

## Private Foundations Bulletin

### Compliance Risks and Penalties to Keep in Sight

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Private foundations can provide a structured, long-term way to support charitable causes. But they also operate under a set of rules that are more detailed and less flexible than those applicable to most other nonprofits. Because private foundations are typically governed by a small group of donors and decision-makers, Congress established a series of excise tax rules designed to ensure charitable assets are used appropriately and for the public benefit.

The good news is that once the most common risk areas for private foundations are understood, it becomes much easier to prevent compliance issues and avoid costly surprises. We outline these risks and how to proactively manage them.

#### Self-Dealing: The Most Common Issue

One of the most significant compliance risks for private foundations is [self-dealing](#) (i.e., certain transactions between foundations and “disqualified persons”). That group typically includes major donors, trustees, officers, directors and their family members, among others. Private foundation self-dealing rules apply regardless of intent or perceived fairness.

Examples of prohibited self-dealing can include:

- Buying or selling property
- Loans or guarantees
- Providing goods or services
- Certain compensation arrangements

Penalties can add up quickly, starting at 10% of the transaction amount and potentially rising to 200% if it isn't corrected. In some cases, foundation managers who knowingly approve a self-dealing transaction can face personal penalties as well.

#### Annual Distribution Requirement (The “5% Rule”)

Generally speaking, most private foundations need to distribute about 5% of their investment assets each year for charitable purposes. This rule is meant to keep foundations actively supporting charitable work rather than simply accumulating assets.

If a foundation falls short, it can trigger:

- A 30% excise tax on the undistributed amount
- An additional 100% tax if not corrected

This is one of those areas where planning ahead and checking progress during the year can prevent headaches later.

## Excess Business Holdings

There are also limits on how much of a for-profit business a private foundation can own. The catch is that ownership is combined with related parties, which can create issues unexpectedly — especially when business interests are received through a gift or inheritance.

If the foundation holds excess business interests, penalties may apply unless the situation is corrected within the allowed timeframe.

## Investment and Grantmaking Restrictions

Private foundations also need to look out for:

- **Jeopardizing investments** (investments that could undermine the foundation's ability to carry out its charitable purpose)
- **Taxable expenditures** (e.g., political activity, most lobbying or grants made without required oversight or IRS prior written approval)

Risk isn't automatically prohibited, but imprudent investment decisions can lead to excise taxes for both the foundation and the managers who approved them. Similarly, restricted expenditures can result in steep penalties if they aren't corrected.

## Filing and Transparency Obligations

Every private foundation must file Form 990-PF each year of its existence, no matter how small. Late or incomplete filings can lead to penalties and additional scrutiny. Failure to make estimated tax payments can also lead to penalties and interest being incurred. And since Form 990-PF is public, compliance issues can create reputational concerns in addition to tax issues.

## What This Means in Practice

For trustees, directors and donors, compliance is part of good governance, not just a "tax filing" issue. Here are a few key takeaways:

- **Routine decisions deserve attention.** Things like reimbursements, leasing arrangements or hiring service providers can create issues if they aren't reviewed through the right lens of private foundation compliance requirements.
- **Planning ahead matters.** Distribution timing, investment decisions and grant structures benefit from early coordination.
- **Oversight carries responsibility.** In some situations, managers who knowingly approve noncompliant actions can face penalties personally.
- **Strong processes reduce risk.** Clear policies, documentation and periodic reviews go a long way toward preventing problems.

Private foundations that take a proactive approach and partner with experienced advisors are better positioned to manage risk and keep the focus where it matters most: advancing their mission and making a meaningful impact.

## Contact Us

We welcome the opportunity to answer any questions you may have related to this topic or any other accounting, audit, tax or advisory matters relative to private foundations. Please call 212.286.2600 or email any of the Private Foundation Services team members below:

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