

Overview of Private Foundations

The term "private foundation" describes a trust or corporation, created for exclusively charitable purposes, that qualifies as a tax-favored "501(c)(3) charitable organization." A private foundation is managed by trustees if it is a trust or a board of directors if it is a corporation (directors may be called trustees). The directors or trustees can be paid reasonable compensation for their services and reimbursed for reasonable expenses but, otherwise, they generally do not receive benefits from the foundation.

As indicated above, the creator of a private foundation can exercise substantial control over it, which is an important factor for many individuals with philanthropic interests. In addition, contributions to a private foundation qualify for gift tax deductions, estate tax deductions and income tax deductions. However, contributions to public charities, including churches and educational institutions, qualify for somewhat larger income tax benefits than do contributions to private foundations. Many donors, nevertheless, feel that the control they can exercise over a private foundation more than offsets the less favorable tax treatment that the foundation receives.

A 501(c)(3) charitable organization is treated as a private foundation unless it qualifies as a public charity under one of the following four exceptions:

1. Churches, schools, hospitals and certain organizations affiliated with churches, schools and hospitals; publicly supported organizations; and governmental units.
2. Organizations that receive more than one-third of their support from gifts, grants, contributions, membership fees (other than from disqualified persons) or receipts from related business activities.
3. Organizations that exist to carry out the purposes of one or more organizations in No. 1 or 2 above.
4. Organizations involved in testing for public safety.

Advantages of a Private Foundation

The primary advantage of a private foundation may be summarized in one word – control – control over the timing and amount of distributions, control over the identity of donees and control over investment management.

Distributions. Within relatively broad limits, the creator of a private foundation can control how the foundation's assets are distributed to charities so that they are consistent with the donor's charitable goals. In addition, future distributions will be governed by the terms of the document creating the foundation.

Compensation for Services. A private foundation can pay reasonable compensation to the donor and members of the donor's family who serve as directors, trustees or officers. Being able to compensate younger family members while they "learn the ropes" as directors, trustees or officers is particularly attractive to some donors, who are counting on the next generation to carry out their charitable wishes in the future. Documenting that the compensation paid to family members is reasonable is important to avoid being subject to penalty taxes.

Tax Deductions. Subject to the generally applicable percentage limitations on deductions, the donor is generally allowed an income tax charitable deduction based on the value of the qualified appreciated stock contributed to a private foundation. The income tax deduction for other types of property contributions is limited to the donor's

basis in such property. The excess value of a contribution over the amount that is deductible in the current year can be carried forward and deducted over the following five years. Unlimited gift and estate tax deductions are allowed for contributions to private foundations. Importantly, property that is transferred to a private foundation during the donor's lifetime is no longer included in the donor's gift and estate tax base.

Major Types of Private Foundations

A private foundation is generally either a "private nonoperating foundation" (also known as a "family foundation" or a "grant making foundation") or a "private operating foundation." There is a third type, a "conduit private foundation," but it is less common.

The most common type of private foundation is the "private nonoperating foundation," which is simply one that receives and holds property that will be used to make contributions to charities or make grants to individuals.

A "private operating foundation" engages in charitable activities itself rather than making contributions to other charities or grants to individuals. Private operating foundations are entitled to more favorable income tax rules relating to the deductibility of contributions.

The "conduit private foundation" must distribute all contributions in a given year within 2 1/2 months of the end of the conduit's tax year. Similar to a "private nonoperating foundation," it is governed by more favorable income tax rules relating to the deductibility of contributions.

Tax Deductions for Contributions to a Private Foundation

Gift and Estate Tax Deductions. Contributions to qualified charities, including private foundations, qualify for unlimited gift and estate tax deductions.

Income Tax Deductions. The rules regarding the income tax deductibility of contributions to private foundations are more complicated. In particular, the percentage limits that apply to contributions depend mainly on the nature of the private foundation and the character of the contributed property. The following limits apply to gifts to the two most common types of private foundations: cash gifts are deductible up to 30% of the donor's adjusted gross income; "qualified appreciated stock" gifts, that is, stock that yields capital gain upon sale and is traded on an established stock exchange, is subject to a 20% limit; other appreciated property gifts are generally deductible only to the extent of their cost basis. Lifetime gifts of cash or appreciated property in excess of the amount currently deductible can be carried over and deducted over five years following the gift. As noted earlier, deductions for contributions to public charities are subject to higher limits.

Special Rules Relating to Private Foundations

Some special rules apply to private foundations. Failure to comply with the rules can result in taxes and penalties for both the foundation and the foundation manager. The rules are:

Net Investment Income. A private foundation is subject to a 2% excise tax on its net investment income. This 2% excise tax can be reduced to 1% if the foundation increases its distributions sufficiently. This is the only excise tax that is not avoidable.

Self-Dealing. Donors and other disqualified persons are prohibited from engaging in any of the following activities:

1. selling, exchanging, or leasing property;
2. lending money or providing credit;
3. furnishing goods or services;
4. paying compensation or reimbursing expenses (except for a nonexcessive amount that is reasonable and necessary);
5. transferring foundation income or assets to or for the use of a "disqualified person;" and/or
6. furnishing foundation money or property to a government official.

In addition, taxes can be imposed on the "disqualified person" or foundation manager. The "disqualified person" is subject to an initial tax of 10%, which can be followed by a 200% additional tax if the self-dealing is not remedied in a timely manner. Foundation managers who knowingly engage in acts of self-dealing are subject to a tax of 5% (\$20,000 maximum per act of self-dealing), which can be followed by an additional tax of 50% if they do not correct the act (\$20,000 maximum per act of self-dealing).

Required Distributions. A private foundation that does not make the required minimum distributions by the end of the next year is subject to a 30% tax. The minimum amount is basically 5% of the private foundation's investment assets. This tax can increase to 100% if the income is not distributed by the date the tax is assessed or by the date the IRS issues a "90-day letter" warning.

Excess Business Holdings. A private foundation and disqualified person cannot own more than a 20% interest in a corporation or partnership (unless the private foundation's interest does not exceed 2% of the stock and value of the corporation). The ownership of a greater interest is an "excess business holding." A tax equal to 10% is imposed on the value of the excess holding. The tax can increase to 200% if the situation is not remedied. Other exceptions apply depending upon the percentage of voting stock owned by the foundation and the disqualified persons.

Jeopardy Investments. A private foundation that invests its income and funds in a way that jeopardizes the charitable purpose of that foundation is subject to an excise tax of 10% of the amount of the jeopardizing investment, which can be followed by a 25% additional tax if the jeopardizing investment is not corrected in a timely manner. The foundation manager may also be subjected to an excise tax equal to 10% of the amount of the jeopardizing investment (\$10,000 maximum). An additional excise tax of 5% may be imposed on foundation managers if the jeopardizing investment is not corrected in a timely manner (\$20,000 maximum).

Legislative Activities and Other Taxable Expenditures. A private foundation is prohibited from applying funds to legislative activities or political propaganda, grants to organizations other than public charities and private operating foundations, unless the foundation exercises expenditure responsibility and makes certain grants to individuals. A violation is subject to an excise tax of 20%. In addition, the foundation manager can be liable for an additional 5% (\$10,000 maximum). Additional taxes of 100% on the foundation and 50% on the manager (\$20,000 maximum) may be imposed when the expenditure is not corrected.

Creating a Private Foundation

The following steps are involved in creating a private foundation:

Step 1. Establish a nonprofit corporation or trust.

Step 2. Prepare a mission statement describing the activities the private foundation will conduct.

Step 3. Prepare a four-year financial projection.

Step 4. Consider the special rules that apply to private foundations, such as issues of self-dealing, excess business holdings and jeopardizing investments.

Step 5. File a Form 1023 with the IRS. The IRS must be notified that the corporation or trust is filing for tax-exempt status. This form must be filed within 27 months from the end of the month when the private foundation was organized.

Summary

Creating and funding a private foundation can offer very attractive benefits. Before doing so, however, an individual should give careful consideration to the pros and cons as well as to possible alternatives. Individuals with long-term charitable objectives should give careful consideration to the creation of a private foundation, particularly if he or she wishes to exert control over the charitable activity to fulfill a very specific intent and is willing to accept greater limits on income tax deductions and stringent limitations on the operation of the foundation.

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