Considering a Private Foundation

California COMMUNITY Foundation

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at a glance

PRIVATE FOUNDATION CONSIDERATIONS

WHY DOES MY CLIENT WANT TO FORM A PRIVATE FOUNDATION?

People who consider forming a private foundation are often seeking to create a structure around their giving, something beyond simply writing a check to their favorite charities. Other reasons may include:

- they assume that is the only way to manage their philanthropy
- their friends have one
- someone said they should have one
- for greater visibility and recognition
- for greater overall control
- to receive tax deductions
- to focus their giving on areas they care about most
- to involve other family members
- to employ themselves or other family members
- to control the foundation's board of directors
- to control investment decisions
- they do not know about any other option

ISSUES TO DISCUSS

When evaluating a philanthropic solution for a client, an advisor faces many considerations, ranging from selecting the asset to discovering the client's appetite for administration and method for making grants. To determine whether a private foundation is the best option, an advisor might consider asking the following questions:

TAX

What assets will be used to make the gift?

The type of asset donated and whether the donation was made to a public charity or a private foundation determine the client's total eligible deduction and how much of that deduction can be claimed each year.

- The total charitable income tax deduction available for gifts of:
  - cash and marketable securities when given to a public charity or private foundation is full fair market value
  - closely held stock, real estate and other illiquid assets:
    - when given to a private foundation is limited to basis
    - when given to a public charity is full fair market value[1]

1. For clients who make gifts of artwork, classic cars or other personal property, the deduction is limited to basis unless the property can be used by the charity to further its mission. For example, a gift of a painting to a museum.

- In the year the gift is made, the client may claim a certain amount of that total depending upon the client's adjusted gross income. For gifts of:
  - cash:
    - to a private foundation, the deduction is capped at 30% of the taxpayer's adjusted gross income
    - to a public charity, the deduction is capped at 60% of the taxpayer's adjusted gross income
  - other assets
    - to a private foundation, the deduction is capped at 20% of the taxpayer's adjusted gross income
    - to a public charity, the deduction is capped at 30% of the taxpayer's adjusted gross income
- If the client has insufficient income to use the entire amount in the year of the gift, the client has five additional years to apply any unused portion of the deduction.

VALUE OF THE ASSETS

What is the value of the assets being donated?

For various reasons, such as start-up and administrative expenses, advisors with whom we work recommend private foundations only when clients plan to donate property valued at $2 million or more. You or your company may have a different minimum.

IMPACT

Does my client know what causes he or she wishes to support and what charities provide that type of support so that the money given makes an impact?

Some clients do not know which charities or causes they wish to support. We usually see this when a client suddenly has more money available – due to receiving a large bonus or selling a business – than he or she previously had. For those clients, exploring possibilities and having the time to make decisions about where to give becomes crucial. In addition, clients may wish to have a partner who can help them on their journey. The journey can be long or short. Therefore, a private foundation might not be the best choice because the IRS can impose tax penalties when annual distributions are not made.

Other clients have given to various charities, yet are now seeking to make a greater impact or learn about other opportunities. Making an impact requires, among other things:

- determining the needs of the community the client seeks to serve
- developing an approach to meeting those needs
- learning which charities are aligned with the client's approach
- evaluating the effectiveness of those charities before partnering with them
- reporting on the impact made

In this situation, clients benefit by having an expert to act as a guide and share the workload. Partners can help your clients:

- create mission statements for their giving
- arrange site visits with charities
- develop questions to ask potential recipients
- discover other charities working in the field

In sum, a good partner can transform ideas into action, ensuring clients make the impact they seek.

Still other clients know exactly what causes they wish to support and are very knowledgeable about the charities working in their area of interest. For those clients, a private foundation might be a good choice after considering the other factors described in this publication.

INVESTMENT

Does my client feel comfortable investing as a fiduciary rather than as an individual?

People who form private foundations must meet prudent investor rules. The assets given away are no longer owned by the client; rather, they are owned by a charity. State and federal laws apply, such as the restriction on jeopardizing investments, excess business holdings and self-dealing transactions. Several exceptions apply, so having good investment and legal counsel is wise.

It should be noted that several charities that offer alternatives to private foundations often permit clients to recommend their financial advisor as the provider of investment management services for their fund.

ADMINISTRATION

How much time and interest does my client have for doing administrative tasks?

Operating a private foundation is like running a business. The client must form an entity at the state and federal levels; make annual tax filings; form and convene a board; evaluate grantees; make distributions; and follow rules on investing assets. At the same time, no private inurement, private benefit or self-dealing may occur. Failure to comply with the rules can result in action by the state's attorney general or the IRS, which could result in penalties and the loss of tax-exempt status. If the client decides to hire experts to do those tasks, then there will be less money available for giving to the client's cause.

Can those involved with making decisions consistently agree upon the charities to support?

Parents sometimes form a private foundation to bring their family together, teach philanthropy or impart certain values on future generations. However, future generations may view the private foundation as being solely reflective of the founders. When family members have different ideas about what the foundation's purpose should be and the types of charities to support, dysfunction often follows. This dysfunction not only causes conflict within the family, but also can result in serious tax consequences.

To avoid tax penalties, private foundations that only give money to other charities must make grants equal to approximately 5% of their endowed assets. To meet the rule, foundations calculate the minimum distribution and then distribute the amount by the end of the following year. If they fail to do so, then the IRS may impose an excise tax equal to 30% of the undistributed amount. If the private foundation fails to correct the error, then the IRS may impose an additional excise tax equal to 100% of the undistributed amount.

Does my client have any concerns with privacy, such as the public knowing the client's name and address or which charities are being supported and in what amounts?

Private foundations provide very little privacy for clients because certain information must be listed on the private foundations' annual return, the Form 990-PF. Anyone with an internet connection can access the names and addresses of the private foundation's major donors; the assets owned by the foundation and their values; contributions received; the names of the charities who received grants and the amounts they received. This is available from sources such as Guidestar, Foundation Directory and the IRS. Consequently, neighbors, friends and other charities will be able to know a lot of financial information about the client and the causes they support.

Can my client manage the influx of unsolicited requests for grants?

Clients who form private foundations often find that they become the target of solicitations from individuals and charities, thanks to the public nature of their foundation's tax returns. Accordingly, clients will need to find a way to manage the onslaught of mail and calls.

Who would my client like to serve as successor, does that person have the ability and time and does the successor share the same charitable interests as my client?

Although private foundations can exist in perpetuity, finding a successor to lead the foundation can be challenging. Parents often form a private foundation to encourage family giving. However, future generations may have different priorities and ideas. For example:

a. Areas of interest change – where Mom and Dad were interested in health care, the children are interested in the arts and the environment.

b. Children do not have the time or energy to spend on private foundation matters due to jobs, a new family or other obligations.

c. Children lack the ability or are simply not interested in managing the administrative burdens required to ensure the tax-exempt status of the family's private foundation.

d. Family members move – where Mom and Dad were interested in supporting local charities, the children do not feel the same connection to a certain place or are more interested in supporting causes elsewhere.

Accordingly, private foundations are often dissolved after the founder's death and their assets distributed to a donor advised fund, supporting organization or public charity after the first or second generation.

ALTERNATIVES TO PRIVATE FOUNDATIONS

When a private foundation is simply not a good fit, the California Community Foundation offers other solutions for clients who are charitably inclined. These include:

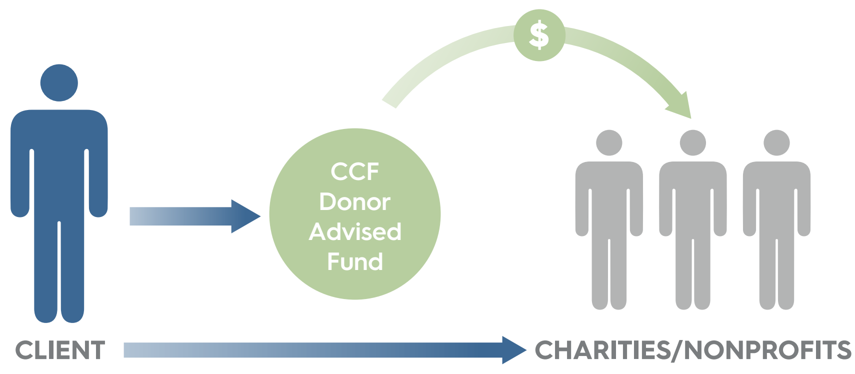
Donor Advised Fund

A donor advised fund ("DAF") is a type of account created when a client makes an irrevocable gift to CCF. The benefits for the client are as follows:

- qualifies for an immediate income tax deduction at full fair market value regardless of whether the asset is a liquid or illiquid asset, in most cases
- pays no capital gains tax on assets donated to CCF when sold by CCF, in most cases
- does not require set-up fees, federal filings, state filings or a separate EIN because the fund is owned by CCF
- recommends which charities to support and when because, unlike private foundations, there is currently no rule requiring distributions from a DAF
- recommends how the assets are invested by choosing either:
    - an investment pool operated by CCF; or

- their trusted financial advisor under CCF's Charitable Asset Management Partnership investment option ("ChAMP")[2]

- retains the level of privacy most comfortable for the client because of the way information is presented on CCF's tax return
- receives the assistance of a designated relationship manager – not a call center – who can provide such services as:
  - creating or refining a giving plan tailored to the client's goals;
  - supplying custom-made research on local, national or international charities;
  - serving as a gatekeeper for solicitations from individuals and charities;
  - connecting donors to community leaders and scheduling visits to charities;
  - identifying emerging giving opportunities; and
  - engaging other family members in giving.
- creates a legacy by appointing successor advisors to the DAF whose powers can be broad or limited. For example, successors could make grants to any charity or be limited to making grants:
  - to certain types of charities or;
  - in an amount equal to a fixed percentage of the DAF's value.
- partners with an expert about other charities, because CCF has been supporting charities for 100 years



2. *Only eligible for gifts having a value of at least $500,000.*

Type I Supporting Organization

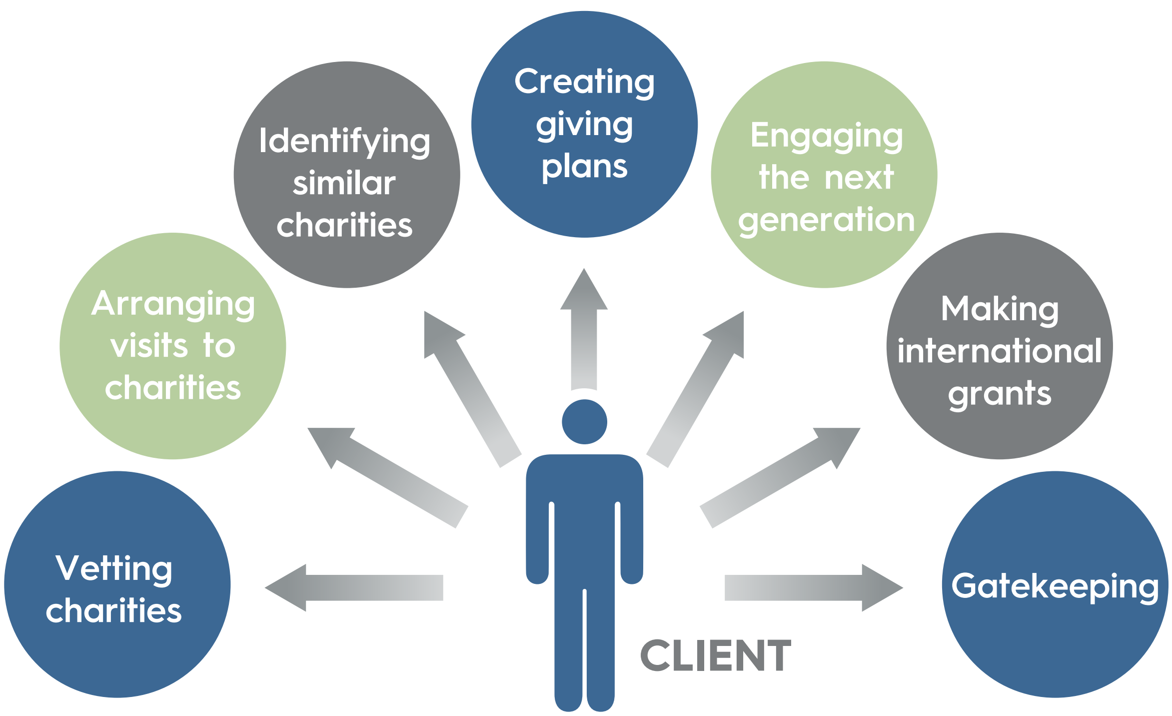
A Type I Supporting Organization ("SO") is a type of public charity whose primary function is to support the work of another public charity. People often describe the relationship between an SO and the other public charity like that of a corporate subsidiary to a parent company. The parent (i.e., the supported charity) must operate, supervise or control the SO, such as by having the power to appoint a majority of the SO's board.

The SO's organizational documents, to meet IRS tests, often specify the parent by name. Advisors often like to name a charity, like CCF, that has a very broad charitable mission so clients have the flexibility to support a wide range of causes. Clients will need to hire experienced counsel when creating an SO.

Because there are many organizational and operational requirements for SO's activities, a more complete discussion of SOs is beyond the scope of this document.

CCF CLIENT SERVICES

CCF's experts partner with clients to transform ideas into action and ensure clients make the impact they seek. Often, those services include:



case study: gift of privately-held c corporation stock

BACKGROUND

Doug, a financial advisor, called CCF to tell us that John and Mary Jones, his clients of more than 25 years, have received an offer to sell a division of their company. The company is a privately-held California C Corporation. The offer is for $30 million, and John's and Mary's basis in their shares is $3 million. John and Mary would like to make a gift of $10 million to charity. They have asked Doug whether they should create a private foundation and, if not, what other options he would suggest. Finally, they would like Doug to manage the assets earmarked for charitable giving.

ISSUES

- ***Tax***
  - charitable income tax deduction
    - If John and Mary donate their shares to a newly formed private foundation, their charitable income tax deduction will be limited to $1 million ($10 million ÷ $30 million X $3 million) – their basis in their shares.
    - If John and Mary donate their shares to a donor advised fund (DAF) at CCF, their charitable income tax deduction will be $10 million: the full fair market value of their shares.
    - If they cannot use the entire deduction this year, they have five more years to apply it against their income.
  - capital gains tax
    - If John and Mary donate their shares before the sale is deemed complete (e.g., signing the agreement to sell), then they will likely avoid paying capital gains tax on the donated shares.
- ***Investment Advisory***
  - John and Mary could continue to have Doug manage the assets earmarked for charity, whether they chose a private foundation or the Charitable Asset Management Partnership investment option ("ChAMP") for their DAF at CCF.
- ***Administration and Services***
  - With the new private foundation, John and Mary would, among other things, need to ensure that 5% of the foundation's endowed assets are distributed annually, vet the charities, make grants and serve as fiduciaries.
  - With a DAF at CCF, John and Mary would not be restricted by an annual distribution requirement, allowing them to make grants on their own timeline. In addition, CCF would provide John and Mary with a designated member of our Donor Relations Team to discuss what types of services would be most helpful to them. Those services could include creating a giving plan, providing research on charities and engaging the next generation.

RESOLUTION

Two days later, Doug discussed the options with John and Mary. Consequently, they decided to donate their stock to CCF to create the John and Mary Jones Foundation Fund. They avoided paying capital gains tax on the shares and were eligible for a charitable income tax deduction of $10 million. Further, $10 million was available for them to grant to their favorite charities. They were thrilled that Doug, their trusted advisor, could serve as the investment manager for their fund at CCF.

REMINDERS

- ***Not all charities will accept gifts of closely-held stock.***
- ***Clients will generally receive the best tax benefits by donating them to a donor advised fund at CCF rather than a private foundation.***
- ***Shareholder agreements may have to be amended to permit transfers to charity.***
- ***Clients can often retain their investment advisor for their fund at CCF when donating property valued at $500,000 or more.***
- ***Clients must obtain a qualified appraisal to substantiate their income tax deduction.***
- ***Clients who create DAFs at CCF become part of a community of like-minded individuals in Los Angeles, supported by a century-old institution.***

To discuss creating personalized giving solutions for your clients, contact your relationship manager or our Development and Donor Relations Team at donorrelations@calfund.org or (213) 239-2310.

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