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PRIVATE FOUNDATIONS

To fulfill one's charitable goals, there may be times that the establishment of a private foundation will be the entity of choice. Like a public charity, a private foundation must be operated for public purposes, i.e., exclusively for religious, charitable, scientific, literary or educational purposes. Generally, the private foundation will be exempt from income tax, and contributions to a private foundation will be deductible for income tax, gift tax and estate tax purposes.

Private foundations differ from public charities insofar as a private foundation often has only one source of funding (usually one person or family), the private foundation does not engage in direct charitable activities (it makes grants to other charities to perform public service), and the funds available for grants and administrative expenses come from income generated from the investment of the assets comprising the private foundation. There are two distinct differences normally associated with private foundations when comparing them to public charities.

The first difference relates to the annual limitation on the federal income tax deduction available for donations made to a private foundation. For example, when cash gifts are made to a public charity, the donor is entitled to a deduction in that year of an amount not exceeding fifty percent (50%) of the donor's adjusted gross income. Any unused charitable income tax deduction can be carried over for five subsequent years. Cash donations made to a private foundation may only be deducted in the year of contribution to the extent of thirty percent (30%) of the donor's adjusted gross income, although the unused portion of such charitable income tax deduction may be carried forward for five subsequent years (although still subject in each of those subsequent years to the thirty percent (30%) of adjusted gross income limitation). The annual deduction limit of gifts of appreciated capital property, such as real estate or marketable securities, whose current fair market value exceeds the donor's adjusted basis, when donated to a public charity, is limited to thirty percent (30%) of the donor's adjusted gross income, whereas the limitation for the donation of appreciated capital property to a private foundation is twenty percent (20%) of the donor's adjusted gross income.

The second difference relates to the special requirements and excise taxes imposed pursuant to Sections 4940 through 4945 of the Internal Revenue Code of 1986, as amended (the "Code"). Because of what the IRS perceived as being abuses of the use of the tax-exempt status of private foundations, Congress enacted a system of alternative penalty taxes that can be imposed against the private foundation and, under certain circumstances, against the manager of the private foundation. The system of penalty taxes is intended to ensure that both public charities and private foundations are organized and operated so that no part of the organization's earnings inure to the benefit of any private shareholder or individual.

Section 4940 of the Code requires each private foundation to pay an annual excise tax equal to two percent (2%) of its net investment income. Net investment income includes interest, dividends, rents, royalties, long-term capital gains and short-term capital gain. The two percent (2%) excise tax can be reduced to one percent (1%) if the qualifying distributions for charitable purposes made by the private foundation are increased by an equivalent amount.

Section 4941 of the Code prohibits the private foundation from entering into financial transactions with persons characterized as "disqualified persons." Disqualified persons include individuals who are members of the board of directors or trustees of a private foundation, foundation managers, substantial contributors to the private foundation, and certain family members of the aforedescribed individuals. The prohibition against acts of self-dealing applies regardless of whether the transaction is fair and reasonable, or economically benefits the private foundation. Prohibited transactions include selling, exchanging, releasing property, lending money or extending credit, and furnishing goods, services, or facilities. The payment of reasonable compensation and the reimbursement of reasonable expenses are specifically excepted from the prohibition, but the Internal Revenue Service strictly scrutinizes compensation paid to disqualified persons and expenses reimbursed to disqualified persons. The self-dealing penalty tax is imposed on the disqualified person at the rate of five percent (5%) of the amount involved. Additional taxes of two hundred percent (200%) of the amount involved is imposed if the self-dealing act is not corrected within a prescribed period of time.

Section 4942 of the Code imposes a penalty tax in the event that a private foundation does not pay, on an annual basis, an amount equal to five percent (5%) of its investment assets in the form of qualifying distributions. For example, a private foundation with investment assets of $500,000 is required to make qualifying distributions equal to roughly $25,000 for that year ($500,000 x 5%). If the private foundation fails to meet this distribution requirement, an initial penalty tax of fifteen percent (15%) will be imposed on the shortfall. Note that the qualifying distributions must be made within twelve months after the end of the previous tax year. Qualified distributions must be made to public charities which are not controlled by the private foundation or its disqualified persons. Administrative expenses which are reasonable and necessary to accomplish the charitable purposes of the private foundation may be included in the calculation of qualifying distributions.

Section 4943 of the Code prohibits a private foundation from *controlling* a business entity. In general terms, a private foundation may not own more than twenty percent (20%) ownership interest in any business entity. Under certain circumstances, that percentage limitation may be increased to thirty-five percent (35%) if effective control of the business entity rests with one or more persons who are not disqualified persons. Note that the interests in the business entity owned by disqualified persons are aggregated with the interests owned by the private foundation for purposes of determining whether the percentage limitations have been exceeded unless the private foundation itself owns less than two percent (2%) of the outstanding business interest.

In the event that more than a twenty percent (20%) ownership in a business entity is contributed to a private foundation, the private foundation is provided with a five year period of time within which to divest itself of enough of its interest in the business entity to reduce its ownership interest to twenty percent (20%) or less. If the private foundation fails to divest itself of a greater than twenty percent (20%) ownership interest within the five year period, the private foundation is

subject to an initial tax of five percent (5%) of the amount held in excess of the twenty percent (20%) limitation.

Section 4944 of the Code prohibits any investment by a private foundation that might jeopardize the private foundation's exempt purpose. An investment is generally considered to be in violation of this prohibition if a determination is made that the board of directors or trustees of the private foundation fail to exercise ordinary business care and prudence in making the investment. An initial tax of five percent (5%) of the amount of the investment will be assessed against the private foundation for any such violation. Furthermore, a tax of five percent (5%) may also be assessed against the foundation manager.

Section 4945 of the Code prohibits certain activities that may promote the contributors' interests rather than interests of the public. A penalty tax is imposed on what is referred to as "taxable expenditures." Taxable expenditures include expenditures made in conjunction with carrying on propaganda or otherwise attempting to influence legislation, attempting to influence the outcome of any special election, making grants to individuals unless the private foundation uses objective and nondiscriminatory procedures that have been approved in advance by the IRS, making grants to entities other than public charities unless the private foundation exercises expenditure responsibility over the grants, and the making of grants for non-charitable purposes. If a private foundation makes taxable expenditures, a tax on the amount of the taxable expenditure is imposed at the rate of ten percent (10%) on the private foundation and two and one-half percent (2½%) on a foundation manager who knowingly approved the taxable expenditure. Additional taxes of one hundred percent (100%) may be imposed on the private foundation (and fifty percent (50%) on the foundation manager) on the amount of the taxable expenditure if the taxable expenditure is not timely corrected.

Generally, private foundations take the form of either a corporate entity or a trust. The choice of which entity to use to establish the private foundation is often affected by state law and the specific objectives of the individual wishing the create the private foundation.

There are several types of private foundations, including nonoperating foundations, operating foundations and pass-through (conduit) foundations. The selection of the specific type of private foundation to be formed will be determined by the goals and objectives of the individual establishing the private foundation.

Private foundations can be funded through direct contributions as well as contributions that occur through a charitable lead trust or a charitable remainder trust. Moreover, private foundations can be created as a result of testamentary distribution, such as a devise pursuant to a will or an inter vivos trust upon the death of the trust's grantor.

A private foundation can provide a fulfilling medium for individuals that wish to engage in charitable pursuits in a business-like manner, while maintaining control and flexibility over their charitable endeavors. It is important that the individuals managing the private foundation pay close attention to the complex rules governing its operation so that neither the private foundation nor individuals closely associated with the private foundation will incur unnecessary excise taxes or cause the private foundation to lose its tax-exempt status. Therefore, individuals establishing or managing private foundations must surround themselves with qualified professional advisors.

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