

Note from Monarch:

In today's investment world you must be careful and make sure you understand what you are investing in. There has been a lot of money lost in some of the more exotic alternative investment programs, such as hedge funds. There is a big incentive to sell these programs because the fees and commissions are quite high.

If you are on the board of directors of a not-for-profit and they have a foundation or endowment fund, you may want to check the investment program. Although the ruling appears to only apply to private foundations, we would guess someone would find some rationale to scrutinize the board should the charity be unable to carry out its intended mission due to a fraudulent or ill-advised investment scheme.

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Private Foundation Managers Possibly Liable For Taxes on Failed Investments With Madoff

Board members of private foundations may find themselves liable for tax under Internal Revenue Code Section 4944 because of a lack of proper oversight in investing all their money with Bernard Madoff, an aide to Sen. Charles Grassley (R-Iowa) told BNA recently.

Section 4944 says foundation officers, directors, and trustees can be held liable for investments that jeopardize carrying out of the exempt purpose of their organizations unless the participation is not willful and is due to reasonable cause. The tax is equal to 10 percent of the amount invested for each year in the taxable period.

However, Theresa Pattara, tax counsel to Grassley, told BNA Jan. 16 that the important thing to note about the Section 4944 excise tax is that the tax only applies to private foundations, and not all the charities that lost money through Madoff were private foundations.

Grassley is the ranking member of the Senate Finance Committee.

"We just don't have all the facts and it's unclear how these investments were made," Pattara said. "The Section 4944 tax is a tax on the foundation and its managers, for

making investments that jeopardize the carrying out of the organization's tax-exempt purposes. But the difficult part is that a determination of whether that had happened would have to be made and it's a very facts-and-circumstances test."

As Grassley ponders further legislation for the tax-exempt sector, the Senate Banking Committee Jan. 27 began hearings on Madoff, founder and president of Bernard L. Madoff Investment Securities, who admitted to running an estimated \$50 billion Ponzi scheme and is under house arrest.

A New York judge agreed several weeks ago to let Madoff remain out on bail in return for additional security at his \$7 million New York penthouse, despite arguments that he should be in jail.


Due Diligence

Pattara said when it comes to Madoff, the argument has been that fraud is fraud and, in this case, even a charity that did its due diligence would have been unable to uncover it. "Yet there are apparently other charities that chose not to invest with him after doing some due diligence. So I think it's fair to ask if those that chose to invest with Madoff actually conducted due diligence as opposed to maybe relying on a personal relationship or a simple referral.

"With respect to charities that apparently have had to close their doors or stop issuing grants because of the losses on their Madoff investments, it would seem hard to argue that these investments did not jeopardize the carrying on of their exempt purpose," she said.

Pattara said Grassley is still considering reforms of the sector after those made by the Pension Protection Act of 2006 (Pub. L. No. 109-280). There was a great deal from the staff discussion draft in 2004 that was not addressed, she said. However, economic stimulus legislation and other matters relating to the new administration are dominating the attentions of the senator and staff right now, she said.

Grassley told BNA Dec. 16, just after the Madoff situation came to light, that the foundation and charitable boards involved should review why they put "all of their eggs in one basket." Better transparency of investments might help to prevent this kind of mess in the future, he said.

He noted that the Finance Committee staff proposed a prudent investor rule in the 2004 staff discussion draft but charities, through the Panel on the Nonprofit Sector, said such legislation was not needed (243 DTR G-5, 12/18/08 ). "It may be time to re-examine that reform," he said.

Marcus Owens, attorney with Caplin & Drysdale in Washington, D.C., told BNA in late December that depending on how the actual facts in the Madoff case emerge, both private foundations and publicly supported charities may have issues with the fiduciary duty of care standard, which is enforced by states. That standard also hinges on the extent to which pre-investment due diligence was performed and the extent to which adequate monitoring of investments occurred.

By Diane Freda

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