Private Foundations

A strategy to help affluent families work toward their charitable goals

Each year, Americans contribute billions of dollars to charitable causes; however, many donors would prefer to give money by creating their own foundations rather than giving to established organizations. In fact, the number of American grant-making foundations has doubled to more than 70,000 since 1990, according to **The Foundation Center.**

Technically, a private foundation is a nongovernmental, nonprofit organization with its own funds (usually from a single source, either an individual, family, or corporation) and a program managed by its own trustees or directors that was established to maintain or aid educational, social, charitable, religious, scientific, or other activities serving the common welfare, primarily by making grants to other nonprofit organizations.*

Less formally, a private foundation is a charitable tool through which individuals and families can implement their personal charitable philosophies in a manner they deem most beneficial. A private foundation was selected by John D. Rockefeller and Andrew Carnegie, and more recently, technology pioneer David Packard (co-founder of Hewlett-Packard), and former Microsoft CEO Bill Gates donated funds for the welfare of the public while maintaining control over the disposition of those funds.

Why create a foundation?

A charitable foundation often bears the name of the family that created and funded it. The foundation lets donors and their families:

- **Create an enduring vehicle for the family's charitable gifts and instill the family's values in future generations.** Trustees or a board of directors—that often includes both family members and professionals outside of the family—manages a foundation. Active participation on the foundation board or committee can serve as a useful tool for educating and instilling the founding family's values in succeeding generations. Involving younger generations in the formal decision-making and analytical process regarding charitable giving can actively teach family values and keep the family vision alive through many generations.
- **Establish a family name among the philanthropic and create a legacy.** Foundations can have a perpetual life. If an individual wants to create a permanent family legacy or keep a loved one's memory and name alive, a private foundation may be the charitable vehicle of choice. In addition, a private foundation can serve as a mechanism to maintain family harmony and enable family members to achieve a number of charitable objectives in their own way.

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- **Achieve tax advantages.** Overcoming income, capital gains, estate, and gift taxes is perhaps one of the foremost challenges facing affluent families. Assets placed in a private foundation will not only avoid these taxes but will also result in an income tax deduction. (Note that the deduction is limited to 30% of adjusted gross income [AGI] in any one year if the donation is in cash and 20% if in appreciated securities. There is a five-year carryforward for any unused deduction. Compare the donation with a public charity that has a 60% annual deduction limit for cash and 30% for securities.)

  Although assets donated to the foundation will not be passed directly to heirs, family members can serve on the foundation's board and be paid a salary based on the reasonable value of the work they perform. (Note: A private foundation that is not a community or operating foundation [see "Foundation Types-at-a-Glance" on page 3] is subject to a 1% to 2% tax on investment income, including interest, dividends, and capital gains.)

- **Maintain a greater degree of control over donated assets.** When donating to a public charity, the donor ultimately loses control over the disposition and use of those assets. When donating to a private foundation, the trustees or board members retain control over the use of the assets. Family members can then support charitable causes that have emotional appeal and provide satisfaction.

Determining the type of foundation to create

The term "foundation" encompasses several different organizations that have different objectives. You will want to familiarize yourself with the possibilities on page 3 and then work with your team of advisors, including your financial advisor, to determine the most appropriate vehicle for your goals.

Establishing a private foundation

Generally, a private foundation is set up as either a trust or not-for-profit corporation. Your state laws may favor one form more than another, and each structure has its own advantages and limitations.

If the legal entity chosen is a trust, the trustees are governed by the trust document terms. Changing those terms requires a court proceeding to amend the trust document, which benefits a donor who wants to maintain the foundation's original purpose and structure. Because private foundations are typically meant to endure for many generations, more flexibility may be desired.

The corporate structure allows such flexibility. A corporate charter and bylaws can be more readily adapted to changing circumstances. Further, corporate documents may provide for the restructuring of the foundation's internal governance, if necessary. But your state will probably require annual corporate filings.

Because both state and federal tax laws govern private foundations, you should talk with an attorney about which option is best given your situation and family goals before structuring your foundation.

Foundation types at-a-glance

Independent foundation

- A private foundation typically funded by a single individual or family (not a corporation).
- Larger foundations tend to be managed by professional staff, smaller foundations by directors or trustees.
- Family members usually take an active role in foundation and asset management.
- Most are endowed, which means they make grants of investment income from a principal fund.
- This category is by far the largest and most varied.

Corporate foundation

- A private foundation established by a business corporation as a separate legal entity.
- Effective for carrying out systematic charitable-giving programs.
- Giving is focused on the local community's educational, cultural, and social welfare needs.
- Company senior executives and directors sit on the foundation's board.
- Most use current profits to distribute funds.

Community foundation

- A public charity that receives funding from multiple sources.
- Typically provides funding for local or regional projects that benefit the public or community.
- May offer donor-advised funds, but some are national in scope.

Operating foundation

- A private foundation that uses its funds primarily for its own charitable activities rather than granting funds to other charities (e.g., the foundation operates a school for disadvantaged children).
- Categorized separately by the Internal Revenue Code and receives a more favorable tax status than a private foundation.

Tax-exempt status

To achieve tax-exempt status under the Internal Revenue Code Section 501(c), a private foundation must file an "Application for Recognition of Exemption" under IRCS 501(c)(3) (Form 1023) within 15 months of establishment. If the application is filed in a timely manner and a tax-exempt status is granted, contributions made to the foundation before approval and thereafter will be tax-deductible. All donors must be provided with a written receipt to substantiate their contributions (see IRS Publication 1771). A private foundation must also file a detailed annual informational return (Form 990PF) and may be subject to a small investment income tax.

Make educated decisions

	Private foundation (PF)	Charitable remainder trust (CRT)	Charitable lead trust (CLT)	Public charity (PC) *(Includes donor-advised funds)*
Is income to donor allowed?	Staff may be paid a reasonable salary for actual work performed; should not be viewed as a vehicle to generate income for donor or his or her family	Donor and/or beneficiaries entitled to income of at least 5% (maximum determined by IRS tables and regulations)	No income to donor or beneficiaries until termination of charity's income interest in the trust.	No income to donor or beneficiaries
What is the benefit to charity?	Charity must receive 5% or more of PF value each year	Charity benefits when trust's term ends	Charity benefits from current annual distributions for trust's term.	Charity receives current benefit from contribution
Are capital gains taxes avoided on donated appreciated property?	Yes	Yes, on initial transfer (some amount of capital gain may be distributed to donor through annual distributions)	No (except if set up at death and assets receive step-up in basis).	Yes
How is the donation's value determined?	Fair market value (FMV) of cash and appreciated marketable securities; may be limited to cost basis on real estate, restricted stock, closely held corporations, and other appreciated assets	A percentage of the FMV of contributed cash and appreciated securities equal to a present value of the charity's future interest; may be limited to a percentage of cost basis on real estate, restricted stock, closely held corporations, and other appreciated assets (depending on status of possible beneficiaries as public or private)	1. Nongrantor trust. No deduction; trust income not taxable to donor. 2. Grantor trust. Present value of charity's income interest; all trust income in subsequent years taxable to donor with no offsetting charitable deduction.	FMV of contributed cash and most appreciated assets
What are the deduction limitations?* *Cash gifts*	30% of adjusted gross income (AGI) with five-year carryover	30% to 60% of AGI (depending on the possible status of the ultimate charitable beneficiary) with five-year carryover	If a grantor trust, same as for CRT.	60% of AGI with five-year carryover
Appreciated securities	20% of AGI with five-year carryover	20% to 30% of AGI (depending on the possible status of the ultimate charitable beneficiary) with five-year carryover	If a grantor trust, same as for CRT.	30% of AGI with five-year carryover
Real estate	FMV reduced by ordinary income that would be realized if sold	FMV reduced by ordinary income that would be realized if sold	If a grantor trust, same as for CRT.	30% of AGI with five-year carryover
Can donor control use of charitable funds?	Yes (except if funds come from donor's CLT)	Donor may change CRT's charitable beneficiary and may include donor's PF	Donor may not change charitable beneficiaries but may appoint independent trustee to do so.	Donor may make suggestions, but charity has ultimate control

Always consult your tax advisor regarding your specific situation.

Other government regulations

A number of Internal Revenue Service Code Sections govern private foundations. The primary provisions are summarized starting on page 7. You will want to review these provisions with your tax and legal advisors.

Investment considerations

Charitable trust investments are subject to a number of standards, most notably the prudent investor standard. More than 40 states have adopted the Uniform Prudent Investor Act (UPIA) either in full or with minor modifications. This act provides fiduciaries greater flexibility in the investment choices they make regarding a foundation's assets.

In jurisdictions where the UPIA has not been adopted, the "prudent man standard" applies. That rule directs that the prudence of investment decisions must be analyzed based on the performance of the individual investments (such as the performance of a particular stock, bond or mutual fund without regard to its role in the overall portfolio).

The UPIA modifies the prior (prudent man) standard by incorporating modern portfolio theory in the analysis. Thus, the prudence of investment decisions under UPIA is measured by the portfolio's performance as a whole rather than investment by investment.

Charitable corporations may be subject to a different, less strict standard, the "business judgment rule." The Uniform Management of Investment Funds Act adopted by the majority of states provides a compromise for both trusts and corporations. You should consult your attorney to determine the standards to which your foundation would be subject.

Foundation trustees or boards are encouraged to develop an investment policy statement. This document outlines the foundation's investment objectives and guidelines and can provide all parties involved:

- A clear understanding of the foundation's needs and goals
- Investment-management guidelines consistent with the foundation's goals and objectives
- Selection criteria for choosing investments or investment managers for all or part of the foundation's assets

Your financial advisor can help educate you about drafting an investment policy statement and then develop a portfolio allocation consistent with it. Particularly useful in this process is a portfolio review, which analyzes your foundation's current asset allocation and proposes a reallocation that may be more in line with your investment policy and charitable goals. This service can help trustees or directors meet the directives of the prudent investor rule or the prudent man standard.

The UPIA also lets fiduciaries delegate investment and management functions to experts as long as the delegation is made in good faith. This provision lets fiduciaries take advantage of private money managers. The evaluation and selection of private money managers can be an integral part of your foundation's portfolio review. Be sure to ask your financial advisor how you can begin taking advantage of these valuable services for foundation investment committees, trustees, and boards of directors. (See also the “Jeopardy Investments” section of “Foundation Rules and Prohibited Transactions” on page 8.)

Alternatives and comparison of gifting techniques

Perhaps you want the tax and control benefits of a private foundation, but a private foundation’s other characteristics are not suitable for your goals. Consider donor-advised funds as an alternative. These funds are generally created in conjunction with a public charity or community foundation. You make a substantial contribution, which is held in the fund until you decide to distribute all or a portion of your contribution to a charity of your choice. You are entitled to an income tax deduction when you make your initial contribution, although you may direct payments to charitable organizations at a later date. Donating in this manner eliminates the cost of establishing a private foundation but also limits the flexibility of controlling your donations.

Certain investment companies have created independent community foundations, sometimes called charitable gift funds.

Private foundations are often discussed in the same context as other charitable-gifting techniques, such as donor-advised funds, charitable trusts, and public charities. Each technique differs in form and function, as the chart on page 4 indicates.

Evaluating your alternatives

During the coming decades, we will witness the greatest wealth transfer in history. Without proper strategizing, more than half of these assets will transfer directly to the IRS. Private foundations let families and individuals target specific charitable causes while reducing the size of taxable estates. As a result, you gain more control over the transfer of family wealth and reduce the amount lost to income and estate taxes.

What steps do I need to take?

If you decide that a private foundation makes sense for you and your family, here are the steps you need to take:

1. Determine your goals—specifically whom you want to benefit and how.
2. Talk with an attorney who is well-versed in this area. Your financial advisor can help you find one if you need assistance.
3. Your attorney will help you establish a not-for-profit corporation or trust.
4. Your attorney should complete Form 1023 to obtain IRS tax-exempt status.
5. Determine the individuals and/or entities that will be involved in your foundation’s management. This may include you (but check with your attorney to be sure that your foundation’s structure allows for your involvement). You may wish to include children, grandchildren, and in-laws. Consider also a corporate trustee to provide expertise in managing assets and maintaining your foundation’s tax-exempt status.

6. Determine what assets and how much you wish to contribute. Account for the following:
    a. Do you have appreciated assets that you would like to sell and avoid capital gains taxes? These may be good assets to fund your foundation.
    b. How much can you deduct in one year? In the next five years? Should you spread your deduction over a number of years or fund your foundation with a substantial lump sum? All donors must be provided a written receipt to substantiate their contributions. Discuss these issues with your tax accountant.
    c. How much of the foundation's assets do you anticipate giving away in the coming years? The answer may affect your investment choices.
7. Work with your financial advisor to develop an investment policy statement for your assets in line with the goals you establish for your foundation. He or she can help you determine the best way to achieve those goals, whether through mutual funds, private money managers, or choosing your own securities with your financial advisor's guidance. You may also wish to delegate full investment authority to a professional trustee and relieve yourself of the burden.
8. Once your foundation is up and running, you must provide the IRS an annual informational tax report on Form 990PF. If you and your family are acting as trustees and investment managers, you will probably need to talk with your tax accountant or attorney to prepare this document.
9. Periodically, you should review your investments with your financial advisor to be sure your goals are being met and have not changed.
10. Many individuals like to involve family members in making grant decisions. Family members could be informal advisors or voting board members.

Foundation rules and prohibited transactions

1. **Exclusively for charitable purposes.** Private foundations must be established and operated exclusively for charitable purposes. Noncompliance with this rule can result in significant penalties.
2. **Mandatory distribution rule.** Private foundations must distribute an amount that generally equals 5% of the foundation's net investment assets each year. Under Section 4942, failure to distribute will result in an excise tax on a percentage of the foundation's accumulated income. The tax is initially 30% of undistributed income. It increases to 100% if the failure to distribute is not corrected within the specified period.
3. **Self-dealing issues.** IRC Section 4941 imposes an excise tax on "disqualified persons" for any transactions involving self-dealing with a private foundation. The tax, imposed on the individual who is self-dealing, initially amounts to 10% of the amount involved in the prohibited transaction and can increase to 200% of the amount involved if the problem is not corrected in a timely manner. Additional excise taxes of 5% to 50% can be imposed on a foundation manager who participates in another's acts of self-dealing. The term "disqualified persons" is interpreted to include the following classes of individuals:

- A substantial contributor to the foundation, which means an individual who donates more than 2% of the total contributions during any taxable year. When dealing with trusts, the substantial contributor would be the trust's creator.
- The manager of the foundation, meaning any foundation officer, director, or trustee.
- An owner of more than 20% of (1) the corporation's aggregate voting power; (2) the partnership interest; or (3) a trust that is a substantial contributor to the foundation.
- Family members of any individual who is a substantial contributor, foundation manager, or 20% owner. Family members include spouses, ancestors, lineal descendants, and the lineal descendants' spouses.
- Corporations, trusts, and partnerships in which substantial contributors, trust creators, foundation managers, 20% owners, or family members of 20% owners own more than a 35% beneficial interest or voting power.

The following transactions between a disqualified person and the foundation can be deemed as self-dealing: (1) selling, exchanging, or leasing of real property; (2) lending money or credit; or (3) furnishing goods, services, or facilities.

4. **Jeopardy investments.** Under IRC Section 4944, a 10% tax is imposed on the value of any investments that jeopardize the foundation's charitable purpose. A jeopardizing investment is one in which the fiduciaries "failed to exercise ordinary business care and prudence under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation." The regulations indicate there are no jeopardizing investments per se. However, there are some investments that are subject to stricter scrutiny and which may be considered to be jeopardizing, such as trading in securities on margin, trading in commodity futures, investing in working interests in oil and gas wells, option trading, buying warrants, and selling short.
5. **Excess business holdings.** Under IRC Section 4943, neither a private foundation nor an individual considered to be a disqualified person may hold greater than a 20% interest in any active business without being penalized with an excise tax amounting to 10% of the foundation's total value of excess business holdings. If the prohibited transaction is not corrected in a timely manner, the tax may increase to 200% of the excess business holding's value.
6. **Taxable expenditures.** Under IRC Section 4945, a 20% tax is imposed on certain foundation expenditures. A separate 5% tax is imposed on the foundation manager who makes the taxable expenditure or who is aware of such expenditure. Taxable expenditures are classified as those made for the carrying on of propaganda, attempting to influence the outcome of public elections, or making grants to nonpublic charities or for noncharitable purposes.

You can count on us

We offer a number of services to help your charitable endeavors. Through our financial advisors, we can provide assistance with one or more of the following services:

- Estate planning services to help you determine how charitable strategies can work for you
- Helping the foundation develop a written investment policy statement and establish a process for setting goals and making investment decisions
- Asset allocation strategies
- Investment manager search and selection
- Quarterly review of investment managers' activities and performance
- Custody services
- Trustee services*

We believe affluent families need the assistance of a complete team, including your financial advisor, tax advisor(s), and legal advisor(s). Be sure to ask your financial advisor about a variety of ways to help you meet your estate planning and gifting goals.

**Trust services through banking and trust affiliates in addition to nonaffiliated companies of Wells Fargo Advisors.*

7. **Unrelated business income.** Private foundations are generally exempt from paying federal income taxes on generated income or gains with the exception of two cases: (1) transactions involving unrelated trade or business income, or (2) transactions involving debt-financed property. If a foundation derives income or gains from unrelated trades or businesses, income taxed at corporate income tax rates, known as unrelated business taxable income (UBTI), must be reported on Form 990-T. Transactions involving unrelated debt-financed property or acquisition indebtedness may also result in UBTI. This means that if a foundation incurs indebtedness to acquire property that produces income, the resulting income from that property will be characterized as debt-financed income and subject to federal income tax.

This publication is for informational purposes only. It is important to seek the advice of your legal and tax advisors to determine whether establishing a foundation is appropriate for you.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is provided with the understanding that the publisher is not engaged in rendering legal, accounting, or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

The information provided is based on internal and external sources considered to be reliable; however, the accuracy of this information is not guaranteed. Specific questions on taxes or other legal issues as they relate to your individual situation should be directed to your professional advisor.