EM&A

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Overview of Private Foundations

A private foundation is a flexible vehicle that can assist a donor in conducting charitable activities, particularly in conjunction with other family members. A private foundation's focus may be very broad, to encompass grants to support almost any type of charitable endeavor, or may be limited to one special area of interest, such as improvement of the environment or the welfare of children, or to one particular geographic area.

A. What is a Private Foundation?

In general, a private foundation is defined in the Internal Revenue Code (hereinafter "IRC" or the "Code") by what it is not, rather than by what it is. The Code defines it as an IRC §501(c)(3) (*i.e.*, charitable) organization that is not:

1. A **public-type institution** listed in the Code (generally, churches, schools, hospitals and certain related organizations, and public university endowment funds);

2. An organization that is **publicly supported** (as determined under rules set forth in the Code and regulations) either through contributions from the general public or through exempt function revenue from the general public (such as museum admission fees); or

3. A **supporting organization** closely aligned (as determined under rules set forth in the Code and regulations) with such public-type or publicly supported organizations.

In addition, split-interest trusts (*i.e.*, charitable lead trusts and charitable remainder trusts) are generally treated as private foundations for purposes of some (but not all) of the tax rules applicable to private foundations, which will be noted below under section E. regarding Operational Rules. Unless the creator of a charitable organization intends to garner contributions from the public or operate a hospital, school, church, etc., he or she generally will be choosing between a private foundation and a supporting organization (#3 above).

B. Creation and Administration of Private Foundation

1. Creation. Although a private foundation can have several different forms, including a corporation or a trust, we generally establish a private foundation by creating a Texas non-profit corporation because of the flexibility of the corporate vehicle. This process involves the adoption of articles of incorporation and bylaws, and filing the articles of incorporation with the Secretary of State to obtain a certificate of incorporation. For purposes of describing the organization's purposes in its articles of incorporation, we generally do so very broadly to allow the directors flexibility to change the charitable endeavors in the future as circumstances may change.

2. Directors; Officers. The foundation must have at least three directors. It should also have a president and a secretary (although both of these offices may be held by the same person), and may have other officers as well.

3. Obtaining Tax-Exempt Status. After the foundation is established, a Form 1023 should be filed with the Internal Revenue Service, which is an application for a recognition of

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exemption from federal tax. Despite the general nature of the description of the foundation's activities in the articles of incorporation, the Form 1023 should include detailed information about the foundation's charitable activities. Once this exemption has been granted, the foundation should obtain an exemption from the property, franchise, and sales and use taxes from the Comptroller of Public Accounts of the State of Texas.

4. Ongoing Administration. State law contains some ongoing requirements for the foundation, such as the preparation of annual financial reports by the board of directors. Each significant action of the private foundation should be approved by the directors and documented in minutes of board meetings, or unanimous consents to the action in lieu of board meetings. In addition, state law governs the fiduciary responsibilities of the officers and directors. The foundation is also required to file annual reports on Form 990-PF with the IRS, and there are certain minimal annual taxes on the income of a private foundation. As you can see from the discussion below, there are detailed federal requirements as to the investments, expenditures, and distributions of a private foundation in order for it to maintain its exempt status and avoid penalties. Please refer to the attached "Private Foundation Manager's Administrative Checklist" for a general overview of ongoing administrative requirements.

C. Comparison of Private Foundations and Supporting Organizations

1. Disadvantages of Private Foundations.

(a) Private foundations are subject to stringent self-dealing rules set forth in the Code (see E.2. below). Unlike public charities (including supporting organizations), there need not be a private benefit to the person involved in a particular transaction for there to be an act of self-dealing with regard to a private foundation. Rather, there need only be a direct—or indirect—transaction between a private foundation and a "disqualified person," even if the transaction is completely fair to the foundation, for self-dealing to have occurred. (In general, foundation managers, officers, and directors, and their family members, are disqualified persons.) These rules can very easily be inadvertently broken, resulting in a tax on the transaction.

(b) Private foundations are generally subject to a federal excise tax of either 1% or 2% on net investment income (see E.1. below).

(c) Private foundations are subject to several other operational rules set forth in the Code relating to distributions and investments (see E.3. through E.6. below).

(d) Private foundations are generally subject to less favorable charitable deduction rules (see D. below).

(e) A private foundation seeking to terminate its status as a private foundation can be subject to a termination tax under the Code if it does not follow the proper termination procedure (see F. below).

2. Disadvantages of Supporting Organizations.

(a) Supporting organizations are not as flexible as private foundations—the governing instrument often must specify the supported organizations.

(b) Supporting organizations cannot be controlled (directly or indirectly) by disqualified persons. One must be careful when appointing "friendly" members to the Board—the

IRS has previously ruled that a four-member board that included a disqualified person and two employees of that person's corporation was indirectly controlled by disqualified persons.

(c) Unless the supporting organization is controlled by, or under common control with, the supported organization, the supporting organization must demonstrate that the amount of its support ensures that it is responsive to the desires of the supported organization, and that the supported organization is attentive to the operations of the supporting organization, as determined under rules set forth in IRS regulations. This test can be difficult to meet if the donee is quite large. Alternatively, the supporting organization can provide the necessary funding for a specific significant program or activity of the supported organization. This often requires the development of a new program or activity that is tailored to the amount of support, along with the creation of a paper trail that memorializes the significance of the program and the attentiveness of the supported organization.

D. Contributions to Private Foundations

1. General Rules.

Except as noted in D.2. below:

(a) Deductions for contributions to private foundations are limited to 30% (rather than the normal 50%) of the donor's contribution base (adjusted gross income before net operating losses).

(b) A donor's charitable deduction for the contribution of an appreciated capital asset to a private foundation will be limited to the donor's basis in the asset (subject to a limitation of 20% of the donor's contribution base), whereas a donation of an appreciated capital asset to a public charity will generally give rise to a deduction equal to the fair market value of the asset (subject to a limitation of 30% of the donor's contribution base).

(c) Certain other favorable charitable deduction rules relating to business property (including inventory), scientific research property, and conservation property are not applicable to contributions to private foundations.

2. Special Types of Private Foundations.

Certain types of private foundations are treated like public charities for purposes of some of the charitable deduction rules discussed above.

(a) Private operating foundations—as the name implies, these foundations run their own charitable activities (*e.g.*, museums, libraries, historical buildings) rather than making grants in aid of the charitable activities of other organizations. Private operating foundations are not subject to the private foundation limitations set forth in D.1.(a) and D.1.(b) above, and they are eligible for the favorable charitable deduction rules relating to business property (including inventory) referenced in D.1.(c) above.

(b) Conduit foundations—as the name implies, conduit foundations are generally required to distribute 100% of contributions received during a taxable year within 2½ months after the close of such taxable year. Conduit foundations are not subject to the private foundation limitations set forth in D.1.(a) and D.1.(b) above.

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(c) Pooled common funds—a pooled common fund is a private foundation that would qualify as a supporting organization but for the retention by the donor or the donor's spouse of the right to designate annually the public charities that will receive the income earned from the donor's prior contribution and the right to direct the transfer of such donor's contribution to a selected public charity. Income must be distributed no later than 2½ months after the close of the taxable year in which the income was realized by the fund, and corpus must be distributed no later than one year after the death of the donor (or of the donor's spouse, if applicable). Pooled common funds are not subject to the private foundation limitations set forth in D.1.(a) and D.1.(b) above.

3. New Substantiation Rules.

Deductibility of all charitable contributions (whether to public charities or to private foundations) is subject to the substantiation rules of §170(f) of the Internal Revenue Code. In general, the rules provide that no charitable income tax deduction will be allowed for any contribution of $250 of more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement from the donee organization. In general, this acknowledgment must provide the following information:

(a) The amount of cash or a description (not including value) of any non-cash property contributed;

(b) Whether the donee organization provided any goods or services in consideration, in whole or in part, for any such contributed property; and

(c) A description and good faith estimate of the value of any such goods or services provided to the donor.

In the case of a donation of an item, or a group of like items, worth more than $5,000 ($10,000 for gifts of closely-held securities), a donor must also obtain a qualified appraisal of such items in addition to the written acknowledgement described above. A summary of such an appraisal must be attached to the donor's income tax return on IRS Form 8283.

E. Operational Rules and Excise Taxes Applicable to Private Foundations and their Managers

1. Tax on Investment Income (IRC §4940). A private foundation is generally subject to a 2% tax on its net investment income, which is basically the income earned from interest, dividends, rents, payments with respect to securities loans, and royalties, less deductions related to the production of such income. The tax rate is reduced to 1% if the foundation makes sufficient "qualifying distributions" (see discussion of IRC §4942 in E.3. below). A foundation that complies with IRC §4942 will usually be able to qualify for this reduced rate. This tax does not apply to a charitable lead trust.

2. Tax on Self-Dealing (IRC §4941). Subject to certain very limited exceptions, a private foundation cannot directly or indirectly engage in transactions (including sales, leases, loans, and the furnishing of goods, services, or facilities) with disqualified persons, regardless of the fairness of such transactions. For instance, a disqualified person may not borrow funds from the foundation, even if the foundation charges a market rate of interest. A private foundation that violates these rules will generally be subject to a tax (generally payable by the participating disqualified person) equal to 5% of the amount involved for each year or each partial year during

which the act remains uncorrected. A similar 2½% tax is imposed on the managers of the foundation (*i.e.*, officers, directors, trustees) that participated in the act knowing that it was an act of self-dealing. Charitable lead trusts are subject to these self-dealing rules.

3. Tax on Undistributed Income (IRC §4942). In general, a private foundation must make qualifying distributions of 5% of the aggregate net fair market value of the foundation's assets that are not used directly to carry out the foundation's exempt purposes. A qualifying distribution generally is a distribution to a religious, charitable, or educational organization (or, in the case of a private operating foundation, an asset expenditure for such purposes) that is not controlled by the private foundation or its managers and is not itself a private foundation (other than a private operating foundation). If a private foundation fails to make the required qualifying distributions, it will incur an annual 15% tax on the amount that it failed to distribute until the distribution is made. Charitable lead trusts are generally subject to this code section, since they are subject to the governing instrument requirements of IRC §508(e) which requires the governing instrument to require the foundation (or, in this case, the trust) to distribute income in such a way as to avoid this excise tax.

4. Tax on Excess Business Holdings (IRC §4943). A private foundation may own the stock of another corporation only up to a permitted level (generally, 20% of the corporation's voting stock (35% if control of the corporation is vested in disinterested persons) less the amount of voting stock owned by disqualified persons with respect to the foundation). If a private foundation owns more than the permitted level of business holdings, it will be subject to an annual 5% tax on the excess amount until the excess is sold. However, foundations receiving excess business holdings by gift or bequest have a 5-year (or 10-year, in certain instances) grace period in which to reduce their holdings to the permitted level. Charitable lead trusts are generally subject to rules regarding excess business holdings, unless the fair market value of the charitable income interest upon the trust's inception did not exceed sixty percent (60%) of the total fair market value of all property contributed to the trust.

5. Tax on Jeopardizing Investments (IRC §4944). A private foundation will be subject to an annual 5% tax on the amount of any investment that the IRS determines will jeopardize the foundation's ability to carry out any of its charitable purposes (*e.g.*, because the investment is too risky). Any foundation manager who participated in the making of the investment, knowing that it was a jeopardizing investment, will also be subject to a 5% tax on such amounts. Again, charitable lead trusts are generally subject to these rules unless the value of the charitable income interest upon the trust's inception did not exceed sixty percent (60%) of the total value of all property passing to the trust.

6. Tax on Taxable Expenditures (IRC §4945). A private foundation will be subject to a 10% tax on any "taxable expenditures" that it makes. Foundation managers that agree to the making of such an expenditure, knowing that it is a taxable expenditure, will be subject to a 2½% tax on such amount. Generally, taxable expenditures include payments for political campaigns and lobbying, certain grants to individuals, and expenditures for non-charitable purposes. In addition, while a private foundation may make qualifying contributions to another private foundation, the distributing foundation will have to monitor the grant to ensure that the recipient foundation spends the funds properly (this is referred to as "expenditure responsibility") in order to avoid the application of IRC §4945. If the private foundation intends to make grants to individuals (*e.g.*, scholarships, research grants), the organization must follow selection and monitoring procedures set forth in the regulations and obtain advance written approval from the IRS in order to avoid the

application of IRC §4945. Charitable lead trusts are subject to all rules regarding expenditure responsibility.

7. Penalties for Failure to Correct. Most of the provisions discussed above impose much higher additional taxes on the foundation itself and on the manager individually if the prohibited act is not corrected prior to official IRS notice or assessment of the initial tax. These additional taxes range from 25% to 200% of the amount involved.

8. State Law Duties. In addition to the rules discussed above, directors and trustees of private foundations will be subject to state law fiduciary standards (*e.g.*, duty of care, duty of loyalty) that apply to directors and trustees of all charitable organizations.

F. Termination of a Private Foundation

In general, in order to avoid a termination tax under the Code, a private foundation seeking to terminate its private foundation status must either:

1. Transfer its assets to a public-type charity (or a charity that is publicly supported through contributions from the general public) that has been in existence for at least five years; or

2. Operate as a public charity (including supporting organizations and organizations publicly supported through exempt function revenue from the general public) for five years.

The termination tax is equal to the lesser of the aggregate tax benefit resulting from the foundation's exempt status or the value of the foundation's net assets. If the private foundation's status is terminated involuntarily due to repeated violations of the tax rules set forth in Section D above, the IRS can abate all or any portion of the unpaid termination tax if the foundation follows step (1) above, or the appropriate State official satisfies the IRS that the assets of such private foundation will be preserved for charitable purposes. Although a charitable lead trust is technically subject to this termination tax, normal trust activities (such as termination of the charitable income interest and distribution of the assets to the trust's non-charitable beneficiary) will generally not trigger this tax.

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