Philanthropy as a Family Affair: Using a Private Foundation to Achieve Your Charitable Goals

~ Susan B. Hecker

Establishing a private foundation can be a fulfilling way to work with charities, but be prepared for added work and extensive oversight.

Private foundations provide a useful long-term vehicle for families to closely manage their charitable activities. A private foundation is established when an individual or family funds a new nonprofit organization. In contrast to a direct charitable gift, a gift to a private foundation provides the donor family with control over the expenditure of funds throughout the life of the foundation. Under the direction of the donor or the donor's family, a private foundation invests the donated funds and makes direct distributions to other charitable purposes each year. Private foundations can be structured with a short-term focus or a broader goal lasting into perpetuity—with many planning opportunities that fall somewhere in between.

Choosing the Right Structure for Your Goals

Once you or your family decides to establish a private foundation, you can choose to structure it either as a trust or as a not-for-profit corporation. Both give you and your family the opportunity to closely manage the affairs of the foundation, but one form may better match your specific philanthropic goals. Let's look at the potential benefits and drawbacks of each.

Formation Documents and Governance. If you form your private foundation using a trust, the trust must be irrevocable (that is, you cede rights over the trust and its property). But this structure offers you, as the founding donor(s), added flexibility since the initial trust agreement can be tailored to meet your particular expectations. The trustees, as set forth in the trust agreement, manage the trust.

A Florida not-for-profit corporation is similar in nature to a regular business (for-profit) corporation, and you establish it by filing Articles of Incorporation with the Florida Department of State. A board comprised of at least three directors who elect corporate officers manages the corporation. If you elect to use a not-for-profit corporation for your philanthropic giving, you can structure the foundation as a membership organization in which family members can elect the board of directors. This is useful if you expect that the board will include family and non-family members or if one generation of your family wishes to control the board's composition.

In either case (trust or not-for-profit corporation), the new entity must apply to the IRS for its federal tax exemption and recognition of its private foundation status. The application for tax exemption is made at the time of entity formation by filing a Form 1023 with the IRS. Although this form can take many months to be reviewed and approved, the IRS typically grants tax-exempt status retroactively to the foundation's formation date.

Annual Reports. A not-for-profit corporation must file an annual report with the state of Florida. A trust is not required to register with the state of Florida on an annual basis.

Ongoing Flexibility to Achieve Your Philanthropic Goals. A corporate foundation is more flexible than a trust on an ongoing basis because the board of directors may limit or expand the foundation's purposes as described in the Articles of Incorporation, Bylaws, and informal policy statements. In contrast, you can generally amend a trust agreement only to maintain the trust's tax-exempt status. While the trust document can incorporate some flexibility (such as providing a mechanism for the election of a board of advisors to make certain decisions), a trust is generally less flexible than a corporation. However, you could consider this inflexibility to be a benefit if you and your founders wish to exercise more control over the private foundation and do not want future generations to change the initial governing documents and purpose for which you created the foundation.

Annual Meeting and Recordkeeping. The board of directors of a corporation, or trustees of a trust, needs to meet at least annually to discuss investment policy and to authorize charitable distributions. The directors or trustees should keep minutes of annual foundation meetings to properly document the decisions they make. Depending upon how distributions are handled (e.g., to other qualified charities or directly to individuals), the board's day-to-day activities may be relatively modest or quite time-consuming. Larger foundations with more activities may need to hire staff.

Distribution for Charitable Purposes: Distribution Requirements

To maintain its tax-exemption status, a private foundation must make "qualifying distributions" during the year or incur an added excise tax. A qualifying distribution is any amount (including ordinary and necessary administration expenses) paid to accomplish one or more charitable purposes. The distribution does not necessarily need to be a grant to another charitable organization. However, unless the same amount is placed into active charitable use within 12 months, a distribution to another private foundation or to a public charity controlled by disqualified persons is not a qualifying distribution. In general, to avoid the excise tax, qualifying distributions must equal 5 percent of the average annual fair market value of the foundation's assets.

You must make all grants and distributions from the foundation for charitable purposes. One simple way to meet the distribution requirement is to distribute funds directly to established, tax-exempt public charities. That is also the safest strategy. However, foundation funds may not be used to satisfy your preexisting charitable pledges. Specific rules govern how a private foundation may make grants to individuals or non-exempt organizations, making these gifts more complex than gifts to public charities. For instance, if the foundation plans to grant scholarships to individuals, then it needs to obtain IRS approval for the grant-making procedure. This can be accomplished when the foundation applies for its tax exemption from the IRS.

Avoid Prohibited Transactions Between You and the Foundation

A private foundation is prohibited from engaging in business dealings with its board of directors, trustees, and substantial contributors (referred to as "disqualified persons"). You, your family members, and any businesses in which you are substantial owners will be disqualified persons with respect to your foundation. These "prohibited transaction" rules are extremely broad and generally prohibit any sale, exchange, lease, or other similar transaction between a foundation and a disqualified person. While there are some reasonable exceptions to these rules, the exceptions are not as reasonable as one might expect. If the IRS determines that a disqualified person has engaged in any activity that violates the prohibited transaction rules, then the disqualified person may face severe monetary penalties called "intermediate sanctions." Further, the foundation could be stripped of its tax-exempt status.

Because of the onerous rules governing prohibited transactions, it is very important that you completely separate your personal business and other business-oriented investments from your foundation's activities. Any investment by the foundation in your business—or any contribution of business assets by you or your family to the foundation—would be either strictly prohibited or would require careful examination by the directors or trustees.

Public Disclosure Requirements

All foundations are required to have certain documents available for public inspection on an ongoing basis during regular business hours at the foundation's regular place of business. These documents include a copy of the application for recognition of exemption (including attachments, such as the trust agreement or Articles of Incorporation), the determination letter from the IRS, and any other document issued by the IRS to the foundation. In addition, the foundation is required to make a copy of its annual information returns available for public inspection and must provide a copy of the foregoing documents to any person requesting them. We sometimes say that private foundations are operated in a fish bowl, as anyone can look in.

Income Tax Deduction for Gifts to the Foundation

You and other donors can deduct contributions of cash or marketable securities to a private foundation to the extent of the gift's fair market value. However, the deduction allowed each year is generally limited to 30 percent of your adjusted gross income. Contributions of other appreciated property (such as artwork, appreciated land, or closely held business interests) are deductible only to the extent of your tax basis in the property (or its original cost), regardless of its fair market value.

In contrast, contributions to a public charity (e.g., a church, a school) are generally deductible in a given year to the extent of 50 percent of your adjusted gross income. Contributions of appreciated real property and closely held business interests are generally deductible to the extent of 30percent of your adjusted gross income if you deduct the fair market value of such assets.

We recommend you coordinate closely with your accountant when structuring any gift to a private foundation to maximize your opportunity for an income tax charitable deduction.

Is a Private Foundation Right for You?

A private foundation provides a mechanism for you or your family to control, invest, and distribute charitable funds. It can also serve as a vehicle to help instruct your children in your philosophy on charitable giving and as a mechanism to bring family members together through the years. A foundation can act as a buffer through which to filter the many charitable requests that you receive annually. A foundation can also have the benefit of providing its board members or trustees with reasonable compensation for actual services rendered. Despite its benefits, operating a private foundation can require a significant amount of time and effort, and, as we've already noted, private foundations are subject to many limitations. As you consider your philanthropic goals, you may wish to compare the benefits of a private foundation with other gifting options.

Other Options to Consider

Donor-advised Funds. Direct gifts to charitable organizations lack the restrictions that apply to private foundations. However, such direct charitable gifts also provide less of an opportunity for you to control the distribution of charitable funds. Depending upon your goals, you may wish to consider establishing a donor-advised fund with a community foundation or other tax-exempt public charity whose mission is consistent with your philanthropic goals. A gift to a donor-advised fund is a completed gift for tax purposes, meaning you can take an immediate income tax charitable deduction. However, your gift would be held in a special "fund," and your family would provide guidance to the community foundation regarding the ultimate charitable recipients of your donated funds. Even though, in this situation, the charity would have control over the donated assets, as a practical matter, your family's recommendations, if reasonable, should be respected. A donor-advised fund can provide a simple, uncomplicated approach to long-term giving if you want to create a lasting legacy without the complexities and administrative burdens of establishing a private foundation.

Public Supporting Organizations. If you have a specific charitable recipient in mind, then you could consider establishing a public supporting organization. A supporting organization is a charitable foundation characterized as a public charity because it is "married" to another public charity. A supporting organization can be established and controlled by a family. However, because it would be organized and operated exclusively to support a particular public charity, the organization would be considered a public charity and not a private foundation. Public charities have the benefit of not being subject to the various excise taxes and prohibited transaction rules discussed above, but they are subject to operational and organizational rules that don't apply to other kinds of charities. Another benefit of this vehicle is that income tax deductions for contributions to public charities are more favorable than they are to private foundations.

Private Operating Foundations. Another option is to establish a private operating foundation, which is a private foundation that directly engages in charitable work. Donations to a private operating foundation are deductible to the same extent that they would be to a public charity. However, because private operating foundations may be funded by a limited source (such as one individual or family rather than by public donations and grants), these foundations are subject to most of the restrictions that apply to non-operating foundations.

A private operating foundation must devote its assets or income to the active conduct of charitable operations rather than make grants to other charitable organizations. The foundation must meet several income and assets tests in order to satisfy the operating foundation rules. If you expect that the foundation will be directly involved in doing charitable work (but it is not expected to meet a broad public support test), then this type of foundation may be appropriate for you and your family.

Conclusion

In summary, private foundations can serve an important role for families that want to deepen their philanthropic efforts. We have helped many families in the Sarasota community achieve their charitable goals and make a meaningful contribution to our community through the creation of private foundations. Because of the added work and extensive oversight they require, as well as other options you may want to consider, it is imperative that you seek legal counsel prior to forming a private foundation for you and your family.

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