PRIVATE FOUNDATIONS

Illinois State Bar Association
Trust & Estate Section
Charitable Planning: Techniques to Help Your Clients

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I. Introduction

Private Foundations are used for families who want to support charitable activities with greater flexibility than outright contributions to public charities and are very often a useful entity for creating a permanent charitable endowment.

II. The 1969 Tax Reform Act

A. Prior to 1070. Before the 1969 Tax Reform Act, foundations were very often used because of their many tax planning possibilities. Donors could receive a current income tax deduction; deductions were available for contributions of closely-held stock; money could be borrowed by the donor from the foundation without adequate security; and foundations were not required to make ongoing distributions to charity.

B. Since 1970. Initially there was a decline in the number of private foundations created because of increased regulation and decreased deductibility of gifts to private foundations. Also, there is the availability of other charitable alternatives, including community foundations, split interest trusts, and supporting organizations. Nevertheless, after 40 years private foundations have continued to grow with as much as $250 billion held for charitable activities.

III. Tax Laws

The 1969 Tax Reform Act substantially changed the tax laws governing charitable contributions and charitable organizations particularly private foundations which became subjected to a variety of rules.

A. Description. A private foundation is a tax-exempt charitable organization described in Section Internal Revenue Code (IRC) 501(c)(3), which is not:

1. So-called 50% organizations such as churches, schools, and hospitals, IRC Section 509(a)(1);

2. Publicly-supported organizations which meet the objective tests as to their support sources and which have limited endowment income, IRC Section 509(a)(2); and
3. Supporting organizations that exist solely to support one or more organizations that are public charities, IRC Section 509(a)(3).

B. Charitable Contributions

1. Cash Gifts. Generally, an individual donor can deduct a cash gift to a public charity provided the cash gift does not exceed 50% of the donor's adjusted gross income (AGI). IRC Section 170(b)(1)(A). However, for cash gifts to private foundations the limitation is 30% of the donor's AGI. IRC Section 170(b)(1)(B).

2. Gifts of Capital Gain Property. Capital gain property is any capital asset the sale of which at its fair market value at the time of gift would have resulted in long-term capital gain. IRC Section 170(b)(1)(C)(iv). Long term capital gain is defined as an asset held more than one year. IRC Section 1222. Generally a gift of such property to a public charity is limited to 30% of the donor's AGI. However, a deduction for contributions of capital gain property to a private foundation is limited to 20% of the donor's AGI. IRC Section 170(b)(1)(D).

    a. Special Rules for Private Foundations. Generally the contribution deduction is further limited to the donor's tax basis. IRC Section 170(e)(1)(B)(ii). However, an exception applies for gifts of "qualified appreciated stock," stock for which market quotations are readily available on an established securities market. The value of such gifts for purposes of a charitable contribution deduction is the full fair market value of the stock, not just the donor's basis in the stock. IRC Section 170(e)(5).

    b. Limitations for Gifts of Ordinary Income Property. The amount of the charitable deduction for gifts of property, the sale or exchange of which would not be a long-term capital gain, is reduced by the amount of the non- long-term gain. IRC Section 170(e). Ordinary income property includes inventory, crops, dealer property, and works created by the donor.

3. Hierarchy for Deductibility. A hierarchy is imposed when determining the application of the various contribution limitations as follows:

    a. Cash gifts to public charities.

    b. Cash gifts to private foundations.

    c. Gifts of 30% capital gain property.

    d. Gifts of 20% capital gain property.

4. Five Year Carryover. For gifts that exceed these contributions limitations, there is a five year carryover period for future deductibility. Carryover gifts are only after the current year gifts. IRC Section 170(d)(1).

5. Limitations on Corporate Gifts. Contributions by corporations are limited to 10% of the corporation's taxable income, computed without regard to its net operating loss carry back. IRC Section 170(b)(2).

6. Transfer Tax Advantages. Unlike income taxes, there are no limitations on how much can be deducted for transfer tax purposes. An unlimited deduction makes it possible to avoid the dilution of a family's wealth through estate taxes.

C. Reporting Requirements. Private foundations file Form 990-PF, an extensive annual information return with the Internal Revenue Service (IRS). In addition, the annual return must be filed with the appropriate state officials and made available to the general public at the foundation's principal office.

1. Failure to file the Form 990-PF return may result in a penalty of $20 per day up to a maximum of $10,000. If the return is not filed, the IRS can make written demand upon the organization and a manager failing to comply with such a demand will incur a separate $10 per day penalty up to a maximum of $5,000. An additional $20 per day penalty up to a maximum of $10,000 can be assessed if the foundation fails to make its return available for public inspection.

2. In addition, there may be criminal liability applicable to a false or fraudulent private foundation return.

D. Excise Tax Rules. In addition to the limitations on deductibility, private foundations are subject to a series of excise taxes. Except for the tax on net investment income, each of the excise tax penalties provides for a two-level tax structure. An initial tax is imposed at a relatively low level, followed by a more severe second-level tax which applies if the foundation fails to "correct" the violation which gives rise to the initial liability. In addition, IRC Section 6684 imposes a penalty equal to the applicable tax if the person liable has previously been liable for such excise tax, or if the transgression is both willful and flagrant; effectively doubling the applicable penalty.

1. Excise Tax on Acts of Self-Dealing. Self-dealings between the foundation and its substantial contributors, foundation officials, and related persons, all called "disqualified persons" are prohibited as provided in IRC Section 4941.

    a. The prohibition on self-dealing can create unexpected difficulties. The prohibition is absolute, and the IRS is without equitable authority to excuse harmless violations. Examples of prohibited transactions are selling or leasing

    of property or making of loans between the private foundation and a disqualified person.

    b. Initially the tax is 10% on the self-dealer and 5% on a foundation manager who knowingly participates in the self-dealing. If the self-dealing is not corrected within the taxable period the tax on the disqualified person increases to 200% of the amount.

2. Excise Tax on Failures to Make Minimum Distributions. The minimum distribution is equal to 5 % of the value of the assets determined as of the previous year end. IRC Section 4942. The excise tax penalty is 30% of the undistributed amount at the beginning of the next year and, if the distribution deficiency is not corrected within the taxable period, the penalty increases to 100%. However, a foundation can treat amounts set aside for a specified charitable project as having been distributed, even though payment is not made until a later year.

    a. Advance IRS approval of the project is required. IRC Section 4942(g)(2)(B).

    b. Set asides typically are used for construction projects and comparable undertakings of a magnitude requiring the accumulation of private foundation funds.

    c. Set asides allow donors and managers to undertake larger projects.

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3. Tax on Excess Business Holdings. The prohibition on excess business holdings is designed to restrict foundation involvement in the ownership and operation of businesses. While this prohibition may be simple in concept, IRC Section 4943 is an intricate statute. In general, it is best to avoid contributions of business interests.

    a. Generally, holdings are excess business holdings if disqualified persons own 20% or more of the voting stock of an incorporated business and the private foundation owns at least 2%.

    b. There is a two-tier tax of 10% or if not corrected 200%.

4. Investment Jeopardizing Exempt Purpose. There is a tax on investments which jeopardize the foundation's exempt purpose under IRC Section 4944. Jeopardy investments include for example trading securities on margin, trading in commodity futures, short selling, and buying

puts, calls, straddles, or warranties. The tax is 10% or if not corrected 25% on the foundation. The tax is 10% for a foundation manager who knowingly participates.

5. Lobbying and Other Prohibited Expenditures. The tax on expenditures for noncharitable purposes include expenditures for lobbying and propagandizing, influencing elections or conducting voter education, making grants to certain individuals unless approved by the IRS in advance, grants to organizations other than public charities unless the foundation monitors grantee's use, and making grants for noncharitable purposes under IRC Section 4945. The tax is 20% or if not corrected 100% on the foundation and 5% or if not corrected 50% on foundation manager who knowingly participates.

6. Tax on Investment Income. The tax on investment income is 2% under IRC Section 4940. It can be reduced to 1%, but not if the foundation was liable for tax for failure to distribute income under IRC Section 4942 during the 5 preceding tax years.

E. Tax on Termination of the Foundation. The tax equals the aggregate benefits of the foundation's exempt status or the net value of its assets under IRC Section 507(c) but can be avoided in several ways. If the foundation continues in existence, it may transform itself into a public charity and operate as such for at least five years. Alternatively, the foundation can terminate and transfer all of its net assets to any public charity which has been a public charity for at least five years. In addition, mergers or comparable combinations between private foundations are permitted.

IV. Nontax Benefits. A private foundation can enhance a family's giving program by creating an independent yet formal structure for giving. In addition, the foundation can be the vehicle for a critical mass of assets to perpetrate a family's giving endeavors and preserve family wealth. Finally, a donor can control and defer the timing of giving while currently deducting contributions to the family's private foundation.

A. Cost Considerations. The creation of a foundation entity involves some expense, as does its ongoing administration, maintenance of its investment portfolio, and the filing of annual reports and tax returns.

B. Intangible Considerations. By creating private foundations, families have a way of giving back to the community the family’s surplus wealth or social venture capital. Private foundations are an effective way for family members to prefund charitable gifts for future generations of family members to stay involved in giving back to the community. Private foundations can insulate family members from grant seekers and in some cases memorialize the donor’s values. Private foundations can be effective investments for change by being close to the needs of the community and having the ability to move quickly.

V. Estate Planning Aspects

A. Use with a Charitable Lead Trust. A family that has sufficient wealth to create a family foundation may consider using one or more charitable lead trusts to minimize transfer taxes on large transfers to younger generations. By directing the ongoing charitable distributions to a family foundation, the tax-saving characteristics of the lead trust are obtained, and the amounts distributed are paid to the foundation, where family members are able to influence, if not control, their ultimate application.

1. Minimum Distribution Requirement. The regulations under Treasury Registration (Treas. Regs.) Section 53.4942(a)-2(c)(2)(iii), take the position that a private foundation that is the beneficiary of a charitable lead trust must take into account as part of the foundation's minimum distribution, the lesser of the income distributions from the lead trust or five percent

of the trust assets. However, these Treas. Regs. were held invalid in Ann Jackson Family Foundation v. Comr., 15 F.3d 917 (9th Cir. 1994), affg. 97 T.C. 534 (1991) (reviewed) where a private foundation did not take into account the assets of the trust or the annuity distributions received from the trust in determining its minimum investment return.

2. Estate Tax Treatment of Foundation. Charitable lead trusts that make payments to a foundation in which the creator of the trust has an influential role can be problematic. In Rev. Rul. 72-552, 1972-2 C.B. 525, the IRS held that the value of property transferred to a foundation was included in the donor's estate under section 2036 because the donor/decedent, in his capacity as a member, director and president of the foundation, had the power to direct the disposition of its funds for charitable purposes. Similarly, in PLR '7929002 this same rule was applied to a decedent who held multiple fiduciary positions in an organization to which the income from a trust he had created was paid. In Rifkind v. U.S., 5 Cl. Ct. 362 (1984), a foundation was the sole beneficiary of a lead trust and its senior in his role as an officer, member and director of the foundation, was able to designate or at least participate in designating the recipients of foundation grants. The court found section 2036(a)(2) applicable, so the lead trust was taxable in his estate.

B. Use with a Charitable Remainder Trust. If the trust instrument requires that the remainder beneficiary be an organization described in IRC Section 170(b)(1)(A), a private foundation cannot receive the remainder interest. If the trust's remainder beneficiary is a private foundation the donor's income tax charitable deduction for the transfer to the trust will be subject to the lower percentage limitations applicable to contributions to private foundations. For purposes of the foundation's minimum distribution requirement, the foundation's future interest in the charitable remainder trust will not be taken into account until all intervening interests in the trust have expired. See Treas. Regs. Section 53.4942(a)-2(c)(2)(i).

C. The Stand-By Foundation. A foundation can be created with only modest current funding and an expectancy that, if the foundation works as anticipated it will receive major testamentary transfers at a later date from one or more family members. On the other hand, lifetime funding can produce a "double" deduction. While the assets used to fund the foundation are removed from the donor's taxable estate, they also may qualify for a current income tax deduction. The stand-by foundation also can be planned as a taker in default in the event one or more beneficiaries disclaim part or all of their interests in an estate or trust.

VI. Special Foundations

A. Conduits. Organizations which pay out all of their contributions within 2-1/2 months after the year received, plus all of their income, are private foundations but are not subject to the income tax deduction limitations on gifts to private foundations. IRC Section 170(b)(1)(F)(ii). This status is often used to help correct an unplanned situation.

B. Operating Foundations. Operating foundations are exempt from the income tax deduction limits. Typically, an operating foundation uses its funds in its own operations. IRC Sections 170(b)(1)(F)(i); 4942(j)(3).

1. An operating foundation must distribute 85% or more of its adjusted net income each year for qualified charitable purposes, or make qualifying distributions of at least 2/3rds of its minimum investment return directly for the active conduct of its exempt purpose; or

2. Substantially all of its support, other than investment income, must come from 5 or more unrelated exempt organizations, with not more than 25% of its support from one or more such organizations, and not more than 50% from gross investment income.

3. Uses.

a. Usually museums and similar institutions are set up as operating foundations, with a building to maintain and a collection to administer. Donors must separate themselves from the administration of the collection. Failure to do so is self-dealing.

b. Operating foundations may serve as income beneficiary of charitable income trust, enabling donor's family to decide how to use the income. Such trust is exempt from the minimum distribution requirements of IRC Section 4942.

VII. Alternatives to Private Foundations. The maximum deductible contributions are available for contributions to donor advised funds and supporting organizations.

A. Donor Advised Funds. Donor Advised Funds are created by public charities as to which advice or recommendations concerning distributions are made by a donor contributing to the fund. The fund must be operated as a "component fund" of the public charity to avoid being treated as a private foundation. Although the donor or person designated may make recommendations as to distributions, the public charity must have ultimate control over decisions concerning distributions. The regulations contain guidelines for determining whether an advised fund is a "component part." Treas. Regs. Sections 1.170A-9(e)(11), 1.507-2(a)(8)(iv)(A)(2) and (3).

B. Supporting Organizations. A supporting organization is a public charity by reason of its relationship to one or more public charities that it supports. Examples are religious organizations connected with churches, trusts organized and operated for the benefit of a school, and organizations controlled by, or operated in connection with a public charity. Under IRC Section 509(a)(3), there are three separate requirements all of which must be satisfied.

1. Be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more specified public charities;

2. Be operated, supervised, or controlled by, or in connection with, one or more public charities; and

3. Not be controlled directly or indirectly by one or more disqualified persons.

There are potential advantages of a supporting organization over a private foundation.

1. No 2 % excise tax on the investment income of a supporting organization.

2. Contributions of any type of long-term appreciated property to a supporting organization, including closely held stock, are deductible to the extent of 30% of the donor's "contribution base."

3. Contributions of cash to a supporting organization are deductible to the extent of 50% of the donor's contribution base.

4. A supporting organization can hold a significant interest in any business, including the donor's business.

5. Transactions between the supporting organization and the donor or related parties are permissible, provided that transactions are at arm's length and are reasonable. For example, stock owned by a supporting organization may be redeemed by a corporation controlled by the donor, a supporting organization may purchase stock from the donor's estate, and may sell stock to members of the donor's family.

6. The costs of operating a supporting organization may be reduced when one or more public

charities assume administrative responsibility for its operation.

7. Restrictions on a supporting organization's investment activities are less stringent than those applicable to a private foundation.

8. A supporting organization controlled by one or more public charities may accumulate income for a reasonable period for future charitable projects; there are no specific annual payout requirements except as provided in paragraph 10 below.

9. Participation of the representatives of the supported public charities on the board of a supporting organization helps to assure continuity and operation in a consistent manner and helps to provide guidance to younger generation members of the donor's family who become members of the board.

10. The IRS issued proposed regulations (Reg-155929-06) on September 24, 2009. It covers supporting organizations that are <u>not</u> in a comparable corporate parent-subsidiary relationship or a corporate brother-sister relationship. When these proposed regulations are issued temporary or final supporting organizations not described above will have additional requirements to meet including a functionally integrated test. If the functionally integrated list is not meet, the supporting organizations will have a 5% payout requirement similar to private foundations.

VIII. <u>Conclusion.</u> Private foundations will continue to have a viable role in the charitable arena even though the excise tax rules and reporting rules add to the cost of a private foundation. If desired, there are professional and service organizations that will do all the paperwork to maintain private foundation’s tax and entity status. This allows for directors of the private foundations to focus on the charity needs of the community through its grant making.