New York State Bar Association Tax Section

Tax Exempt Entities Committee Report on Private Foundation Investors in Ponzi Schemes

May 7, 2009

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On March 5, the Internal Revenue Service ("IRS")[1] reached out to the private sector for assistance in understanding the implications of Ponzi schemes on private foundations.[2] This report responds to that request.[3] Bernard L. Madoff and Bernard L. Madoff Investment Securities LLC (together, "Madoff") have admitted to defrauding investors out of upwards of \$65 billion.[4] Although the Madoff fraud has been the main focus of the press and tax commentary, foundations need guidance on how to treat investments in all of the various Ponzi schemes and other frauds that have come to light in connection with the downturn in the economy.

This report primarily is intended to identify the issues that foundations and the IRS need to address in connection with foundation investments in Ponzi schemes.[5] For each of the identified issues, this report will discuss alternative approaches for addressing the issues and, to the extent available, will identify relevant statutes, Regulations, case law or other authorities. Private foundations reporting on a calendar year basis generally are required to file Form 990-PF, Return of Private Foundation, with the IRS by May 15. In view of the IRS's need for immediate assistance in identifying private foundation issues and the shortage of time to fully

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1 Unless otherwise specified, all references in this report to "Section" are to the Internal Revenue Code of 1986, as amended (the "Code"), and to "Reg. §" are to the Treasury Regulations issued thereunder (the "Regulations").

2 This request was in a speech given by Lois Lerner, Director, Exempt Organizations Division of the IRS, as reported in the Daily Tax Report, March 11, 2009. In this report, the terms "foundation" and "private foundation" are used interchangeably and mean a "private foundation" as defined in Section 509(a). The focus of this report is on foundations that are grant-making organizations (that is, private nonoperating foundations), rather than private operating foundations as defined in Section 4942(j)(3).

3 The principal drafter of this report is Richard R. Upton, with substantial contributions from K. Eli Akhaven, Audry Casusol, Edward Hein, Elizabeth Kessenides and Nicole A. Spooner. Helpful comments were received from Kim Blanchard, Dahlia Doumar, Michael Farber, David S. Miller, Andrew W. Needham, Erika W. Nijenhuis, Andrew L. Oringer, Michael Schler, Michelle Scott and David Sicular.

4 As discussed in the "Background" section of this report, below, at footnotes 6 through 10.

5 This report does not address the impact of investments in Ponzi schemes on public charities. Although many of the fiduciary and prudence issues facing public charities and private foundations are the same, the analysis of the issues facing public charities differs because they are not subject to the detailed rules applicable to private foundations.

consider the impact of various alternative approaches to addressing these issues, this report does not recommend any particular approach for dealing with most issues, but does present some of the pros and cons of the differing approaches. We would be pleased to follow up with specific recommendations on any or all of the issues raised, if we are requested to do so.

I. Background

A. Overview

On December 11, 2008, the Securities and Exchange Commission issued a press release that saying it had "charged Bernard L. Madoff and his investment firm, Bernard L. Madoff Investment Securities LLC, with securities fraud for a multi-billion dollar Ponzi scheme that he perpetrated on advisory clients of his firm. . . ."[6] Bernard Madoff was arrested and charged with criminal securities fraud that same day and, on March 12, 2009, pleaded guilty to swindling investors through a grand Ponzi scheme.[7]

Estimated losses from the Madoff scheme total as much as $65 billion.[8] According to press reports, Madoff's Ponzi scheme involved hundreds of charities, many or most of which are private foundations.[9] Some foundations' losses were so extensive that they had to shut down.[10] However, Madoff is not the only Ponzi scheme uncovered in recent months. A search through available materials reveals numerous references to Ponzi schemes discovered

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6 Press Release, Sec. Exch. Comm'n, SEC Charges Bernard L. Madoff for Multi-Billion Dollar Ponzi Scheme (Dec. 11, 2008) (on file with the Sec. Exch. Comm'n). Additional background information and discussions of the tax consequences of investing in Ponzi schemes may be found in an unpublished paper by Laurence M. Bambino, "The Madoff Mess, Some Observations on Tax Losses and Ponzi Schemes," The Tax Club, January 26, 2009.

7 *United States v. Madoff*, S.D.N.Y. No. 09-cr-213, 3/12/09. as reported in The Daily Tax Report, 3/19/09.

8 The Daily Tax Report, 3/19/09.

9 http://www.charitygovernance.com/charity_governance/2009/02/the-list-charityrelated-victims-of-bernard-madoff.html#more. Notable investors include Yeshiva University, New York University, and the Elie Wiesel Foundation for Humanity. See Brannigan, "South Florida foundations face Bernard Madoff losses," Palm Beach Post, January 14, 2009: http://www.palmbeachpost.com/news/content/local_news/epaper/2009/01/14/0114foundations.html.

10 See, for example, Ponzi Scheme Wipes Out Foundation That Gave to U., Brown Daily Herald, April 9, 2009 (JEHT Foundation reported it will shut down as a result of losses from Madoff investments); US Charity Picower Says Closes From Madoff Losses, Dec. 20, 2008, available at http://uk.reuters.com (the Picower Foundation invested over $1 billion with Madoff and will be shutting down because of losses from such investments).

during 2008 and 2009, including, for example, the program led by Allan Stanford, who has been accused of running a multi-billion dollar Ponzi scheme.

B. The IRS Response to Ponzi Schemes

1. Ms. Lerner's Speech

In a speech on March 5, 2009, before a Washington Non-Profit Legal and Tax Conference, Lois Lerner, Director, Tax Exempt Organizations Division of the IRS, requested assistance in identifying the issues confronting private foundations that invested in Ponzi schemes, such as Madoff.[11] She noted in particular the issue of whether foundation investors in Madoff might be subject to penalty excise taxes under Section 4944, concerning jeopardizing investments. In addition, she noted issues under Section 4940, which imposes a 2% (or 1%) excise tax on a foundation's net investment income and Section 4942, which provides for minimum payment requirements based on the value of a foundation's assets.

2. The IRS's March 17 Guidance

On March 17, 2009, IRS Commissioner Douglas Shulman presented guidance to assist victims of Ponzi schemes, Rev. Rul. 2009-9 and Rev. Proc. 2009-20.[12] Commissioner Shulman, in testimony before the Senate Finance Committee on Ponzi schemes and offshore tax evasion legislation,[13] noted that, although the Senate Finance Committee was focusing on Madoff, "thousands of taxpayers have been victimized by dozens of fraudulent investments schemes," and that the IRS guidance is not specific to Madoff, but rather is intended "to assist taxpayers who are the victims of losses from Ponzi-type investment schemes."

Rev. Rul. 2009-9 and Rev. Proc. 2009-20 are not aimed at exempt organizations and does not squarely address the issues facing private foundations. However, the guidance is relevant both for its general approach to the tax treatment accorded victims of Ponzi schemes as

11 As reported in The Daily Tax Report (March 11, 2009).

12 Both appear in IRB 2009-14 (April 6, 2009).

13 Commissioner Shulman's prepared testimony may be found on the IRS's website, IRS.gov.

well as its analysis of some of the trickier issues, including the appropriateness of filing amended returns for open years in which income, which turned out to be illusory, was reported.[14]

a. Rev. Rul. 2009-9

Rev. Rul. 2009-9 involves an individual ("A"), who invests $100x directly in a Ponzi scheme run by ("B"). B's scheme purportedly invests in securities on the investor's behalf. Over years two through seven, A reports interest, dividends and capital gains of $10x each year. In year 7, A withdraws $30x from the B account. In year 8, it is discovered that B was running a fraudulent Ponzi scheme. After discussing relevant authorities, Rev. Rul 2009-9 holds that:

- The investor is entitled to a theft loss, which is not a capital loss;
- The theft loss is an investment loss that is not subject to limitations applicable to "personal" casualty and theft losses;
- The theft loss is deductible in the year the fraud is discovered, except to the extent there is a claim with a reasonable prospect of recovery;
- The amount of the theft loss includes the investor's unrecovered investment, including income reported in prior years; and
- A theft loss deduction that creates a net operating loss ("NOL") can be carried back and forward to generate of refund of taxes paid in other years.[15]

[14] Of interest in this regard, given the similarities between the fiduciary duties of foundation managers and persons managing ERISA plan assets, is the limited guidance issued on February 5, 2009, by the Department of Labor and the Pension Benefit Guaranty Corporation to fiduciaries of ERISA plans affected by losses from Madoff investments. The news release advises plan fiduciaries that they should take appropriate steps to protect the interests of the plan and its participants and beneficiaries. Such steps may include:

(1) requesting disclosures from investment managers, fund managers, and other investment intermediaries regarding the plan's potential exposure to Madoff-related losses; (2) seeking advice regarding the likelihood of losses due to investments that they be at risk; (3) making appropriate disclosures to other plan fiduciaries and plan participants and beneficiaries; and (4) considering whether the plan has claims that are reasonably likely to lead to recovery of Madoff-related losses that should be asserted against responsible fiduciaries or other intermediaries who placed plan assets with Madoff entities, as well as claims against the Madoff bankruptcy estate.

A related news release dated February 6, 2009 is at: *http://www.pbgc.gov/media/news-archive/news-releases/2009/pr09-14.html*

[15] Interestingly, Rev. Rul. 2009-9 indicates that an individual is a "sole proprietorship" within the meaning of Section 172(b)(1)(F)(iii), so that the individual, so long as he or she does not have gross revenues in 2008 of $15,000,000 or more, may elect the 5-year NOL carryback that was provided in the Stimulus Act for "small businesses."

- In addition, neither Section 1341, concerning the restoration of amounts previously reported under a claim or right nor the mitigation provisions of Sections 1311 through 1341 apply to give relief to Ponzi-scheme investors.

b. Rev. Proc. 2009-20

According to Commissioner Shulman's Senate Finance Committee Testimony:

> the revenue procedure is intended to: (1) provide a uniform approach for determining the proper time and amount of the theft loss; (2) avoid difficult problems of proof in determining how much income reported from the scheme was fictitious, and how much was real; and (3) alleviate compliance burdens on taxpayers and administrative burdens on the IRS that would otherwise result.[16]

The Revenue Procedure provides a safe-harbor approach for taxpayers to claim a theft loss for Ponzi scheme investments in the year of discovery. Taxpayers following the safe-harbor approach must agree not to amend returns for prior years that included what now turns out to be phantom income. Rev. Proc. 2009-20 provides two simplifying assumptions that taxpayers may use to report their losses:

- Deemed theft loss. The Revenue Procedure provides that the IRS will deem the loss to be the result of theft if: (1) the promoter was charged under state or federal law with the commission of fraud, embezzlement or a similar crime that would meet the definition of theft; or (2) the promoter was the subject of a state or federal criminal complaint alleging the commission of such a crime, and (3) either there was some evidence of an admission of guilt by the promoter or a trustee was appointed to freeze the assets of the scheme.

- Safe harbor prospect of recovery. Once theft is discovered, it often is difficult to establish the investor's prospect of recovery. The Revenue Procedure generally permits taxpayers to deduct in the year of discovery 95 percent of their net investment less the amount of any actual recovery in the year of discovery and the amount of any recovery expected from private or other insurance, such as that provided by the Securities Investor Protection Corporation (SIPC). A special rule applies to investors who are suing persons other than the promoter. These investors compute their deduction by substituting "75 percent" for "95 percent" in the formula above.[17]

Rev. Proc. 2009-20 Section 8 provides guidance for taxpayers that choose not to apply the safe harbor. Of particular note, Section 8.02 provides:

> A taxpayer that chooses not to apply the safe harbor treatment of this revenue procedure to a claimed theft loss and that files or amends federal income tax returns for years prior to the discovery year to exclude amounts reported as income to the taxpayer from

[16] See footnote 13 above.

[17] See footnote 13 above.

> the investment arrangement must establish that the amounts sought to be excluded in fact were not income that was actually or constructively received by the taxpayer (or accrued by the taxpayer, in the case of a taxpayer using an accrual method of accounting).

Rev. Rul. 2009-9 involves an individual investor. Rev. Proc. 2009-20 applies to a "qualified investor," defined in Section 4.03 of Rev. Proc. 2009-20 as "a United States person, as defined in § 7701(a)(30)- - (1) That generally qualifies to deduct theft losses . . . ." Section 6.01 provides that a qualified investor that uses the safe harbor must mark "Revenue Procedure 2000-20" on Form 4684, Casualties and Thefts, for the federal income tax return for the discovery year.

As a threshold matter, it would be helpful for the IRS to give guidance on whether the analysis, conclusions and guidance of Rev. Rul. 2009-9 and Rev. Proc. 2009-20 apply to foundations. In this regard, foundations are "U.S. persons," but foundations do not file "income tax returns."[18]

II. Private Foundation Issues

A private foundation must conduct its activities in accordance with strict federal tax law mandates. These mandates include: i) the payment of an excise tax on net investment income (Section 4940); ii) the prohibition against self-dealing (Section 4941); iii) the mandatory payout requirement (Section 4942); iv) the excess business holdings rule (Section 4943); v) the prohibition against jeopardizing investments (Section 4944); and vi) the restrictions on the purposes and activities for which an organization's assets may be expended (Section 4945). Private foundation investors in Ponzi schemes may have difficult issues concerning each of the foregoing Code Sections, with the probable exception of the prohibition on excess business holdings.[19]

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[18] Although foundations reporting unrelated business taxable income ("UBTI") subject to unrelated business income tax ("UBIT") do file Form 990-T, Exempt Organization Business Income Tax Return, typically investments in Ponzi schemes would not have been subject to UBIT.

[19] Section 4943 prohibits certain holdings by a private foundation in a "business enterprise." In general, a business enterprise is a trade or business unless at least 95% of the gross income of the trade or business is from passive sources, such as dividends, interest and capital gains. Madoff and other similar Ponzi schemes purported to be investment funds, not business enterprises.

Broadly stated, these private foundation issues fall into two categories. Sections 4940 and 4942 involve the measurement of income and asset values. In our view, a critical initial question relevant to both Section 4940 and Section 4942 is whether a foundation should go back in time and measure its income and asset values for prior years based on current knowledge and information or whether the foundation should view prior year income and asset values as correct and deal with Ponzi scheme losses only in the year of discovery. Sections 4941, 4944 and 4945 involve a second category of issues that address or relate to the foundation's process for making the Ponzi scheme investment in the first place. With respect to these provisions, the critical question in our view is whether making the investment involved some prohibited conduct that should be punished by the imposition of a penalty excise tax.

The most important issue identified by the IRS for foundations that invested in Ponzi schemes is the potential application of the penalty excise taxes on foundations and foundation managers under Section 4944, concerning jeopardizing investments. These issues are discussed in Part II.B.2 of the report. Under the applicable Treasury Regulations, a jeopardizing investment occurs where it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the financial needs of the foundation to carry out its exempt purposes. The report points out that the Regulations clearly provide that the determination of whether an investment is a jeopardy investment is made at the time of the investment and that therefore, if a foundation or a foundation manager conducted proper due diligence, there should be no penalty. The report discusses a number of considerations that should be taken into account on the key question of what constitutes adequate due diligence.

Another related group of important issues arise under Section 4940 (which imposes a 1% or 2% excise tax on a foundation's net investment income) and Section 4942 (which imposes a mandatory payment requirement based on the value of a foundation's assets). These issues are discussed in Part II.A of the report. Since these provisions are inextricably intertwined, the report generally recommends that a consistent approach be followed to address issues under these Sections. It presents three possible approaches to addressing Section 4940 and 4942 issues. First, the foundation could amend its Forms 990 PF for all open years to correct its asset values and to exclude illusory Ponzi scheme income and gains from its net investment income. Second, rather than amending prior year returns, the foundation could file its Form 990 PF for the year of discovery and attach a schedule adjusting its Section 4942 carryforwards to reflect the impact of the Ponzi scheme on its asset values for prior years. Third, the foundation could assume its asset values and income were correctly reported for prior years.

Additional private foundation issues raised by investments in Ponzi schemes and similar frauds involve whether penalty excise taxes under Sections 4945 (dealing with expenditures other than for charitable or investment purposes) or 4941 (self-dealing rules) should be imposed on the foundation and/or the foundation's managers (or other disqualified persons) who caused the foundation to make the investment. In our view, the fact that an investment is subsequently discovered to be a Ponzi scheme may be indicative of a failure of diligence or business judgment, but does not indicate the foundation's purpose was not a valid, bona fide investment purpose to earn a profit. The mere fact that an investment turns out to be a Ponzi scheme therefore should not give rise to Section 4945 penalty excise taxes. The report concludes that Ponzi scheme investments do not raise any new or novel Section 4941 self-dealing issues that are not addressed by existing guidance.

The last part of the report also identifies other issues, including whether the statute of limitations might be extended to six years and the possible need for foundations to disclose Ponzi scheme investments on Form 8886, Reportable Transaction Disclosure Statement, as a loss transaction.

In addition to these substantive tax questions, another important issue that we have considered concerns electivity. Is there one right approach to dealing with a foundation's investment in a Ponzi scheme? For example, are foundations that invested in Ponzi schemes required to amend prior year Forms 990-PF or are foundations prohibited from amending prior year returns to take into account a Ponzi scheme discovered in a later year? Alternatively, may a foundation choose whether to amend prior year returns or not? Our initial conclusion is that there are too many differences between foundations (multibillion dollar foundations vs. small family foundations; foundations with minor losses from a Ponzi scheme vs. foundations with all or most of their assets lost in a Ponzi scheme, etc.) for a one-size-fits-all approach to be appropriate. Different institutions inevitably will have different needs and administrative capabilities for dealing with Ponzi scheme losses.

We acknowledge that the recent guidance provided by Rev. Rul. 2009-9 and Rev. Proc. 2009-20 strongly evidences a preference by the IRS that taxpayers not amend prior year returns, but rather deal with Ponzi scheme losses in the tax return for the year of discovery (with prior hear returns amended only to take its account NOLs generated by the Ponzi scheme losses). It may be important for the IRS that any foundation guidance not be seen to undercut or contradict its theft loss analysis and the appropriateness of dealing with such losses in the year of discovery. Although the tax returns and underlying taxes and issues for foundations are different from those of taxable investors, the conditions that undoubtedly informed the recent guidance (*i.e.*, reopening prior years, statute of limitation issues, constructive receipt of fictitious income, etc.) are in many respects similar.

However, amending returns may be the only opportunity some foundations have to obtain potentially meaningful refunds of Section 4940 taxes paid on fictitious income.[20] In deciding whether to provide guidance that generally permits or encourages foundations to file amended returns, the IRS may want to take into account factors such as administrability, the relatively low Section 4940 tax rates and the legal and accounting costs of amending returns, the absence of any loss carryback or carryforward provisions under Section 4940, fiduciary duties to appropriately recover lost foundation assets and legal rights to file amended returns for open years.

Further, the IRS may want to consider the benefits of quickly issuing a notice or other announcement that it is considering the issues of foundations that invested in Ponzi

[20] Amending returns also might allow a foundation to create substantial carryforwards of excess qualifying distributions under Section 4942. This potentially could allow the foundation to rebuild its endowment by reducing or eliminating required charitable distributions for a number of years. In this regard, we suggest an alternative approach that would give this Section 4942 relief without the need for amending prior year returns.

schemes and that it will allow affected foundations an extended period of time to correct any filings, without penalties, to be consistent with any IRS guidance ultimately provided on these issues.

This discussion proceeds on the assumption that affected private foundations were not complicit in the fraud, for example, as co-conspirators, but rather were purely unwitting victims.

A. Income and Asset Value Issues: Sections 4940 and 4942

1. Relationship Between Sections 4940 and 4942

Sections 4940 and 4942 are inextricably intertwined. The value of a foundation's assets determines the amount of its minimum annual distributions. The amount of a foundation's distributions as a percentage of its assets affects whether a foundation pays Section 4940 tax at a 2% rate or a 1% rate.

In broadest overview, we see three approaches to addressing Section 4940 and 4942 issues for foundation investors in Ponzi schemes. First, the foundation could amend its Forms 990-PF for all open years to correct its asset values and to exclude phantom Ponzi scheme income and gains from its net investment income. Second, rather than amending prior year returns, the foundation could file its Form 990-PF for the year of discovery adjusting its Section 4942 carryforwards to reflect the impact of the Ponzi scheme on its asset values for prior years. Third, the foundation could assume its asset values and income were correctly reported for prior years and thus make no retroactive adjustments in the year of discovery.

Generally, the required distribution amount under Section 4942 is 5% of the value of the foundation's investment assets. Thus, if the value of a foundation's assets is $100, it must make qualifying distributions of $5. Further, excess distributions for any year (those distributions in excess of 5% of its asset value) may be carried forward for up to five years and the foundation may use the excess to offset future years required distributions. Thus, assuming asset values do not change, if a foundation distributes 10% of the value of its assets in year one, it need make no distributions in year two.

The Section 4940 tax on a foundation's net investment income generally is 2%. However, this tax is reduced to 1% if the foundation makes qualifying distributions that exceed, as a percentage of its assets, the average percentage payout for the preceding five years plus one percent of its net investment income for the year. Thus, for example, the foundation will pay a 1% Section 4940 tax if, for each of the preceding five years, the foundation paid out 5% of its asset value, and if a foundation's payout for the current year exceeds 5% of its current asset value plus 1% of its net investment income for the year. If a foundation thought its asset value for a year was $200 and it paid out $10 (*i.e.*, 5%), but in fact its asset value was $100, it will have paid out 10% in that year. As described above, this change in asset value could result in substantial carryforwards under Section 4942 that could allow it to not make any distributions for up to five years. Further, because the percentage payout was so large, the foundation likely will be a 2% Section 4940 taxpayer for up to five subsequent years. In summary, a foundation that restates prior year asset values to reflect a Ponzi scheme investment is likely to have reduced or no mandatory distributions under Section 4942 for a number of future years, but is more likely to be subject to a Section 4940 2% excise tax for those years.

2. Section 4940 and Ponzi Schemes

The Code imposes an excise tax at the rate of two percent on the net investment income of every private foundation.[21] Importantly, the tax on a private foundation's net investment income is reduced to one percent for any tax year in which the organization makes qualifying distributions in an amount at least equal to the sum of 1) the value of the foundation's

[21] Under Section 4940(c), net investment income is defined as the amount by which the sum of gross investment income plus capital gain net income exceeds allowable deductions.

Gross investment income is defined as income from interest (excluding interest on certain governmental obligations, such as municipal bonds), dividends, rents, and payments with respect to securities loans and royalties, except to the extent that such income is included in computing the tax on unrelated business income. Gross investment income also includes income from sources similar to the types of income listed in the preceding sentence.

Capital gain net income is determined by taking into account gains and losses from the sale or other disposition of property, including property used for the production of income included in computing the tax on unrelated business income (except to the extent that gain or loss from the sale or other disposition of such property is includable in the computation of the unrelated business income tax). Net capital losses for any year may not be carried forward or backward; to the extent they are not used to absorb capital gains from the same year, they are lost.

assets for the tax year multiplied by its average percentage payout for the preceding five tax years plus 2) one percent of its net investment income during the year in question. Section 4940(e).

Rev. Rul. 2009-09 and Rev. Proc. 2009-20 answer many difficult questions regarding how a “taxpayer” may treat “phantom” investment income from past and current taxable years, when and how to characterize the loss, and whether taxpayers should amend returns for open taxable years. It is unclear how this guidance applies to the Section 4940 taxes payable by private foundations. The calculation of Section 4940 tax differs from the calculation of personal income tax in many ways. Importantly, Section 4040 has no provision for NOLs or for carryforwards or carrybacks of capital losses. Further, it is unclear whether theft losses are deductible for Section 4940 purposes.

a. Section 4940 issues or questions

i. May a foundation file amended Forms 990-PF for open years to claim refunds of Section 4940 tax on “phantom” investment income? If so, how should such amended returns deal with Section 4942 issues?

ii. May a foundation exclude any purported “income” from the scheme in the year of discovery?

iii. May a foundation take a theft loss deduction in the year of discovery as a deduction against current year i) gross investment income, and ii) capital gain net income? How is this theft loss calculated? What about current year “fees”? Are these issues affected by filing amended returns?

iv. If there was a prospect of recovery and, in a later year less was recovered than expected, may a foundation take the balance as a theft loss deduction against its gross investment income or capital gains net income in that succeeding year? If there was more recovered in a succeeding year than expected, would the foundation have to report net investment income in that succeeding year under tax benefit principles? Is there any impact if different tax rates (1% vs. 2%) applied to the different years?

v. If a foundation paid Section 4940 tax at a 1% rate, but absent the inflated/fictitious values reported for the foundation's investment in the Ponzi scheme, the percentage payouts in prior years would have been sufficiently high that the foundation would not have qualified for the 1% tax rate, will the IRS seek to adjust such values and assert deficiencies based on application of the 2% tax rate?

b. Discussion of the issues

Presumably, analysis of the nature of the fraud applies equally to individuals and private foundations. For individuals, the loss of investment funds may be treated as a theft and deducted against income in the 2008 taxable year, possibly creating NOLs that may be carried back or forward. For purposes of Section 4940 it is not at all clear that a private foundation will be entitled to deduct its losses as a theft loss from either its gross investment income or its capital gain net income, either in 2008 or other years.[22] Reg. § 53.4940-1(a) provides that, "[e]xcept as provided herein, no exclusions or deductions from gross investment income or credits against tax are allowable under Section 4940." Indeed, it remains open whether a private foundation may even exclude "phantom income" reported to it in 2008 from its 2008 taxable year return.[23]

If a theft-loss deduction is allowable against the current year's gross investment income or capital gain net income (that is, income and gains from other, non-Ponzi scheme investments), clarification should follow regarding the appropriate calculation of the deduction. It may be that the simplest and most equitable approach is to instruct private foundations to calculate its theft loss in the manner set forth in Rev. Proc. 2009-20. Note in this regard that

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[22] We found no authority allowing a foundation a theft loss deduction for Section 4940 purposes. Under Section 4940(c)(3) and Reg. § 53.4940-1(e), in determining its net investment income, a foundation is allowed to deduct from its gross investment income and capital gain net income all the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation or maintenance of property held for the production of such income. These deductible expenses include compensation of officers, other salaries and wages of employees, outside professional fees, interest, and rent and taxes upon property used in a foundation's operations.

[23] This issue may be more theoretical than real. Presumably most Ponzi schemes would do no information reporting of income with respect to the year of discovery. In general, the IRS and courts have pretty consistently permitted taxpayers to exclude, under the open transaction doctrine, amounts the taxpayer actually or constructively received after the fraud was discovered. IRS Chief Counsel Advice 2008-11016 (June 22, 2007); *Premji v. Comm.*, T.C. Memo 1996-304, aff'd 81 A.F.T.R.2d 861 (10th Cir. 1991).

Section 4940(c)(3)(A) allows a deduction from "net investment income" for investment related expenditures; this deduction may capture fees and expenses connected to the Ponzi scheme investments and recovery. Although authority exists for individual taxpayers to include recovery expenses in the calculation of a theft loss claim, *see, e.g.*, *Ander v. Comm'r*, 47 T.C. 592 (1967), Rev. Proc. 2009-20 does not contemplate the inclusion of those fees in the calculation of a theft loss deduction.[24] In addition, any guidance to private foundations should clarify how to treat recoveries in subsequent years that exceed or fall short of the amount anticipated (*i.e.*, whether a private foundation may deduct any unrecovered balance of its theft loss against gross investment income or net capital gain income in the year of recovery, or whether a private foundation that recovers more than expected in a subsequent year should report some or all of the excess recovery as investment income or capital gain net income).

Whether or not a private foundation may deduct its Ponzi scheme losses as a theft loss against its gross investment income or capital gain net income, it remains open whether such a foundation may file amended Forms 990-PF for taxable years for which the statute of limitations has not expired, in order to eliminate "phantom income" reported in past years. In considering this issue, attention should be paid to the interplay between Sections 4940(e)(2) and 4942, particularly with respect to the valuation of investment assets and the computation of qualifying distributions.

3. Mandatory Payout Requirement — Section 4942

Private foundations that have suffered a significant decline in the value of their investment assets as a result of fraudulent investment schemes may determine that they have made excess qualifying distributions. That is, the foundation made current year and prior year qualifying distributions under the faulty assumption that the Ponzi scheme investment had full value. Given the losses suffered, a number of such foundations may desire to preserve and/or accumulate investment assets for some period of time, so that they may be in a better position to meet their exempt purpose in future years.

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[24] Individual taxpayers may be permitted to deduct such expenses under Section 212, subject to limitations such as the 2% floor.

Section 4942 requires private foundations (other than private operating foundations) to make certain minimum annual distributions. Generally, "qualifying distributions" are grants to independent public charities or payments of administrative expenses which are allocable to the making of qualified grants. If certain conditions are satisfied, grants to private foundations, individuals and organizations which are not public charities may be qualifying distributions.[25] If a foundation distributes amounts in excess of the required distributable amount, it may carry forward the excess amounts for five years.

If in any year a foundation fails to make the required distributions and if it does not have sufficient excess qualifying distributions from prior years to cover the shortfall, the foundation will be subject to an initial excise tax of 30% of the amount which has not been distributed. Second-tier taxes will be imposed if the situation is not corrected.

The required distribution amount is derived from the foundation's "minimum investment return." The minimum investment return is generally 5% of the reported value of the foundation's assets (over and above the amount of any related acquisition indebtedness), but excluding the value of the entity's "charitable use" assets (those assets used directly to conduct charitable activities). The required minimum distributions under Section 4942 must be made no later than the first day of the second taxable year following the year for which the relevant calculation is made, thus essentially allowing a one-year grace period.

There are narrow exceptions to the minimum distribution requirement of Section 4942. One exception allows foundations to "set aside" amounts if certain conditions are met (Section 4942(b)(2)(B)(i)) -- this exception is a deferral mechanism, and it is not relevant for purposes of this discussion. Another exception provides that if foundations make qualified distributions in excess of the minimum required amount in any year, that excess may be carried forward for five years, thereby allowing smaller distributions to be made in future years (Section 4942(i)).

[25] Those conditions also apply to grants to organizations that are "supporting organizations" under Section 509(a)(3) and are not "functionally integrated" with their supported organization. Program related investments may also count as qualifying distributions.

Regulations issued under Section 4942 address how assets held by a foundation are to be valued. In general, the valuation rules require an "average value" to be used, as opposed to a "year-end value." Thus, securities for which market quotations are available generally are required to be valued on a monthly basis, and an average of monthly values is used in the computation. Certain assets may be valued on an annual basis (see Reg. § 53.4942(a)-2(c)(4)(iv)(a)). However, even in the case of assets that are to be valued annually, it is not necessarily the "year end" value that can or must be utilized; the applicable Regulations state that assets which are to be valued on an annual basis may be valued "as of any day in the foundation's taxable year to which the valuation applies," provided the foundation adopts a consistent practice for valuing its assets (see Reg. § 53.4942(a)-2(c)(4)(vi)).[26]

Private foundations may have meaningful carryforward amounts under Section 4942(i) due to having made distributions in excess of the minimum required percentage in previous years; these foundations may not be terribly affected by losses suffered in a fraudulent investment scheme or Ponzi scheme operation. Other private foundations, however, may currently face serious concerns in terms of understanding and calculating their distribution requirement in 2009 -- given what turns out to have been a gross over-valuation of certain investment assets held during 2008 (prior to the discovery of the fraud) and in previous years.

a. Section 4942 issues or questions

i. How are Ponzi scheme losses to be taken into account in calculating a foundation's distributable amount? How are prior year investments to be valued?

ii. May foundations go back and amend prior year returns, in order to recalculate asset values for prior years, taking into account the fraud/theft that was discovered in 2008 (or later)? If such a re-computation of asset values and amendment of prior year returns is permitted, it is likely to have the effect of creating a meaningful carryforward amount under Section 4942(i).

[26] For valuation standards for financial accounting purposes, see FAS 157: Fair Value Measurement, issued September 15, 2006 by the Financial Accounting Standards Board ("FAS 157").

iii. May a foundation adjust its minimum investment return for prior years without amending its prior year returns, for example, by attaching a schedule to its current year Form 990 PF?

iv. May a foundation treat Ponzi scheme investments as having full value (as reported by the Ponzi scheme) until the time of discovery? If so, is the loss of value taken into account for the full year of discovery or just the month of discovery (and succeeding months)? Is the amount of a possible recovery an asset that must be valued; if so, how?

v. Should a distinction be made between a direct investment in a Ponzi scheme — where, arguably, the issue might be described as more of a mistake (i.e., the asset simply did not exist) — as opposed to the case of an indirect investment through a fund, where the issue is more how to value the investment in the fund, which may hold assets other than the Ponzi scheme investment.

b. Discussion of the issues

i. An approach allowing private foundations to amend prior returns to re-determine asset values and their five-year carryforward amount could provide significant relief to a number of private foundations. Such an approach would serve to address the compliance issue for the current year (2009) and for the next four years, since it would likely generate a significant carryforward for a number of private foundations under Section 4942(i).

However, allowing a re-determination of asset values for prior years, based on facts that became known only after those prior years were closed, (a) involves certain complexity, particularly in terms of proving what the asset could have been worth in any particular year, (b) may create a somewhat problematic precedent, and (c) is likely to be administratively burdensome, both for foundations as well as the government. Furthermore, it is unclear whether this approach is authorized by the current statute or Regulations, which essentially require annual valuations of assets. Indeed, the valuation issue is made more difficult considering the fact that any given investor may have been able to withdraw funds invested in the Ponzi scheme in prior years (some foundations actually may have withdrawn funds in prior years).

There are two private letter rulings where foundations were allowed to amend calculations under Section 4942 for prior years and to re-determine asset values and recompute their five-year carryforward amounts (See, PLR 9530033 (July 28, 1995) and PLR 9233031 May 19, 1952). However, in these private letter rulings, the "revised valuation" was caused by facts that existed and could have been known in the original year of valuation; the rulings are therefore distinguishable from a situation where, in a later year, a foundation first learns of a fraud that was perpetrated. Allowing a re-opening/amendment of prior year returns under this approach is arguably inconsistent with the notion of an "annual accounting period." Finally, in terms of complexity, this approach could impact the calculation of the Section 4940 excise taxes required to be paid by the foundation for prior years.

ii. Another approach is to allow foundations to re-determine asset values for prior years in order to recompute their minimum investment return and carryforward amount without having to actually amend prior year returns, but by attaching a statement to the 2008 return filed in 2009. This approach would permit foundations to avoid the substantial administrative burden of preparing and filing amended returns for each of those years. PLR 9530033 indicates that the foundation in that situation did not have to go through the formality of actually amending prior year returns; in fact, that PLR authorized a re-computation for years for which the statute of limitations period was closed to the extent the calculation affected the current year.[27] Thus, if it is decided that foundations may re-determine values of

[27] With regard to the question of whether prior year minimum investment return may be recalculated for prior years in order to correctly determine the amount of the current year's required qualifying distributions, PLR 9530033 states:

> "In Rev. Rul. 69-543, 1969-2 C.B. 1, the Service drew an analogy to the cases involving net operating loss carryovers and held that with respect to the investment credit (under former law), where carryovers were incorrectly calculated in a closed year, the resultant carryover to open years could be allowed. Similarly, in Rev. Rul. 82-49, 1982-1 C.B. 5, the Service held that the failure to claim the credit originally in a closed year did not bar the taxpayer from carrying over the "unused credit" (calculated as though it had been taken) into open years. The Service has also held that the income of a closed year may be recomputed for purposes of income averaging (under former law) with respect to an open year. Rev. Rul. 74-61, 1974-1 C.B. 239."

assets held in prior years that are later discovered to have been the subject of a fraud, it might be appropriate to create a simpler mechanism than filing amended returns for each year.[28]

iii. A third approach is for the foundation to treat prior year returns as correct and to adjust asset values for the year of discovery. This approach has two alternative valuation approaches: value the Ponzi scheme asset for the full year using the estimated amount of any recovery or keep the asset at full value until the month of discovery and then revalue it. For example, assume the asset purportedly had a value of $100 until the Ponzi scheme was discovered in December and the estimated amount recoverable is $5. The asset could be valued at $5 for the full year of discovery. Alternatively, the asset could be valued at $92 (using average monthly values). In this regard, some foundations may prefer the higher value for internal reasons and, rightfully or not, in order not to bring public attention to the Ponzi scheme investment.

An approach of not revaluing assets for prior years seems to fall within the scope of the current Regulations and does not appear to be inconsistent with the general valuation principles adopted in the Regulations. The foundation manager has now discovered that, whatever the foundation manager may previously have believed, the foundation's account balances did not accurately reflect the value of its investments. This approach would be less administratively burdensome than going back to prior years (either by amendment or attaching a schedule to the current year's Form 990-PF), and it does not present the difficult questions of proof that revaluing prior years presents. It would not create a problematic precedent by

> "If the Foundation can establish that the fair market value of the assets described above was incorrectly determined in a particular year, the Foundation may take a revised appraisal into account in computing and recomputing the current year's and prior year's distributable amount for all open years. The Service will permit an error affecting current computations to be corrected even though recomputation of the distributable amount for the some affected years is barred by the statute of limitations."

[28] We note that the approach of not amending prior year returns, but including a schedule or statement of Section 4942 carryovers, as adjusted to take into account recomputed prior year values, does not necessarily result in consistent treatment under Sections 4940 and 4942. The Section 4940 tax rate (1% or 2%) for an earlier year might have changed if amended returns were filed which increased the payout percentage for years in which asset values had been inflated by reason of a Ponzi scheme investment.

allowing facts discovered in later years to cause a re-determination of amounts for previous years.

iv. A further issue is whether a distinction should be drawn for Section 4942 valuation purposes between direct investments in a fraudulent Ponzi scheme and indirect investments.[29] Should private foundations be allowed to amend prior year returns (or, alternatively, attach a statement to a current return re-computing their carryforward amount) only in order to reduce the value attributed to a fraudulent investment scheme asset if the asset was held directly—essentially allowing for the correction of a "mistake" (since the asset arguably did not exist) as opposed to taking the position that this constitutes a re-determination of asset values for prior years? Although this approach adopts a somewhat arbitrary cut-off, presumably indirect investors are more likely to have claims to pursue against the intermediary (and, it is noted that the recent guidance that was issued did draw a distinction between direct and indirect holders).

B. Penalty Excise Taxes — Sections 4941, 4944 and 4945

The second set of private foundation issues raised by investments in Ponzi schemes and similar frauds involve whether penalty excise taxes should be imposed on the foundation and/or the foundation managers (or other disqualified persons) who caused the foundation to make the investment. Was there any direct or indirect self-dealing involved (Section 4941)? Did the investment jeopardize the ability of the foundation to carry out its charitable purposes (Section 4944)? Was there a use of charitable assets for purposes that were neither charitable nor investment (Section 4945)? If the answer to more than one of these questions in "yes," it is possible that multiple penalty excise taxes could be imposed?[30]

These private foundation penalty excise tax issues inevitably raise governance questions. This report does not discuss governance issues and does not address the extent to

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[29] We note that there has been considerable debate concerning appropriate use of fair value reporting for investments, including alternative investments, as required by FAS 157, and we make no comment on these valuation issues.

[30] See Reg. § 53.4941(d)-1(a) indicating that an act of self-dealing might implicate other foundation exercise taxes. See also, Reg. § 53.4944-1(a)(2)(iv).

which the IRS should involve itself with questions of governance. Governance of tax-exempt organizations is a larger issue. Perhaps governance issues, and whether such issues are best addressed by state attorneys general rather than the IRS, should be studied carefully and addressed outside of the fury over Ponzi scheme investments.

1. The Prohibition Against Self-Dealing — Section 4941

Section 4941 prohibits as self-dealing both direct and indirect transactions between a private foundation and a disqualified person.[31] Presumably, if, for example, a foundation manager directed that a foundation invest in a Ponzi scheme and the foundation manager was aware of the fraud or a person affiliated with that foundation manager earned a fee or otherwise benefited from the foundation's investment, that would be a self-dealing transaction under current law.[32]

Prohibited self-dealing transactions generally include all sales or exchanges of property to or from a disqualified person, the payment of compensation (or the payment or reimbursement of expenses) by a private foundation to a disqualified person and the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private

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[31] Under Section 4946(a), the following individuals and entities are disqualified persons:

- foundation managers (all directors, trustees and officers of a foundation, as well as individuals having powers or responsibilities similar to those of directors, trustees or officers) and their families;
- substantial contributors (generally, any person who has contributed or bequeathed more than $5,000 to a foundation) and their families;
- individuals who own more than 20 percent of the total combined voting power of a corporation, the profit interest of a partnership, or the beneficial interest of a trust or unincorporated enterprise, any of which is a substantial contributor to the private foundation, and their families;
- corporations, partnerships, trusts and estates in which disqualified persons hold more than 35 percent of the ownership or beneficial interest; and
- government officials (although not their families).

Family members are spouses, ancestors, children, grandchildren, great-grandchildren, as well as spouses of children, grandchildren and great-grandchildren.

[32] However, if the same foundation manager were unaware of the fraud and received reasonable compensation, the manager likely should not be guilty of self-dealing.

foundation.[33] A direct act of self-dealing is one between a disqualified person and a foundation itself. An indirect act of self-dealing generally is a self-dealing transaction between two disqualified persons that affects a foundation or between disqualified person and an organization controlled by a foundation.

In general, we do not see any self-dealing issues that are unique to Ponzi schemes. It would be helpful for the IRS to confirm this.[34]

2. Prohibition Against Jeopardizing Investments — Section 4944

The Code prohibits the investment by a foundation of any amount which would jeopardize the carrying out of any of a foundation's exempt purposes. The jeopardizing investment issue is a key issue for foundations that invested in Ponzi schemes. It is the principal issue Lois Lerner singled out in her speech requesting guidance on how the IRS should treat foundation investments in Ponzi schemes.

Under the Regulations, a jeopardizing investment occurs where it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long-term and short-term financial needs of the foundation to carry out its exempt purposes. The judgment as to whether a foundation manager acted in a prudent manner is made on an investment-by-investment basis, but the foundation's portfolio as a whole may be taken into account. Under Regulations that many consider outdated, examples of investments which will be viewed with suspicion are: trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of "puts," "calls" and "straddles," the purchase of warrants, and selling short.[35]

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33 Section 4941(d)(1)(A), (D) and (E). The payment of compensation or reimbursement of expenses by a foundation to a disqualified person is an act of self-dealing unless such payment or reimbursement is for "personal services" which are reasonable and necessary to the carrying out of the foundation's tax-exempt purposes and the payment or reimbursement is reasonable and not excessive.

34 For example, if a foundation and a disqualified person are both invested in a Ponzi scheme, and the disqualified person withdraws from the Ponzi scheme, has an act of indirect self dealing occurred? Assuming the disqualified person would be a "qualified investor" under Rev. Proc. 2609-20, no act of self dealing should arise in this situation. See Reg. § 53.4941(d)-1(b)(4).

35 Reg. § 53.4944-1(a)(2).

If a foundation makes a jeopardizing investment, a tax equal to 10% of the amount of the investment would be imposed on the foundation. At the same time, a similar 10 percent tax (subject to a $10,000 limit with respect to any one investment) would be imposed on any foundation manager who knowingly participated in the investment, unless the foundation manager's participation was not willful and was due to reasonable cause. If the investment were not removed from jeopardy within the required period, a second-tier tax would be imposed.

a. Section 4944 issues

i. What are the standards to be applied to Ponzi scheme investments that appeared legitimate at the time the investment was made?

ii. Is placing a substantial portion or all of a foundation's assets with one fund manager an indication of a jeopardizing investment?

iii. Assume the Ponzi scheme investment is a jeopardizing investment. How many years back may the IRS go to impose this excise tax; what is the statute of limitations? When does the taxable period end -- when the Ponzi scheme is discovered? If the Ponzi scheme investment is exchanged for cash, but the cash continues to be subject to a clawback obligation, does the taxable period continue?

b. Discussion of Section 4944 issues

i. What are the standards to be applied to Ponzi scheme investments that appeared legitimate at the time the investment was made?

Reg. § 53.4944-1(b)(2)(i) provides that a foundation manager is considered to have participated in the making of an investment "knowing" that it jeopardizes the carrying out of a foundation's exempt purpose only if the foundation manager: (i) has actual knowledge of sufficient facts so that, based solely upon such facts, such investment is a jeopardizing investment; (ii) is aware that such an investment may violate federal tax law prohibitions on jeopardizing investments; and (iii) negligently fails to make reasonable attempts to ascertain whether the investment is a jeopardizing investment.

A foundation manager is not subject to the penalty if the manager's participation in making the investment was not "willful" and was due to "reasonable cause." Reg. § 53.4944-

1(b)(2)(ii) provides that a foundation manager's participation in a jeopardizing investment is willful if it is voluntary, conscious and intentional. A foundation manager's participation in a jeopardizing investment is not willful if the manager does not know that it is a jeopardizing investment. Reg. § 53.4944-1(b)(2)(iii) provides that a foundation manager's actions are due to reasonable cause if the manager exercised his or her responsibility on behalf of the foundation with ordinary care and prudence. Reg. § 53.4944-1(a)(2) provides that generally, an investment is considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is found that the foundation managers in making such investment failed to exercise ordinary business care and prudence under the facts of circumstances prevailing at the time of making the investment and in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

The Regulations clearly provide that the determination of whether an investment is a jeopardy investment is made at the time of the investment, and not based on hindsight. Therefore, it would appear that if a foundation or a foundation manager conducted proper due diligence, there should be no penalty. The key question is what constitutes adequate due diligence. In this regard, as noted above, this report does not address foundation governance issues or the extent that the IRS should involve itself in governance issues.

Based on the ordinary care and prudence standard described in the Regulations (see generally, Reg. § 53.4944-1(b)(2)), foundations and foundation managers who conduct reasonable due diligence of investments which appear legitimate should not be penalized if it later turns out investments are part of a Ponzi scheme. There may be a chilling effect on potential investments by private foundations in legitimate investment vehicles if the IRS were to broadly apply the Section 4944 penalties.

It is not clear what constitutes reasonable due diligence under the circumstances of Ponzi scheme investments. Clearly, some due diligence needs to be done for any investment. The behavior of other fiduciaries may help to determine what is reasonable, although the mere fact that "everyone is doing it" should not be an excuse for not asking questions.[36] In considering what diligence is appropriate (a question that is relevant for both tax and non-tax purposes), considerations may include the size and sophistication of the foundation with respect to both the resources available to the foundation for conducting diligence and the suitability of the investment for that foundation, the extent to which the foundation's investments are diversified, the investment's track record, and the extent to which the foundation reasonably relied on a financial advisor that recommended the investment. However, frauds are structured and documented in ways to avoid detection and so by definition a Ponzi scheme may not be discovered by a foundation that conducts reasonable diligence.

A relevant question for a foundation that had most or all of its assets in a Ponzi scheme may be whether placing a substantial portion or all of a foundation's assets with one fund manager (who represents that its investments are prudent and diversified) is an indication of a jeopardizing investment. The Regulations provide examples of investments that require closer scrutiny, but these examples are outdated and, as such, do not provide helpful guidance for private foundations in today's market.[37]

Under various state laws, managers of foundations have fiduciary duties to their foundations and must abide by a prudent investor standard when making investment decisions for the foundation. Having clear guidance on what constitutes a jeopardizing investment would be helpful to foundation managers. In today's market, many agree that certain investments require close scrutiny. It has been asserted that investing in one fund manager, whether or not the manager states that it is diversified or has excellent investment strategies, is per se jeopardizing because such a choice fails the prudent investor standard for lack of diversification, which is an integral part of a prudent investment strategy.[38] The better view may be that investing with one manager is not per se a jeopardizing investment if the foundation uses due

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36 See, *Hecker v. Reese*, Nos. 07-3605, 08-1224 (7th Cir. Feb. 12, 2009), an ERISA case discussing fiduciary prudence issues.

37 See, Reg. § 53.4944-1(a)(2).

38 See, Responding to a Faithful Reader: Family Foundations and Madoff. http://www.charitygovernance.com/charity_governance/2009/01/responding-to-a-faithful-reader-family-foundations-and-madoff.html

diligence in selecting and monitoring the manager and its actual investments. The test of prudence under the Uniform Prudent Investor Act depends on the relationship of any security to the portfolio as a whole rather than applying the test of prudence to be made on a "per se" basis. The diversification requirement has to do with diversification of securities, not diversification of managers. However, in a case by case basis, prudence may argue for manager diversification and we expressly state no views on what constitutes prudence, under the circumstances.

If the Ponzi scheme investment is a jeopardizing investment, how many years back may the IRS go to impose this excise tax; what is the statute of limitations? If the Ponzi scheme investment is exchanged for cash, but the cash continues to be subject to a clawback obligation, does the taxable period[39] continue? Assuming that the Ponzi scheme investment is a jeopardizing investment, it is unclear how these issues should be resolved. If, for example, the private foundation exchanges a jeopardizing investment for cash, then the amount has been removed from jeopardy.[40] However, if the cash investment is subject to clawback, the jeopardizing investment presumably continues or has been exchanged for another jeopardizing investment.[41]

The above situations also raise the issue of whether discovery of the Ponzi scheme means that the investment was actually removed from jeopardy.[42] The Regulations appear to treat the investment as removed from jeopardy when the foundation actively does something to change, exchange, or dispose of the investment. Therefore, in a Ponzi scheme situation, which is discovered and collapses on its own, it is unclear whether the foundation has disposed of a jeopardizing investment for Section 4944 purposes. Notably, if the additional tax under Section 4944 applied, these issues would also impact any correction periods affecting the additional tax.

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39 See, Section 4944(e) for definition of taxable period.

40 Reg. § 53.4944-5(b).

41 See, Reg. § 53.4944-5(c), example 3. In this regard, Irving Picard, the Trustee in the Madoff case, sent out letters to hundreds of investors in Madoff asking that any money withdrawn within the six years before the discovery of the fraud be returned. Reported in *The Daily News*, Saturday, April 25, 2009.

42 Notably, there is generally little guidance available with respect to the removal of an investment from jeopardy by a disposition other than a sale to an unrelated party.

3. Taxable Expenditures - Restrictions on the Purposes and Activities for Which a Foundation May Expend Its Assets — Section 4945

Any expenditure made by a foundation for other than religious, charitable, scientific, literary or educational purposes will be a taxable expenditure. As a result, a foundation may not make a grant to an organization other than a charitable organization unless i) the making of the grant itself constitutes a direct charitable act of the foundation; ii) the grant is a program related investment; or iii) the foundation is reasonably assured that the grant will be used exclusively for proper purposes, i.e., a specific charitable project. Of relevance in the context of Ponzi schemes is whether such investment, which turned out not to be an investment at all, could be viewed as a "grant" to individuals or noncharitable organizations for a noncharitable purpose. The same questions apply to fees paid in connection with such an investment.

If a foundation were to make any taxable expenditures, it would be taxed at the rate of 20 percent of each taxable expenditure, and each foundation manager who knowingly, willfully and without reasonable cause agreed to make a taxable expenditure would be taxed 5 percent of the value of the taxable expenditure (subject to a limit of $10,000). If the expenditure was not corrected, an additional tax equal to 100 percent of the amount of the expenditure would be imposed upon the foundation and a tax of 50 percent of the amount of the expenditure would be imposed upon the participating foundation manager (subject to a limit of $20,000).

Is a private foundation's investment in a fraudulent investment scheme in a taxable expenditure under Section 4945(d)(5)[43] and Reg. § 53.4945-6(b)[44]?

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[43] Section 4945 states: ". . . the term 'taxable expenditure' means any amount paid or incurred by a private foundation . . . (5) for any purpose other than one specified in Section 170(c)(2)(B)."

[44] Reg. § 53.4945-6(b) states:

> (1) The following types of expenditures ordinarily will not be treated as taxable expenditures under Section 4945(d)(5):
>
> (i) Expenditures to acquire investments entered into for the purpose of obtaining income or funds to be used in furtherance of purposes described in Section 170(c)(2)(B), [or]
>
> (ii) Reasonable expenses with respect to investments described in subdivision (i) of this subparagraph, . . .

Section 4944 and the regulations thereunder specifically address the suitability of investments. Section 4945(d)(5) concerns expenditures for an impermissible "purpose." The fact that an investment is subsequently discovered to be a Ponzi scheme may be indicative of a failure of diligence or business judgment, but does not indicate the foundation's purpose was not to earn a profit.

Absent evidence of self-dealing or jeopardizing investment, an assertion that the amount paid by the private foundation constituted a taxable expenditure may be the only possibly available sanction. However, it is not at all clear that there is any benefit in stretching the statute to punish a foundation for an investment in a Ponzi scheme where there has been no self-dealing and where the investment was not a jeopardizing investment, based on facts known at the time the investment was made. See generally Reg. § 53.4945-6(b)(1)(i).

Taxable expenditure questions could be asked of fictitious income reported and reinvested in the arrangement. Are such amounts paid or incurred for purposes of Section 4945(d)? Are amounts paid, as investment advisory or management fees, in connection with investments in a fraudulent investment scheme, (i) to the operator of the fraudulent arrangement or (ii) to a person unaware of the fraud who invested the private foundation's funds in the scheme taxable expenditures? What criteria are to be applied in evaluating the reasonableness of expenses under Reg. § 53.4945-6(b)(1)(ii) or (2)?

C. Other Issues

1. Form 990-PF Disclosures

Exactly what must a private foundation disclose on its Form 990 PF for the year of discovery? Are any special disclosures required?

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(2) Conversely, any expenditures for unreasonable administrative expenses, including compensation, consultant fees, and other fees for services rendered, will ordinarily be taxable expenditures under Section 4945(d)(5) unless the foundation can demonstrate that such expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses in such amounts was consistent with ordinary business care and prudence. The determination of whether an expense is unreasonable shall depend upon the facts and circumstances of the particular case.

2. Statute of Limitations

What is the relevant statute of limitations for a foundation investor in a Ponzi scheme? Reg. § 301.6501(e)-1(c)(3)(ii) allows assessment of tax under Sections 4941 through 4945 within six years after filing Form 990-PF unless the item was disclosed in a manner sufficient to apprise the IRS of the existence and nature of such item. Prior to discovery of a Ponzi scheme, foundations presumably checked the "no" boxes for questions that should have been checked "yes" had the Ponzi scheme been discovered.

3. Loss Transactions

Are Ponzi scheme losses reportable transactions that must be disclosed on Form 8886, Reportable Transaction Disclosure Statement? Specifically, would a private foundation be subject to Section 6011 reporting for any losses that it suffered as a result of its investment in a Ponzi scheme?[45]

Even if private foundations are seen as generally subject to Section 6011 reporting for their losses, under Rev. Proc. 2004-66[46], it can be argued that an investment in a Ponzi scheme would qualify under example 9[47] as a loss that did not qualify as a loss transaction, and thus did not have to be reported.

4. Investments in Funds

How are any of the issues discussed in this report affected by the fact the foundation invested through a fund that invested in the Ponzi scheme rather than directly? In such a case, the investment in the fund itself may continue to have some value, and a portion of the income reported by the fund may be real. Also, fund managers provide varying levels of information about how they will select their investments, so that the Ponzi scheme exposure may not have been discoverable by the foundation even if the fund manager could have discovered it.

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45 TD 8877 (emphasis added).

46 2004-50 IRB 966.

47 Example 9 of Section 3 of Rev. Proc. 2004-66 provides that a loss that is equal to, and is determined solely by reference to, a payment of cash by the taxpayer may not be reportable.

5. UBIT Issues

If a Ponzi scheme purported to use leverage which purportedly gave rise to debt-financed UBIT income, would the guidance in Rev. Proc. 2009 20 apply to a foundation's Form 990 T?

6. Valuation Issues

What is the fair market value of an investment in a Ponzi scheme prior to discovery of the fraud?