foundation's sale of privately held stock that had been donated, it will pay a nominal excise tax on the realized capital gain, as determined by reference to the donor's basis in such stock. The foundation's excise tax liability will be calculated using a 1% or 2% tax rate.

Prohibited Sales: A foundation may not sell stock to certain insiders known as "disqualified persons." This term includes the foundation's substantial contributors, officers, directors, trustees, persons with a 20% or greater interest in an entity that is a substantial contributor, the family members of all such individuals, and certain entities partially or wholly owned by disqualified persons. Such a sale would result in a "self-dealing" violation and is prohibited. Generally, when such a sale occurs, it must be rescinded or corrected to the extent possible, and the resulting penalties will be assessed against the disqualified person *personally* without the possibility of indemnification by the foundation.

- In the context of a privately held business, this may be a serious concern, as the typical purchaser of the privately held stock would be a family member related to the foundation's officers or directors. That family member usually will be considered a disqualified person, making the contemplated sale prohibited. Under such circumstances, the foundation would be permitted to sell the stock without violation only to an outsider. However, the other owners of such a business may protest a stock sale to an outsider.

Liquidity Concerns: A foundation must obtain an annual valuation of its interest in privately held stock for purposes of calculating its annual 5% minimum distribution requirement.

- Privately held stock held as an investment is included in the asset base referenced to calculate the annual 5% minimum distribution requirement. Therefore, if such stock is illiquid, does not give rise to a dividend income stream, and constitutes a large proportion of the foundation's investment portfolio, the foundation may face a serious cash flow problem. The foundation should ensure that it owns other liquid assets to draw upon so that it can make necessary grants and pay taxes and operating expenses.

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Excess Business Holdings: A foundation's level of ownership of privately held stock in a business may be limited by the IRS' excess business holdings rules. If a foundation owns more than the maximum allowed percentage of stock in a business, the foundation may be subject to a penalty on its "excess holdings" of stock in such business. This discussion is limited to investments in entities that are not themselves disqualified persons in respect of the foundation. An investment made by a foundation in an entity that is a disqualified person may result in a self-dealing violation, the analysis of which is beyond the scope of this discussion.

- These excess business holdings rules apply only to a business that is a "business enterprise," which is defined by the Treasury Regulations to include the active conduct of a trade or business, including any activity regularly carried on for the production of income from the sale of goods or the performance of services. A passive investment vehicle that derives 95% or more of its gross income from "passive sources" will not be considered a business enterprise and, therefore, the excess business holdings rules would not apply to an investment in such an entity.
 - Generally, the Internal Revenue Code defines "passive sources" to include dividends, interest, payments with respect to certain securities loans and annuities, royalties, rents, and capital gains.
 - If a foundation is invested in a business enterprise directly or indirectly through attribution, the foundation will need to be vigilant in monitoring its own and its disqualified persons' ownership levels in such business enterprise to ensure that the foundation is not in violation of the excess business holdings rules.
- To remain in compliance with the excess business holdings rules, the foundation must determine if the stock is voting or nonvoting. Generally, the combined voting power of the foundation and its disqualified persons in a business enterprise may not exceed 20%.
 - However, under the *de minimis* exception to the general rule, a foundation may own up to 2% of a business enterprise without regard to the ownership levels of its disqualified persons.
 - To qualify for this *de minimis* exception, the foundation must not own more than 2% of: (1) the business enterprise's voting stock; and (2) the business enterprise's value of all outstanding shares of all classes of stock. The foundation will qualify for the 2% *de minimis* exception only if both of these conditions are satisfied.
- As noted above, the basic rule is that the combined voting power of the foundation and its disqualified persons in a business enterprise must not exceed 20%. For these purposes, the percentage of voting stock held by a person in a corporation is normally determined by reference to the power of stockholders to vote for the election of directors, disregarding treasury stock and stock that is authorized, but unissued.

For example, suppose that XYZ Corporation has a total of eight director positions comprising its Board. Three of the eight director positions are elected by Class A common stock shareholders and five of the eight positions are elected by Class B common stock shareholders. Thus, Class A and Class B common stock shareholders elect 37.5% ($3/8 = 37.5\%$) and 62.5% ($5/8 = 62.5\%$), respectively, of the Board. The private foundation owns 20% of the shares of the Class A common stock and no shares of Class B common stock.

Here, the private foundation is treated as holding 7.5% of the XYZ Corporation voting stock as follows: $20\% \times 37.5\% = 7.5\%$ (percentage of Class A common stock owned by the private foundation \times percentage of director positions elected by Class A common stock = percentage voting power).

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- In some cases, the level of permitted holdings of voting stock can be increased to as much as 35% if the foundation and its disqualified persons lack effective control of the business enterprise. In this context, the term “effective control” means the ability, directly or indirectly and whether or not actually exercised, to direct or cause the direction of the management and policies of a business enterprise. Such control can be obtained in any number of ways, such as through ownership of voting stock, the use of voting trusts, or contractual arrangements.
- If all of a foundation’s disqualified persons collectively own no more than 20% of the business enterprise’s voting stock, the foundation can own an unlimited percentage of nonvoting stock. Stock carrying contingent voting rights is treated as nonvoting until the event triggering the right to vote occurs. Where the foundation and its disqualified persons can show that they lack effective control of the business enterprise, this special rule is applied by substituting 35% in place of 20%.

For example, suppose that a foundation owns 90% of a business enterprise’s nonvoting stock and 3% of its voting stock (making the 2% de minimis exception inapplicable). If the disqualified persons collectively own only 15% of the business enterprise’s voting power, this special rule would shield the foundation from an excess business holdings violation because the disqualified persons, collectively, own no more than 20% of the voting stock.

- If a foundation and its disqualified persons collectively own more stock in a business enterprise than the maximum percentage allowed, the following special rules apply to determine if and when a penalty will be assessed:
 - *Donated stock:* A foundation that receives a donation of privately held stock that would result in an excess business holdings violation has five years to dispose of the excess holdings. If the foundation does so, no penalty will be assessed.
 - *Stock acquired by a disqualified person:* A foundation has only 90 days to dispose of its excess holdings if the maximum percentage limitation is exceeded because one or more disqualified persons acquire too much stock. In this case, the foundation must dispose of the excess holdings within 90 days of the date it knows or had reason to know of the event that caused it to have such excess holdings. If the foundation does so, no penalty will be assessed.

For example, if the foundation and its president collectively own 15% of a business enterprise’s voting stock, and the president’s grandfather acquires more than 5% of that enterprise’s voting stock, the foundation will have exceeded the 20% limitation.

- *Stock purchased by the foundation:* The foundation may never purchase stock in a business enterprise that will immediately cause its ownership percentage in that enterprise to exceed the maximum percentage allowed. If a foundation does so, it will be subject to a penalty immediately.
- If the excess holdings are not disposed of within the time periods outlined above, a tax is imposed on the foundation equal to 10% of the highest value of the excess holdings owned during each year. Where the IRS becomes aware of an excess business holdings violation and specifies a date by which the violation must be corrected, failure to comply by the specified date can cause the tax to escalate to 200% of the value of the excess holdings.

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