

Private Foundations Granting to *For-Profit* Organizations? It's Possible.

In certain situations, private foundations can support for-profits as well as nonprofits

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Although it's well known that a private foundation ("PF") can freely make grants to Internal Revenue Code ("IRC") Section 501(c)(3) public charities, many are surprised to learn that a PF may make a grant to a for-profit organization ("FPO")¹ by satisfying certain requirements.² Due to the potential for the enrichment of private interests, however, a PF must contend with an added layer of complexity when granting to an FPO: the need to conduct a private benefit analysis, as the presence of substantial private benefit can subject the PF to a 20% penalty on the grant. This article will provide an analytical framework to help a practitioner gauge whether the private benefit concern posed by a PF's grant to an FPO poses a threat and, if so, guidance as to how it might be overcome.

As a starting point, it's critical that the PF identify a sufficiently large group of individuals—a broad charitable class³—that it intends to benefit through a grant to an FPO. After all, the FPO itself is not the intended beneficiary; it is merely the instrument used by the PF to achieve its charitable objectives. For instance, if the PF were to make a grant to an FPO caterer to provide free meals to children attending a particular school in a disadvantaged neighborhood, the children, not the caterer, would be the intended beneficiaries of the PF's largesse.

Additionally, the PF must consider the degree to which the grant serves the private interests of the FPO and others who will benefit from the grant, even though they are not part of the charitable class that the PF intends to benefit (in other words, the unintended beneficiaries). This requirement stems from the private benefit doctrine embodied in IRC Section 501(c)(3), which provides that PFs and other charitable organizations must be operated exclusively for charitable and other exempt purposes. Specifically, Treasury Regulations ("Reg.") § 1.501(c)(3)-1(c)(1) provides that an organization will be regarded as operated exclusively for exempt purposes unless more than an insubstantial part of its activities is in furtherance of a non-exempt purpose. Further, Reg. § 1.501(c)(3)-1(d)(1)(ii) adds that an organization is not organized or operated exclusively for exempt purposes unless it serves a public rather than a private interest. Thus, an organization's exemption may be lost if it serves a private interest to a more than insubstantial degree, although there is no bright-line test to make such determination.⁴

¹ Note, however, that the self-dealing rules under IRC Section 4941 would prohibit the PF from making a grant to an FPO that is a "disqualified person," as defined in IRC Section 4946.

² Generally, Reg. § 53.4945-5 outlines a set of mandatory procedures, collectively termed "expenditure responsibility," for making grants to organizations not classified as public charities. Expenditure responsibility requires a specified charitable purpose, pre-grant due diligence, a written agreement incorporating certain terms, oversight of the grantee's expenditure of grant funds, and reporting to the IRS.

³ A broad charitable class is one that is "large enough or sufficiently open-ended that the community as a whole, rather than a pre-selected group of people, benefits when a charity provides assistance." IRS Pub. 3833 at 9 (Dec. 2014).

⁴ Taxation of Exempt Organizations, Hill & Mancino, § 4.02[2]; see also GCM 37789.

The ability to make such a determination is also key in avoiding a penalty when making a grant to an FPO. The Regulations specifically address activities that could cause a PF to lose its charitable status if such activities were a substantial part of the PF's total activities. If a PF makes an expenditure for such an activity, Reg. § 53.4945-6(a) provides that the PF will be subject to a 20% taxable expenditure penalty. Since the presence of a private benefit can cause a PF to lose its charitable status if it were a substantial part of its overall activities, it follows that a grant conferring a substantial private benefit also may be subject to a taxable expenditure penalty. The key is knowing when a private benefit is merely insubstantial and, therefore, permissible.

As noted by Mancino and Hill, the IRS "has taken the position that insubstantial is properly understood as an "incidental" amount and that the position that whether an activity is incidental will be tested on both qualitative and quantitative grounds."⁵ To be deemed qualitatively incidental, the primary benefit must flow to the public at large and any benefits to private interests must be a necessary concomitant to achieving the organization's charitable objectives.⁶ The qualitative test is illustrated by Rev. Rul. 70-186,⁷ in which an organization was formed to improve the condition of the water in a lake that was available to the community as a recreational facility. While the improvement would benefit the public at large, it also would benefit the owners of lakefront property by increasing property values. The IRS concluded that the private benefit was incidental in a qualitative sense because the benefits would flow to the general public, and such benefits could not be attained without necessarily benefitting the private property owners.

When making a grant to an FPO, a PF must apply the qualitative test to both the intended and unintended beneficiaries of the activity conducted by the FPO, as well as to the FPO itself. For instance, consider the school meal program discussed above. There, the PF should consider whether the benefit will reach the needy children (the intended beneficiaries) and whether the benefit provided to the other children who will receive the meals even though they are not in need of them (the unintended beneficiaries) is an unavoidable byproduct of the program. Suppose that the school insists on providing the meals to all children because it would be administratively burdensome to keep track of those who would not qualify for the program, as nearly all would be eligible. In that case, the benefits to the small group of unintended beneficiaries would be a necessary byproduct of the program.

Similarly, conferring a benefit upon the FPO likely would be unavoidable if the PF exercised reasonable judgment in determining that its charitable goals would be best achieved through an FPO. In any event, a PF should not be compelled to choose a less effective option for achieving its charitable purposes just because that other option might confer a lesser degree of private benefit. For example, while a loan or equity investment provides a lesser degree of private benefit than a grant because the PF stands to recover its investment, a grant may still be the best option because the FPO may not earn sufficient revenue to service debt or pay dividends, and a PF investment may deter commercial investors. Further, an FPO might be the best choice because of superior experience, track record, qualifications, lower cost, higher quality, etc., even if a charity also could carry out the program, albeit not as well. However, in the unlikely event that an alternative option would be equally effective while conferring less private benefit than a grant to an FPO, one may infer that the PF should choose that alternative in order for the private benefit to be qualitatively incidental. After all, to the extent that private benefit can be reduced, but

⁵ Mancino and Hill at § 4.02[2].

⁶ See GCM 37789.

⁷ 1970-1 C.B. 128.

isn't, the portion of the private benefit that could have been avoided, but wasn't, can't be considered a necessary byproduct of the activity.⁸

Additionally, as noted above, an activity must be quantitatively incidental, requiring the application of “a comparative standard in which the private benefit is measured against the specific public benefit provided.”⁹ In weighing the private against the public benefit, the IRS has acknowledged that the degree to which private benefit will be tolerated will vary in proportion to the degree of public benefit conferred.¹⁰ This principle is illustrated in Rev. Rul. 76-152,¹¹ where an organization was established to promote community understanding of modern art trends. The organization selected modern art works of local artists for exhibition and sale at its gallery. Upon sale of an artwork, the artist received the sales proceeds after paying a ten percent commission to the organization. Noting that the artists were not members of the charitable class intended to benefit from the activity, the ruling concluded that the private benefit to the artists could not be overlooked as being merely insubstantial in relation to—and despite—the public benefit conferred by the exhibitions.

In applying the quantitative test to an FPO grant, the PF must weigh any private benefit conferred upon the grant's unintended beneficiaries against the public benefit. Of course, the larger the charitable class, the greater the number of intended beneficiaries who are likely to be reached, and the greater the benefit to the intended beneficiaries, the more likely the public benefit will outweigh the private benefit. Another way to tip the scale in favor of public benefit would be to minimize the private benefit as much as possible. In fact, an implied imperative to minimize private benefit can be found in IRC § 501(c)(3), which expresses the ideal of an organization's operating exclusively for charitable purposes. Although the Regulations clarify that an incidental amount of private benefit may be tolerated, a PF nevertheless should conform as closely as possible to the IRC's ideal.

Referring back to the example with the school meal program in a disadvantaged neighborhood, local demographics should ensure that the number of intended beneficiaries would greatly outnumber the unintended beneficiaries. Therefore, one may readily conclude that the private benefit in this scenario is quantitatively incidental because the public benefit outweighs the private benefit. By contrast, had the program been conducted in an affluent neighborhood, the private benefit could have been minimized by limiting program eligibility to those in need.

Additionally, the quantitative test must be applied to the FPO itself. Here, too, the PF should strive to minimize the benefit to the FPO to increase the likelihood that any private benefit will be outweighed by the public benefit. However, a PF should employ a different approach for minimizing the FPO's private benefit, given its unique role as the PF's instrument for carrying out its charitable objectives. Namely, the PF should avoid granting more than a reasonable amount in exchange for the value furnished by the FPO in terms of goods, services, and other tangible benefits.¹² If the PF does not negotiate fair value in

⁸ See GCM 3778, which reasoned that a hospital's renting land to physicians for the construction of a medical building essentially free of charge was not a necessary concomitant to the hospital's charitable purposes because its purposes could have been just as readily achieved by charging rent at market rates.

⁹ Hill & Mancino, Section 4.02[2].

¹⁰ GCM 38459 (07/31/80).

¹¹ 1976-1 C.B. 151.

¹² See GCM 37789, *infra*, noting that an exempt organization intending to lease land for less than fair rental value might have avoided private benefit concerns by obtaining “tangible benefits” that may have had the effect of increasing the lease payments to market value. For instance, suppose that a PF were to decide that a grant to a pharmaceutical FPO is the best way to develop an “orphan” drug, one that is generally considered unprofitable because it would treat

exchange for the grant, as required by the ongoing fiduciary duty of care,¹³ the ensuing private benefit to the FPO may outweigh the grant's public benefit. For instance, referring back to our example, suppose that the going rate charged by other caterers for the same meals is substantially less than the grant paid to the FPO. In that case, the PF's substantial overpayment for the value received could cause the private benefit to the FPO to outweigh the public benefit.

In GCM 37789, the Office of the Chief Counsel reasoned that private benefit would be merely incidental if a nonprofit hospital were to lease land to physicians at market value and provide financing to them at the prevailing rate for the construction of a medical building on such land. The GCM noted that, as originally proposed, the hospital would have leased the land at virtually no cost to the physicians, resulting in a more than incidental quantitative private benefit because it may well have outweighed the benefit to the public at large.¹⁴ In this vein, the GCM noted that while the financing arrangement at market rates was not problematic, it would have been "troublesome" if the hospital were to lend its funds at less than market rates.

Finally, Reg. § 53.4945-6(b)(2) supports the conclusion that paying fair value to an FPO for goods, services, or other tangible benefits should not give rise to a substantial private benefit. Generally, this regulation provides that an expense payment in excess of fair value may be subject to a taxable expenditure penalty unless it is paid in the good faith belief that such expense was reasonable and is consistent with ordinary business care and prudence.¹⁵ As with the private benefit analysis, the determination as to whether an expenditure is reasonable will depend on the particular facts and circumstances of each case.

In determining whether a grant to an FPO would result in impermissible private benefit, a PF would be well advised to thoroughly document its reasoning. The answers to the following questions can assist a PF in documenting its reasoning in ruling out an impermissible private benefit that could expose the PF to a penalty:

- What is the charitable purpose served?
- Describe the "broad charitable class" that will benefit from the PF's grant.
- In the judgment of the PF's board, is the FPO the best vehicle for achieving the PF's charitable purposes? If so, why?
- If the FPO is the best vehicle for achieving the PF's charitable purposes, is a grant the best means of providing funding to the FPO in the judgment of the PF's Board, as opposed to a loan or equity investment? If so, why?
- With respect to the qualitatively incidental test, is the private benefit, if any, a necessary byproduct of an activity that benefits the public at large?
- With respect to the quantitatively incidental test:

only a rare medical condition. To ensure that the PF receives at least fair value in return for the grant, it may require the pharmaceutical FPO to make various concessions, like agreeing to market the drug in underdeveloped countries, sell the drug at affordable prices, and publish a research paper after the drug has been patented.

¹³ Aside from private benefit concerns, a PF's Board members have a fiduciary duty of care to avoid wasting corporate assets by overpaying to such an extent that no business person would reasonably conclude that the PF had received fair value in exchange for the payment.

¹⁴ The GCM also noted that leasing the land essentially free of charge would not have been *qualitatively* incidental, either, because it was not necessary to charge below rental value to achieve the desired public benefit, as such benefit could have been just as readily achieved by leasing at market rates.

¹⁵ Reg. § 53.4945-6(b)(2).

- Does the public benefit outweigh the private benefit? If so, why?
- Is the program designed to target the grant's intended beneficiaries to the greatest extent possible while minimizing benefits to unintended beneficiaries? If so, how?
- Is the PF receiving at least fair value in terms of goods, services, and other tangible benefits (to be provided by the FPO to the intended beneficiaries) in exchange for the amount of the grant? What is the basis for this conclusion?
- If the goods and services received for the grant constitute less than fair value, has the PF obtained other concessions from the FPO? If so, what concessions were gained?

Although using an FPO as an instrument to advance a PF's charitable purposes adds a layer of complexity, more and more PFs are expressing interest in this unique approach. Indeed, working through an FPO can certainly be a highly effective option for accomplishing a PF's charitable purposes, so long as the PF exercises business judgement and thoughtfully analyzes the private benefit concerns.

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