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PRIVATE FOUNDATIONS

What is a Private Foundation?

A private foundation is a charitable organization that is not publicly funded. That is, it is funded primarily by a single donor or a small number of major donors. A private foundation uses its assets to carry out the charitable giving program of the people contributing to the foundation. The private foundation does so by making grants to the public charities that the contributors wish to support rather than engaging directly in a charitable activity. Contributors to the private foundation receive an immediate income tax deduction for the contribution, yet the funds may be held in the foundation for distribution over time.

A private foundation is a way for the donor to fund a charitable gift-giving program without surrendering control of investment of assets. By using a private foundation, the donor and the donor's family members can centralize the management of the family's charitable giving and pool the family's resources to make a larger impact in that giving. A private foundation also allows the donor to establish an endowment that will appreciate, permitting funds to be accumulated and distributed in the future for charitable purposes.

Creating a Private Foundation

A private foundation may be created and organized as a corporation or a trust under state law and receives its federal tax exempt status under the Internal Revenue Code. If a corporate entity is used, various documents must be filed with the Secretary of State where the corporation is incorporated. An application for tax exempt status, federal Form 1023, must be prepared and filed with the IRS to obtain tax exempt status for the foundation, together with filings required by the state's Attorney General. Once the corporation or trust is established, assets will be transferred to the foundation. A board of directors, or persons selected in the trust agreement, would operate the foundation and decide on the charitable distributions to be made each year.

Taxation of Contributions to a Private Foundation

Estate and Gift Taxes. Contributions to a private foundation will qualify for a charitable gift tax deduction if made during donor's lifetime, or a federal estate tax deduction if made at donor's death under donor's will or trust. The donor can make a contribution to a foundation already in existence or to a foundation to be created at donor's death under the terms of his or her will or trust agreement. The gift and estate tax charitable deductions are unlimited.

Income Taxes. Unlike the estate and gift tax charitable deductions, the donor's income tax charitable deduction for gifts to a private foundation during his or her life are subject to percentage limitations. In general, the income tax deduction for a cash contribution to a private foundation is limited to 30% of donor's adjusted gross income ("AGI") in the year of the

contribution. The deduction for a contribution of appreciated publicly-traded stock is generally limited to 20% of AGI in the year of the contribution. Contributions that exceed the limitation percentage in the year of the gift may be carried over for five succeeding taxable years. Any unused carryover is lost at donor's death. For example, if donor's AGI is \$200,000, the most donor could deduct for a cash contribution to a private foundation would be \$60,000 (30% of \$200,000). The most donor could deduct for contributing publicly-traded stock held for more than one year would be \$40,000 (20% of \$200,000). If the amount donor contributes is \$150,000 in cash, the \$90,000 in excess of the limit could be carried forward and used as a charitable income tax deduction next year, subject to the same limitations in future years.

The maximum deduction allowable for contributions to a private foundation must be determined after donor's contributions to public charities are considered. The deduction for contributions to public charities is limited to 50% of donor's AGI. Therefore, the maximum deduction allowable for a contribution of cash to a private foundation would be equal to the lesser of (i) 30% of donor's AGI, or (ii) the amount of donor's 50% limitation remaining after donor's contributions to public charities are considered. For example, if the donor contributes cash equal to 40% of donor's AGI to a public charity, then the donor is limited to a deduction equal to 10% of his or her AGI for contributions to which the 30% limitation applies, such as donor's contribution to a private foundation.

Subject to the percentage limitations, a donor can deduct contributions of cash in full. A donor generally can deduct contributions of appreciated property only to the extent of his or her tax basis in the property, although an exception to this rule exists for publicly-traded stock held for more than one year contributed to a private foundation, which can be deducted at its full fair market value at the time of the contribution.

Filing Requirements

A private foundation must file federal Form 1023 with the IRS to obtain recognition of its tax exempt status. A private foundation also must file federal Form 990-PF annually with the IRS. Form 990-PF reports income earned, includes details of the foundation's expenses of operation, lists charitable grants made, lists names and addresses of the foundation's directors and officers and otherwise provides detail on the foundation's activities.

Charitable organizations are subject to the supervision and control of the Attorney General of the state in which they are organized and operated. Many states require a private foundation to file with the Attorney General an initial registration statement and an annual return containing detailed financial information.

Private Foundation Restrictions

Private foundations are subject to several complex operating rules and restrictions not applicable to public charities. Failure to follow these rules results in additional taxes and penalties. If the foundation fails to correct the activity, then the IRS may impose punitive second-tier taxes. These rules may be summarized as follows:

Self Dealing. A private foundation cannot engage in "self dealing" with any person or organization that might be classified as a "disqualified person" in relation to the private foundation. The law imposes an excise tax equal to 5% of the amount involved in the act of self

dealing. In general, this excise tax is paid by any disqualified person who participates in the act of self dealing. A “disqualified person” includes substantial contributors (the creator of a foundation, for example), foundation managers (e.g., officers, directors and trustees), family members, and entities subject to more than 20% control by any such persons and members of their families. The individual who creates a private foundation, the founder’s spouse, the founders’ children and their spouses would all be disqualified persons in relation to the founder’s private foundation. In general, a disqualified person may not have any financial dealings with, and may receive no financial payments from, the private foundation. Exceptions to the self dealing rules exist for gifts the founder makes to the foundation, reimbursement of expenses incurred in conducting the private foundation’s grant-making programs, and reasonable compensation for services as director of the foundation.

Excise Tax on Investment Income. An excise tax of 2% is imposed each year on the net investment income of a private foundation. This tax may be reduced to 1% if the foundation makes sufficiently large distributions to public charities.

Minimum Distribution Requirements. A private foundation is required to make qualifying distributions for each taxable year equal to 5% of the net fair market value of the foundation’s assets (other than those used in carrying out the foundation’s charitable purposes). This required distribution amount is reduced by any income and excise taxes for the year. In general, “qualifying distributions” include any amount paid to accomplish exempt purposes, other than payments to an organization controlled by the foundation or by disqualified persons or to a non-operating foundation, or any amount paid to acquire an asset used in carrying out charitable purposes. Charitable distributions in excess of the amount required to be distributed for a given year generally reduce the required distributions in subsequent years. The foundation must pay the required distribution amount before the beginning of the second year following the taxable year. Thus, the foundation must distribute the year one amount by the end of year two, the year two amount by the end of year three, and so forth.

Excess Business Holdings. A foundation that owns more than 2% of the outstanding stock of any company may be subject to restrictions on excess business holdings. In general, combined holdings of the foundation and disqualified persons in any “business enterprise” are limited to 20%, or 35% if unrelated third parties have control of such business enterprise.

Jeopardizing Investments. Generally, the law imposes a tax on high risk investments, on the assumption that these investments jeopardize the carrying out of the exempt purposes of a foundation. The IRS has indicated that the following types of investments will be scrutinized closely: trading in securities on margin, trading in commodity futures, investments and working interests in oil and gas wells, purchase of puts, calls and straddles, purchase of warrants, and selling short. A standard portfolio of stocks and bonds should not violate the jeopardy investment restrictions.

Taxable Expenditures. A foundation generally is subject to a 10% tax on the amount of a taxable expenditure. Taxable expenditures are payment by the foundation other than qualifying distributions and payments of taxes and expenses. Specifically, taxable expenditures include: lobbying expenditures, political campaign expenditures, most grants to individuals unless made pursuant to programs pre-approved by the IRS, grants to organizations other than public charities

unless the foundation exercises “expenditure responsibility,” and expenditures for non-charitable purposes.

Conclusion

The private foundation is an attractive vehicle for charitable giving. Potentially significant estate, gift and income tax deductions may be available for contributions to a private foundation. A private foundation allows individuals to receive an immediate charitable income tax deduction for contributions, yet distribute the funds over time. A private foundation also provides opportunities for continuing asset management and control by family members who act as directors of the foundation. The foundation assets also provide a source of funds for other family members to make the charitable contributions they want to make themselves. The complexity of administration, however, may limit its usefulness to persons willing to contribute assets greater than one million dollars.

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Please contact Albertson & Davidson, LLP at (951) 686-5296 for further information on private foundations.

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