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BASICS*

Private Foundations

Synopsis

Establishing a private foundation can be one of the most important and lasting decisions you will ever make for the benefit of your family and your community. It is an effective way to combine your philanthropic and financial objectives and a creative and orderly way to support your favorite causes while receiving tax advantages, both during your lifetime and for your estate upon your death. Creating a private foundation that you and your family members control allows for many years of working together for the common good, and ensures a lasting legacy by allowing your children and grandchildren to continue to pursue your philanthropic goals after your death. Philanthropy is something that is learned, and who better to teach your children and grandchildren about "giving back" than you? A private foundation can also help alleviate the problem of "affluenza"–a malaise that can fall upon some children and grandchildren who receive too much and lose their incentive to be productive. Although private foundations are subject to many technical rules, their benefits can be enormous.

I. Overview of Private Foundations.

A. General Concepts.

Private foundations are charitable entities created to hold assets for charitable purposes, usually for distribution to publicly supported charities. Contributions by an individual to a private foundation qualify for the charitable income, estate, and gift tax deductions, subject to a number of technical restrictions regarding deductibility for income tax purposes. The major advantage of a private foundation is that the founder (and his or her family) can control the contributed funds, and decide on an annual basis how those funds will be applied each year.

Congress perceives that some people may attempt to use private foundations inappropriately. As a result, they have enacted a number of restrictions on their activities, and have imposed limitations on non cash contributions made to them. One of the most significant restrictions is the limitation on income tax deductibility for contributions of appreciated property to a private foundation. Generally, when an individual contributes appreciated property to a private foundation, the income tax deduction is limited to the cost of the property (not its current value). However, a special exception to that rule permits an income tax deduction of the full fair market value of appreciated publicly traded stock contributed to a private foundation. In other words, if you have appreciated stocks or bonds that are publicly traded, you may

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contribute them to a private foundation and take a deduction for their full fair market value, without having to take the gain on the disposition of the stock or bond into income. If the private foundation later sells the security, it does not pay tax on any gain, since the foundation is a charitable entity.

B. Advantages of Creating a Private Foundation.

When an individual creates and contributes money or property to a private foundation during life, he is able to take an income tax deduction in the year of the contribution, but may continue to control the distribution of the foundation's assets to donee charitable organizations in the future. Another option is for an individual to create a private foundation under his Will. In that case, the individual's estate would be entitled to an estate tax charitable deduction for the full amount used to fund the foundation, but no income tax deduction is available.

One of the primary advantages of setting up a private foundation, particularly during the donor's lifetime, is that it offers the donor's family an opportunity to work together toward the common goal of establishing an entity that can have a lasting impact on the community where the family lives or on the charitable area of their choice. In working together, the older generation has the chance to teach younger family members management and investment techniques and strategies so that the private foundation may, in addition to serving its charitable purpose, serve an educational purpose for the younger generation. The private foundation affords a valuable opportunity for younger family members to carry on the goals of the older generation after the older members of the family die.

C. Deductibility of Contributions to Private Foundations

Contributions to private foundations are subject to a number of restrictions relating to income tax deductibility. Cash contributions are generally deductible up to 30% of the donor's adjusted gross income (AGI), while contributions of appreciated property are generally deductible up to only 20% of the donor's AGI. If the 20% or 30% limitation is exceeded, the excess deduction may be carried forward for five years. The limitations on deductibility for contributions to private foundations are less generous than those applicable to contributions to public charities. A cash contribution to a public charity is deductible up to 50% of a donor's AGI, and a donor may deduct contributions of appreciated property to a public charity of up to 30% of his AGI.

In addition to the AGI percentage ceiling placed on deductions, a donor is limited as to the amount of the value of some types of appreciated property contributed to a standard grant-making private foundation. In particular, if a donor contributes property other than money or publicly traded securities, the donor is limited to deducting his cost basis for all contributions of long-term appreciated property.

For example, suppose that a donor contributes real estate or stock in a closely held business he has owned for ten years to a private foundation. The property originally cost $100,000, but now has a fair market value of $1 million. Under current law, the donor will be permitted to deduct only $100,000 for income tax purposes. He will, however, be able to deduct the full $1 million for gift tax purposes so that there will be no gift tax as a result of the contribution. If appreciated property is contributed at death, the full value of the property qualifies for the estate tax charitable deduction. As noted earlier, if the contributed property is stock in a publicly traded company, the donor would be entitled to deduct the entire $1,000,000 value of the stock (subject to the percentage limitations and carry forward rules outlined above).[1]

As in the case of the percentage limitations, the Internal Revenue Code (the "Code") treats gifts of appreciated property to public charities more favorably than it does similar gifts to private foundations. A donor may deduct the full fair market value of appreciated property contributed to a public charity, subject to the requirement that any appreciated tangible personal property contributed be related to the charitable purpose of the public charity.

II. Choice of Legal Entity.

Generally, private foundations are structured either as trusts or not-for-profit corporations. When creating a private foundation, a number of considerations must be analyzed in determining which structure is preferable. The corporate structure usually offers more flexibility than does the trust structure because the corporate documents may be easily amended to take into account changing circumstances. Also, unlike a trust instrument, corporate documents can provide for the election of new officers and the formation of new committees to restructure the corporation's internal governance and method of accomplishing its charitable purposes. Approvals from various state officials may be required, however, when corporate purposes are amended.

An additional advantage of the corporate structure is that the standard of care to which a director is held is often less rigorous than that applicable to a trustee. A trustee may be liable for negligence, but a director benefits from the protection of the business judgment rule, which generally provides that a director is liable only for acts of self-dealing, willful misconduct, or gross negligence. Most states now have statutes that extend the ability of a corporation to indemnify its directors. In Texas, a director may delegate investment decisions to investment advisers and will have no liability for the actions of the advisers, provided that the directors acted prudently in selecting the investment advisers.

Another consideration favoring the corporate structure is that contributions made by a corporation to a trust are deductible only if the contributions are to be used within the United States for charitable purposes. That restriction does not apply to contributions made to a private foundation structured as a corporation. Nevertheless, unless it is anticipated that the foundation may receive such contributions, this concern alone should not be determinative as to which entity is selected.

Although there are a number of significant advantages to the corporate structure, there are certain advantages to using a trust. A trust normally can be established more quickly than can a corporation. Particularly when a client decides in late December that it is desirable to create a private foundation so that he can make a contribution to it before year-end for tax planning purposes, a trust—rather than a corporation—should be considered. Moreover, depending on applicable state law, a trust may have fewer annual filing requirements, so fewer annual fees and less paperwork may be required.

There is no requirement that a trust hold annual meetings or keep minutes of meetings held by the trustees. A settlor may reserve the right to amend the trust to provide for new charitable purposes, and no approval will be required for this type of amendment. The settlor may control the persons or entities that

[1] A special rule limits the deduction to basis if the donor and his or her family contribute more than ten percent of the stock of a public company to a private foundation.

will serve as successor trustees, whereas it is very difficult for the creator of a charitable corporation to control the appointment of successor directors.

III. Types of Private Foundations.

Any type of charity, including private foundations, that desires to be exempt from income taxes has to apply for that exemption within 15 months after the end of the month in which the charity was formed. Private foundations usually apply for tax exempt status by filing Treasury Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. If Form 1023 is timely filed, once tax exempt status is granted, it relates back to the date the charitable organization was formed.

Every charitable organization exempt under Section 501(c)(3) is assumed to be a private foundation under Section 509(a) unless the organization can establish to the satisfaction of the Internal Revenue Service (Service) that it qualifies as a public charity. Regardless of whether a private foundation is structured as a trust or a corporation, it will be subject to the same federal tax rules and will fit within one of the following three basic types of private foundations.

A. Standard Private Foundations.

The "standard private foundation" is the most common type of private foundation and is also sometimes referred to as a "grant-making foundation" or a "family foundation." The standard private foundation usually does not carry out any charitable activity itself but is created to hold funds, a portion of which is used each year to make contributions to other charities and occasionally to make grants to individuals. Most standard private foundations receive their funds from either one or only a few sources (e.g., an individual, a family, or a corporation). A standard private foundation does not, therefore, generally engage in any sort of fundraising nor does it typically apply for grants.

The standard private foundation is the only foundation that is subject to all the excise tax rules in Sections 4940 through 4945, and it is subject to the strictest limitations on income tax deductibility. Thus, this type of foundation is the primary focus of this memo. It is useful, however, to be familiar with the other two types of private foundations, so a brief description follows.

B. Private Operating Foundations.

A private operating foundation is a foundation that itself engages in charitable activities rather than merely making grants to other charitable organizations or individuals. Typically, private operating foundations operate museums, libraries, nursing homes, and historic preservation sites.

Although a private operating foundation is subject to most of the excise tax rules to which a traditional private foundation is subject, a major benefit is that donors to a private operating foundation may take advantage of the significantly more liberal income tax deduction rules generally applicable to gifts made to publicly supported charities. Accordingly, a donor contributing cash to a private operating foundation can deduct up to 50% of his AGI, rather than 30%.

Perhaps more importantly, contributions of appreciated property are deductible at their full market value, except that contributions of appreciated tangible personal property must be related to the exempt purpose of the private operating foundation, or else the donor is limited to deducting his basis. For example, if a donor contributes an appreciated oil painting to a private operating foundation that operates a museum, he can deduct the full fair market value of the painting. In contrast, if the donor contributes his yacht to the museum and the museum will sell the yacht because it is not related to its charitable purposes, the donor is limited to deducting his basis.

An additional benefit of a private operating foundation, as opposed to a standard private foundation, is that the requirements for the charitable payments it must make each year are less onerous, so that it need not invade corpus in years when it has a poor investment return. A private operating foundation must spend at least 85% of the lesser of its adjusted net income or its minimum investment return directly on its charitable purposes. In addition, it must:

- Devote at least 65% of its assets to its charitable activities or to a functionally related business;
- Derive substantially all its support (other than its gross investment income) from at least five independent exempt organizations or from the general public, with not more than 25% of its support received from any one exempt organization and not more than half its support received from its gross investment income; or
- Make qualifying distributions of at least two-thirds of its minimum investment return directly for the active conduct of its exempt activities.

A private operating foundation may count its administrative and operating expenses toward meeting the income tests.

C. Conduit Foundations.

A conduit foundation is a private foundation through which all contributions must flow out to charitable entities within two and one-half months after the end of the conduit foundation's tax year in which the contributions were received. Although a conduit foundation, like a standard private foundation, is subject to all the excise tax rules, a significant benefit is that the more favorable rules governing the deductibility of contributions to publicly supported charities apply to contributions to a conduit foundation. Because of the flow-through requirement, the endowment of a conduit foundation can never grow, and therefore many of the advantages of creating and maintaining a standard private foundation are unavailable.

IV. The Excise Tax Provisions.

Standard private foundations and private operating foundations are subject to a number of rigorous rules regarding their governance, known as the "excise tax provisions." These provisions, contained in Sections 4940 through 4945 of the Internal Revenue Code (the "Code"), impose harsh tax penalties on foundations that do not comply. For example, some of the taxes are imposed at a rate of 200% if the foundation fails to correct certain acts. Congress adopted the excise tax provisions to correct perceived abuses of privately controlled foundations, and to ensure that a minimum percentage of a foundation's assets are distributed each year. In order to pay for the cost of administering these rules, each standard private foundation must generally pay a 2% tax on its net investment income each year.

The excise tax provisions preclude a substantial contributor to a private foundation from committing certain acts of "self-dealing." In addition, a private foundation is limited as to the percentage of an active trade or business it may hold. Furthermore, the assets of a private foundation may not be invested in such a way that would jeopardize those assets (i.e., cause the assets to lose value) nor may the private foundation expend its assets in other than a certain circumscribed manner. The excise tax provisions are explained in further detail below.

A. Excise Tax on Investment Income.

Under Section 4940 of the Code, an excise tax of 2% is generally imposed on the net investment income of a standard private foundation each year, and the tax due is reported on Form 990-PF. Certain private operating foundations are exempt from the 2% excise tax, and certain standard private foundations that make substantial distributions may qualify for a reduction in the excise tax to only 1%.

A private foundation must file Form 990-PF each year by the 15th day of the fifth month following the end of its fiscal year (May 15 for private foundations on a calendar year).[2] Form 990-PF reports financial information about the foundation, including contributions received for the year, capital gains, investment income, expenses, and "qualifying distributions" made by the foundation for the year. A "qualifying distribution" is generally any amount paid to a charitable organization or to carry out or accomplish a charitable, religious, educational, or scientific purpose or any other purpose set forth in Section 501(c)(3).

A standard private foundation may be subject to only a 1%, rather than a 2%, excise tax if it makes qualifying distributions during the tax year at least equal to the sum of: (1) the foundation's assets for that year multiplied by the average percentage payout for the five preceding tax years plus (2) 1% of the foundation's net investment income for the year. For example, assume a private foundation has assets of $1 million and an average payout of 7% for the five preceding years. If the foundation makes qualifying distributions of $70,000 plus 1% of its net investment income for the tax year, the excise tax payable by the foundation will be 1% rather than 2%. A foundation is not eligible for the excise tax rate reduction if in any of the five preceding years it failed to make sufficient qualifying distributions.

B. Tax on Self-dealing.

Section 4941 of the Code sets forth a list of specific, forbidden acts of self-dealing between a private foundation and certain donors to a private foundation, as well as the family members of such donors, other individuals like foundation managers, and entities controlled by such individuals. These individuals are defined as "disqualified persons." The self-dealing rules impose an excise tax on any disqualified person who knowingly engages in any act of self-dealing. The rate of taxation begins at 10% of the amount involved with respect to the act of self-dealing and increases to 200% of the amount involved if the act is not corrected within a designated period of time. Any foundation manager who knows of the self-dealing and allows it to continue is also subject to imposition of the excise tax on self-dealing, up to 50% of the amount involved in the self-dealing. The maximum tax imposed on the foundation manager, however, is $20,000 for any single act of self-dealing.

A disqualified person is defined in Section 4946 as:

- A substantial contributor to the foundation (i.e., generally, anyone who contributes more than $5,000 to a private foundation if that amount is more than 2% of the total contributions received by the foundation for its taxable year);

[2] A private foundation may select any fiscal year and is not limited to a calendar year.

- A foundation manager (i.e., any officer, director, trustee, or certain employees or agents of the private foundation);

- The owner of more than 20% of a corporation, partnership, trust, or unincorporated enterprise that is a substantial contributor to the foundation;

- A member of the family of any individual described above;

- A corporation, partnership, trust, or estate, if a person listed above holds more than a 35% interest in the entity; or

- A government official.

Under Section 4941, "self-dealing" includes the following acts, whether direct or indirect: (1) the sale, exchange, or leasing of property between a private foundation and any disqualified person; (2) the lending of money between a private foundation and any disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and any disqualified person; (4) the payment of compensation by a private foundation to a disqualified person; and (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation.

In most cases, the "fairness" of a self-dealing transaction is not relevant. For example, if a company that you control leases office space to your private foundation for $1 per year, that transaction is a prohibited act of self dealing, even though the rent is substantially below market rates. The Regulations under Section 4941 set forth a number of exceptions to these all-encompassing rules against self-dealing.

One of the most important of these exceptions allows a private foundation to pay compensation to a disqualified person for personal services actually performed by that person as long as the services are reasonable and necessary to carrying out the exempt purpose of the private foundation, and as long as the compensation is reasonable. As a result, the creator of a private foundation or members of the creator's family may be employed by the foundation and paid reasonable compensation. Employment by the foundation may be an additional advantage to be considered in creating a private foundation. Care must be exercised in determining a reasonable salary, however, because salaries paid must be reported on Form 990-PF and will be scrutinized by the Service. Industry groups review and publish compensation averages that may be viewed as a guide to the reasonableness of compensation paid.

C. Tax on Undistributed Income.

A standard private foundation may not accumulate all its income. Each year, it is required to make certain qualifying distributions as set forth in Section 4942 of the Code. If the foundation does not comply with the rules governing qualifying distributions, it is subject to an excise tax. Like the tax on self-dealing, the tax imposed on a private foundation for failure to make adequate distributions increases if the foundation fails to cure the problem within a specified time.

The amount that a standard private foundation must distribute each year is its "minimum investment return," reduced by the payment of the excise tax under Section 4940 and adjusted upward by the amount of certain loan repayments and other receipts. In general, the minimum investment return equals 5% of a foundation's net investment assets. Specifically, the minimum investment return is calculated by multiplying the aggregate net fair market value of the foundation's assets that are not used directly for charitable purposes by 5%. The minimum amount that a standard private foundation may distribute each year to be in compliance with Section 4942 (the "distributable amount") is the foundation's minimum investment return less the sum of the excise tax it pays pursuant to Section 4940 and any unrelated business income tax it pays.

If a standard private foundation makes qualifying distributions that exceed its distributable amount, the excess distributions may be carried over and used to reduce the amount the foundation would otherwise be required to pay out over the following five years.

If the foundation fails to make its required distributions, the initial excise tax equals 30% of the income of the private foundation not distributed as required within the tax year or within the next tax year. A second tier tax, equal to 100% of the undistributed income, is imposed if the foundation fails to make the necessary qualifying distributions within a specified period of time. A third tier tax may be imposed by the Service if there have been previous violations or if the violation for which the current tax is imposed is willful or flagrant.

D. Tax on Excess Business Holdings.

Code Section 4943 generally provides that the combined holdings of a private foundation and all disqualified persons in any corporation conducting a business which is not substantially related to the charitable purposes of the private foundation are limited to 20% of the voting stock in the corporation. In addition, the combined holdings of a private foundation and all disqualified persons in any unincorporated business (other than a sole proprietorship) which is not substantially related to the exempt purposes of the foundation are limited to 20% of the beneficial or profits interest in the business. In the case of a sole proprietorship, a private foundation can have no permitted holdings unless the business of the sole proprietorship is substantially related to the exempt purposes of the foundation.

If unrelated third parties have effective control of the business, the percentage limitation on the combined holdings of the private foundation and all disqualified persons is increased to 35%. These provisions are subject to a variety of exceptions and special rules that must be examined in detail if the 20% (or 35%) limitation is exceeded. Regardless of the holdings of substantial contributors, if the private foundation itself (together with any related private foundations) holds an interest of 2% or less in an unrelated business, it will not be required to divest its holdings. If the private foundation acquires excess business holdings by gift or bequest, it will have five years to dispose of those holdings before any excise tax is imposed.

E. Taxes on Investments That Jeopardize Charitable Purpose.

Section 4944 of the Code provides that a private foundation may not invest its assets in any manner that could jeopardize the carrying out of any of its exempt purposes. If the foundation does make "jeopardizing investments," a tax equal to 10% of the amount so invested is imposed initially and a second-level tax of 25% may be imposed if the situation is not corrected within the specified time limit. No investment is unacceptable *per se*, but the following types of investments may be carefully scrutinized as evidencing a lack of reasonable business care and prudence:

- Trading in securities on margin;

- Trading in commodity futures;

- Investing in working interests in oil and gas wells;
- Buying "puts," "calls," and "straddles;"
- Buying warrants; and
- Selling short.

To correct a jeopardizing investment, a private foundation must sell or otherwise dispose of the investment, and the proceeds of the sale or disposition must not be invested in a way that jeopardizes the carrying out of the foundation's exempt purposes. Section 4944 of the Code does not apply to an investment given to (as opposed to being purchased by) the private foundation.

F. Taxable Expenditures.

Standard private foundations typically achieve their charitable aims by distributing funds to qualified public charities. Code Section 4945's taxable expenditure rules play a central role in the operation of a private foundation. These rules preclude a private foundation from making "taxable expenditures": (1) to carry on propaganda or to attempt to influence legislation; (2) to influence the outcome of any specific public election or to carry on any voter registration drive; (3) as a grant to an individual or to another private foundation, unless certain rigorous requirements are met; or (4) for any purpose other than the charitable purposes described in the Code.[3]

The taxable expenditure rules impose significant burdens on a private foundation's ability to make grants (including providing scholarships) to individuals. To make a grant to an individual, the private foundation must obtain advance approval from the Service that its grant-making procedure awards grants on an objective and nondiscriminatory basis and that the grant constitutes a scholarship, fellowship, prize, or award or that the purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

To make a grant to another private foundation, the grantor foundation must exercise what is known as "expenditure responsibility." This means that the grantor foundation is responsible for exerting all reasonable efforts to establish adequate procedures to: (1) see that the grant is spent solely for the purpose for which it was made, (2) obtain full reports from the grantee as to how the funds are spent, and (3) make detailed reports as to such expenditures to the Service.

If the foundation makes a distribution to an individual without having prior IRS approval of its grant-making procedure, or if the foundation makes a distribution to another foundation without exercising expenditure responsibility, an initial tax of 20% is imposed on a private foundation's taxable expenditures. In addition, a tax of 5% (up to a maximum of $10,000) is imposed on a foundation manager who knowingly agrees to the expenditure.

[3] In this context, the Code describes charitable purposes as religious, charitable, scientific, literary or educational purposes, or to foster national or international sports competition, or for the prevention of cruelty to children or animals.

If the improper expenditure is not corrected, a second-level tax of 100% of the amount of the taxable expenditure is imposed on the foundation. A second-level tax of 50% (up to $20,000) is also imposed on a foundation manager who does not agree to the correction. If there are repeated or flagrant taxable expenditures, a third-tier tax, which is in the nature of an income tax, is assessable at any time. Ultimately, willful repeated and flagrant violations can result in the involuntary termination of private foundation status.

V. Summary.

Although a private foundation is subject to many requirements and does not receive as favorable tax treatment as does a public charity, there are still numerous reasons to consider creating a private foundation.