



MAKING A DIFFERENCE: PRIVATE FOUNDATIONS

One of the many challenges facing wealthy families in today's fast-paced society is the need to meaningfully involve family members, including the rising generation, in the management of the family wealth enterprise. Families can derive great benefit from working together to define their core values and shared vision, and philanthropic work can further strengthen family engagement and commitment.

When the next generation experiences the satisfaction of making a positive impact on the world, it can demonstrate to them the value of working together as a family for a common purpose and help prepare them for their transition to leadership roles in the family wealth enterprise when the time comes. There are many types of philanthropy that a family can engage in, including direct donations, planned gifts, impact investing, and working with IRC Sec. 509(a)(3) supporting organizations. With the assistance of BDO's Private Client Services, your family can take a purposeful and structured approach to giving.

One way to do this is to establish a charitable organization that is designed to further the family's philanthropic goals. This approach has the potential to make giving more efficient and convenient, and it can lend credibility, permanence and professionalism to a family's philanthropic work. If your family decides to take a more formal approach to giving to provide a lasting philanthropic legacy for your descendants, a private foundation may be the right answer for you.

CHOOSING THE RIGHT ORGANIZATION

When deciding whether a private foundation is right for your family, you should also consider the alternatives. To help decide which option would work best for your particular situation, one should consider whether family members wish to participate directly, how much time they will want to give, the desired geographic scope and longevity of the organization, and the core values that will help guide the organization's philanthropy. A brief comparison may be helpful:

Private Foundations

Private foundations offer greater control over where donations are spent, and how investments are made. It is important to note, however, that there are very strict rules that must be adhered to when forming and operating a private foundation. Any donations made to a private foundation are irrevocable.

Donor Advised Funds

Making a donation to a donor advised fund is administratively simpler than creating a foundation, but, as with a private foundation, any donations to the fund are irrevocable. The donor can make recommendations about how the money in the fund should be distributed, though these recommendations are not binding. Gifts to a donor advised fund are not publicly disclosed, meaning this structure provides greater anonymity, which some families may prefer. Finally, donations made will afford a current tax deduction even if the recommendation for the fund's allocation occurs in the future.

Public Charities

Public charities are tax-exempt entities that receive their funds from multiple sources, including extensive support from the public at large. There are fewer rules and regulations governing public charities than private foundations, but public charities are subject to much greater public oversight to ensure they are adhering to standards of conduct.

WHAT IS A PRIVATE FOUNDATION?

A private foundation is a charitable entity set up by an individual, a family, or a small group of individuals or businesses, with funding generally coming from one source or a handful of sources rather than from the public at large. A donor may choose to create a non-operating foundation, which would focus on making grants to other organizations, or an operating foundation that would carry out its own charitable programs, with limited grant-making allowed.

Non-operating foundations must annually distribute at least 5 percent of their assets for charitable purposes, usually through grants, whereas an operating foundation must make qualifying distributions in support of the active conduct for which it has been organized. Non-operating foundation donor deductions are limited to 30 percent of adjusted gross income for a cash donation and 20 percent of adjusted gross income for a donation of most long-term appreciated property. Operating foundation limits for the same categories are 50 percent and 30 percent, respectively.

For tax years beginning after December 31, 2017, and before January 1, 2026, the AGI limitations for deductions of cash contributions by individuals to private operating foundations have been increased to 60 percent of adjusted gross income, as a part of the 2017 tax reform known as the Tax Cuts and Jobs Act. Private foundations are strictly regulated by the state in which they are founded, as well as by the IRS, and research should be done well in advance of formation to avoid costly penalties.

PRIVATE FOUNDATIONS - A CLOSER LOOK

In addition to providing a solid framework for the family's philanthropy, private foundations offer numerous advantages over other types of charitable giving. A private foundation allows greater control over the allocation of funds and investment choices. There are other benefits, for example:

- ▶ Private foundations offer an organized administrative structure that can handle monitoring and evaluation of requests for donations, if the family wishes to delegate this.
- ▶ The stability of a private foundation structure can make the pursuit of philanthropic goals more effective over the long term, with the positive results lasting for generations.
- ▶ Capital gains will be taxed at the reduced excise tax rate of two percent.

With these advantages, however, come greater administrative and tax compliance burdens. Private foundations and those who are involved in their administration must be aware of all regulations and laws for federal and state purposes, and scrupulously avoid any prohibited activities. Seeking assistance from advisors can help protect the foundation's status and its reputation, and is highly recommended. Form 990-PF, Return of Private Foundation, or Section 4947(a)(1), Trust Treated as a Private Foundation, the foundation's yearly federal tax return, is required to be made available for inspection by the public. Tax returns should be prepared carefully and completely so that they accurately reflect the activities of the foundation and are not vulnerable to misinterpretation by outside readers.

NEXT STEPS - FORMATION

The foundation's official formation is completed under state jurisdiction, and regulations pertaining to the formation and operations of the foundation will vary from state to state. The first choice the founders will need to make when requesting formal incorporation will be whether to form as a corporation or as a trust. These differ in several ways:

- ▶ Using a trust structure is administratively simpler than using a corporate structure; however, making changes to a charitable trust instrument can be challenging, and may involve court approval or notice to the attorney general.

- ▶ A corporate structure brings with it more requirements for state filings, meetings, and other administrative housekeeping, but is more adaptable to the changing needs of philanthropic work. Using a corporate structure for your private foundation may also provide more protection from liability for the directors.

As part of the formation of a private foundation, a formative document will need to be created. This document, either a declaration of trust or articles of incorporation, should be carefully considered, as it will set forth many guidelines for the organization that must be followed to ensure that the foundation is compliant with state laws and regulations. State laws governing charitable corporations also require the creation of a set of bylaws, and often trusts will create a set of bylaws to guide their day-to-day administration, though this is not required.

THE FINAL STEP - IRS RECOGNITION

Once the foundation receives official status at the state level, the next step is to seek recognition from the IRS as a charity. This allows the foundation to receive tax-deductible contributions, and it exempts the foundation from federal income tax. To apply for this status, the foundation will need to complete Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. Like the annual Form 990-PF, Form 1023 will be available for inspection by the public once approved.

ONGOING OBLIGATIONS OF PRIVATE FOUNDATIONS

Private foundations are subject to public scrutiny, and must be carefully administered so that they comply with all state and federal regulations and laws. Some areas of concern are discussed below.

RULES AND REGULATIONS

Directors and officers of the foundation should have an awareness of the requirements set forth in the founding documents, and they need to ensure that they are being met. This includes the following:

- ▶ Are meetings being held as often as required by the bylaws or by state regulations, and is proper notice of these meetings being given?
- ▶ Are minutes being taken for all meetings, and are these minutes then archived properly?
- ▶ Are any required accounting procedures being carried out as directed in the bylaws or as part of state regulations?
- ▶ Have the correct number of officers or directors been appointed, are they performing the activities as described in the bylaws, and have procedures for naming new or substitute directors or officers been followed?
- ▶ Has the foundation made appropriate notification to state and federal government of changes to their status, revisions of the bylaws, or changes in address or contact information for the foundation?

IRS PRIVATE FOUNDATION EXCISE TAXES

The Internal Revenue Code contains several special excise taxes that apply to private foundations. These are highlighted below.

- ▶ **Sec. 4940** imposes a two-percent excise tax on net investment income, though this can be reduced to one percent if certain conditions are met.
- ▶ **Sec. 4941** imposes an excise tax on self-dealing. A private foundation is prohibited from engaging in certain transactions between a foundation and disqualified persons such as substantial foundation contributors, managers, or certain members of their families, also known as self-dealing. The excise tax on this prohibited activity is 10 percent for the self-dealer, and 5 percent for foundation managers with a \$20,000 cap for any one act of self-dealing.
- ▶ **Sec. 4942** imposes an excise tax on the private foundation's undistributed income. The initial excise tax imposed is 30 percent but can be as high as 100 percent for private foundations that fail to distribute income after the initial excise tax is imposed. Private foundations are required to pay out a distributable amount generally equal to at least 5 percent of net asset value per year, and careful calculations must be done to ensure that the amount of distributions is correctly figured.
- ▶ **Sec. 4943** imposes a 10-percent tax on the fair market value of a private foundation's excess business holdings that are held beyond the time permitted (generally five years).
- ▶ **Sec. 4944** imposes a penalty on any investments that jeopardize the charitable purpose of the private foundation. Investments that put the foundation's exempt purposes at risk will result in a 10-percent excise tax imposed on the foundation. An additional 10-percent tax will be imposed on the foundation manager for making the investment unless their participation was not willful and due to reasonable cause.

- **Sec. 4945** imposes an excise tax on certain taxable expenditures. A private foundation is prohibited from making certain types of grants or expenditures, called taxable expenditures. Some examples are grants for non-charitable purposes, political donations, and, in most cases, lobbying. Careful research must be done to avoid prohibited spending, which can result in penalties of 20 percent per impermissible expenditure for the foundation, and 5 percent for managers.

REPORTING REQUIREMENTS

All private foundations must annually file a federal Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation, which will be due by the 15th day of the fifth month after the end of the foundation's annual accounting period. Because it will be available for public inspection, this form is often used by potential grant applicants and by the general public to become familiar with the activities of the foundation, and so it must clearly reflect these activities to avoid possible confusion and misinterpretation. Depending on the amount of tax due, the foundation may also need to make quarterly estimated tax payments. If the foundation receives unrelated business income of \$1,000 or above, it will also need to file federal Form 990-T, Exempt Organization Business Income Tax Return (and proxy tax under Section 6033(e)).

If it employs paid staff, the foundation will need to meet filing requirements for employers, including withholding for Social Security and Medicare, income tax, and unemployment insurance. For consultants and director or officer fees, Forms 1099-MISC, Miscellaneous Income, and W-9, Request for Taxpayer Identification Number and Certification, will need to be produced.

There are also annual state filing requirements that must be met for the foundation to remain in good standing. Care should be taken to monitor federal and state law for changes that affect your reporting and filing requirements, so that you remain in compliance and avoid violations or penalties.

Finally, a foundation that receives a donation above a certain amount is required to provide a written acknowledgment to the donor. There are several scenarios that you will need to become familiar with, and your advisers can assist with specific questions about large or non-cash donations.

DIRECTORS AND OFFICERS LIABILITY INSURANCE

Directors and officers, or D&O, liability insurance protects the directors and officers for losses and legal costs related to damage claims. In some cases, there are state regulations requiring this type of insurance, and the foundation should make sure that it is meeting these requirements, if applicable. Once the policy is in effect, you should be sure what the policy covers, and when it needs to be renewed each year.

CONCLUSION

If you are interested in making philanthropic giving a part of your family wealth enterprise, BDO Private Client Services can help you determine what charitable structure will best help you meet your individual and family philanthropic goals. Contact any member of our team for more info.

CONTACT

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