K. INVESTMENTS THAT JEOPARDIZE CHARITABLE PURPOSES

1. The Statute

IRC 4944(a)(1) imposes an initial tax of 5 percent of the amount so invested on a private foundation if it invests any amount in a manner that jeopardizes the carrying out of its exempt purpose. IRC 4944(a)(2) imposes an initial tax of 5 percent of the same amount on any foundation manager who knowingly participates in making the investment.

IRC 4944(b)(1) imposes an additional tax on the foundation of 25 percent of the amount so invested if the investment that caused the initial tax is not removed from jeopardy within the taxable period. The section imposes a similar additional tax of 5 percent of the amount so invested upon a foundation manager who refuses to agree to the removal from jeopardy of an investment that has triggered the imposition of the initial tax.

IRC 4944(c) excepts from taxation program-related investments, which it describes as investments which have the primary purpose to accomplish one or more of the purposes described in IRC 170(c)(2)(B) and which do not have as a significant purpose the production of income or the appreciation of property.

IRC 4944(d) and (e) provide, respectively, certain special rules and definitions.

2. Background

Charitable trusts traditionally received protection from misuse or mishandling of funds at English common law and under the Statute of Charitable Uses enacted in 1601, the sources from which much American charitable law derives. In the United States the protection has continued in the various state jurisdictions with supervision generally being exercised by the state attorneys general and in some cases by designated state courts.

Some states have statutes imposing standards as to what constitutes a proper investment for charitable trusts. In the absence of statutory provision, state courts have imposed a "prudent man" test.

The concern for protection of charitable investments has been carried over into the tax law. Specific protection was first inserted in 1950 as section 3814 of the 1939 Code (which language was substantially retained in former section 504(a)(3) of the 1954 Code). Before that time it was necessary for the Service to deal with improper investments as a violation of the operational test of IRC 501(c)(3). However, the former IRC 504(a)(3) provided that if a charitable organization invested its accumulated income in a manner that would jeopardize the carrying out of its charitable purpose, it would be denied exemption for the taxable year in which the bad investment was made or continued. By 1969, Congress had come to view this approach as too draconian and, in the Tax Reform Act of 1969 repealed the provision and imposed a penalty tax upon investment of any amount by a private foundation where it constitutes a jeopardizing investment. The Senate Finance Committee report pointed out that the bill (subsequently adopted as the Tax Reform Act) ". . . imposes upon all assets of a foundation the same limitation presently applicable to accumulated income." The committee report thus conveys the Congressional intent that the meaning of "jeopardizing investments" under prior law that dealt with loss of exemption has been retained under the new law with regard to the penalty excise tax.

3. <u>What Is a Jeopardizing Investment</u>?

The question of what investments "jeopardize" a foundation's charitable purpose is another way of asking what constitutes permissible investments for such charitable organizations. The regulations suggest that foundation managers have a wide latitude in seeking investment opportunities inasmuch as the regulations state that no category of investments shall be treated <u>per se</u> as a violation of IRC 4944. The regulations do, however, express a standard as to what is an acceptable quality of investment.

Section 53.4944-1(a)(2) of the Foundation and Similar Excise Taxes Regulations characterizes a jeopardizing investment as one in which the foundation managers making the investment have failed to exercise "ordinary business care and prudence" in providing for the long and short term financial needs of the foundation under the facts and circumstances at the time the investment is made. The regulation further states that the determination shall be made on an investment-by-investment basis taking into account the foundation's portfolio as a whole. The regulation indicates that expected return, fluctuation in price level, and need for diversification are factors to be considered in making the investment selections.

The regulation also identifies certain types of investments that are not favored and thus will be closely scrutinized when found in an investment portfolio. These are: (1) securities purchased on margin, (2) commodity futures, (3) working interests in oil and gas wells, (4) "puts", "calls", and "straddles", (5) warrants, and (6) short sales.

Case law throws very little light on what was meant by jeopardizing investments under the law as it existed prior to the 1969 Tax Reform Act. The problem may be illustrated in three cases where the government, in reaction to the questionable nature of the investments, pressed for revocation on grounds that the organization had not been operated exclusively for exempt purposes. The Courts, directing their attention to the reasonableness of the investments, responded in the following manner:

(1) Cummins-Collins Foundation, 15 T.C. 613 (1950). The organizers of a charitable and religious organization had bought a distillery business for the organizers individually as independent investors. As part of the deal, they caused the charity to buy a $277,000 block of 6 percent mortgage notes secured by the distillery assets. The charity's purchase was partly financed by a 4 1/2 percent loan made to it by a life and casualty insurance company. The loan was secured by the $277,000 block of notes. The Court concluded that the charity's purchase was amply secured and provided for a reasonable return. The Court was persuaded of the investment's legitimacy by a showing that the commercial lender had accepted the loan as collateral for another rather substantial loan.

(2) Samuel Friedland Foundation, 144 F. Supp. 74 (D.N.J. 1956). The foundation's investment portfolio consisted of certain mortgages on various parcels of real estate valued at approximately $900,000 and 57,000 shares of stock in the founder's business with a value of about $1,000,000. Disregarding a small amount of high risk assets, the Court noted that the government had not presented any evidence addressing the question whether the investments were risky. It noted that the value of the collateral was substantially greater than their face amount and that the founder had testified persuasively as to the value of the business stock. The Court stated that the evidence would not support a conclusion that the investments jeopardized the foundation's charitable purpose or function.

(3) Donald G. Griswold, et ux., 39 T.C. 620 (1962). The foundation made loans and gifts to a variety of churches and educational organizations. It also made loans of a total of $197,300 to the founder, his relatives, and controlled corporations. Based on the testimony, the Court concluded that the foundation's

loans to these insiders were on terms no more favorable than what would be available to them by regular commercial channels. The Court also emphasized that the questionable loans amounted to no more than 10 percent of the foundation's total loans.

In each of these cases, one can see the Court's concern about the lack of a standard against which the questionable investments may be tested. One can also see a confusion in government at that time about how the issues of self interests and imprudent investment must interact. Most importantly, one may see the reluctance of courts to impose a result (revocation of exemption) that falls so heavily upon intended charitable beneficiaries in the absence of statutory directions.

The test of "ordinary business care and prudence" used in the regulations is obviously a more useful standard than the government's assertion that the organizations were not operated exclusively for exempt purposes in the above case. One might speculate as to the court's actions had they been presented with a definite investment standard.

The various concepts discussed in this article are applied in a series of numbered hypotheticals which follow. A citation follows the hypothetical where its fact pattern is taken from an authoritative source. Where no citation is given, the issue has not been addressed in the regulations or any published ruling by the Service and the conclusion with respect to such hypothetical should be regarded as tentative.

1. Foundation B has an investment portfolio of $ 100,000. Its foundation managers state they have taken into account the foundation's portfolio requirements. The following investments are under question:

> 1 - A $ 5,000 purchase of Corporation X's common stock. The corporation has been in business for a considerable period of time and has a good record of earnings and dividends.
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> 2 - A $ 10,000 purchase of Corporation Y's common stock. The corporation has a promising product with earnings in some years and substantial losses in others. It has never paid a dividend and is widely reported in the financial services as being seriously undercapitalized.

3 - An $ 8,000 purchase of Corporation Z's common stock. The corporation has been in business for a short period of time. It manufactures a new product that must compete with well established alternative products. The investment services say there is a possibility of long term appreciation but there is little prospect for a current return.

Y and Z are characterized as jeopardizing investments. See Regs. 53.4944-1(c), Example (1).

The regulations do not state why the investments in Y and Z are bad. However, it should be noted that Y and Z stock are high risk items that have a very short performance history and provide no income; also important is that they constitute a significant portion (18 percent) of the foundation's investment portfolio. A high percentage of questionably secure and low yielding investments does not ordinarily serve a foundation's investment needs and could be said to jeopardize "the foundation's charitable purpose.

2.

Same facts as in 1, above, except that:

1 - The $ 10,000 investment in Y is for a new issue of stock. Funds thus raised will relieve Y's shortage of capital. Y's management has submitted information that the added resources will overcome the problems resulting in an uneven earnings record.

2 - Z's management has demonstrated the capacity for getting new business started successfully in other business ventures. Z has already received substantial orders for its product.

B's purchases of Y and Z-stock are not jeopardizing investments. See Regs. 53-4944-1(c), Example 2.

It appears from the additional information that the prospects of Y and Z for a successful business operation are current, not remote.

3.

> Foundation E, after careful research into how best to diversify its investments, provide for its long-term needs, and hedge against long-term inflation adopted a strategy of allocating a portion of its investment assets to unimproved real estate in selected areas where population patterns and economic factors indicate a rapid and continuing growth. E's other investments are designed to meet its short-term needs for cash to carry out its charitable programs. E's investment manager is shown to be highly credentialed based on extensive documentation of her training and experience. The acquisitions of unimproved real estate are not jeopardizing investments. See Regs. 53.4944-1(c), Example 3.

The example makes clear that long-term investments for appreciation are valid investments where they are designed to serve identified requirements of the charitable program. (Note, however, that a foundation that invests too much of its corpus in assets that do not produce current income available to be paid out annually for charitable purposes is likely to run afoul of IRC 4942). It also shows the desirability of establishing that the investment decision was based on expertise and careful thought. The above examples suggest that the regulations test of investment quality tends to approximate those of the business community and preserves considerable discretion in foundation managers to seek out appropriate investments.

4. <u>When an Investment Goes Sour</u>

IRC 4944 does not take a stance to protect investment quality when a foundation's existing investment begins to erode because of either market conditions or circumstances bearing upon the foundation's investment asset. The regulations state at 53.4944-1(a)(2)(i) that once the investment has been ascertained as not jeopardizing the foundation's exempt purposes, it will not subsequently be considered jeopardizing even though the foundation realizes a loss.

One should bear in mind, however, that if the terms or conditions of an investment have been varied, a new set of rules prevails. Regs. 53.4944-1(a)(2)(iii) says that if a private foundation changes the form or terms of an investment after December 31, 1969, the foundation will be considered as having entered into a new investment on the day of such change. The determination whether the investment is a jeopardizing one shall be made as of the date of such change.

Another set of rules applies if the foundation has received the investment asset by gift. Regs. 53.4944-1(a)(2)(iii)(a) provides that if the investment has been gratuitously transferred by any person by the foundation the transaction is not subject to IRC 4944 except to the extent the foundation has furnished consideration. Similarly, Regs. 53.4944-1(a)(ii)(b) provides that IRC 4944 shall not apply if the investment is received solely as the result of an IRC 368(a) reorganization.

These principles are illustrated by the following examples:

4.

> In 1975 Foundation H made a $500,000 loan with scheduled payments to Corporation W at 9 percent. The last scheduled payment will be due on January 1, 1990. At the time the loan was made, the transaction clearly satisfied the jeopardizing investment rules. In 1987, the corporation asked the foundation to increase the unpaid balance of $350,000 to $500,000, with a final payment to be made on June 30, 1995. The loan is to be treated as a new loan entered into as of 1987 for the purpose of applying the section 4944 rules.

Either the change in loan payments or the increase in the amount of the loan would require the foundation manager to consider as part of M's request the investment quality of the debt and, in so doing, he or she must consider the facts and circumstances as they are in 1987.

5. <u>Exception for Program-Related Investments</u>

IRC 4944(c) provides that, if a foundation makes an investment which, by its very nature, serves primarily to accomplish one or more of the foundation's charitable programs, and no significant purpose of it is the production of income or property appreciation, the investment shall not be a jeopardizing investment.

The regulations state that a program-related investment must possess the following characteristics:

(1) The primary purpose is to accomplish one or more purposes described in IRC 170(c)(2)(B).

(2) The production of income or appreciation of property must not be a significant purpose.

(3) There must be no purpose described in IRC 170(c)(2)(D) (influencing legislation or political intervention).

The program-related exception allows foundations to direct their resources into IRC 501(c)(3) purposes as equity purchases or loans without the requirement of investment quality. The following examples suggest the opportunity for a broad range of charitable initiatives for foundations in this area:

5.

Foundation X makes a loan of $250,000 at regular commercial rates to Corporation L, a small business enterprise located in a deteriorated urban area and owned by members of an economically disadvantaged minority group. L does not have access to such loans from conventional sources because of perceived credit risks. X's primary purpose for making the loan is to encourage the economic development of such minority groups and it has not significant purpose to produce income. The loan is a program-related investment. Compare with Regs. 53.4944-3(b), Example 1.

6.

Foundation X makes a loan of $2,000,000 to Corporation M, a nationally known manufacturer with a strong credit rating. The loan is made under terms more favorable to M than regular commercial rates. The terms require M to locate its distribution center in a particular deteriorated urban area into which it would not otherwise have gone. The purpose of the loan is to help enhance the economic development of the disadvantaged area and promote employment opportunities for low-income persons at the new facility. The loan is a program related investment.

7.

Foundation X makes a loan of $5,000 to N, a student at Y College. The loan, made under X's scholarship program, is based on academic merit. X's purpose in making such loans is to promote higher

> academic achievements in the educational system. The loan is a program-related investment. On the other hand, a foundation that has made a program-related investment may take prudent action to avoid or minimize loss. Thus:
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> 8.
>
> Foundation S makes a program-related investment in a large part of the common stock of T, a business corporation. T incurs a number of business reverses which in S's judgment are due to financial and management problems. S believes that X, an independent person, can successfully run the business and, through its representation on the board, S causes T to sell its business assets to X for a 10 year purchase money mortgage. T's principal asset is now the purchase money mortgage. S's investment in T remains a program-related investment. See Regs. 53.4944-3(b), Example (8).

The example treats the transaction as a change in the foundation's form or terms however the change is justified on the basis of a "prudent protection" principle. Regs. 53.4944-3(a)(3)(i) says that a change made in the form or terms of a program-related investment for the prudent protection of the investment will not ordinarily cause it to cease to qualify as program-related the investment.

Also, Regs. 53.4944-3(a)(3)(i) provides that a change in a program-related investment's form or terms made primarily for exempt purposes and not for any significant purpose involving the production of income or the appreciation of property does not cause a change in the investment's program related status. Thus:

> 9.
>
> Foundation U makes a program-related loan to Z, a business corporation, for 10 years at 7 percent without security. Later, encounters business difficulties and has problems meeting its scheduled payments. U thereupon lowers the interest rate to 5 percent, reduces the size of the scheduled payments, and stretches out the payment schedule to 15 years. Notwithstanding the changes in loan terms, the loan remains a program-related investment. See Regs. 53.4944-3(b), Example (2).

In this case, the investment in Z continues to serve U's charitable purpose. U has determined that even though Z is encountering business difficulties, its continued investment in is warranted. The alteration of terms to make it easier for Z to continue in business serves U's charitable purposes and is not intended to enhance or protect its income.

The regulations also state that a program-related investment may cease to be program-related because of a critical change in circumstances. An example of this is where a foundation has made a program-related investment which subsequently becomes illegal or serves the private purposes of the foundation managers. The regulation further states that an investment that ceases to be program-related because of a critical change in circumstances will not subject the foundation to IRC 4944(a)(1) tax until 30 days after the date on which a foundation or a manager has knowledge of the critical change.

6. Tax Treatment of Jeopardizing Investments

As mentioned before, IRC 4944(d) imposes a tax of 5 percent on the "making" of an investment by a private foundation which jeopardizes its charitable purpose. The Code states that the tax is measured by "any amount" which is invested and the regulations explain that the term means investments of both principal and income.

In addition, IRC 4944(a)(1) provides that the tax is imposed for each year that the amount remains invested during the "taxable period." IRC 4944(e)(1) states that the taxable period begins on the date the amount is invested and ends at the earliest of (1) the date the Service mailed a deficiency notice with respect to the tax, (2) the date on which the tax is assessed, or (3) the date on which the invested amount is removed from jeopardy.

The explanation given in Regs. 53.4944-5(a)(1) as to when the taxable period ends differs from what is stated in IRC 4944(e)(1). Notice, however, that the regulations were issued in 1972 and the statutory language results from an amendment to the Code in 1980. Public Law 96-56, Paragraph 2(a)(2) (December 24, 1980). The reader should avoid any interpretation at variance with the statute.

10.

Foundation M purchased $100,000 of bonds of N Corporation on December 31, 1984, which, under the circumstances, was a

> jeopardizing investment. On January 2, 1987, the Service mailed a notice of deficiency with respect to the matter. M has kept its books and records and has filed its returns on a calendar year basis. M has made 4 jeopardizing investments within its taxable period commencing on December 31, 1984 and ending on January 2, 1987.

Since making a jeopardizing investment is taxed for each year in the taxable period, and there were four years (1984, '85, '86 and '87) in the period, M has committed four taxable acts.

11.

> Same facts as in Example 10, except that the Service has assessed the tax on November 1, 1986. M has made 3 jeopardizing investments within its taxable period which commenced on December 31, 1984, and ended on November 1, 1986, the day the Service assessed the tax.

The significant difference in this situation is the Service's assessment of tax which shortened M's taxable period. Thus, the taxable period extends over three years instead of four.

12.

> Same facts as in Example 11, except that M resold the N Bonds to a speculator for $101,000 on January 31, 1985, and deposited the cash proceeds in its bank account. M later invested the proceeds in securities of acceptable investment quality. M has made 2 jeopardizing investments within its taxable period commencing on December 31, 1984, and ending on January 31, 1985.

The statute allows the foundation to minimize its penalty for a jeopardizing investment by removing it from jeopardy promptly. Here, the foundation has shortened its taxable period by removing the investment from jeopardy. It's taxable period thus covers a correspondingly smaller number of taxable years.

IRC 4944(a)(2) imposes a similar 5 percent tax on the foundation managers that have participated in the foundation's making a jeopardizing investment where they know such an investment is a jeopardizing one and where their participation is willful and not due to reasonable cause. The regulations specify that "knowing" means having actual knowledge of the facts upon which the investment is based, being aware that an investment under such circumstances may violate IRC 4944, and either knowing that the investment is a jeopardizing one or negligently failing to make reasonable attempts to ascertain whether the investment is a jeopardizing one. A foundation manager's participation is "willful" if participation is voluntary, conscious, and intentional. The foundation manager's participation may be due to reasonable cause if the foundation manager has exercised his or her responsibility using ordinary business care and prudence. The tax shall be paid by any foundation manager who participated in the making of the investment.

13.

> A and B are foundation managers of the Y Private Foundation. A tells B that a particular issue of debenture bonds is rated AAA+ in Moody's Bond Reports. In fact, the particular issue is unrated and not traded on any organized exchange. B agrees to Y's making a purchase of $500,000 of the issue and A arranges for the purchase. The Service later determines that the purchase is a jeopardizing investment. It can be established that A and B are experienced trustees and know generally that bad investments may be subject to penalty under IRC 4944. A has participated in the making of a jeopardizing investment within the meaning of IRC 4944(a)(2). B has not participated in such act.

At issue is whether B violated the regulation's standard of "knowing." B knew that purchasing unrated and untraded bonds in the amount involved might violate IRC 4944 but did not know that the bond issue in question was, in fact, unrated and untraded. Therefore, B's actions will not support "participation" under IRC 4944(a)(2) and B is not liable for tax under that provision. Even if B is determined to have been negligent in failing to adequately investigate whether the investment was a jeopardizing one, the requirement of "knowing" under Reg. 53.4944-1(b)(2)(i) would not be satisfied.

14.

> C is the foundation manager of Z Foundation. C's business partner, X, offered the foundation a portfolio of mortgage notes for $1,000,000. C learned that the real estate which forms the collateral for the mortgage notes is the subject of a court action to quiet title. C thereupon requested his attorney, W, to furnish him a legal opinion whether the purchase would violate section 4944. C receives a letter from W that

> recites several pages of background concerning the litigation over the title to the collateral and concludes that, in the opinion of counsel, the investment in the notes would not be a jeopardizing investment. However, the letter cites no authority and presents no legal arguments for its conclusion.

The regulations state that if a foundation manager makes full disclosure of the facts to his legal counsel and relies upon the attorney's reasoned written opinion, his participation will not ordinarily be regarded as "due to reasonable cause". In this case, it is hard to imagine how the note whose collateral is at risk in a lawsuit could seriously be considered as meeting the investment standard of ordinary business care and prudence. This calls into question whether W's opinion should be treated as a "reasoned" opinion. The fact that the opinion cites no valid authority is further evidence of the doubtful reliability of the opinion. Although the regulations state that an opinion may be reasoned even if the conclusion is subsequently determined to be incorrect, the remark is not a blank check for unsupported assertions and, under the circumstances presented here, C's participation is not due to reasonable cause because he has not relied on a "reasoned" written opinion.

15.

> Same facts as in Example 13, above. During the Service's examination of Y's return, A persisted in refusing to remove the investment from jeopardy. However, B agreed to the removal and ordered Y to sell the bonds through regular financial channels, whereupon Y received $100,000 in cash. B then commenced a lawsuit against A to compel him to restore to the foundation the lost $400,000 and reasonable earnings during the investment period. The Service issued notices of deficiency to A and Y for violations of IRC 4944 including violations of IRC 4944(b)(1) and (2).

Y is clearly liable for tax on $400,000 under IRC 4944(b)(1) as such part of the original $500,000 investment has not been removed from jeopardy. The asset cannot be considered to be of investment quality. It also seems that restoration of income not earned during the investment period might be part of removal of jeopardy.

A should be liable for tax under IRC 4944(b)(2) for the entire $500,000 and unrestored earnings as he has not taken action to remove jeopardy and, in fact, has impeded the action to restore the funds. The reader is reminded that the issues raised in any of the examples in this article for which no citation is given have not been addressed in the regulations or in any published ruling by the Service. Therefore the conclusions are tentative and should not be viewed as precedent.

7. Relationship to Other Chapter 42 Provisions

If an investment made on behalf of a foundation is demonstrably sound, it will be less likely to be viewed as made for the benefit of related parties. Violation of the standard of ordinary business care and prudence should trigger the danger signal that private interests are possibly being served in a particular investment transaction. (Although the cases discussed at the beginning of this article were decided well before enactment of IRC 4944, they are illustrative of the pattern of inquiry which is now employed by the Service and by the courts.) Thus, it will be commonly found that IRC 4944 issues will involve questions of self dealing under IRC 4941, excess business holdings under IRC 4943, and/or taxable expenditures under IRC 4945.

16.

> Foundation P purchased a sole proprietorship under circumstances that made the asset a jeopardizing investment. The purchase was made after May 26, 1969. In addition to violating IRC 4944, P is in an excess business holdings position with respect to the proprietorship and may be liable for tax under IRC 4943.

8. The Significance of Section 4944

The Internal Revenue Statistics of Excise Taxes show that very little revenue is obtained from the penalty excise tax on jeopardizing investments. Yet, the tax is important as a deterrent to abuses in the management or investment of charitable funds. Internal Revenue officials believe that the small amount of tax indicates that the measure is really working. When an agent finds indications of abuse in a particular case, vigorous investigation and compliance action are necessary to uphold the integrity of charitable funds among private foundations and to preserve public confidence in our system of charitable giving.