PRIVATE FOUNDATIONS

Private foundations are legal entities set up by an individual or by family members for philanthropic reasons and are established as a nonprofit corporation or as a charitable trust with funds generally from a single source, such as an individual, family, or corporation. They are used to aid social, educational, religious or other charitable activities, primarily through making grants. One of the largest foundations in the U.S. is the Bill and Melinda Gates Foundation which has over $36 billion in assets.

HOW THEY WORK

The first step in establishing a private foundation is to create the governing documents such as articles of incorporation and bylaws. It must then register with the state and file with the IRS to obtain tax exemption status and also create a governing Board of Directors. The founding member(s) may appoint themselves, their family members, or others to sit on this Board, which is required to meet periodically and to keep minutes of all meetings.

Once the foundation is set up, it is then funded, typically from a single source rather than funding from many sources. This type of organization is ideal for those who intend to endow the foundation with a substantial amount to be managed over an extended period of time. For those with lesser amounts to contribute or with shorter time frames, other options such as donor-advised funds, community foundations, or donations made directly to charitable organizations may be a better strategy.

TYPES

There are three main types of private foundations:

- Private Endowed Foundation – Funds are invested and the foundation is required to distribute income of at least five percent of its net assets to charitable organizations annually which can include certain administrative-related expenses. Generally, only the income is spent, not the principal or endowment. Therefore, the principal can increase through investing over time, ensuring the foundation's continuation and growth. This is the most common type of a private foundation.
- Pass-Through Foundation – This distributes all of the contributions it has received each year and has a pass-through option, which may be made or revoked on a year-to-year basis.
- Private Operating Foundation – In this type of foundation, it uses its income to actively run its own charitable programs or services. This is often seen with museums, libraries, research facilities, and historic properties.

TAXATION

A private foundation is treated as an IRS section 501(c)(3) organization so its income is exempt from federal income tax. However, the foundation must pay a one to two percent excise tax on its net investment income. Any gifts made to establish a new foundation or to an existing foundation are tax deductible and may create certain income, gift, and estate tax benefits for families and their estates.

BENEFITS

- Family Legacy – It provides for a legacy of giving that can go on indefinitely supporting charitable activities in the name of the family and supports causes that are important to its members.
- Control and Flexibility – It offers the greatest control of any planned giving vehicle as members decide which charities to support and how the assets are invested. In addition, private foundations also have flexibility as to the types of assets donated to the foundation.
- Tax Deduction - Members can take an immediate tax deduction for assets contributed to a private foundation, even if it does not make charitable grants until a later date. Also, these contributions help to reduce one's estate, without being subject to capital gains taxes.

PRIVATE FOUNDATIONS VS. PUBLIC CHARITIES

Private foundations are essentially defined in the tax code by what they are not. They are a 501(c)(3) organization but, most importantly, they are not a public charity. Although all 501(c)(3) organizations are organized and operated exclusively for religious, charitable, or educational purposes, there are substantial differences in the way they are created, funded, and operated. Public charities generally derive their funding or support primarily from the general public. They receive grants from individuals, government, and private foundations and conduct their own service or other tax-exempt activities.
Public charities may also engage in making grants, but their primary function is their own charitable service. With a private foundation, it does not solicit funds from the public and its primary function is making grants to other charitable organizations.

PRIVATE FOUNDATIONS VS. DONOR-ADVISED FUNDS

The primary difference between the two comes down to control and flexibility. With private foundations, the donor has control over where charitable donations are made and also oversee the administrative aspects. These entities can set up structured giving programs as well as initiate grants directly to individuals in need. In addition, donors can contribute various types of assets to fund the private foundation, including restricted stock (also known as Rule 144), and retain control over how the assets are invested.

As a contrast, contributions to a donor advisor fund are irrevocable and the non-profit organization has control with investment and administrative decisions. The contributor may recommend which charities they would like to be grant recipients, but the fund's governing body in the end has the final say.

SUMMARY

Private foundations can be useful strategy for both charitable and estate planning purposes. Given the various requirements in setting up and administering these, it is highly recommended to consult with legal and tax professionals to ensure these are established correctly and are in accordance with current IRS rules.