Guide to Creating a Private Foundation, Estate Planning Journal, Dec 2003
Estate Planning Journal (WG&L)

CURRENT LITERATURE

Guide to Creating a Private Foundation

Author: NANCY SHURTZ

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This new book, *Creating a Private Foundation: The Essential Guide for Donors and Their Advisers,* demystifies a quadrant of the financial planning field that has not received its fair share of attention. The principal authors, Roger D. Silk and James W. Lintott, have vast experience running and advising charitable organizations. Their focus is on educating prospective philanthropists about the establishment of private foundations, which are preferable to other vehicles of charitable giving for many people because of one central factor: control over the foundation's assets.

The approach of the book is laudably simple. The first five chapters provide an overview of the field of charitable giving (Chapter One), the tax advantages enjoyed by certain charitable entities (Chapters Two and Three, respectively), and the personal, familial, and communal rewards to be cultivated through thoughtful construction and direction of philanthropic activities (Chapters Four and Five).

The next chapters are devoted to the wide swath of processes involved in establishing private foundations, including initial funding, the foundation's stated mission, and establishment of executive directors (Chapter Six), as well as sound investment and asset allocation strategies (Chapters Seven and Eight, respectively). Other chapters discuss alternative charitable giving vehicles (Chapter Ten), tips on how to select a foundation manager (Chapter Eleven), and donation of noncash property to charity (Chapter Thirteen). A brief conclusion and a reference list of books, other pertinent publications, websites and organizations follow. An index rounds out the volume.

This is a very informative and readable book. The authors score high marks for their thoughtful introduction to key themes at the beginning of each chapter, effectively augmented by easy-to-use charts, tables, and practical examples. Their writing is clear and has a nice conversational style. Moreover, it is obvious that the authors' perspectives are born of invaluable seasoning and experience.

With so much potential for expanded philanthropic activity in this country, a book that might facilitate easier entry into this vital social lifeline is certainly most welcome. It is equally appropriate for donors and their financial advisors, and is sure to broaden the perspectives of anyone who reads it.

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Private Foundations

WHAT IS A PRIVATE FOUNDATION?

A private foundation is an organization established exclusively for charitable, educational, or religious purposes which fails to qualify as a public charity, generally because it lacks sufficient ongoing financial support from the general public. Usually, a private foundation is controlled by a small group of individuals or a family who constitute its major contributors.

A private foundation is either a corporation or a charitable trust. The corporate form is more flexible, imposes a less stringent standard of care on its directors, and provides statutory protection for its officers and directors. The formation of the organization is governed by state law, but its status as a private foundation is controlled by federal tax law.

ADVANTAGES

There are both tangible and intangible advantages of private foundations. The tangible advantages relate to income, gift, and estate taxes and to investment control.

- Gifts of cash are fully deductible for income tax purposes.
- Gifts of most publicly traded stock are fully deductible at fair market value.
- All gifts are fully deductible for federal gift and estate tax purposes.
- Managers are free to pursue any reasonably prudent investment strategy. Public charities typically will not accept and retain assets that have limited marketability or difficult management issues.

Intangible benefits are more personal to the individuals or families who create their private foundations.

- The donors or family managers may plan and schedule charitable giving. Foundation managers usually know near the beginning of the year approximately how much the foundation must distribute that year. The foundation can then clarify and prioritize its goals and objectives.

- The donors or the family managers establish their own grantmaking guidelines and delineate particular areas of interest.

- A foundation can help cement family ties and carry on family traditions. Family members can come together to share their philanthropic interests and goals.

- A foundation can provide recognition and allow perpetuation of the family name. Alternatively, a foundation can provide anonymity in giving.

DISADVANTAGES

There are some disadvantages that are peculiar to private foundations:

- The amount of a deduction for a gift of appreciated property to a public charity is usually the fair market value of the property. However, with exception of publicly traded stock, appreciated assets contributed to a private foundation will result in a deduction at cost basis. This difference may be very significant for owners of a family business who intend to contribute interests in the business.

- A private foundation is more limited than a public charity in the ways it may make grants. Unless the private foundation grant is made to a public charity, the foundation must undertake fairly onerous "expenditure responsibility," including formal pre-grant inquiry and record keeping.

- A foundation must estimate and pay a tax of 2 percent of its net investment income. The tax may be reduced to 1 percent if the foundation expends a large enough amount for charitable purposes. Net investment income includes dividends, interest, and capital gains, less the expenses directly related to the production of such income.

IRS LIMITATIONS

Because contributors to a private foundation, or their family members, often manage the foundation themselves, private foundations activities are strictly regulated. Some of the most important restrictions are as follows:

1. **No Self-Dealing.** With very few exceptions, a foundation may not sell, exchange, or lease real property, lend money or extend credit, or furnish goods, services, or facilities to or with "disqualified persons." The fairness of the transaction or adequacy of consideration received by the foundation is no defense. Generally, a "disqualified person" is a substantial contributor, foundation manager, family member, or related business.

2. **Excess Business Holdings.** A private foundation and its disqualified persons may not hold more than a 20 percent interest in any active business without incurring an excise tax. Thus, if disqualified persons own 12 percent of a corporation's stock, the foundation can only own 8 percent. An exception to this prohibition permits a family foundation to own up to

2 percent of the voting stock and 2 percent of the value of all classes of outstanding stock, no matter how much stock anyone else owns.

3. **Payout Requirements.** A private foundation must annually distribute an amount equal to 5 percent of the foundation's net assets that are not used directly in conducting charitable activities. Reasonable and necessary administrative expenses to accomplish a foundation's charitable purposes (such as expenses allocable to grant making, auditing, tax returns, and general administration) and capital expenditures for assets used solely in the foundation's exempt activity (such as office furniture, equipment, an office building) apply toward satisfying the minimum distribution requirements.

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Internal Revenue Service
United States Department of the Treasury

Life Cycle of a Private Foundation

During its existence, a private foundation has numerous interactions with the IRS - from filing an application for recognition of tax-exempt status, to filing required annual information returns, to making changes in its mission and purpose. The IRS provides information, explanations, guides, forms, and publications on all of these subjects - they are available through this IRS Web site. The illustration below provides an easy-to-use way of linking to the documents most foundations will need as they proceed through the phases of their "life cycle."

In addition to the following illustration, you can also download a graphical depiction of the life cycle, which includes functioning links back to our site.

Starting Out

- Types of Foundations
- Articles, Trust, or Charter
- By-Laws
- Employer Identification Number
- Charitable Registration and Solicitation
- Help from the IRS

Applying to IRS

- Application Forms
- Help from the IRS
- IRS Processing

Required Filings

- Annual EO Return
- Unrelated Business Income Tax
- Employment Taxes
- Help from the IRS

Ongoing Compliance

- Jeopardizing Exemption
  - Political Activities and Lobbying
  - Operating for Private Benefit
  - Private Foundation Excise Taxes
  - Tax on Net Investment Income
  - Self-Dealing
  - Failure to Distribute Income
  - Excess Business Holdings
  - Jeopardizing Investments
  - Taxable Expenditures
- Substantiation and Disclosure of Charitable Contributions
- Public Disclosure Requirements
- Help from the IRS

Significant Events

- Notifying the IRS of Material Changes
- Private Letter Rulings
- IRS Audits
- Termination of Private Foundation
- Help from the IRS

Internal Revenue Service
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Private Operating Foundations

Source: Publication 578, *Tax Information for Private Foundations and Foundation Managers*, p. 2

In general, a private operating foundation is a private foundation that devotes most of its resources to the active conduct of its exempt activities.

A private foundation may qualify for treatment as a private operating foundation. These foundations generally are still subject to the tax on net investment income and to the other requirements and restrictions that generally apply to private foundation activity. However, operating foundations are not subject to the excise tax on failure to distribute income. Also, contributions to private operating foundations described in section 4942(j)(3) are deductible by the donors to the extent of 50% of the donor's adjusted gross income, whereas contributions to all other private foundations (except those discussed under Private Passthrough Foundation) are generally limited to 30% of the donor's adjusted gross income. In addition, a private operating foundation may receive qualifying distributions from a private foundation if the private foundation does not control it.

Return to Life Cycle of a Private Foundation