

## OVERVIEW OF PRIVATE FOUNDATIONS

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### INTRODUCTION

A private foundation is a charitable corporation or trust which receives financial support from a limited number of sources. A private foundation's charitable activities most commonly consist of making grants or contributions to other charitable organizations which are themselves engaged directly in charitable work. For example, a private foundation might make a grant to a hospital, a community fund agency or an educational organization. Most private foundations are subject to a requirement that they make a minimum amount of distributions each year. Some private foundations themselves directly carry on charitable activities and are not subject to this distribution obligation.

Private foundations are exempt from income tax but most are subject to a one or two percent "excise tax" on investment income. Private foundations are also subject to other types of excise taxes meant to insure that the activities, distributions and investments of the foundation are directed toward charitable activities.

Contributions to private foundations are generally tax deductible by the contributor. Special rules govern the amount that may be deducted. These rules take into consideration the donor's adjusted gross income and the nature of the property contributed.

### ORGANIZATION AND GOVERNANCE OF A PRIVATE FOUNDATION

Most private foundations are organized as nonprofit corporations. The corporate entity is created by filing articles of incorporation with the Secretary of State of the state of incorporation. In some cases, private foundations are trusts. However, the corporate form is often preferable because state nonprofit corporation law provides clear guidelines for governance and operation of the foundation.

Nonprofit corporations are governed by members and/or trustees. Members are the functional equivalent of share-holders of a for-profit corporation. The trustees are the functional equivalent of the board of directors of a for-profit corporation. Often, the trustees of a private foundation are also its only members. This creates in effect a self-perpetuating board of trustees. This structure is often preferable for a family foundation.

The trustees of a foundation possess all power and authority with respect to corporate actions (except, in unusual cases, as may be reserved to the members of the foundation). The trustees elect the officers of the foundation who are charged with managing the day-to-day affairs of the foundation. The trustees make significant decisions concerning the foundation, such as those dealing with the contribution of funds by the foundation. For smaller foundations the trustees may directly carry out the duties of officers.

The number of trustees of a foundation will generally be fixed by the foundation's code of regulations or by-laws. However, most state nonprofit laws require that a nonprofit corporation be governed by at least three trustees or directors. Generally, there is no limit to the number of persons who may serve as trustees but state law must be consulted on this point.

### TAX BENEFITS

#### *Income Tax Exemption*

Private foundations are exempt from federal income tax because they are charitable or "section 501(c)(3)" organizations. This means that the foundation's investment earnings, capital gains and certain other types of income are not subject to income tax. (However, as discussed below under the heading "Excise Taxes", a foundation's investment income is subject to a one or two percent "excise" tax.)

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### ***Deductibility of Contributions***

Contributions to private foundations are generally tax deductible by the donor. The amount deductible is determined by the donor’s adjusted gross income and the nature of the property contributed. The amount of a deduction for cash contributions is limited to 30% of the donor’s adjusted gross income. Contributions of capital gain property, including gifts of appreciated stock, are generally deductible to the extent of 20% of the donor’s adjusted gross income.

### **THE ADVANTAGES AND DISADVANTAGES OF A PRIVATE FOUNDATION**

The principal advantage of a private foundation is that it provides a vehicle for the person(s) establishing the foundation to make a tax deductible charitable contribution and retain significant control over the foundation’s charitable giving program. Other advantages of a private foundation include the opportunity to involve family members in philanthropic projects and flexibility in charitable giving.

The principal disadvantage of a private foundation is that such organizations are subject to the strict and complex private foundation excise tax provisions of the Internal Revenue Code (see discussion below). These excise taxes are meant to prevent certain types of conduct believed to lead to abuse in the private foundation area.

One alternative to using a private foundation is to consider establishing a “donor-advised fund” of a foundation that qualifies as a public charity. These donor-advised funds provide some of the advantages of a private foundation while avoiding some of their disadvantages. However, detailed description of donor-advised funds is beyond the scope of this memo but is available on request.

### **ACTIVITIES**

Most often, the activities of a private foundation will consist of awarding grants or making contributions to other organizations directly engaged in charitable or similar activities. (Special rules apply if the foundation makes grants to individuals or makes awards such as scholarships.) Grant-making foundations are sometimes referred to as “non-operating” foundations. A limited number of foundations are classified as “private operating foundations” because they are directly engaged in the active conduct of charitable activities.

### **MANDATORY DISTRIBUTIONS**

Assuming that a private foundation is an “operating foundation” because it does not directly carry on some type of exempt activities then, as a non-operating private foundation, it is required to make a minimum amount of contributions each year in furtherance of charitable activities. Generally, the amount which must be contributed to charitable organizations is 5% of the fair market value of the foundation’s investment assets. A failure to make these contributions can result in the imposition of an excise tax on the foundation (See discussion of “Excise Taxes”, below).

The board of trustees of a foundation has discretion as to how the foundation will distribute its funds. The board should make contributions in light of the requirement that the foundation distribute a minimum amount of its assets each year in the form of “qualifying distributions.” This means that as a general rule contributions should be made only to organizations which are “public charities.” Such organizations include hospitals, churches, educational institutions, governmental units and many community fund agencies. Except in certain limited circumstances, contributions to other private foundations are not permitted. The purpose of this rule is to insure that foundation money is distributed for the active conduct of charitable activities as opposed to being moved from one private foundation to another.

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Before making a distribution to any organization, a foundation should obtain documentary evidence of that organizations tax exempt status. The easiest way to do this is to obtain from the potential donee a copy of its Internal Revenue Service “determination letter.” This letter specifies whether an organization is a tax-exempt public charity (as opposed to a tax-exempt private foundation). The tax exempt status of an organization can also be verified through IRS Publication 78 which contains a listing of all organizations, contributions to which are tax deductible.

**EXCISE TAXES**

In order to insure a foundation’s activities and investments are directed in furtherance of charitable purposes, the Internal Revenue Code contains a number of excise taxes that can be imposed on the foundation, the officers and trustees of the foundation personally and/or certain other persons who are involved in “prohibited transactions” with a foundation.

***Tax on Investment Income***

Almost all foundations are subject to a two percent tax on their net investment income. Net investment income means the income of the foundation from interest, dividends, rents, royalties and similar sources plus capital gain income, less deductions directly connected with the production and collection of such income. In some cases the tax is reduced to one percent depending upon the amount of distributions the foundation has made in furtherance of charitable purposes.

If a foundation anticipates an investment income tax liability in excess of \$500 in any one year, it must make estimated payments of the tax throughout the year.

***Taxes on Self-Dealing***

The Internal Revenue Code attempts to prohibit, through penalty excise taxes, certain types of behavior (“prohibited transactions”) between private foundations and persons who stand in special relationships to the foundation (“disqualified persons”). Disqualified persons include substantial contributors to the foundation, officers and trustees of the foundation and corporations which are, in one or more ways, affiliated or related to the foundation itself or to contributors to or officers or trustees of the foundation. A “substantial contributor” is any person who contributes an aggregate amount of more than \$5,000 to the foundation if such amount is more than 2% of the foundation’s total contributions in the taxable year. The creator of a private foundation which is a trust is considered to be a substantial contributor.

Prohibited transactions generally involve transfers of value between disqualified persons and the foundation. For example, sales, exchanges or leasing of property between a private foundation and disqualified persons, the lending of money or other extensions of credit between private foundations and disqualified persons, the furnishing of goods or services between a private foundation and disqualified person, payment of compensation by a private foundation to a disqualified person (other than reasonable compensation for personal services necessary to carrying out the foundation’s exempt purposes) and transfers to, for use by or for the benefit of, a disqualified person of the income or assets of a private foundation are all prohibited transactions.

A prohibited transaction gives rise to excise taxes on the disqualified persons involved and on foundation managers who knowingly participate in the prohibited transaction. If the prohibited transaction is not corrected within a specified period, the excise taxes are increased in the case of the disqualified person to 200% of the amount involved in the prohibited transaction and, in the case of the foundation manager, to 50% of the amount involved in the prohibited transaction.

### ***Tax on Failure to Distribute***

A foundation is also taxed if it fails to make minimum distributions in furtherance of charitable, purposes. The amount of distributions that must be made is roughly equal to 5% of the aggregate fair market value of assets of the foundation not used directly in carrying out exempt purposes. This generally means that the amount that must be distributed is equal to 5% of the foundation’s investment portfolio. Distributions should be made to public charities and not to other private foundations or to individuals. Furthermore, distributions to certain types of supporting organizations do not count as qualifying distributions.

Distributions must be made by no later than the first day of the second tax year following the year for which the distribution is required. (For example, for a calendar year foundation, 2008 distributions must be made no later than January 1, 2010).

The tax on the failure to distribute income is equal to 30% of the amount by which the foundation has fallen short of the required minimum distributions. Furthermore, if sufficient distributions are not made within a specified period, the tax increases to 100% of the amount by which distributions have fallen short of the required minimum.

### ***Tax on Certain Stock Holdings***

In order to discourage foundations from carrying on business activities or becoming too greatly involved in such activities, the Internal Revenue Code imposes an excise tax on a private foundation’s stock holdings in excess of 20% of the voting stock of any one corporation. In cases where a foundation holds the stock of publicly traded corporations, these rules generally do not present any problem. However, the rules do prevent the transfer of all voting stock of a closely-held business to a foundation. When a private foundation holds less than 20% of the voting stock of a corporation, then nonvoting stock of such a corporation can generally be held by the foundation as well.

### ***Taxes on Investments Which Jeopardize Charitable Purposes***

If foundation managers invest a foundation’s assets in a manner that does not evidence ordinary business care and prudence, such investments can be treated as jeopardizing the foundation’s charitable purpose and be subject to an excise tax. The tax can be imposed on both the foundation and on foundation managers who participate in making such investments. A foundation manager can be found to have acted imprudently in investing a foundation’s assets if an investment does not appear to provide for the long or short term financial needs of the foundation.

### ***Tax on Taxable Expenditures***

The Internal Revenue Code also imposes a penalty excise tax on certain types of expenditures by a private foundation. The penalty tax is imposed on the foundation itself and on any foundation manager who knowingly agrees to the making of the prohibited expenditure.

Generally, an expenditure is prohibited if it is made to carry on propaganda or to influence legislation, to influence the outcome of a specific election, or to carry on a voter registration drive, to make a grant to an individual, to make a grant to an organization which is not a public charity or a “supporting organization” of a public charity, or for any purposes other than religious, charitable, scientific, educational or other exempt purposes. Distributions from one private foundation to another private foundation would also be a taxable expenditure to the transferor foundation unless certain “expenditure responsibility” requirements are met.

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### **UNRELATED BUSINESS TAXABLE INCOME**

A private foundation is generally exempt from income tax but any income it earns from a regularly carried trade or business that is unrelated to its charitable purposes is subject to income tax. Such income must be reported on IRS Form 990-T, Exempt Organization Business Income Tax Return, for the year in which the foundation earns such income. Such unrelated business taxable income (“UBTI”) is taxed at the general corporate rates.

### **TAX FILINGS**

#### ***Application for Exemption***

In order to obtain tax-exempt status, a private foundation must file with the Internal Revenue Service a “Form 1023, Application for Recognition of Exemption.” The application must be filed within fifteen (15) months of the date of incorporation of the foundation. The foundation will be granted tax-exempt status if it demonstrates that it has recognized charitable purposes (e.g. contributing to charitable organizations), does not provide financial or other benefits to its creators or other private persons, is governed by appropriately drafted articles of incorporation and code of regulations or by-laws and is not permitted to engage in non-charitable, political and/or lobbying activities. The Internal Revenue Service charges a fee for processing the application for recognition of exemption. The fee ranges from \$150 - \$500 and must be paid at the time the application is submitted to the IRS. If the IRS approves the application, the private foundation will receive a determination letter attesting to its exempt status. This letter must be made a permanent part of the books and records of the foundation.

#### ***Tax Returns***

Private foundations are required to file annual information returns with the Internal Revenue Service on Form 990-PF. The form is due on the 15th day of the fifth month following the close of the foundation’s tax year. In order to complete the 990-PF, the foundation must keep detailed books and records throughout the year of its contributions, disbursements, expenses, sales of assets, capital gains and similar items. If a foundation has over \$1,000 in UBTI in a year it must also file a Form 990-T as discussed above.

### **PUBLIC INSPECTION OF DOCUMENTS**

A private foundation must make available for public inspection a copy of its three most recently filed annual returns (Forms 990-PF) and its Application for Recognition of Exemption (Form 1023). These documents are to be made available at the foundation’s principal office during regular business hours. In addition, a private foundation must also provide a copy of one or all of its three most recent annual returns and its exemption application to any individual who makes an appropriate request. The copies must be furnished without charge other than a reasonable fee for any reproduction and mailing costs. A private foundation may omit the identity of contributors to the foundation from the materials it makes available to or distributes to the public. The effect of this law is to make all information disclosed on a foundation’s application for exemption and its annual tax returns available to the public.

### **STATE FILINGS**

A private foundation is required to file a copy of its 990-PF with the state in which it maintains its principal office, its state of incorporation, any state to which it must make reports and any state in which it has made a filing related to its charitable status. These filings are open to public inspection and this provides another means for someone to review a foundation’s tax return. In many cases, state officials impose charges for these filings. Many states also require charitable organizations such as private foundations to register with the state attorney general or a similar state official.

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### **RECORD KEEPING**

A foundation must keep accurate records of its income, expenses, sales, asset transfers and distributions. A checking account should be established in the name of the foundation. This will facilitate an accurate record of all receipts and disbursements. A ledger should be maintained dealing all receipts such as dividends, interest and proceeds received from the sale of assets, as well as all disbursements for items such as routine expenses and qualifying contributions to 501(c)(3) organizations. A brokerage account with check writing privileges could be established instead of a checking account. This is usually an efficient way to keep accurate records of income, expenses, distributions, asset transfers and sales.

An inventory of each security held by the foundation should also be maintained. This should include the name of the security, date acquired (either date purchased by the foundation or date received as a donation) and its original cost basis (either purchase price or carryover basis of the donated security). A record of each sale, stock split or additional donation of securities to the foundation should also be recorded. This will provide an easy and accurate way to calculate the basis of each security sold during the year, as well as provide the carrying value of each security for tax return purposes.

### **TERMINATION**

There are complex rules governing the termination of private foundation status. For purposes of these rules, a “termination” is not the same as the dissolution of the organization. Under certain circumstances, a draconian tax can be imposed upon the termination of private foundation status. The tax is equal to the lesser of (a) the aggregate tax benefits received by the (1) substantial contributors to the foundation on account of their contributions for all years of the foundation’s existence and (2) the foundation itself on account of its tax-exemption or (b) the total net assets of the foundation. Any activity, transaction or corporate action which even remotely suggests that it might involve termination of private foundation status must be carefully reviewed under the special termination rules.

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