

## **The Foundation of Philanthropy**

### **Private Foundation Primer**

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#### **What is a Private Foundation?**

From a broad perspective, private foundations are a unique method for individuals, or even businesses, to implement long-term philanthropic goals. Foundations can benefit a region, support a cause, or a specific group of other charities. Foundations can be established in a manner that encourages philanthropy or fosters responsibility in younger generations. And, from a financial standpoint, foundations can provide beneficial tax strategies for various types of estate or wealth planning vehicles.

In a formal legal and structural context, a private foundation (or “family foundation”) is a non-profit, non-governmental organization created for one or more of a number of broad purposes identified in the Internal Revenue Code. These are listed under section 501(c)(3) of the IRC as follows: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, and preventing cruelty to children or animals. Private foundations are often perpetual and generally funded by a single source, such as a family, a corporation, or an individual.

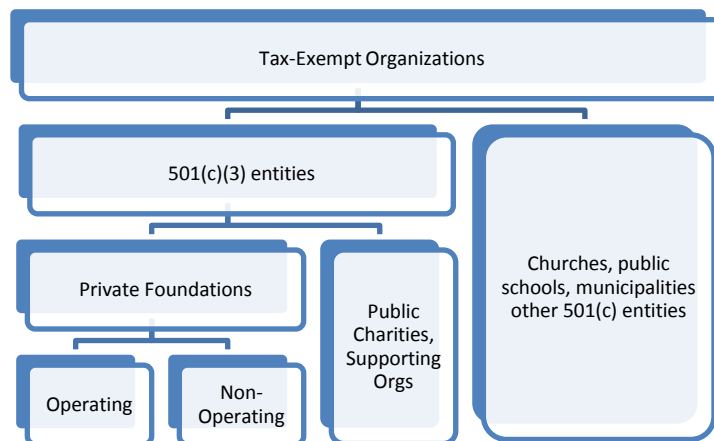
Use of the term “nonprofit organization” can be misleading. This is because there is a large variety in the types of nonprofit (or tax-exempt) organizations. Generally, the term “charity” is used to describe those nonprofits (including private foundations) that are organized for one of the purposes under section 501(c)(3) listed above. The “other” nonprofits are typically organized for other purposes, and are organized under different statutory provisions. These include, for example, civic or business leagues and social organizations and are not private foundations.

The term “foundation” by itself can also be misleading, because it is frequently used in different contexts. An organization created under section

501(c)(3) is considered to be a “private foundation” unless it meets a definition for one of several other types of charities, including community foundations, public charities, and supporting organizations.<sup>1</sup> Sometimes, the term “public foundation” is used to describe these other 501(c)(3) organizations, in contrast with private or family foundation. Although there are several distinguishing factors, one rule of thumb that may help draw a line between a private foundation and a public charity is the source of funding. If a charity receives substantial support from the public or the government, then it is likely classified as a public charity (or “public foundation”). If a single source provides more than half of the support for an organization, it is likely a private foundation. This will not always be true, but may provide a general distinction between a “public” foundation or charity and private foundation.

Nothing is, of course, very simple. There are two subcategories of private foundations: “operating” and “non-operating.” A private “operating” foundation is one that operates its own program, perhaps a museum. Generally, one might think of a museum as a public charity, but there may be reasons why it is not classified as such (for example, by not generating enough “public support”). A private “non-operating” foundation, the most common type, typically distributes funds to other charities or causes, usually through grants.

That seems like a maze of distinction and definitions. Here is a picture to help distinguish private foundations for other non-profits.



<sup>1</sup> Other entities that are defined as public charities, and not private foundations, are organizations defined in section 170(b) of the Internal Revenue Code, **including** municipalities and churches.

## Formation of a Private Foundation

Some people are surprised to learn that private foundations can be created either under a trust instrument or under articles of incorporation. Whether a trust or articles of incorporation, the governing document is simply a legal formality that establishes the framework under which the private foundation operates, both administratively as well as substantively. The form of the document does not necessarily determine whether an organization is a private foundation or a public charity. This document is what legally creates the entity for purposes of state law.

Because the governing document incorporates the substantive purpose of the private foundation, one of the first steps in creating the organization is to try and determine the charitable scope of the foundation's activity. Generally this is accomplished through a mission statement. If the founding donors are unable to agree on a specific purpose, practitioners will sometimes draw up broad charitable purposes in the governing document, but then create a method for a board or committee or other decision-maker to tailor the foundation's focus as community needs develop. All of this requires careful drafting and discussion with the foundation's legal and tax advisors.

Once the governing instruments are drafted and executed, and the foundation is created under state law, then the Application for Tax Exempt Status (either Form 1023 or 1024) is filed. This document is the application to the IRS for tax-exempt status under federal law: the 1023 is for entities seeking status under 501(c)(3) and the 1024 is for entities seeking tax-exempt status under other code provisions.<sup>2</sup> This form requires extensive information on the purpose of the organization, donors, funding, assets and procedures that will govern the entity. The IRS then reviews the application and, sometimes,

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<sup>2</sup> Some states may have filing requirements, in addition to the articles of incorporation, but these do not supersede IRS filing requirements or the authority of the IRS to recognize an organization as tax exempt under the U.S. Internal Revenue Code. Any state requirements are beyond the scope of this discussion.

engages in a written dialogue with the future entity, requesting additional information. Once this process is complete, the IRS then issues a Determination Letter that indicates how an organization is classified.<sup>3</sup> This letter is phrased in terms of a ruling that an organization “is” or “is not” a private foundation. If the organization “is not a private foundation” but is considered another type of tax-exempt organization, the letter will indicate what organization has been created (i.e., a supporting organization, etc).

This letter is an important document for the charitable organization, because it is the sole document that grants tax-exempt status under the Internal Revenue Code. Thus, the 1023 should be drafted with care, and should not substantively conflict with the organization’s governing documents under state law.

## **Private Foundation Administration**

Entire treatises are written on private foundation governance and administration, which is why many foundations work closely with their tax advisors and other consultants. Given the unique nature of foundations and the close relationship many have with the family of the original donor, a number of rules have developed that apply solely to foundations to ensure that these entities are used for charitable purposes and not as tax shelters. A few key distinguishing rules are briefly discussed here, to give an overview of what is expected of private foundations.

### 1. Required Minimum Distribution

One of the most commonly known, yet often misinterpreted rules, is the Required Minimum Distribution (“RMD”). Sometimes referred to as the “five percent rule,” private foundations must pay out a certain percentage of non-charitable assets each year in the form of qualifying distributions. Because the calculation used to determine the “RMD” incorporates a number of variables, a

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<sup>3</sup> This is not the same letter used by the IRS to assign a tax identification number.

generic reference to “five percent” can be misleading and thus requires a little bit of understanding.

The RMD is calculated when a foundation’s tax return is prepared. So, on the 2007 tax return, a line item will provide the minimum amount that must be paid out in 2008. This calculation starts with 5% of the monthly average of the foundation’s assets over the prior tax year. Foundations that do not expect additional contributions may balk at such a figure, when trying to target an investment return sufficient to keep pace with inflation over time. Fortunately, in reaching the actual required minimum, a number of other factors are considered, including a portion of expenses paid and a five-year history of distributions. These factors help a foundation satisfy its annual payout requirements. Thus, the RMD that a foundation must distribute to other charities is generally less than a true five percent.

If a foundation fails to distribute the RMD in a given year, the foundation is subject to a penalty excise tax. Under current law, this tax is 30% of the undistributed amount. If this same amount is not paid out within the next year, then the penalty increases to 100% of the undistributed amount. Quite simply, the goal of these high penalties is to ensure that the foundation’s assets are, in fact, used for charitable purposes. To further ensure this goal is met, states have language that requires fiduciaries to avoid any penalty taxes imposed by failure to pay out the RMD. This means that a foundation which fails to meet its RMD violates both federal and state law.

How does a foundation satisfy payment of the RMD? Quite simply. The foundation must make qualifying distributions that equal the amount of the RMD. “Qualifying distributions” generally include:

- a) direct expenditures for charitable purposes
- b) accounting, legal fees and other administration expenses, and
- c) amounts paid to acquire assets used directly in carrying out the foundation’s charitable purposes.

The most efficient method to make a qualifying distribution is pay grants to another qualified public charity. Distributions to other organizations or

individuals, for proper educational, scientific or charitable purposes, may also qualify; however, these distributions require “expenditure responsibility” by the foundation. This is a technical term to describe the additional documentation and tax reporting that a foundation must perform to ensure that the funds are used for appropriate, qualified purposes. Generally, this results in additional work on the annual tax return that not all foundations are willing to incur.

## 2. Self-Dealing

Another rule that impacts foundation operation is the prohibition on self-dealing. This rule prohibits certain transactions between a foundation and “disqualified persons.” Disqualified persons in the most basic sense include a substantial contributor to a foundation; a foundation manager; or an immediate family member of either of these. This is not an exhaustive list, and the Internal Revenue Code also defines a number of other entities and individuals as a “disqualified person” by virtue of circumstances or relationships based upon the amount of control by a disqualified person. For example, a partnership in which a disqualified person owns more than 35% of the combined voting power is also a “disqualified person” with respect to the private foundation.

These rules were initially designed to ensure that charitable assets are indeed use for charitable purposes and not a tax-shelter for the family or individual who created the foundation. Examples of prohibited transactions are broad, and include: the sale, exchange, or lease of property; extension of credit; provision of goods, services, or facilities to or from a disqualified person; and the transfer of any foundation income or assets to the disqualified person. There are carefully crafted exceptions to these broad prohibitions, such as payment of reasonable compensation for services rendered to the foundation. However, any time a potentially disqualified person interacts with a foundation, a tax advisor should be consulted to ascertain whether or not one of the prohibited transactions is invoked.

The tax return requires reporting on various types of transactions between disqualified individuals and the foundation, in efforts to identify

violations of this rule. When a prohibited transaction takes place, the funds must be returned to the foundation. Additionally, a penalty tax is imposed on both the disqualified person and any foundation executives who approved of the transaction.

Many states have enacted language around self-dealing as well. Thus, in some states, a violation of the prohibitions against self-dealing under federal law will also result in a violation of state law.

### 3. Other Rules of the Road – Excise Tax, Unrelated Business Income

All of the complex nuances of private foundation administration and governance cannot be adequately captured in an introductory summary. However, there are two other points that can be addressed briefly.

A private foundation is not completely exempt from taxation, but pays a 2% excise tax on “net investment income.” Depending upon how much the foundation distributes in the form of qualifying distributions, this tax can be reduced to 1%. Questions around this calculation, what it includes, and how to reduce the tax rate should be directed to the foundation’s tax advisor.

“Unrelated business income” may arise periodically with private foundations. This type of income is distinguished from “net investment income” and is subject to higher tax rates, rather than the reduced excise tax rate. Unrelated business income may arise in two difference situations:

- a) Income from a regularly conducted trade or business not substantially related to the foundation’s exempt function.
- b) Income incurred from debt-financed property.

Income from property financed with debt may include rental income from mortgaged property. Although there are exceptions to these rules, various other circumstances arise where, under the Treasury Regulations, income is defined as “unrelated business income” thereby invoking the higher tax rates.

The rules on unrelated business income do not preclude this type of income in private foundations, but subject it to higher tax rates. Thus, these rules are important to keep in mind so that the foundation can have an

accurate assessment and expectation of not only its investment activity but also the potential returns it faces, particularly when considering “alternative” investments. Foundation executives that ordinarily expect the organization to pay 1-2% in excise taxes on investment income may not welcome the surprise of “unrelated business income” resulting in higher tax rates on the income and, effectively, a lower yield on foundation investments.

### **Concluding Remarks**

Establishing a private foundation is a noble goal that can be very rewarding for all who are involved. With this opportunity comes accountability, as well, to ensure that the foundation is used for proper charitable purposes. Although assets owned by a foundation are legally no longer owned by the donor, these formalities do not unwind the very real heart-strings between the foundation and the donor and, usually, the donor’s family. Because of the unique relationship between donors and private foundations, whether making qualifying distributions or investment decisions, foundation executives sometimes face a challenging role. Fortunately, however, there are trusted, experienced advisors who are able to assist foundations in all aspects of management and administration.

For questions on how JB & CO PHILANTHROPIC ADVISORS, LLC, may partner with your team to assist you, please visit [www.JBPhilanthropicAdvisors.com](http://www.JBPhilanthropicAdvisors.com).

#### IRS Tax Advice Disclosure

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