

Private Foundations

A Private Foundation is a charitable entity that is exempt from income tax under IRC § 501(c)(3). By establishing such a foundation, an individual (or family) can create a charitable legacy that can last for many generations.

Why establish a Private Foundation?

Private Foundations also offer an opportunity to introduce and/or involve family members in charitable activities. The founder of such an organization is able to educate younger generations as to the value of charitable giving and provide the means by which a family's charitable visions can grow.

Members of the family can serve on the board of directors of the foundation, thus helping to determine what programs the foundation will establish or which grants the foundation will make. It also allows the opportunity to oversee a younger generation's development of its own charitable traditions as the family grows and evolves.

When the founder is satisfied with the judgment and activities of the younger generation, he or she can pass control of the board to those individuals. Until that time, the founder can retain control.

By establishing a Private Foundation, the founder retains greater control over the contributed assets, and the charitable purposes to which they are applied, than if the assets were contributed to a public charity. For example, a Private Foundation can establish programs within the community for education, scholarships, the arts, etc., rather than merely making contributions to other charitable organizations.

This retained control also allows for considerable flexibility. Specifically, unless restrictions are placed within the original organizational documents, a Private Foundation can change the focus of its charitable activities as times change. Thus, if in the future the family decides that its charitable activities should focus upon a different area (*e.g.*, medical research as opposed to the arts) the board of the Private Foundation can vote upon and approve such a change.

An added benefit of a Private Foundation is that the assets in the foundation grow free of income tax since such foundations enjoy tax-exempt status (although, as noted below, an excise tax is imposed on certain investment income). This allows an even greater opportunity for charitable giving.

The Rules

While offering the above-described benefits, Private Foundations are subject to strict rules by the IRS. Following “the rules” is very important to the continuing tax-exempt status and integrity of a Private Foundation, but the benefits can far outweigh any burdens.

The following is a list of some of the more important rules imposed by the IRS, although this list is not meant to be exhaustive:

- **Prohibition on Self-Dealing:** No transactions can take place between the foundation and “disqualified persons” (the founder, family members, or entities in which the founder or family members own an interest, certain government officials, directors and officers of the foundation, etc.) even if such transactions ultimately benefit the foundation. Thus, for example, a disqualified person could not lease a building to his foundation even if the lease payments were equal to or even less than the fair market value. This rule is very easy to follow.

- **Ownership of Private Business:** a foundation can own no more than 20% of any active business (regardless of the form of the business). In calculating this 20%, all interests held by disqualified persons are considered to be held by the foundation. This rule is also very easy to follow since most Private Foundations are not in the business of owning active businesses.

- **Jeopardizing Investments:** The foundation’s investment of assets is limited so that no speculative investments may be made. Prudent investment should be an important goal for a Private Foundation, in any event, so this rule should not be difficult to follow.

- **Minimum Distribution Requirements:** A Private Foundation must distribute at least 5% of its asset value in the form of “qualifying distributions” each year. This prevents Private Foundations from holding their assets indefinitely, without fulfilling their charitable purpose.

- **Certain Expenditures Prohibited:** No funds of the Private Foundation can be distributed for anything other than charitable purposes and the Private Foundation may not participate at all in any political campaigning or lobbying.

- **Tax on Investment Income:** A Private Foundation is subjected to a 1% or 2% tax on its net investment income (depending upon the particular situation).

- **Unrelated Business Taxable Income:** Income earned by activities not related to the foundation’s charitable purpose are not exempt from tax. Specifically exempted from the definition of unrelated business taxable income are items such as interest, dividends,

certain rents, royalties, and capital gains. Generally, a Private Foundation will not be engaging in activities not related to their charitable purpose.

• **Private Inurement:** The founder and family members may not receive any benefit from the foundation other than reasonable compensation for services performed (e.g., services performed as a member of the board of directors).

As you can see, while the IRS has many rules governing the activities of a Private Foundation, they are generally not difficult to follow. Also, although a Private Foundation is tax exempt, informational tax returns and forms must still be filed each year. In addition, the foundation's application for tax exempt status as well as its annual informational returns must be available to the public for review upon reasonable request.

Private foundations are also required to register with the Office of the State Attorney General. This is a relatively simple procedure.

The Charitable Deduction

Deductions for contributions of cash to a Private Foundation are limited to a maximum of 30% of the donor's "contribution base." A taxpayer's "contribution base" is defined as adjusted gross income, computed without regard to any net operating loss carryback to the taxable year.

Contributions to a Private Foundation of assets other than cash are limited to a maximum of 20% of the donor's contribution base and the deductible amount, in most instances, will be limited to the donor's cost basis (as opposed to the fair market value of the property contributed). An exception to this rule, however, allows a deduction for the full fair market value of "qualified appreciated stock." In general, "qualified appreciated stock" is long-term capital stock of a publicly-traded company of which the donor (and family members) has not contributed more than 10% (cumulatively) of the value of the company to private foundations.¹

If the donor is not able to use the entire amount of his or her charitable deduction, it may be carried over for five years.

While contributions of cash to public charities are deductible to the extent of 50% of the donor's contribution base (contributions of other assets may be limited to 30% of the contribution base), the donor retains no control over the contributed assets.

¹ It should be noted, however, that California will allow a deduction only for the basis of such property (as well as for any other long-term capital gain property) and does not exclude the gain on appreciated property from its calculation of alternative minimum tax.

The Structure of a Foundation

A Private Foundation is usually structured as a Non-Profit Public Benefit Corporation since this form of business allows the most flexibility for the foundation's operation. Using a corporation can also protect the board members and officers from liabilities incurred by the Private Foundation.

The governing body of such a Non-Profit Public Benefit Corporation is the Board of Directors, which operates pursuant to the Articles of Incorporation and the Bylaws of the foundation. The Board can be self-perpetuating in that it can choose its own successors.

While the requirements for various organizations differ, the boards of most Private Foundations meet at least once a year.

Both the officers and directors have a fiduciary responsibility to the foundation and must operate the foundation in a manner that is consistent with the foundation's stated charitable purposes. In addition, transactions between the foundation and board members or officers are subject to strict self-dealing rules.

Conclusion

A Private Foundation can be a wonderful legacy for its founder and an inspiration for his or her family to continue his or her philanthropic goals. It is typically used where relatively large sums are being or will be transferred to it. There are also other methods of creating funds for charitable purposes, some of which may be just as effective in meeting your goals and less time consuming to manage. If you are interested in charitable planning, you should contact Roberta Repasy of our firm, who can help review the options available to you and, if appropriate, assist you in setting up your own Private Foundation.



[Click the back button on your browser to return to the Miller, Monson, Peshel, Polacek & Hoshaw web site.](#)