Private Foundations

People give money and property to charity for a number of reasons. Among the most common are the following:

- To make a difference in the lives of others.
- The desire to help society by funding one or more worthy causes.
- To enjoy the income, gift, and estate tax benefits derived from charitable giving.

Despite these benefits, one concern a donor may have is the loss of control over money and property gifted to a charity. To meet this concern, a donor can create a private foundation that must distribute annually to charitable causes favored by the donor.[1]

What Is a Private Foundation?

A private foundation is a charitable organization created and funded by a donor (during life or at death) which is designed to achieve one or more specific charitable purposes. Overall management of the foundation is provided by a board of directors or trustees often selected by the donor. The directors or trustees can be paid reasonable compensation for their services.

Tax law describes a private foundation as a charitable organization exempt from income tax under IRC Sec. 501(c)(3) other than the following:

- Organizations that generally receive a substantial part of their support from the general public or from the government.
- Religious organizations.
- Educational institutions with regular learning facilities, a student body and a specific curriculum.
- Organizations devoted to promoting public safety.

In addition, a private foundation does not include any charitable organization which:

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[1] A private foundation serves not only to distribute funds to charity, but also to transmit the donor's name and personal values to succeeding generations.

- Receives more than one-third of its support from the sum total of gifts, grants, contributions, membership fees and receipts from a permissible business or activity; and/or,
- Receives one-third or less of its support each year from the sum of gross investment income and excess unrelated business income.

Choice of Entity

A private foundation can be structured as either a corporation or a trust. There are advantages to each type of arrangement:

- A corporation may be more flexible than a trust, to meet changing circumstances. Corporations operate through a board of directors and officers.
- Trustees may be held to a higher degree of responsibility than corporate officers, with respect to liability.
- It may be easier to establish a trust. A trust can be written to allow the donor to be more specific and restrictive; an important point if a donor wants to realize a tax deduction before a tax year closes.
- The filing requirements for a trust may be simpler than for a corporation, which could reduce administrative costs.

Tax Deduction for Contributions to a Private Foundation

Contributions to a private foundation are generally deductible as follows:

- Cash contributions are generally deductible up to 30% of a donor's adjusted gross income (AGI).
- Gifts of appreciated property are generally deductible up to 20% of a donor's AGI.
- Gifts of qualified appreciated stock are fully deductible up to fair market value. The deduction for full market value of qualified appreciated stock by one donor is limited to 10% of the stock of a corporation.
- All appreciated property (other than qualified stock) contributed by a donor during the donor's lifetime is deductible only up to cost basis.
- Testamentary (at death) bequests of cash and property are fully deductible from the decedent's estate.

- Lifetime gifts of cash or appreciated property, which exceed the applicable 20% or 30% of AGI limitation, can be carried forward for up to five years.

Note: The contribution and deduction limitations described above are unique to private foundations. Gifts to public charities are treated differently under federal tax law.

Special Rules for Private Foundations

Private foundations are subject to a variety of complex tax rules that must be carefully followed to avoid additional taxation and/or penalties. Some of the most important rules include:

- **Failure to distribute income:** If a private foundation fails to distribute its annual income by the end of the year, it is subject to a tax of 30% on the undistributed income. The 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 warning (90-day letter).
- **Self dealing:** An excise tax is triggered when a disqualified person[1] engages in any of the following activities:
  - Selling, exchanging or leasing property.
  - Lending money or providing credit.
  - Furnishing goods or services.
  - Paying compensation or reimbursing expenses.
  - Transferring foundation income or assets to or for the use of a disqualified person.
  - Furnishing foundation money or property to a government official.

  A disqualified person who conducts an act of self-dealing is subject to an initial penalty tax of 10% of the amount involved and a 200% additional tax if the self-dealing isn't corrected in a timely manner. Foundation managers who knowingly participate in acts of self-dealing are subject to a tax of 5% of the amount involved. If foundation managers fail to correct an act, an additional penalty of 50% may be imposed.

[1] Under current law, a disqualified person is an individual who is a substantial contributor to a foundation, a foundation manager, certain family members, related business entities, government officials, and others who may hold a fiduciary capacity with regard to the foundation. A disqualified person can be held liable for an excise tax even if a transaction was completed at arms length.

- **Excess business holdings:** A private foundation that possesses any excess business holdings is subject to a tax of 10%.
- **Bipartisan Budget Act of 2018:** One part of the Bipartisan Budget Act of 2018, signed into law on February 9, 2018, allows a private foundation to own an operating company, provided it owns 100% of the voting stock. All of the profits of the business must go to the private foundation, which will then distribute the funds to charity. In addition, the company must be independently operated – neither the donor nor the donor's family may be an officer or director of the company. The majority of the board of directors of the private foundation must be individuals who are **not** directors or officers of the business, nor members of the donor's family.
- **Net investment income:** A private foundation is liable for an excise tax of 1.39% on its net investment income.
- **Investment jeopardizes charitable purpose:** An excise tax of 10% is imposed if the foundation invests its income and funds in such a way that its charitable purpose is jeopardized.
- **Legislative activities:** An excise tax of 20% is imposed if funds are used for legislative activities or for engaging in propaganda. In addition, foundation managers who authorize such expenditures can be liable for an additional 5% tax.
- As an alternative, a prospective donor may wish to consider contributing to a Donor Advised Fund, a simpler and less expensive option.

Seek Professional Guidance

The rules for establishing and managing a private foundation are extensive and complex. The counsel and guidance of competent, experienced income tax and legal professionals is strongly recommended.

Disclosure Notice

The information that follows is intended to serve as a basis for further discussion with your financial, legal, tax and/or accounting advisors. It is not a substitute for competent advice from these advisors. The actual application of some of these concepts may be the practice of law and is the proper responsibility of your attorney. The application of other concepts may require the guidance of a tax or accounting advisor. The company or companies listed below are not authorized to practice law or to provide legal, tax, or accounting advice.

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