# PRIVATE FOUNDATIONS

CHAPTER 21

## WHAT IS IT?

A private foundation (also sometimes called a "family foundation") is a charitable organization created, funded, and usually controlled by a single donor or by members of the donor's family.

Provisions regulating private foundations were originally inserted into the tax code as part of the Tax Reform Act of 1969. These rules were in reaction to what was perceived by some members of Congress as abuses of the tax-exempt, charitable status conferred on certain charities, particularly ones that were not subject to public oversight or scrutiny. As a result, Congress chose to place into the tax code rules that generally classify charities into two groups: public charities and private foundations. Private foundations are subject to a very restrictive set of rules and potential excise taxes, which were designed to prohibit the sort of behavior by foundations and their managers that Congress was concerned about when it enacted the private foundation rules. There are also punitive excise taxes that may be levied on both the foundation and individuals if these rules are violated. The Pension Protection Act of 2006 (PPA 2006) increased these restrictions and penalties on foundations making grants to supporting organizations.

Of all the possible tools and techniques of charitable planning, private foundations provide the greatest degree of long-term control and flexibility to a donor in terms of how a substantial charitable gift will be applied to charitable purposes. Many charitably inclined donors who have substantial wealth prefer utilizing a private foundation despite the presence of the restrictive tax rules because of the degree of control and involvement that the donor's family may have with a private foundation. This control often would be diluted or even nonexistent if the donor's contribution was made directly to a public charity.

Most private foundations do not engage directly in charitable activities themselves (e.g., operating a food bank), but instead distribute funds to other charities that perform charitable activities. There is a separate category of private foundations, called private operating foundations, that is subject to less restrictive rules than private foundations. However, private operating foundations have specific expenditure requirements, and must directly participate in charitable activities rather than simply make contributions to other charitable organizations. Under a change made by the PPA of 2006, grants made by private foundations to supporting organizations of public charities that are not "functionally integrated" (explained further below) with their public charities will not count toward the foundation's 5% distribution requirement.

## WHEN IS THE USE OF SUCH A DEVICE INDICATED?

1. When the donor is charitably inclined and intends to make substantial gifts to charity (at least $1 million) either during his lifetime or at death.

2. When the donor has substantial wealth (generally at least $5 million) and cannot reduce the taxable estate in any other acceptable fashion. Typically a private foundation grantor prefers the scenario where 100% of the amount going into the private foundation will be devoted to charitable purposes and causes favored by the donor rather than losing a significant amount to death taxes, with only the remainder after taxes going to the donor's heirs. Typically, the donor's heirs have received or will receive substantial gifts or future inheritances apart from the amount going into the private foundation.

3. When the donor desires a high degree of control over the manner in which the funds inside the



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private foundation will be expended for charitable purposes.

4. When the donor likes the idea of utilizing a private foundation as a vehicle for his family to come together on a regular basis to discuss the expenditure of a portion of the family's wealth on charitable causes. The donor also likes the fact that these meetings and discussions will teach the family the need for social responsibility.

5. When the donor likes the idea of having his name or family's name associated with a foundation that can raise the social profile of the donor and family in local charitable giving circles and in the community in general. Similarly, a corporate donor can raise its public profile by forming its own private foundation.

## ADVANTAGES

1. A private foundation provides the donor and family significant control over the timing and manner (subject to the private foundation rules discussed below) in which charitable expenditures are made by the foundation, and substantial year by year flexibility in the choice of recipients.

2. Capital gains taxes can be avoided on highly appreciated assets transferred to the private foundation.

3. A full fair market value deduction can be taken for appreciated publicly traded securities donated to the foundation.

4. A private foundation can provide the donor and the donor's family with significant visibility in a local community for the charitable work.

5. A private foundation can act as the focal point for a family's charitable activities, and instill in the original donor's children and descendants a lasting sense of social responsibility and awareness that might not be achievable through other means.

6. If the donor regularly makes charitable contributions that cause the donor (either individual or corporate) to consistently exceed the donor's percentage limitation on charitable deductions, use of a private foundation can assist, since the foundation can make charitable contributions from its income that otherwise would be made by the donor.

## DISADVANTAGES

1. Administrative costs can be high. These include costs to create the foundation, obtain tax-exempt status, annually ensure the foundation complies with the private foundation rules, and file the necessary annual reports.[1]

2. Application of the private foundation rules creates constant exposure to excise taxes for failure to stay within the rules, not only for the foundation, but for its managers as well. This requires constant monitoring and vigilance by both the foundation's board and its tax advisors.

3. The private foundation tax rules restrict a foundation's ability to expend funds for charitable purposes to a greater extent than a public charity is restricted.

4. Lower annual charitable contribution percentage limits apply to donations made to a private foundation (generally, 30% vs. 50% of AGI for contributions of cash, and 20% vs. 30% for contributions of capital gain property) compared with donations made to a public charity.

5. Holders of interests in closely-held businesses are denied a deduction for the fair market value of interests contributed to a private foundation.

6. The excess business holdings rule means that typically owners of closely held businesses cannot contribute their interests to a private foundation unless the foundation disposes of the interest within certain time limits (generally, five years).

## WHAT ARE THE REQUIREMENTS?

A charity must request classification as either a public charity or a private foundation at the same time that it applies to the Service for recognition of its tax exempt status.

The tax code classifies a charity as a "private foundation" in the negative; that is, a charity is automatically classified as, and therefore is considered and taxed as, a private foundation unless it fits into one of the following categories:[2]

1. *activity-based public charity* – a charity that is deemed to be a public charity by virtue of the



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inherently public nature of its activities (e.g., a hospital, church, or school);

2. *publicly-supported organization* – a charity that receives most of its donations and support from a broad spectrum of the general public (e.g., a museum), as opposed to from a single individual, a single family, or a limited number of persons or organizations; or

3. *supporting organization* – an organization that is operated, supervised, or controlled by or in connection with a public charity. There are three types of supporting organizations. See Chapter 24 for details on supporting organizations.

### Private Foundation Excise Taxes

A charity classified as a private foundation (and any individual deemed to be a "disqualified person" related to that foundation) is subject to the following excise taxes.

1. *Tax on investment income*. A 2% excise tax is levied on the net investment income[3] of a domestic private foundation. This rate is reduced to 1% if the foundation's qualifying charitable distributions equal or exceeds the sum of: (1) an amount equal to the assets of the foundation multiplied by the average percentage payout of the foundation's assets for the previous five years; and (2) 1% of the net investment income for that year. The foundation must also not have been subject to the tax on failure to distribute income (discussed below) for the previous five years, in order to qualify for the 1% rate. Certain private operating foundations are exempt from this tax.[4] Foreign private foundations are subject to an annual 4% tax on gross investment income from United States sources.[5]

2. *Taxes on self-dealing*. A private foundation is subject to an excise tax if it participates in a "prohibited transaction" with a "disqualified person."[6] The term "disqualified person" includes: a substantial contributor to the foundation; a foundation manager; an owner of 20% or more of a substantial contributor to the foundation; and any family member of the preceding. Also included in the definition of a disqualified person is a corporation, partnership, estate or trust *if* more than 35% of the organization is owned by individuals who satisfy the first four (4) conditions. Finally, government officials are disqualified persons.[7]

"Prohibited transactions" include: (1) any direct or indirect sale, exchange, or leasing of property between a private foundation and a disqualified person; (2) any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person; (3) any direct or indirect furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) any direct or indirect payment of compensation, or payment of reimbursed expenses, by a private foundation to a disqualified person; (5) any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and (6) any direct or indirect agreement by a private foundation to make any payment of money or other property to a government official, other than an agreement to employ the official for any period after termination of government service if the official is terminating that service within 90 days. There is an exception in the latter case for reasonable compensation paid to a disqualified person (other than certain government officials) for personal services performed to carry out the foundation's exempt purposes.

Self-dealing can result in two types of excise taxes, each with two levels of tax, as explained below. The taxes are imposed on disqualified persons and private foundation managers.[8] The tax will apply even if the transaction was on an arms-length basis, and even if the result of the transaction was not overly favorable to the disqualified person.

One self-dealing excise tax is imposed on each act of self-dealing between a private foundation and a disqualified person.[9] The second self-dealing excise tax is imposed on a foundation manager who knowingly participates in an act of self-dealing between a private foundation and a disqualified person—that individual is personally subject to a tax of 5% of the amount involved.

A first level tax of 10% of the amount involved is imposed on a disqualified person who engages in an act of self-dealing (as defined above) with a

private foundation. The maximum amount of tax on self dealing that may be imposed on a foundation manager is $10,000 for each level of tax.[10]

A second level tax of 200% of the amount involved is imposed on a disqualified person if the self dealing is not corrected. If a foundation manager refused to agree to part or all of the correction, another self-dealing excise tax of 50% of the self-dealing amount is imposed on the foundation manager. Again, the maximum amount of tax on self dealing that may be imposed on a foundation manager is $20,000 for each act of self-dealing.[11]

3. *Tax on failure to distribute income*. An excise tax is generally levied on a private foundation (other than certain private operating foundations) that fails to distribute at least 5% of its investment assets annually for charitable purposes. (See the Q&A section of this chapter for which distributions qualify under this rule.)

   An initial tax of 30% of the undistributed amount is levied if the foundation has failed to make the required distribution by the first day of the year succeeding the year the distribution was required to have been made. An additional tax of 100% of the amount that remains undistributed is imposed if the foundation does not correct the failure to distribute the funds by the time the IRS mails a notice of deficiency or the tax is assessed.[12]

4. *Tax on excess business holdings*. Private foundations are not allowed to own more than 20% of the voting stock in a corporation (35% where it can be established that an independent third party has effective control over the corporation). Stock owned by disqualified persons is included in calculating the permissible limits for stock owned by a foundation. A 2% de minimis exception is available. A comparable rule applies to the holdings of non-corporate enterprises, such as partnerships.

   Excess business holdings are the amount of stock in a corporation (or interests in an unincorporated business enterprise) that a private foundation is not permitted to hold. These non-permissible holdings include and must count the stock or interests held by disqualified persons.

   The initial tax is 10% of the excess business holdings amount; however, this 10% tax can be avoided in certain situations if the foundation disposes of the excess business holdings within 90 days of learning of the excess business holdings. Failure to dispose of the excess business holdings by the time the first tier tax is assessed or a deficiency notice is mailed exposes the foundation to a 200% tax.

   Special rules permit private foundations to dispose of a business interest that was received by a gift or bequest over a five-year period without triggering the excise tax. In certain circumstances, this five-year period may be extended to 10 years.[13]

5. *Tax on investments that jeopardize charitable purposes*. A private foundation (and a foundation manager) is subject to an excise tax if it makes investments that are deemed to jeopardize its charitable purposes.[14] While there are no specific investments that are defined under the tax law to be *per se* violations of this rule, the regulations direct special attention to be paid to the following practices and investments: (a) trading securities on margin; (b) trading in commodities futures; (c) working interests in oil and gas; (d) puts, calls, straddles, and warrants; and (e) selling securities short.

   A 10% tax is separately imposed on both a foundation and its managers for making an investment that jeopardizes the charitable purposes (limited to $10,000 per investment on a foundation manager). A foundation manager must have participated in the investment knowingly and that participation must have been willful and not due to reasonable cause to be held liable for this excise tax.[15] An additional tax of 25% is levied for failure to correct these investments (limited to $20,000 per investment on a foundation manager).

6. *Tax on taxable expenditures*. A private foundation is subject to an initial tax of 20%, and its foundation managers who knowingly made a taxable expenditure are subject to an initial tax of 5% on any "taxable expenditures" (limited to $10,000 on foundation managers).

   "Taxable expenditures" include: (a) amounts spent to influence legislation; (b) amounts spent to participate in a political campaign; (c)



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grants made to individuals or noncharitable organizations that fail to meet certain objective criteria that ensure the funds are used for certain approved purposes or goals (such as a scholarship award to an individual to permit the grantee to achieve a specific objective or enhance a particular talent); and (d) expenditures for noncharitable purposes, among others.

Under a change made by PPA 2006, distributions to non-functionally integrated Type III supporting organizations and to Type I and Type II supporting organizations that are controlled (directly or indirectly) by foundation insiders or disqualified persons relative to the distributing foundation may also be considered taxable expenditures unless the foundation exercises "expenditure responsibility" (explained further in the Q&A section of this chapter).

An additional tax of 100% on the foundation and 50% on the foundation manager (limited to $20,000 on foundation managers) can be levied for failure to correct the taxable expenditure.[16]

## HOW IS IT DONE?

1. The donor creates a nonprofit corporation or a charitable trust under the applicable state law.

2. The corporation or trust applies to the Internal Revenue Service for recognition of its tax-exempt charitable status, and for classification as a private foundation using IRS Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code" (revised June 2006).

3. The donor transfers cash or title of the property to be given to the private foundation to the corporation or trust.

4. The donor receives an income tax deduction for the contribution. The income tax deduction is limited to 30% of the donor's adjusted gross income in the year of the contribution (20% for contributions of capital gain property). The donor is also allowed to carry over any excess for up to five future years, subject to the same limitations.

5. The donor files a federal gift tax return (IRS Form 709, "United States Gift (and Generation-Skipping Transfer) Tax Return") to report the gift.

6. The private foundation files information returns IRS Form 990-PF, "Return of Private Foundation") annually.

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*Example:* Even after implementing an estate plan that has already substantially reduced her taxable estate, Mary Ann McDunn has a net worth of $10 million, mostly in publicly traded securities. Mary Ann has already transferred significant portions of her wealth to her heirs through estate planning devices such as family partnerships, GRATs, sales to defective grantor trusts, and other methods. She regularly donates substantial amounts to charity, and finds the idea of The Mary Ann McDunn Foundation very appealing. She has an annual income of approximately $1 million.

Mary Ann has in her portfolio of securities a block of shares in a publicly traded corporation worth approximately $1 million. She has a very low basis, as these shares were received as a gift from her father many years ago. Her broker has advised Mary Ann that she should sell the stock because (1) he feels the stock is presently overvalued in the market, and (2) that Mary Ann's portfolio is not sufficiently diversified because of the presence of this large block of stock. Mary Ann is unwilling to sell because of the substantial capital gains tax she will pay if she sold the shares; however, she is willing to part with these shares to start The Mary Ann McDunn Foundation.

Mary Ann's attorney creates a nonprofit corporation under local state law and applies to the IRS for charitable tax-exempt status. The board of directors of the new corporation consists of Mary Ann and some of her family members. Mary Ann is the president and sole officer of the corporation. The IRS approves the application for charitable tax-exempt status and classifies the new corporation as a private foundation.

Mary Ann transfers the $1 million of low basis, publicly traded securities to the private foundation. Mary Ann will receive an income tax deduction of $1 million for the full fair market value of the shares donated to the foundation. She will not report the gain (or be able to recognize any loss) on the difference between her tax basis and the fair market value of the stock.



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Because her adjusted gross income (AGI) is $1 million for the year of contribution, her deduction will be limited to $200,000 for that year (20% of her AGI). But the excess of $800,000 may be carried over and deducted over up to five subsequent years, subject to the same 20% AGI limitation for those years.

During Mary Ann's lifetime, the foundation board meets regularly and decides to contribute to those charitable causes that Mary Ann traditionally supports with her direct annual contributions. As the foundation is making these gifts, Mary Ann can reduce or eliminate her direct personal contributions to these same charitable organizations, except when she desires to make unusually large donations (e.g., for a capital campaign). Mary Ann can also continue to add to the foundation's endowment as her investment decisions and the percentage limitations on the deductions for her charitable contributions permit.

Mary Ann also changes her will so that everything above the statutorily protected amount ($2,000,000 in 2007) will pass to The Mary Ann McDunn Foundation at her death. Her heirs have essentially received their inheritances during Mary Ann's lifetime as a result of careful estate planning (or perhaps from life insurance on her life purchased with lifetime gifts that she made to them), so the net effect of creating the foundation and passing everything to it at Mary Ann's death effectively results in no federal estate taxes imposed on Mary Ann's estate.

### Private Operating Foundations

A private foundation that engages primarily in the active conduct of charitable, religious, educational, or similar activities, and meets certain income and asset tests may be classified as a private operating foundation. Private operating foundations are not subject to the income distribution requirements and the tax on investment income that otherwise apply to private foundations.

A private operating foundation must spend the lesser of: (1) its annual adjusted net income, or (2) 5% of its investment assets directly in the active conduct of charitable, religious, educational or similar purposes for which it was organized, and also meet certain asset, endowment or support tests.[17] For purposes of the annual percentage limitation on charitable contributions, a private operating foundation is treated as a public charity (in other words, contributions of cash are deductible up to 50% of the taxpayer's adjusted gross income, as opposed to the lower 30% limit for contributions of cash to private foundations).

## WHAT ARE THE TAX IMPLICATIONS?

1. The donor of cash or property to a private foundation is eligible for an income tax deduction. The amount of the deduction in the case of long-term capital gain property is the fair market value of the property, so long as the property consists of publicly traded securities. Otherwise, the deduction is limited to the tax basis in the property. For contributions of property that would give rise to short term capital gains or ordinary income if sold by the donor, the donor must reduce the deduction by the amount of short term capital gain or ordinary income that would have been recognized if the property had been sold. In other words, the deduction is limited to his adjusted basis.

   An individual donor's annual percentage limitation is limited to 30% of adjusted gross income (AGI) for cash donations made to private foundations and to 20% of AGI for donations of capital gain property to private foundations. Private operating foundations are treated as public charities for these purposes. A corporation may deduct up to 10% of its taxable income (with certain adjustments) in any one taxable year.[18]

   No gain (or loss) is recognized on the contribution of property to a private foundation. Generally, a later sale of the property by the foundation will not cause recognition of gain or loss to the donor. But there is an important exception: if the circumstances indicate that the sale of the property had in fact already been consummated by the donor prior to the contribution to the foundation, and the contribution was a mere assignment of income, the donor will be taxed on any gain on the sale.[19]

2. Donors of cash or property to a private foundation are not subject to gift tax on the value of the amount transferred due to an unlimited gift



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tax charitable deduction. Likewise, the value of the property donated to a private foundation is excluded from an individual donor's estate. If the transfer to a private foundation occurs at a person's death, the donor's estate receives an estate tax deduction for the value of the amount bequeathed to the private foundation.

## WHAT ARE THE ALTERNATIVES?

Community foundations are charitable organizations that typically make grants to benefit local communities and local community organizations. They are classified as public charities[20] and, hence, are free of most of the restrictions applicable to private foundations. These organizations usually permit donors contributing a minimum amount set by the foundation to create a separate account (also known as a "donor advised fund"— see Chapter 19).

The donor advised fund makes it possible for the donor or members of the donor's family to recommend (but not dictate) how distributions from the separate account will be made. Although these foundations are usually community based, donor advised funds are not geographically limited, with a number of national financial institutions having established separate organizations that are classified as public charities. Donor advised funds relieve the donor of most of the administrative burdens associated with private foundations. Community foundations are discussed in more detail in Chapter 17. See Figure 21.1 for a comparison of the advantages and disadvantages of a community foundation account as compared to a private foundation (and supporting organizations). Supporting organizations are discussed in Chapter 24.

## WHERE CAN I FIND OUT MORE ABOUT IT?

1. Toce, Joseph, Abbin, Byrle, Vorsatz, Mark, and Page, William, *Tax Economics of Charitable Giving 2006-2007* (Warren Gorham & Lamont, 2006).

## QUESTIONS AND ANSWERS

**Question –** Can a foundation manager, who is also a donor or a member of the donor's family, accept a salary and benefits (e.g., group term life, split dollar life insurance, death benefit only, or a pension plan) from the foundation?

**Figure 21.1**

| COMPARISON OF A PRIVATE FOUNDATION TO A SUPPORTING ORGANIZATION AND A COMMUNITY FOUNDATION ACCOUNT | | | |
|---|---|---|---|
| | **Supporting Organization to an Operating 501(c)(3) Charity** | **Community Foundation Account** | **Private Foundation** |
| What other names might it be called? | "Supporting organization," "Foundation," or "Auxiliary" | "Donor Advised Account" | "Family Foundation" |
| Is it considered a 501(c)(3) organization? | Yes | Yes | Yes |
| Individual AGI deduction limit on cash gifts? | 50% | 50% | 30% |
| Individual AGI deduction limit on gifts of appreciated property? | 30% | 30% | 20% |
| Corporate deduction limit on cash gifts or gifts of appreciated property? | 10% of taxable income (with certain adjustments) | 10% of taxable income (with certain adjustments) | 10% of taxable income (with certain adjustments) |



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**Figure 21.1 (cont'd)**

| COMPARISON OF A PRIVATE FOUNDATION TO A SUPPORTING ORGANIZATION AND A COMMUNITY FOUNDATION ACCOUNT | | | |
|---|---|---|---|
| | **Supporting Organization to an Operating 501(c)(3) Charity** | **Community Foundation Account** | **Private Foundation** |
| Carry forward of deductions that exceed AGI or taxable income limits available? | Yes, 5 Years | Yes, 5 Years | Yes, 5 Years |
| Values of appreciated property for deduction purposes? | Fair Market Value | Fair Market Value | Fair Market Value for publicly traded stock only; cost basis for other property |
| Engaged directly in charitable activities? | Often | Often | Not Usually |
| Sources of funding? | Public gifts, grants, single source individual family or endowment | Public gifts | Single source such as an individual family; or a limited number of donors |
| Objective with money raised? | Currently spent or Endowment | Currently spent or Endowment | Endowment |
| Minimum payout requirements? | No | No | Yes, generally 5% of investment assets |
| Tax for failure to meet minimum payout requirement? | No | No | Yes, 15% tax on undistributed amounts |
| Subject to investment tax? | No | No | Yes, 2% of investment income; can be reduced to 1% if amounts in excess of minimum required payout are distributed |
| Subject to self-dealing tax? | No | No | Yes |
| Subject to excess business holdings tax? | No | No | Yes |
| Tax on jeopardy type investment? | No | No | Yes |
| Tax on restricted activities? | No | No | Yes |

**Figure 21.1 (cont'd)**

| COMPARISON OF A PRIVATE FOUNDATION TO A SUPPORTING ORGANIZATION AND A COMMUNITY FOUNDATION ACCOUNT | | | |
|---|---|---|---|
| | **Supporting Organization to an Operating 501(c)(3) Charity** | **Community Foundation Account** | **Private Foundation** |
| Informational return required for IRS | Form 990 | Form 990 | Form 990PF |
| When is Form 990 or 990-PF required? | Gross receipts over $25,000 | Always filed at CF level | Always |
| Cost to set up and maintain? | Expensive to start, and costs are incurred to continue operations | Typically no up front cost, but investment management fee/year is charged as a percentage of the account (usually .5%-1%) | Expensive to start, and costs are incurred to continue operations |
| Eligible receivers of grants? | Supported organizations that are also 501(c)(3) organizations | 501(c)(3) organizations | What the donor desires, but most often grants to other 501(c)(3) organizations |
| When is it used? | When a donor is willing to give up some control and flexibility in exchange for escaping classification as a private foundation | As either a donating or endowment alternative which allows some family involvement without private foundation rules and at a very reasonable cost | When donors wish to pursue their own charitable endeavors and create flexibility to change the foundation's purpose; usually want to create a permanent endowment and are not concerned about overhead costs |

*Answer* – Yes. But the salary and benefits must be reasonable relative to the value of services that are actually performed by the manager.

**Question** – If a foundation wishes to avoid private foundation status by demonstrating that it receives support from the general public, how much support is required?

*Answer* – There are two categories of private foundations that can qualify as "publicly supported organizations:"

1. An organization that: (a) receives at least one-third of its support from certain government sources or the general public, or (b) receives at least 10% of its support from government sources or the general public and in addition meets a facts and



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circumstances test demonstrating that it is organized and operated to attract additional government or public support.[21]

2. An entity that normally receives more than one-third of its support from members of the general public (exclusive of disqualified persons) and receives no more than one-third of its revenue from gross investment income.[22]

**Question** – What sort of transactions can give rise to a prohibited act of self-dealing?

*Answer* – Acts of self-dealing include: any direct or indirect sale, exchange, or leasing of property between a private foundation and a disqualified person; any direct or indirect lending of money or other extension of credit between a private foundation and a disqualified person; any direct or indirect furnishing of goods, services, or facilities between a private foundation and a disqualified person; any direct or indirect payment of compensation, or payment of reimbursed expenses, by a private foundation to a disqualified person; any direct or indirect transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and any direct or indirect agreement by a private foundation to make any payment of money or other property to a government official, other than an agreement to employ the official for any period after termination of government service if the official is terminating that service within 90 days.

It is important to bear in mind that the above transactions constitute acts of self-dealing even if a particular transaction is done at arms-length and the foundation suffered no economic loss or detriment and the recipient received no special benefit or advantage as a result of the transaction.

**Question** – What distributions qualify for purposes of satisfying the requirements that a private foundation distribute at least 5% of its investment assets each year?

*Answer* – *Grants to public charities or governmental agencies*. Most commonly, private foundations satisfy their distribution requirements by making grants to other organizations. Grants to public charities (excepting certain 509(a)(3) supporting organizations detailed below) or governmental agencies will qualify so long as the public charity is not controlled by the foundation, or the terms of the grant do not cause the grant to be treated as earmarked for, or used by, the foundation itself. Grants to a "functionally integrated" Type III supporting organization also satisfy the distribution requirement. A Type III supporting organization is "functionally integrated" (according to interim IRS guidance) if the activities engaged in by the Type III supporting organization carried out for and on behalf of the supported public charities are activities that perform the functions of, or to carry out the purposes of the supported organizations and, *but for* the involvement of the supporting organization, such activities would normally be engaged in by the supported organizations themselves. An example of this would be a blood bank operating as a supporting organization to a hospital.

Grants to 509(a)(3) supporting organizations that are (i) non-functionally integrated type III supporting organizations, and (ii) any other supporting organization if a disqualified person of the distributing private foundation directly or indirectly controls the supporting organization or one of its supported organizations, are *not* qualifying distributions (even if the foundation exercises "expenditure responsibility" with respect to the grant, as "expenditure responsibility" relates only to whether the grant may be a taxable expenditure, not a qualifying distribution). See Chapter 24 on Supporting Organizations for a more detailed discussion of Type I, II, and III supporting organizations.

*Grants to a private operating foundation*. Grants to private operating foundations may qualify so long as the donor private foundation exercises Section 4945 expenditure responsibility, as described below.

*Grants to a foreign charity*. Distributions made to a foreign charity may qualify so long as the private foundation has made a good faith determination that the foreign charity would qualify as a public charity or a private operating foundation if it were located in the United States. The foreign organization must provide sufficient documentation to the foundation to permit the IRS to confirm such a determination.[23]

*Grants to noncharitable organizations*. Grants made to a noncharitable exempt organization (e.g., a trade association) or to a for-profit entity may qualify for the distribution requirement so long as the foundation has assured itself that the grant will be applied



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for charitable purposes by exercising Section 4945 expenditure responsibility.

*Set-asides*. Amounts set aside for a charitable purpose (but not currently distributed) may be counted towards the distribution requirement if the set-aside meets either a suitability test or a cash distribution test. Approval for the set-aside must be obtained from the Service.[24]

**Question** – May a private foundation ever make a grant to a private individual?

*Answer* – Yes. But the foundation must be very careful in making that grant. It must be: (1) made for study, travel, or similar purposes, (2) a scholarship, fellowship, prize, or award, (3) awarded on an objective and nondiscriminatory basis under a procedure approved in advance, or (4) intended to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill or talent of the grantee.

**Question** – What constitutes Section 4945 expenditure responsibility?

*Answer* – A grantor may rely on information in the IRS Business Master File ("BMF") or the grantee's current letter from the IRS granting exempt status (to ensure the donee organization is not a 509(a)(3) Type III, non-functionally integrated; see Chapter 24). The preferred method is to use the grantee organization's letter from the IRS granting exempt status because the BMF is relatively inaccessible. To determine whether a 509(a)(3) grantee organization is a Type I, Type II, or functionally-integrated Type III supporting organization , a private foundation may:

(1) Rely on a written representation signed by an officer, director, or trustee of the grantee that the organization is a Type I or II supporting organization. The grantor must also review and retain copies of the governing documents of the grantee organization and the written representation must describe the selection of the grantee organization's officers, directors, and trustees, and reference specific provisions within the governing documents creating a Type I or Type II supporting organization.

(2) Rely on a written representation signed by an officer, director or trustee of the grantee that the organization is a Type III functionally-integrated supporting organization, as long as:

- one or more supported organization(s) is identified;
- the governing documents and/or any other documents are collected and reference such a relationship; and
- an officer, director, or trustee of each supported organization provides a written representation confirming that it is functionally-integrated and describing the activities of the supporting organization.

A grantor may always rely on written opinion of counsel of either the grantor or grantee in the alternative.

**Question** – Are there significant non-tax benefits to creating a private foundation?

*Answer* – Although there are as many non-tax reasons for creating and funding a private foundation as there are potential donors, many donors and their families find that a private foundation can provide a focal point for family members to work together as they implement the mission of the foundation. Thus, a private foundation can serve as a way to both insure the passing on of the family's values, and to encourage the cooperation of family members with each other. Younger family members can often acquire valuable business and management skills through their involvement in the foundation's activities, and can also gain access and exposure to important local business and political leaders in their communities through the foundation. Family members can receive compensation for services rendered to the foundation, so long as the compensation is reasonable relative to the actual value of the services rendered to the foundation, and the work performed is actually needed by the foundation.

**Question** – What are a private foundation's annual reporting requirements?

*Answer* – Private foundations must file an annual information return with the IRS on Form 990-PF, "Return of Private Foundation."[25] This return is a public document and the foundation must make it



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available to any citizen who requests inspection of it. Any foundation that is subject to any of the excise taxes discussed above (except the tax on investment income, which is reported on and paid with the Form 990-PF) must file Form 4720, "Return of Certain Excise Taxes," and pay the excise tax imposed on it with the return. In addition, there may be state or local filing requirements that vary by jurisdiction.

**Question** – Who is a "substantial contributor" to a private foundation?

*Answer* – Anyone who makes a donation or bequest of more than $5,000, if the amount donated exceeds 2% of the foundation's total contributions and bequests received by the end of the year the donation is received.[26] Donations by a spouse or a trust are treated as made by the individual or the creator of the trust, respectively. Once a person has become a substantial contributor with respect to a private foundation, he retains that status until: (1) he makes no contributions to the foundation for 10 years, (2) he (and any related person) is not a foundation manager during the same 10-year period, and (3) the IRS deems the contributions to be insignificant relative to the contributions of one other person. If someone is a substantial contributor, that person is also considered a disqualified person for purposes of the excise taxes that are imposed on transactions involving self-dealing.

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*Example*: If Mr. Wong makes a donation of $10,000 to a private foundation, and in the year of the donation the foundation's total contributions and bequests received were $100,000, Mr. Wong would be a substantial contributor relative to that private foundation. However, if the foundation received $1,000,000 in total contributions and bequests in the year of Mr. Wong's donation, he would not be considered a substantial contributor, as his contribution does not exceed 2% of $1,000,000 (i.e., $20,000).

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## CHAPTER ENDNOTES

1. The fees for establishing and maintaining private foundations can vary depending on the location of the foundation, the size of the legal and accounting firms involved, and their experience, and the volume of work they do in this highly specialized area. There is, therefore, a considerable difference in opinion as to the size of the overall charitable gift that will make the creation of a private foundation economically cost-effective and viable. Some commentators feel a private foundation can be justified from a cost/benefit standpoint even in cases where much lower amounts than $1 million are involved. Others suggest alternative techniques should be considered for more modest overall gifts.
2. IRC Sec. 509(a).
3. Net investment income = Gross Investment Income (includes income from interest, dividends, rents, and royalties as well as similar sources) + Capital Gain Net Income (gain/loss on all property, except for gains from exempt use property held for at least one year).
4. IRC Sec. 4940.
5. IRC Sec. 4948(a).
6. IRC Sec. 4941.
7. IRC Sec. 4946(a).
8. IRC Sec. 4941(a).
9. IRC Sec. 4941(a)(1).
10. IRC Sec. 4941.
11. IRC Sec. 4941.
12. IRC Sec. 4942.
13. IRC Sec. 4943.
14. IRC Sec. 4944.
15. Treas. Reg §53.4944-1.
16. IRC Sec. 4945.
17. IRC Sec. 4942(j)(3).
18. IRC Sec. 170(b)(2).
19. *Blake v. Comm.*, 83-1 USTC 86,081 (2nd Cir. 1982).
20. Treas. Regs. §§1.170A-9(e)(10), 1.170A-9(e)(11), 1.170A-9(e)(12), 1.170A-9(e)(13), -1.170A-9(e)(14).
21. IRC Sec. 170(b)(1)(A)(vi).
22. IRC Sec. 509(a)(2).
23. Treas. Reg. §53.4942(a)-3(a)(6).
24. IRC Sec. 4942(g)(2).
25. IRC Sec. 6033.
26. IRC Secs. 4946(a)(2), 507(d)(2).