# Private Foundations: Charitable Giving, Tax Considerations and Compliance

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High-net-worth individuals have a long history of charitable giving. Historically, many individuals made their contributions directly to public charities. In recent years, private foundations have become popular as a vehicle for high-net-worth individuals to promote charitable giving. While a private foundation may appeal to an individual for a variety of reasons, an individual should understand the following tax and compliance considerations with regard to foundations prior to forming a foundation.

## Overview

Private foundations are typically funded by a single contributor, such as a family or corporation, rather than the general public, as with a public charity. Private foundations may either directly conduct exempt activities (operating foundations) or make grants and distributions consistent with their exempt purpose (non-operating foundations).

Private foundations can be used as a means to accelerate tax deductible charitable deductions, while still maintaining control of the funds. Control can not be confused with ownership, as the donor no longer owns the funds contributed; however, the donor can control the funds in a fiduciary capacity. The funds can be invested as the foundation managers see fit (*i.e.*, investments in hedge funds, publicly traded securities, *etc.*), provided that the investment does not violate the prudent investor rules as elaborated below.

A private foundation is required to make annual distributions of approximately five percent of the average fair market value of the private foundation's assets. The distributions must be paid out to qualified charitable organizations or disbursed for charitable purposes. A private foundation is generally exempt from income tax, with the exception of an annual excise tax of either one percent or two percent of net investment income.

As long as a private foundation complies with the rules and filing requirements, many of which are noted in this article, it can be used as a tool to leave a legacy for one's family to become involved and continue to promote the charitable ideals that the founder has established with their private foundation.

## Self-Dealing

The laws relating to private foundations are not governed by a reasonableness standard, but are meant to be restrictive and completely eradicate certain practices of wealthy donors. In most situations, a transaction between a "disqualified person" (*i.e.*, foundation managers, substantial contributors, and various relatives of managers and contributors) and the private foundation will be considered self-dealing, even if the transaction is conducted at fair market value.

Penalties in the form of excise taxes up to ten percent of the transaction, with additional taxes if the expenditure is not corrected, may be imposed if transactions with disqualified persons occur, even if they are arms' length transactions. However, a disqualified person is allowed to provide property to a foundation free of charge. If the disqualified person provides property for a price, including the reimbursement of rent paid on the foundation's behalf, it is generally considered self-dealing.

Compensation paid to disqualified persons for services that are reasonable and necessary are generally exempt from the self-dealing restrictions. Private foundations often use this exception to employ family members of the donor and pay compensation for personal services. The Internal Revenue Service (IRS) has recently increased their attention and resources on tax exempt organizations, and particularly on salaries paid by exempt organizations. It is advisable to make sure that the private foundation performs due diligence to assure that it only pays reasonable and necessary compensation. The private foundation should document the job duties and workload of the disqualified person as well as compensation paid to persons with similar

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duties and workloads at similar foundations. The documentation should be retained in order to satisfy a potential IRS examination.

The self-dealing rules include restrictions other than compensation and are often overlooked by disqualified persons. For example, paying for personal charitable pledges of a foundation manager may be considered self-dealing as it satisfies a personal obligation of the foundation manager. Also, paying for the foundation manager to attend a dinner not related to the foundation's purpose may also be considered self-dealing.

## Taxable Expenditures

Private foundations must pay an excise tax of up to twenty percent of the amount of "taxable expenditures," with additional taxes if the expenditure is not corrected. "Taxable expenditures" are expenditures for any purpose other than religious, charitable, scientific, literary, educational or other public purposes. Examples include lobbying expenses, efforts to influence public elections, and grants to organizations other than public charities and private operating foundations. Unless a foundation exercises "expenditure responsibility," grants to other private non-operating foundations or for profit organizations may also be considered taxable expenditures.

Expenditure responsibility requires a pre-grant inquiry, a written grant agreement, follow-up reports from guarantees and reports to the IRS. Private foundations must be careful when making grants to other private non-operating foundations or non-charitable organizations. Although the foundation may have the proper motive when giving to these organizations, the foundation has the burden to prove the funds were properly spent. Before the foundation pays a grant, it is advisable to check the status of the donor organization on ***www.Guidestar.org*** or ***www.IRS.gov***, to confirm that it is a qualified organization.

## Jeopardizing Investments and Excess Business Holding

A "jeopardizing investment" demonstrates a lack of reasonable business care and prudence in providing for the short-term and long-term needs of a foundation in carrying out its exempt purpose. Although no specific investment category is considered jeopardizing, the Treasury regulations state that the following investments will be closely scrutinized to determine if the investment managers have met the requisite standard of care and prudence:

**A private foundation is generally exempt from income tax, with the exception of a annual excise tax of either one percent or two percent of net investment income.**

- Trading securities on margin;
- Trading in commodity futures;
- Investing in working interests in oil and gas reserves;
- Buying puts, calls and straddles;
- Buying warrants; and
- Selling short.

It is important to note that these regulations were written over twenty years ago and recent advancements in modern endowment management, investment portfolio management and legal concepts of prudence have evolved significantly since that time. Arguably, using modern investment techniques, the purchase of any of these so-called closely scrutinized investments could be accomplished without incurring a penalty.

"Program related investments" are not considered jeopardizing investments. Program related investments are investments that have a charitable purpose, such as a below market loan to help a distressed area. Program related investments are considered disbursements for charitable purposes and will be included in the required minimum distribution calculation.

The combined holdings of a private foundation and its disqualified persons are limited to twenty percent or more of the voting interest in another entity. Foundations may be allowed up to thirty five percent if a third person, not considered a disqualified person, has effective control over the business enterprise in question. As such, a private foundation will generally be prohibited from owning a business.

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## Unrelated Business Income Tax

Unrelated business income tax (UBIT) relates to the net taxable profits from the substantial commercial activity of an exempt organization, either a private foundation or a public charity. Three criteria must be met:

- The entity conducts a trade or business;
- The trade or business is not substantially related to the exempt purpose of the exempt organization; and
- The entity regularly carries on the trade or business.

Unrelated Business Taxable Income (UBTI) received by an exempt organization is generally taxed at the corporate income tax rates for U.S. and state purposes. The tax is imposed in order to put the exempt organization on equal footing with taxable entities and prevent unfair business practices. Specific exclusions for non-business investment income allow exempt organizations to generally invest in a wide array of financial products. However, debt-financed income, regardless of type, is generally subject to UBIT.

Although many private foundations typically do not conduct activities that generate business income, it is still possible that the foundation may invest on margin, which potentially can produce UBIT, or invest in a partnership that may invest in activities that produce UBIT, either with debt financed income or through trade or business income. Generally, partnership investments will disclose this information on the Schedule K-1s. When choosing investments, a private foundation should consider the potential UBIT.

## Practical Applications

It is very common for donors to contribute appreciated securities to private foundations, thereby avoiding paying income tax on the appreciation, and at the same time, receiving a charitable deduction for the securities' fair market value. A private foundation can sell the appreciated securities and invest the proceeds, as long is it satisfies the required minimum distributions.

Grants should be paid to public charities, and not private foundations, unless it adheres to the expenditure responsibility requirements. A foundation should make sure that grants are utilized properly and should avoid taxable expenditures and transactions which may benefit the foundation's disqualified persons. Disqualified persons may be compensated for reasonable and necessary services.

Often, principals of hedge fund managers form private foundations and invest the foundation's capital solely in a hedge fund that they manage. A hedge fund manager should consider whether an investment in their fund may constitute a jeopardizing investment. It is also possible the foundation and a disqualified person may have a controlling interest in the fund which may be deemed an excess business holding. The fund may also generate UBIT which is subject to corporate income tax rates. Although, it may be possible to invest in a hedge fund investment that is managed by the foundation's managers, consideration should be given to the factors noted above.

There are many factors that relate to private foundations, as the laws and requirements are very complex. The above article briefly addresses some of the common areas that impact many private foundations and is not intended to be relied upon for tax advice. We suggest that each taxpayer consult his or her tax advisor regarding their specific situation.

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