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Excess Business Holdings and 4943(g): A New and Narrow (but Important) Exception

When the Bipartisan Budget Act of 2018 passed last night, most of the country focused on the end to a brief government shutdown. The Newman's Own Foundation, along with other private foundations holding or planning to receive an active business and their tax attorneys, however, were reading through a new addition to the Internal Revenue Code Section: 4943(g). While it is unlikely to be an option for many family foundations, it creates a new planning opportunity for business owners that want to leave their business to a private foundation, without any plans to have family members control the foundation or to have any involvement with the business.

Background on Excess Business Holdings

As background, Section 4943 imposes the "excess business holdings" rule on private foundations. This rule says that, generally, a private foundation and its disqualified persons (i.e., substantial contributors, directors, officers, and their family members and businesses) cannot in the aggregate own more than 20% of an active trade or business.

So, if a foundation purchases 50% of a car wash, that is an excess business holding. If the foundation owns 10% of a car wash and the foundation's sole donor purchases 40%, that is also an excess business holding because they add up to more than 20%. In both of those situations, the foundation would be subject to excise taxes in the amount of 10% of the business holding's value for each year that the foundation holds the business. They would need to correct it by going under the 20% limit within a certain amount of time, or be subject to even harsher penalties (200% of the business's value).

There are already many exceptions to the excess business holding rule, including: (1) it does not apply to a business that receives at least 95% or more of its income from passive sources (for example, rent), (2) a foundation can own 2% or less of a business, regardless of how much disqualified persons own, (3) the 20% limit can be raised to 35% if persons other than the private foundation and its disqualified persons have effective control over the business, (4) it does not apply to businesses that are "functionally-related" to the foundation's exempt purposes, and (5) there is a 5 (which can sometimes be extended to 10) year grace period if the foundation received the business as a gift or bequest.

These exceptions are helpful for many private foundations. However, the combination of a philanthropic business owner and an estate planner unaware of Section 4943 could still lead to situations where foundations received the family business and had to offload it within 5 to 10 years or face significant penalties.

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The New Exception, Including Some Stringent Requirements

The new exception is intended to remedy a (very) specific situation. Section 4943(g) now provides that a foundation's ownership of a business is not an excess business holding if *all* of the following are true:

1. The foundation owns 100% of the business's voting stock;
2. All of the foundation's interest must have been acquired "by means other than by purchase" (e.g., gift or bequest);
3. All of the business's net operating income (as defined in the statute) is distributed to the foundation within 120 days of the end of the tax year;
4. No substantial contributor or family member of the contributor to the foundation is a director, officer, trustee, manager, employee, or contractor of the business enterprise;
5. At least a majority of the foundation's board are persons that are not directors or officers of the business or family members of a substantial contributor, and
6. There is no outstanding loan from the business to a substantial contributor or his or her family members.

What This Means for Newman's Own

Perhaps not coincidentally, the above requirements more or less describe the situation that the Newman's Own Foundation found itself in after having received 100% of Paul Newman's salad-dressing (and more) company that paid all of its profits to charity. Without this exception, the Foundation would have soon faced the end of its grace period and needed to make significant changes to avoid excise taxes. Now, the Foundation has a path forward to keeping the company.

What this Means for Everyone Else

It is unclear how many other private foundations will benefit from this new exception. Given how many family foundations and their underlying businesses are controlled by the substantial contributor's children, the majority would likely not meet requirements 4. and 5. above without making significant changes to their governance structure. It is also worth mentioning that the exception is available only to private foundations (and not, for example, to donor-advised funds and charitable remainder trusts, which are also subject to the excess business holdings rules).

Still, for certain situations, such as a philanthropist with no children who leaves everything to charity, Section 4943(g) (likely forever known as the "Newman's Own exception") creates an opportunity for private foundations to receive and control businesses that will provide them with ongoing financial support.

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