Eye on the Prize—and the Rules

How private foundations need to structure their prize programs in accordance with IRS rules

By Susan L. Abbott and Alyssa C. Fitzgerald

The awarding of prizes by charitable organizations has increased in popularity in recent years.[1] Research has shown that this is the result of a new appreciation for the ways in which a charitable organization can produce change and an increased focus on encouraging innovation and mobilizing new talent or capital. Recent trends have shown a shift from prizes for recognition for past achievements to incentive prizes, with a focus on science and engineering rather than art and literary prizes.[2] However, recognition prizes still play a vital role in establishing the importance and legitimacy of a field and setting a consistent, widely recognized standard of excellence.

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A number of the charities handing out these prestigious awards are private foundations organized in the United States and exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1986 (the "Code"), as amended. As such, these foundations are subject to two sets of rules that are of particular importance when establishing and implementing a prize program: those governing gifts to individuals and those governing acts of self-dealing. This article will describe how a private foundation should structure its prize program in accordance with these rules to avoid potential prohibitive excise taxes.

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Grants to Individuals by a Private Foundation and the Taxable Expenditure Rules

Section 4945 of the Internal Revenue Code imposes harsh excise taxes on any "taxable expenditures" made by private foundations. As a threshold matter, a prize may be classified as a taxable expenditure if it is not for a charitable purpose as specified in Section 170(c)(2)(B) of the Code. Thus, the prize must be in furtherance of the foundation's charitable, scientific or educational purposes in order to avoid being classified as a taxable expenditure.

Additionally, grants paid by a private foundation to an individual for travel, study or similar purposes are taxable expenditures unless the foundation has obtained advance approval of its grant-making procedures from the IRS.[3] However, a grant to an individual for purposes other than travel, study or similar purposes is not a taxable expenditure, even if advance approval of grant-making procedures is not obtained from the IRS. Thus, prizes awarded by a private foundation as part of a contest or in recognition of past achievements would not constitute taxable expenditures under Section 4945, provided that the prizes are not tied to future travel or study. Such a prize should recognize past achievements, meaning that the foundation may not impose restrictions on how the award is to be used, may not finance future activities of the recipient and may not require any future commitment from the recipient.

Essentially, if the private foundation seeks to control the recipient's behavior or future use of the funds, then the prize would not recognize past achievement and would not fall into the exception for taxable expenditures.[4] IRS rulings suggest that contests geared toward specific educational, charitable or scientific matters can usually be framed in such a way so as to avoid taxation. Even if the foundation has a hope that the prize funds will be used for a specific research purpose, or if the contest sets forth a discrete problem for solution, the private foundation often may construct its contest in a manner that does not place conditions on the recipient's behavior or spending of the award.

If a prize program cannot be structured in such a manner and will involve awards to individuals for travel, study or similar purposes, then the foundation will need to obtain IRS approval of its procedures for awarding prizes prior to implementing the program. To secure such approval, a foundation must demonstrate to the IRS that its grant-making procedure includes an objective and nondiscriminatory selection process; that its grant-making procedure is reasonably calculated to result in the performance by the grantees of the activities that the grants are intended to finance; and that the foundation plans to obtain reports from grantees to determine whether they have, in fact, performed such activities. Treas. Reg. § 53.4945-4(c)(1).

For a new foundation, such approval can be requested in the foundation's Form 1023 (Application for Recognition of Exemption), and the foundation must submit Schedule H with its Form 1023. An existing foundation must separately request approval from the IRS. The submission must include a statement describing the selection process; a description of the terms and conditions under which the foundation will make grants, in sufficient detail for the IRS to determine whether the grants are made on an objective and nondiscriminatory basis; a detailed description of

the foundation's procedure for exercising supervision over grants; and a description of the foundation's procedures for reviewing grantee reports, investigating possible diversion of grant funds and recovering diverted grant funds. Treas. Reg. § 53.4945-4(d)(1).

If the IRS does not reply to the request for approval within 45 days of its submission, the foundation may consider its procedures approved and grants made will not be subject to the taxable expenditure penalty. However, if the IRS later notifies the foundation that its procedures are not acceptable, any grants made after the notification will be taxable expenditures. Treas. Reg. § 53.4945-4(d)(3).

Alternatively, foundations may avoid the taxable expenditure penalties by awarding prizes to organizations if they are 501(c)(3) public charities or if the prizes are for charitable purposes and the foundation exercises "expenditure responsibility" as defined in I.R.C. § 4945(h). In such a case, however, the foundation should be sure that the prizes are not earmarked for payment to a particular individual or individuals.

If a foundation awards a prize that is found to be a taxable expenditure, penalty taxes will be imposed on the foundation and potentially on foundation managers who approved the award. The tax on the foundation will be equal to 20 percent of the value of the prize.[5] A 5 percent penalty also may be imposed on foundation managers who agreed to payment of the award, knowing that it was a taxable expenditure.[6] If the taxable expenditure is not corrected—in this case, presumably by repayment of the prize—second-tier penalties may be imposed on the foundation in the amount of 100 percent of the taxable expenditure and on foundation managers who refuse to agree to the correction in the amount of 50 percent of the taxable expenditure.[7]

Prohibition on Self-Dealing

All private foundations are also subject to stringent self-dealing rules that impose harsh penalty taxes on most transactions entered into with disqualified persons. The Internal Revenue Code imposes severe excise taxes on any disqualified person who engages in an act of self-dealing with a private foundation, which would include receiving a prize from the foundation. Private foundations, therefore, should put procedures in place to ensure that they are not awarding prizes or awards to disqualified persons.

The definition of "disqualified persons" includes

(i) directors, officers, trustees and other foundation managers (i.e., persons having similar powers or responsibilities who, in the case of a prize foundation, might include the persons charged with selecting prize recipients[8]);

(ii) substantial contributors to the foundation;

(iii) persons who have more than a 20 percent interest in an entity that is a substantial contributor to the foundation;

(iv) persons who are related to any of the above;

(v) any entity in which a disqualified person has more than a 35 percent interest; and

(vi) government officials.[9]

Private foundations should create a policy that prohibits the awarding of prizes to disqualified persons and should closely monitor their selection processes to ensure that no prizes are awarded to disqualified persons. Note that if an individual is a disqualified person by virtue of his or her ability to select prize recipients, he or she would not cease

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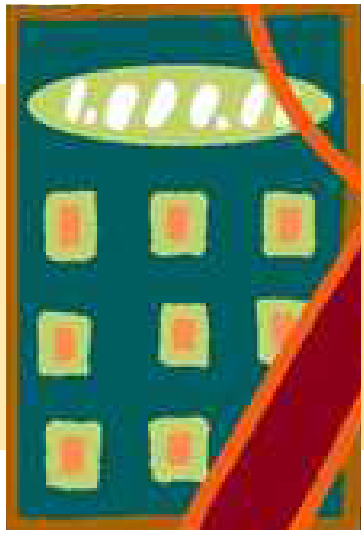
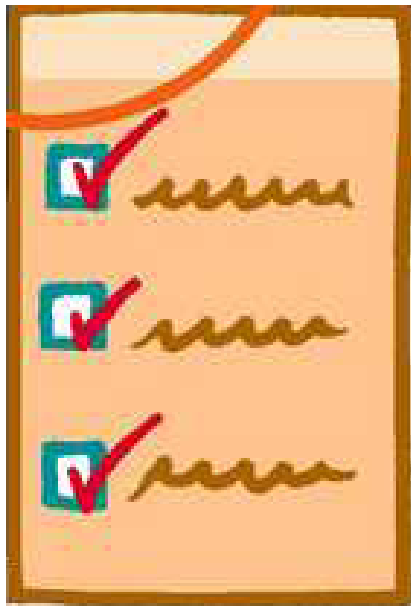


to be a disqualified person simply by recusing him- or herself from voting on a prize awarded to him- or herself or a related party.[10]

If there is an act of self-dealing, the IRS will impose harsh taxes on both the disqualified person (here, the prize recipient) and on any foundation manager who knowingly approved the act (here, any foundation manager who voted to award the prize to the disqualified person, knowing that it was an act of self-dealing). A tax equal to 10 percent of the value of the prize will be imposed on the disqualified person, and a tax equal to 5 percent of the value of the prize will be imposed on the foundation manager.[11] In addition, if the disqualified person does not correct the act by repaying the amount of the prize, then he or she will be subject to a second tax equal to 200 percent of the amount involved, and a foundation manager could be subject to a tax of 50 percent of the amount involved if he or she refuses to agree to part or all of the correction.[12] A foundation cannot reimburse the individuals for these penalties, as that would be a further act of self-dealing.



Other Legal Issues

Structuring a prize competition can involve a number of other legal issues. A foundation entering into this area should be careful to structure its competition in a manner that will avoid the competition's being classified as a lottery or raffle, which is either prohibited altogether or in some cases permissible but tightly regulated for nonprofit organizations. Contests requiring submissions or solutions to a problem will raise questions about the ownership of intellectual property. The foundation will need to consider tax-withholding obligations with respect to the payment of cash prizes. Each prize competition will need to be analyzed with respect to its own unique set of circumstances.

Conclusion

There are, of course, numerous nonlegal issues involved in structuring a prize program: establishing rules and selection procedures, communicating the program to the appropriate communities, celebrating the prize winners and ensuring the fair administration of the program. However, prize programs also involve a number of legal issues, particularly when administered by a U.S. private foundation. Foundations must structure their prize programs carefully to avoid harsh penalty taxes on taxable expenditures and self-dealing.

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References

1 According to a 2009 study by McKinsey & Company, the total funds available from large prizes has more than tripled over the last decade to surpass $375 million (*And the Winner Is ...* , page 16).

2 ibid., page 17.

3 I.R.C. §§ 4945(d)(3) and 4945(g).

4 See Rev. Rul. 76-460 and Rev. Rul. 76-461.

5 I.R.C. § 4945(a)(1).

6 I.R.C. § 4945 (a)(2).

7 I.R.C. §§ 4945 (b)(1) and (b)(2).

8 See Rev. Rul. 74-287. (Employees of a bank served as trustees of a foundation that awarded scholarships. The employees were responsible for determining the recipients of the scholarship and were therefore considered foundation managers.)

9 I.R.C. § 4946(a)(1). Note that a payment to a government official would not be considered an act of self-dealing if (i) the prize recipient is selected from the general public; (ii) the prize is made in recognition of religious, charitable, scientific, educational, artistic, literary or civic achievement; (iii) the recipient was selected without any action on his or her part to enter the contest or proceeding; and (iv) the recipient is not required to render substantial future services as a condition of receiving the prize. (I.R.C. § 4941(d)(2)(g) and I.R.C. § 74(b)).

10 There are several IRS rulings, however, which hold that a transaction will not be self-dealing if the disqualified person resigns prior to the transaction (PLR 201130008, PLR 199943047).

11 I.R.C. § 4941(a).

12 I.R.C. § 4941(b).