Private Foundations and the Alternatives

A private foundation offers an individual donor significant flexibility and control in making charitable gifts. A private foundation also can provide opportunities for a donor's family to become involved in charitable giving in an organized and meaningful way. However, some donors find the administrative work required for maintaining a private foundation somewhat overwhelming. A donor who is interested in establishing a private foundation may wish to consider alternative methods of charitable giving before deciding to form a private foundation. This memorandum (1) summarizes the advantages and disadvantages of establishing a private foundation; (2) discusses different forms of private foundations; and (3) describes some alternative vehicles for charitable giving.

Private Foundations

A private foundation is a type of trust or corporation that qualifies as a tax-exempt entity under Section 501(c)(3) of the Internal Revenue Code (the "Code"). All Section 501(c)(3) organizations must be organized and operated exclusively for charitable, religious, scientific, or educational purposes. Certain Section 501(c)(3) organizations that are publicly supported (as opposed to being funded by an individual or family) are treated more favorably under the Code. Those organizations are commonly referred to as "public charities." Virtually every foundation established by an individual donor or family will be treated as a private foundation and not a public charity under the Code. One essential difference between a private foundation and a public charity is that deductions for gifts to private foundations are more limited than deductions for gifts to public charities. For example, a donor can deduct a cash gift to a public charity up to 50 percent of the donor's adjusted gross income for that year. A cash gift to a private foundation is subject to a deduction limitation of 30 percent of a donor's adjusted gross income. Gifts of appreciated property are subject to 20 to 30 percent limitations, and a donor to a private foundation may deduct only the tax basis rather than the fair market value for gifts of certain kinds of appreciated property.

To establish a private foundation, a donor must form a charitable corporation or trust under state law, register the private foundation with the state, and apply to the Internal Revenue Service (the "IRS") to obtain tax-exempt status. Once a private foundation is funded, it must file annual informational returns with the state and the IRS.

A donor will receive an immediate income tax charitable deduction for contributions to a private foundation, regardless of when the foundation ultimately distributes the money to other charities. A private foundation is unlike other vehicles for charitable giving in that a donor may control the investment and distribution of funds. Another advantage to a private foundation is that it can support significant charitable work over decades, allowing generations of family members to become involved with a charitable legacy.

The primary disadvantage to establishing a private foundation is the administrative burden associated with establishing and operating it. There is a 2 percent tax on the foundation's net investment income (which may be reduced to 1 percent if certain distribution requirements are met) and a prohibition on transactions between the foundation and donors, foundation managers, and family members of donors. In addition, a foundation must distribute each year an amount equal to at least 5 percent of its assets and comply with other significant restrictions on investments and distributions. These distribution requirements and restrictions are enforced by penalty taxes ranging from 2.5 to 200 percent.

Despite the burden of complying with the rules governing private foundations, many donors find private foundations to be an extremely satisfying and enriching way to engage in charitable giving.

Private Operating Foundation

A private operating foundation is a private foundation that actively engages in charitable activities. Because a private operating foundation does more than just distribute funds, contributions to a private operating foundation are subject to the more generous deductibility rules that apply to public charities. Private operating foundations are also exempt from some of the rules and excise taxes imposed on ordinary private foundations. However, a private operating foundation is subject to strict requirements regarding the distribution of income and management of assets. A foundation must actively conduct exempt activities on a continuing basis in order to qualify as a private operating foundation.

Supporting Organizations

A supporting organization is structured like a private foundation but qualifies for treatment as a public charity based on its relationship with one or more public charities. A supporting organization must carry out the purposes of a particular public charity or be operated, supervised, or controlled by or in connection with the charity. The board of directors or trustees of a supporting organization cannot be controlled by donors or their family members. A donor may wish to create a supporting organization to support a certain public charity that the donor has personally supported in the past. Because a supporting organization is so closely connected to a public charity, many of the regulations and prohibitions that apply to private foundations do not apply to supporting organizations. In addition, contributions to a supporting organization are subject to the more favorable deductibility rules that apply to public charities.

Pass-Through Foundations

A pass-through foundation is a type of private foundation that distributes all of its contributions within a given time frame, rather than allowing the contributions to grow in an endowment as with a traditional private foundation. All contributions to a pass-through foundation must be distributed to public charities no later than two and one-half months after the close of the foundation's taxable year. Pass-through foundations are subject to the investment and self-dealing restrictions that apply to traditional private foundations, but a donor receives an income tax deduction for contributions as if he or she had given directly to a public charity. Distributions from a pass-through foundation may not be made to an organization controlled directly or indirectly by the foundation, by a disqualified person, or by another private foundation.

Donor-Advised Funds

Donor-advised funds present an attractive alternative for donors who do not want to invest the time and money necessary to create and maintain a separate charitable entity. Donor-advised funds are separate accounts, but not separate entities, within a public charity. Donor-advised funds have much of the flexibility of a private foundation, without the donation restrictions and administrative burden ordinarily associated with a private foundation.

A donor-advised fund works as follows: A donor makes an unconditional and outright gift to a donor-advised fund administered by a public charity. The charity then grants the donor the privilege of making nonbinding recommendations regarding the distribution of funds to various charities. It is a key point that the donor's recommendations are advisory only. The donor is entitled to an income tax deduction for amounts contributed to the fund in the year of the contribution. Because the contribution is actually made to the public charity that administers the fund, the donation is subject to the more favorable deductibility rules that apply to public charities. Depending on the policies of the public charity administering the fund, the donor may be able to let a percentage of the assets in the fund build up for a number of years before making recommendations about distributions to charitable organizations.

Donor-advised funds have been in existence for decades; traditionally, they have been offered by community foundations with a local or statewide focus. Community foundations ordinarily control the investment of the fund assets, handle all tax reporting requirements, and offer information and assistance with grants to charities. This assistance makes community foundation donor-advised funds easy and inexpensive for a donor to set up and maintain. In recent years, large public charities and commercial mutual funds have offered donor-advised accounts with a national scope. Some charities that offer donor-advised funds require that some or all of the assets in a donor-advised account be spent on programs sponsored by the charity.

Charitable Remainder Trusts

A charitable remainder trust is an irrevocable trust that provides for distributions, at least annually, to one or more noncharitable beneficiaries over the lifetime of the beneficiaries or the term of the trust. After the trust terminates, the assets remaining in the trust are distributed to a charitable organization. Charitable remainder trusts allow a donor to give assets to a charity and receive a current income tax deduction for the donation while reserving an income stream for the benefit of the donor or members of the donor's family.

Charitable remainder trusts are subject to some of the restrictions that apply to private foundations. In particular, the prohibitions on self-dealing and the provisions relating to taxable expenditures apply to charitable remainder trusts. If the remainder beneficiary of the trust is a public charity, gifts will be subject to more favorable deductibility rules. If the remainder beneficiary is a private foundation, the donation is subject to the deduction limitations applicable to contributions to a private foundation.

Charitable Lead Trusts

A charitable lead trust is an irrevocable trust that provides for an income interest that benefits a charitable organization for the lifetime of an individual (or individuals) or a certain term of years. At the termination of the trust, the remainder interest may be retained by the donor or given to a noncharitable beneficiary such as a family member. The charitable lead trust offers donors a way to provide a benefit to a charitable organization and transfer assets to younger family members. To receive an income tax deduction for donations to a charitable lead trust, the donor must be treated as the owner of the income interest. In other words, the income must be taxed to the donor as it is received by the trust.

In general, charitable lead trusts are treated as private foundations in regard to the prohibitions against self-dealing, excess business holdings, jeopardy investments, and taxable expenditures. Therefore, it can be difficult to use an interest in a closely held business to fund a charitable lead trust.

Conclusion

Establishing and operating a private foundation can be an extremely rewarding experience for a donor and his or her family. Before undertaking such a venture, however, a donor may wish to explore other options for charitable giving.