Establishing a private foundation brings both responsibilities and rewards

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In brief

High-net-worth individuals have a long history of charitable giving. Historically, many individuals made their contributions directly to public charities. For families contemplating substantial contributions, private foundations provide a structure to create a legacy of family charitable giving. Even as donor advised funds and community foundations have become more popular for their ease of administration and cost, private foundations remain a popular vehicle for charitably inclined families. Private foundations provide families with the opportunity to formalize their philanthropic goals and to set a course for the future. Additionally, private foundations allow younger family members to become involved with these philanthropic goals, establishing a continuous impact through the generations. Private foundations can also be used as a means to accelerate tax deductible charitable contributions, while still maintaining family control of the funds.

While a private foundation may appeal to an individual for a variety of reasons; private foundations come with responsibilities. Prior to forming a foundation, consideration should be given to, among other things, developing a clear charitable mission, determining appropriate assets for funding the foundation and becoming familiar with unique rules and related penalties associated with these organizations. Whether a private foundation provides benefits superior to a donor advised fund or community foundation must be evaluated.

In detail

A private foundation is a nongovernmental, nonprofit organization having a principal fund managed by its own trustees or directors. Private foundations maintain or aid charitable, educational, religious, or other activities serving the public good, generally through the making of grants to other nonprofit organizations. Rules regulating private foundations are complex and not always intuitive. The following are some common issues that need to be addressed.

Considerations in forming a foundation

When should a family consider forming a private foundation? The principal advantage of establishing a private foundation is having 'control' over your charitable activity. One of the key benefits of this type of control is over the distribution of funds and maintaining the corpus of the trust. You and your family will decide how, when, and at what rate foundation funds are spent. A private foundation can establish an annual payout amount that provides grants and covers administrative expenses while preserving its endowment. Another benefit is that a foundation allows the family to enjoy the opportunity to see their philanthropy put to work. The family should put in place a governance structure designed to assure that the charitable mission and goals are furthered through the foundation's operations, investments, and grant-making. This structure will also help to guide the younger members of the family as they become more involved in the private foundation's philanthropic goals.

Establishing a private foundation has many benefits, but there are also administrative burdens and costs associated with operating a private foundation. Various tax and state law compliance requirements, some very complex, must be met. Annual federal filings and many state filings are required and are publicly available, including the names and amounts contributed by major donors. It is also important to note that a private foundation is not necessarily the best approach to philanthropy for every family. In some cases, families have created foundations without a mission statement or a clear idea of what they hope to accomplish. When this happens, the family can incur the costs and face the complexities of organizing and operating the foundation, without enjoying the fulfilment of furthering a worthy cause or building the family legacy.

Are the benefits of a foundation outweighed by the costs?

There are more than 60,000 private foundations in the United States with assets of less than $1,000,000, including many with assets of less than $100,000. Whether such a small foundation makes sense is a question to which there is no simple answer. The appropriate minimum size depends on several factors, including the amount of volunteer help, expected life of the foundation, and size of the annual budget that must be funded by an endowment or on-going contributions. Depending on the answers to these questions, an alternative charitable vehicle, such as a donor advised fund, may provide a more suitable philanthropic vehicle. The compliance and reporting costs associated with tax filings, audited financial statements, and other matters may prove too burdensome relative to the benefits derived from a small family foundation.

Which assets to donate? Which assets to accept?

Because not all assets produce the same tax benefits, families should carefully plan how they will fund a private foundation. The most common assets used to fund private foundations include cash, appreciated stock, real estate and closely-held business interests.

Considerations for the donor:

- A gift of cash is the simplest funding asset. The donor can deduct up to 30% of his or her adjusted gross income for gifts of cash to most private foundations, and carry forward any unused portion of the deduction up to five years.
- A gift of appreciated capital gain property, such as artwork, real property, and interests in a closely-held business entitles the donor to deduct up to 20% of his or her adjusted gross income in the taxable year. The donor can carry forward any unused portion of the deduction up to five years. The value of the donation for deductibility purposes is limited to the **lesser** of: **(1)** the gifted property's fair market value; or **(2)** the donor's cost basis. There is an exception for publicly traded stock that has been owned for more than one year that permits the donor a deduction for the stock's fair market value. In addition the donor avoids paying any capital gains on the appreciation.

Considerations for the private foundation:

- A private foundation must exercise particular caution when accepting interests in a closely held business. A private foundation and its disqualified persons, e.g., the donor and the donor's spouse, children and grandchildren and related entities, are generally prohibited from owning more than 20% of a business.
- Private foundations must obtain certified, independent appraisals of their investment real estate every five years. Given the high cost of appraisals, private foundations should consider avoiding donations of modest parcels of real estate.

What is self-dealing?

Laws relating to private foundations are meant to be restrictive and therefore, eliminate certain practices of wealthy donors. In most situations, a transaction between a 'disqualified person' (e.g., foundation managers, substantial contributors, various relatives of managers and contributors, and related entities) and the private foundation will be considered self-dealing, even if the transaction is conducted at fair market value.

Types of self-dealing transactions include the sale, exchange, or lease of property, loans, extensions of credit, payments to government officials, satisfying pledges, furnishing goods, or services, and more.

Example 1: The foundation uses a family member's house as its office.

Paying rent to the family member would be self-dealing, although providing the space for free would not be considered self-dealing.

Example 2: A family trustee personally pledged to give to the local PBS, but now would like to use a foundation grant to satisfy the pledge instead of her personal funds. It is self-dealing for a foundation to pay a legally enforceable pledge of a disqualified person.

Example 3: A family member with no duties for the foundation attends a fundraising dinner which is paid for by the foundation. This is another form of self-dealing.

Example 4: A board member of the foundation attends a conference on family foundations; the foundation pays for the reasonable travel expenses of the board member and the board member's spouse ($1,000 for each). The $1,000 spent by the foundation for the board member is reasonable and necessary and, therefore, not a violation. However, attendance by the spouse is not necessary to further the foundation's purposes, and would be viewed as self-dealing. .

While repeated acts of self-dealing can lead to severe penalties for a private foundation (and even recovery of assets equal to the value of all tax benefits derived), the self-dealing rules are designed to provide a sanction where the penalty (in the form of an excise tax) is applied to the wrongdoer (or self-dealer) and certain foundation managers. The excise tax is measured as a percentage (10% in the case of a disqualified person) of the amount involved. The foundation itself is not assessed for a violation of the self-dealing rules, but must report instances of self-dealing to the IRS. Further, the self-dealing must be corrected to avoid additional excise taxes.

Are any expenditures subject to tax?

Private foundations must pay an excise tax of up to 20% of the amount of 'taxable expenditures,' with additional taxes if the expenditure is not corrected. 'Taxable expenditures' are expenditures for any purpose other than religious, charitable, scientific, literary, educational or other public purposes. Examples include lobbying expenses, efforts to influence public elections, and grants to organizations other than public charities.

Private foundations must be careful when making grants to other private foundations or non-charitable organizations. Even if the foundation has the proper motive when giving, the foundation must undertake special due diligence procedures (called expenditure responsibility) to avoid the excise tax on taxable expenditures. Foundation managers responsible for approving expenditures of any type should have a comprehensive understanding of the complex rules associated with taxable expenditures. Expenditure responsibility requires extra administrative and reporting measures designed to ensure a grant is spent only for the intended charitable purpose.

Private foundations should consider two additional measures to prevent taxable expenditures. First, all expenditures with possible legislative implications should be carefully scrutinized to ensure they are not associated with lobbying for specific outcomes to legislation, and no payments may be made to influence political elections. Foundations should be aware of the limited exceptions that allow for legislative expenditures to be excluded from taxable expenditures. Second, foundations should verify the status of public charities requesting a grant, such as by checking the IRS Business Master File, and be prepared to exercise expenditure responsibility for grants made other than to a public charity.

What are jeopardizing investments and excess business holdings?

If a private foundation makes any investment that would jeopardize the carrying out of its exempt purposes, a 10% excise tax on each jeopardizing investment may be assessed against both the private foundation and the foundation manager (if the manager is wilfully involved) for each year in which the jeopardizing investment is held. If the investment is not removed from jeopardy, additional excise taxes of 25% and 5% may be imposed upon the foundation and foundation manager, respectively. Jeopardizing investments generally are investments that show a lack of reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation for it to carry out its exempt function. Diversification of the investment portfolio is critical. Although no single investment category is specifically considered jeopardizing, careful scrutiny is applied to:

1. Trading in securities on margin;
2. Trading in commodity futures;
3. Investing in working interests in oil and gas wells;
4. Buying puts, calls, and straddles;
5. Buying warrants; and
6. Selling short.

'Program related investments' are not considered jeopardizing investments. These are investments that have as their primary purpose the accomplishment of a charitable purpose, and no significant purpose of which is the production of income or appreciation of property. One example includes a below market loan to help a distressed area.

Example: Two hypothetical private foundations, Foundation A and Foundation B, recently made high-risk below-market business loans to entrepreneurs interested in opening a shopping centre in a very poor neighborhood. The exempt purpose of Foundation A is to provide grants for world health initiatives, while that of Foundation B is to promote small business growth in economically disadvantaged communities. The loans are directly related to the exempt purpose for Foundation B and, therefore, might be considered program-related investments with respect to Foundation B. However, for Foundation A, the loans might be considered jeopardizing investments, since they do not significantly further its specific exempt purpose. Foundation A and its managers need to assess whether reasonable business care and prudence was exercised in providing the loans to avoid the excise tax on jeopardizing investments.

Finally, the combined holdings of a private foundation and its disqualified persons are limited to 20% or more of the voting interest in a business entity. Foundations may be allowed up to 35% if a third person, not considered a disqualified person, has effective control over the business enterprise in question.

Is the foundation required to make distributions?

In order to prevent private non-operating foundations from receiving tax-deductible gifts, investing the assets and never spending funds for charitable purposes, Congress established a minimum payout requirement. Each year, a private foundation must make eligible charitable expenditures roughly equal to, or exceeding, five percent (5%) of the value of the foundation's non-charitable assets, also known as the required distributable amount. Failure to pay out the annual distributable amount results in a penalty equal to thirty percent (30%) of the underpayment. The penalty is only applied to the foundation, not the foundation manager. However, the foundation manager may be penalized if he or she fails to exercise his or her fiduciary duties.

A private foundation has until 12 months after the end of its taxable year to pay the required distributable amount. For example, a foundation might pay nothing for its first year and then satisfy the first year's minimum payment requirement by making additional payments in the second year and applying them to the first year distribution requirements. All payments considered "qualifying distributions" contribute to meeting the required minimum payout. Qualifying distributions include grants to charities, charitable administrative expenses, set-asides and program-related investments. Investment expenses in managing an endowment will not be counted towards meeting the minimum payout requirement. In any year the foundation's qualifying distributions exceed its calculated distributable amount, the excess may be carried over up to five years and applied towards any underpayment.

Is there a risk of Unrelated Business Income Tax (UBIT)?

Even though a private foundation is recognized as tax exempt, it still may be liable for tax on its unrelated business income (UBI). For most exempt organizations, unrelated business income is income from a trade or business, regularly carried on, that is not substantially related to the charitable, educational, or other purpose that is the basis of the organization's exemption. Unrelated business income received by an exempt organization is generally taxed at the applicable corporate or trust income tax rates for U.S. and state purposes. This is done to prevent unfair business practices by putting exempt organizations and taxable entities on equal footing.

A private foundation must scrutinize its investment activities to determine whether they generate unrelated business income. For example, the foundation may invest on margin, or in a partnership that may in turn invest in activities that produce UBI, either with debt financed income or through trade or business income which would be considered UBI.

Investment income that is not subject to UBIT is subject to the excise tax on net investment income.

The takeaway

A private foundation can provide structure, control and direction to a family's charitable vision. As with the creation of any enterprise, establishing a private foundation involves an array of organizational, financial, and legal issues that must be addressed. Family dynamics also can play a role.

Developing a clear charitable mission or similar set of guiding principles is the first step to setting up a private foundation. Educating yourself, your family and the people involved on the requirements of organizing and operating a private foundation is crucial. Only after developing a clear charitable mission and evaluating the various alternatives (for example a donor advised fund) can a family determine whether a private foundation makes sense. Addressing the various issues discussed in this article will help ensure your decision to establish a private foundation fulfils your philanthropic mission.

Let's talk

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