



## PRIVATE FOUNDATIONS

### What Is a Private Foundation?

A private foundation is an organization established exclusively for charitable, educational, or religious purposes which fails to qualify as a public charity, generally because it lacks sufficient ongoing financial support from the general public. Usually, a private foundation is controlled by a small group of individuals or a family who constitute its major contributors.

A private foundation is either a corporation or a charitable trust. The corporate form is more flexible, imposes a less stringent standard of care on its directors, and provides statutory protection for its officers and directors. The formation of the organization is governed by state law, but its status as a private foundation is controlled by federal tax law.

### Advantages

There are both tangible and intangible advantages of private foundations. The tangible advantages relate to income, gift, and estate taxes and to investment control.

- Gifts of cash are fully deductible for income tax purposes.
- Gifts of most publicly traded stock are fully deductible at fair market value.
- All gifts are fully deductible for federal gift and estate tax purposes.
- Managers are free to pursue any reasonably prudent investment strategy. Public charities typically will not accept and retain assets that have limited marketability or difficult management issues.

Intangible benefits are more personal to the individuals or families who create their private foundations.

- The donors or family managers may plan and schedule charitable giving. Foundation managers usually know near the beginning of the year approximately how much the foundation must distribute that year. The foundation can then clarify and prioritize its goals and objectives.
- The donors or the family managers establish their own grantmaking guidelines and delineate particular areas of interest.

- A foundation can help cement family ties and carry on family traditions. Family members can come together to share their philanthropic interests and goals.
- A foundation can provide recognition and allow perpetuation of the family name. Alternatively, a foundation can provide anonymity in giving.

## Disadvantages

There are some disadvantages that are peculiar to private foundations:

- The amount of a deduction for a gift of appreciated property to a public charity is usually the fair market value of the property. However, with exception of publicly traded stock, appreciated assets contributed to a private foundation will result in a deduction at cost basis. This difference may be very significant for owners of a family business who intend to contribute interests in the business.
- A private foundation is more limited than a public charity in the ways it may make grants. Unless the private foundation grant is made to a public charity, the foundation must undertake fairly onerous “expenditure responsibility,” including formal pre-grant inquiry and record keeping.
- A foundation must estimate and pay a tax of 2 percent of its net investment income. The tax may be reduced to 1 percent if the foundation expends a large enough amount for charitable purposes. Net investment income includes dividends, interest and capital gains, less the expenses directly related to the production of such income.

## IRS Limitations

Because contributors to a private foundation, or their family members, often manage the foundation themselves, private foundations activities are strictly regulated. Some of the most important restrictions are as follows:

1. **No Self-Dealing.** With very few exceptions, a foundation may not sell, exchange, or lease real property, lend money or extend credit, or furnish goods, services or facilities to or with “disqualified persons.” The fairness of the transaction or adequacy of consideration received by the foundation is no defense. Generally, a “disqualified person” is a substantial contributor, foundation manager, family member or related business.

2. **Excess Business Holdings.** A private foundation and its disqualified persons may not hold more than a 20 percent interest in any active business without incurring an excise tax. Thus, if disqualified persons own 12 percent of a corporation’s stock, the foundation can only own 8 percent. An exception to this prohibition permits a family foundation to own up to 2 percent of the voting stock and 2 percent of the value of all classes of outstanding stock, no matter how much stock anyone else owns.

3. **Payout Requirements.** A private foundation must annually distribute an amount equal to 5 percent of the foundation's net assets that are not used directly in conducting charitable activities. Reasonable and necessary administrative expenses to accomplish a foundation's charitable purposes (such as expenses allocable to grant making, auditing, tax returns, and general administration) and capital expenditures for assets used solely in the foundation's exempt activity (such as office furniture, equipment, an office building) apply toward satisfying the minimum distribution requirements.

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