

START YOUR OWN CHARITY!

A Look at Private Charitable Foundations and Their Uses Under Current Tax Law

Background

For as long as anyone cares to remember, the Internal Revenue Code has allowed income, estate and gift tax deductions for gifts to charity and has exempted charitable organizations from income tax on their earnings. These advantages have been allowed not only to public charities such as the Red Cross or the Salvation Army, but also to private organizations, commonly known as private foundations, organized and operated exclusively for charitable purposes.

A 1984 study by the Council on Foundations indicated that there were 22,000 foundations in the United States at that time with assets of nearly \$50 billion. Some foundations are household words (Ford, Post, Rockefeller, etc.) but most are not--in fact, most of the foundations surveyed in the 1984 study had assets of less than \$10 million. As will be seen, foundations offer significant tax planning opportunities for individuals whose assets exceed the current estate tax exemptions (\$650k per individual or \$1.3 million for married couples). From a legal standpoint, there is no minimum asset requirement.

The Tax Reform Act of 1969 introduced various restrictions on private foundations which were designed to prevent foundations from being used to control corporate empires and to deal with certain other practices which were deemed abusive at the time. These rules, the most important of which are discussed below, are complex in some areas and generated considerable controversy at the time of their enactment. However, the 1969 rules did not fundamentally alter the tax treatment or the economics of private foundations. Also, the rules have been relaxed in significant respects by subsequent legislation.

Principal Benefits

The principal benefits of a private charitable foundation are as follows:

- Contributions to the foundation are deductible for income tax purposes. Income tax deductions can be timed so as to maximize the benefits to the donor.
- The Foundation is exempt from income tax and may qualify for other (e.g., property tax) exemptions.
- Gifts and bequests to the foundation are deductible for purposes of the Federal gift, estate and generation-skipping taxes.
- The foundation can fund charitable programs which would be non-deductible if funded directly by the donor.
- The donor may retain control over the investment and ultimate distribution of funds after they are donated to the foundation, subject only to legal limitations on the use of charitable funds.
- The foundation can be utilized by the donor in combination with certain trust arrangements to significantly reduce wealth transfer taxes on the donor's family.

- The donor can arrange for control of the foundation's grant policy by family members in perpetuity.
- Subject to certain limitations, management of the foundation can provide employment opportunities for the donor and members of his family.

The following examples may be helpful in illustrating the kinds of results which can be achieved:

Example 1

John Evans, age 55, has built a successful plastics business which he has just sold to a conglomerate for \$5 million cash--all but \$1 million of which is taxable gain.

John would like to donate \$1 million of the proceeds to his alma mater, Calzona State University for a scholarship program for chemical engineers. However, he has been busy running the business and has not had time to think through the details of his program or to discuss them with University officials.

If John sets up a foundation and contributes the funds to the foundation, he can secure a current income tax deduction in the year of the sale. Upon receipt by the foundation, the funds will accumulate income tax-free until John decides what to do with them.

Since John will be president of the foundation and will control its grant policy, it is safe to assume that his plans for the scholarship fund will be listened to very carefully by University officials. Ultimately, he has the authority to redirect the funds to another institution if the program they propose is unsatisfactory. If anything happens to John, his wishes can be carried out by his survivors through their control of the foundation.

Example 2

Bob Yates is a successful minority businessman from South Los Angeles who has been approached on several occasions for financial aid by other minority entrepreneurs. Bob is willing in principle to put up some money for "soft" loans to businesses which he believes are viable. However, his accountant tells him that the loans will not be deductible when made and may only be deductible in part later on if they are written off.

If Bob contributes the funds to a foundation, he can take an up-front charitable deduction for the entire amount. The foundation can then make the loans as and when suitable applicants for assistance are identified. If the loans are repaid, the interest income will be tax-free to the foundation and can be used to make further loans or for other charitable purposes. If they are not the money will be lost, but in that case Bob will be no worse off than if he had made the loans directly, and he will have at least obtained a tax deduction.

Example 3

Janice Brown is a marriage and family counselor who conducts drop-in group therapy sessions for senior citizens and children in her community.

Janice has done this work on a pro bono basis for many years. However, she would like to be paid something for her efforts and would also like to get funding to pay others to carry on her work. She has learned that there are funds available from the Area Agency on Aging and under the Federal Foster Grandparents program which could support some of her activities.

Janice has a wealthy aunt, Mildred Miller, who has an estate of approximately \$1 million. Mildred is 85 years old, in poor health and currently confined to a nursing home.

Janice is the sole beneficiary of Mildred's estate. However, she has been told by her attorney that bequests from Mildred which exceed the \$600,000 estate tax exemption will be taxable and that Federal estate taxes payable on Mildred's death will be approximately \$150,000.

Janice should consider starting a charitable foundation which will carry on and perhaps expand her group therapy services. As a tax exempt entity, the foundation will be able to apply for grants from the Area Agency on Aging as well as grants from other governmental and private sources. These grants would not be available to Janice individually since she is not a charity and does not have state and Federal tax exemptions. Grant funds, when and if obtained, can be used to pay Janice for her work as well as to support other charitable activities.

Another use of the foundation will be to receive part of Mildred Miller's estate at her death, perhaps the entire portion of the estate which exceeds the estate tax exemption. This can be done by means of a simple amendment to Mildred's will or trust. The net result will be to eliminate all Federal estate taxes on Mildred's estate and increase funding for Janice's charitable programs by \$150,000.

Example 4

Sue and John Morris are 85 and 86 years old, respectively, and have an estate worth approximately \$10 million. They have been advised that the entire estate will be subject to estate taxes, that the total tax will be about 46% of their total estate and that the tax rate on the portion over \$3 million will be 55%. After considering various strategies for reducing this burden, Sue and John enter into the following arrangements:

They donate \$5 million to a charitable lead trust, which specifies that an annuity of 7.5% per year is to be paid to a charitable beneficiary for 15 years. At the end of that time, the trust terminates and the corpus then existing is paid in equal shares to their three children. Also, Sue and John form a private foundation known as the Morris Charitable Fund which is named as the income beneficiary of the trust. The results of this arrangement are as follows:

- The transfer to the trust is treated as a gift in the amount of \$5 million. However, Sue and John are entitled to a deduction for the value of the income interest, which works out to be \$3,690,150.¹ The balance of the gift is taxable, but all but a nominal portion is sheltered by their unified credits against estate tax.²
- The trust invests in a balanced portfolio of income and appreciation-oriented securities which yields a combined return of 9%. Although the trust is a taxable entity, no taxes are paid because all of the current income is sheltered by distributions to the Morris Charitable Fund. These distributions are \$375,000 per year (7.5% of initial principal) and do not increase over the term because the trust is written as a fixed annuity lead trust.

¹ This assumes a discount rate of 5.8 percent, which was the applicable IRS "Table 5" rate as of March, 1999.

² The value of the remainder is \$1,309,850, of which their combined unified credits shelter \$1,300,000.

- The Morris Charitable Fund accumulates funds at the rate of 375,000 per year plus investment income, which is assumed to be a conservative 8% per year, less the amounts it distributes for charitable purposes (5% annually). At the end of the term, the foundation's endowment is approximately \$7.2 million.
- The children receive the balance remaining in the lead trust at the end of the term, which is approximately \$7.2 million. No estate taxes are payable because the initial transfer to the trust was already subject to tax. In addition, the children are nominated to the board of directors of the Morris Charitable Fund. After the death of Sue and John, they will control its assets and can pass this control to their descendants if they so choose – and pay no estate taxes in the process.
- Estate taxes on Sue and John's estates are cut from about \$4.6 million to about \$2.4 million, assuming that they die shortly after the arrangement is set up. If they survive for a substantial period of time, the savings will be much greater because appreciation on the \$5 million is out of the estate tax base.³

Regulatory Constraints

All assets donated to a private foundation or any other charitable organization are deemed subject to a public trust and may be used only for charitable purposes. All such organizations must file annual reports with the State Attorney General and are subject to audit by the State Attorney General's office.

In addition, the Internal Revenue Code imposes certain regulatory requirements which apply only to private foundations. The most important of these are as follows:

- **Limitations on Deductions for Contributions.** Income tax deductions for gifts to a private foundation are limited to 30% of the donor's adjusted gross income (versus 50% for public charities). However, there is a five-year carryover for any excess contributions. Also, foundations which spend all of their investment income for the direct conduct of charitable activities (as opposed to making grants to other organizations) may qualify for the 50% contribution limit.
- **Contributions of Appreciated Property.** Deductions for contributions of appreciated property may be limited in some circumstances to the donor's tax basis (cost) in the property. However, there are exceptions to this rule for gifts of certain appreciated securities and for gifts to foundations which spend their investment income for the direct conduct of charitable activities.
- **Excise Tax on Investment Income.** Foundations must pay a 2% excise tax on their net investment income, i.e., gross investment income minus investment advisory fees and other investment-related expenses.⁴ This tax is reduced to 1% for foundations which meet certain

³ See *Ann Jackson Foundation v. Commissioner*, (9th Cir. 1994), 15 F.3d 917; 94-1 U.S. Tax Cas. Para. 50,068; 73 A.F.T.R.2d 1023

⁴ The Tax Reform Act of 1969 ("TRA 1969") provided that this tax was 4%.

distribution requirements. It is important to note that this tax applies only to investment income and is *not* applicable to gifts and bequests received by the foundation.

- **Required Charitable Distributions.** A foundation is required to distribute or spend for charitable purposes at least 5% of its assets for charitable purposes each year.⁵ In general, required distributions in each year are based on the foundation's average assets for the preceding year.
- **Excess Business Holdings.** A foundation is not permitted to hold more than 20% of the equity in a business enterprise, reduced by any percentages which are held by persons who are directors, substantial contributors or other "disqualified persons" with respect to the foundation. As an exception to the above, a foundation can hold more than 20% of a business which it receives by gift or bequest (e.g., under a will or trust) for up to 5 years.
- **Self-Dealing.** Most kinds of self-dealing between the foundation and its directors and substantial contributors are prohibited. For example, the foundation cannot lease office space from a "disqualified person" (director, substantial contributor, etc.) even if the rent is at or below the market rate for similar space. However, the payment of compensation for services necessary to carry on the foundation's activities is not prohibited provided that the compensation is not excessive.
- **Speculative Investments.** Speculative investments are subject to careful scrutiny by the IRS and may be subject to penalty taxes. Investments in this category include commodities futures, working interests in oil and gas wells, puts, calls, straddles, warrants and short sales.
- **Grants to Individuals.** Grants to individuals for travel, study or similar purposes are not allowed unless made pursuant to a non-discriminatory procedure approved by the IRS in advance. Also, a foundation must file certain reports and exercise certain supervisory responsibilities over grants to organizations which are not publicly supported charities.

None of the above rules apply to publicly supported charities, and to that extent the Code discriminates against charitable organizations which do not meet the Code's public support tests. However, for most donors the rules are not so pervasive or restrictive as to fundamentally alter the economics of creating a private foundation. As noted above, those economics can be extremely attractive in a variety of situations.

Start-Up Procedures and Costs

A private foundation may be organized either as a trust or as a non-profit corporation under state law. The corporate alternative is usually used because it is simpler, i.e., the rights and liabilities of the corporation and its officers and directors are extensively defined by law and need not be spelled out in the corporate charter.

In California a corporate charter may be obtained on short notice where the circumstances warrant, usually a week or less. Obtaining tax rulings for the foundation typically takes longer (currently about 4 months), and cannot be applied for until after the charter is filed. However,

⁵ TRA 1969 provided that the foundation had to distribute the greater of 6% of its assets or its entire net income.

these rulings when obtained are retroactive to the date of formation provided that the applications are filed within 15 months of the date the foundation is formed.

Legal fees for starting a foundation and obtaining its exemptions may vary widely depending on the time and effort required, but are likely to be very modest relative to the tax savings generated by the foundation. Formation costs for a relatively simple, start-up foundation should be \$5,000 or less.

In addition to start-up costs, a private foundation can expect to incur some expense in filing annual reports with the Attorney General's office and with the Federal and state tax authorities. However, these costs are not likely to be any greater than those which would apply to a business organization of similar size and complexity.

Conclusion

The private charitable foundation continues to be a potent device for income, estate and gift tax planning under current tax laws. Use of private foundations to control business empires and for certain other abusive purposes has been curbed somewhat by the special rules introduced by the Tax Reform Act of 1969. However, those rules have been significantly relaxed by subsequent legislation and in any case do not alter the basic economics of private foundations for most donors.

J. CHRISTOPHER TOEWS

San Luis Obispo
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