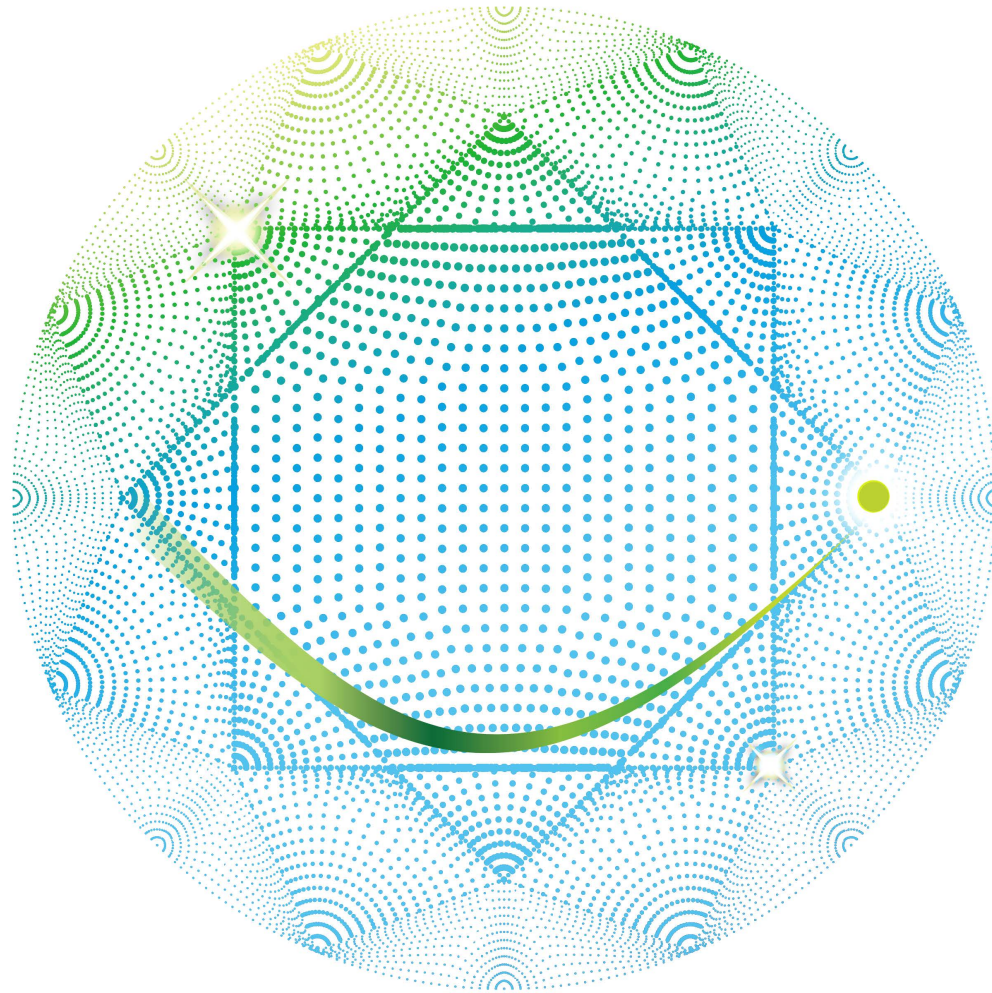


**Deloitte.**



Global Center for Excellence in Philanthropy

## **Private foundations**

Establishing a vehicle for  
your charitable vision

“I didn’t know where to start. The advice I received on creating a private foundation pointed me in the right direction, and now I’m confident that I’ve done the right thing—both financially and philanthropically.”

# Content

Private foundations can help individuals and families reach their philanthropic goals while offering multiple benefits along the way. There are several important decisions that need to be made before committing to establish a private foundation. Knowing what questions to ask and obtaining sound advice can assist you with the complexities of creating and maintaining a private foundation. We can help. It is vital to begin with the basics before moving forward, particularly relating to:

- The advantages and disadvantages
- The types of assets you can contribute
- How to form a private foundation
- The potential tax implications





# Accomplishing your charitable vision

If you think you might be ready to establish a private foundation, you must objectively consider why a private foundation makes sense for you or your family.

## Is a private foundation right for you?

### Do you or your family:

- Have a charitable vision?
- Want to control the timing and use of your charitable funds?
- Want to introduce children and grandchildren to philanthropy?
- Want to create a charitable legacy for your family?

**If you answer yes** to one or more of these questions, a private foundation could be right for you.





# Private foundation basics

## What is a private foundation?

### A private foundation is

- A formal vehicle for charitable giving
- A non-governmental, non-profit organization
- A principal fund managed by its own trustees or directors
- An entity that maintains or aids charitable, educational, religious, or other philanthropic activities
- An organization serving the public good through structured grantmaking to public charities
- A separate legal entity that provides a formal structure to carry out a donor's or family's charitable intentions

The legal and tax requirements of private foundations require a disciplined approach to grantmaking and investment decisions. Establishing formal policies and procedures can help a family determine that the private foundation will be operated in accordance with the donor's charitable intentions. Such policies may also drive families to build consensus and a shared vision for their charitable goals.

“Our family believes in the importance of educating young students about science, technology, engineering and mathematics. We created a private foundation to fund a STEM program at our local high school.”



# Private foundation basics

## Is a foundation right for you?

Donors can accomplish their planned giving strategy through several alternatives, including creating a private foundation or donor-advised fund, or making direct donations to an existing public charity. Each has its own benefits. The option you choose depends on your unique needs and circumstances. The objective is to decide which matches your specific goals.

“Our private foundation helps us support the causes that are important to us while gaining some tax advantages along the way.”

### Matching your charitable vision to the right planned giving strategy

Planned Giving Option:	Private Foundation	Donor Advised Fund	Public Charity
Deductible contributions?	Yes	Yes	Yes
Contribution limit?	30% of AGI* for cash contributions; 20% of AGI for noncash (Public charity AGI limits apply—w/out of corpus election)	50/60% of AGI for cash contributions; 30% of AGI for noncash	50/60% of AGI for cash; 30% of AGI for noncash
Donor controls grantmaking?	Yes	No, but donor can advise	No
Donor controls investment decisions?	Yes	No. Donor may advise on investment plan, but sponsoring organization has control.	No
Donor manages operations and administers organization?	Yes	No. Donor pays a fee to sponsoring organization to provide administrative services.	No
Annual distribution requirements?	Yes (5% of fair market value of non-charitable use assets)	Generally No; DAFs may set their own requirements	No
Organization subject to income/ excise tax?	Yes (1.39% Excise tax on Net Investment Income and Corporate or Trust income tax rates on net unrelated business income)	No, unless there is unrelated business income. Then, Corporate or Trust income tax rates apply on net unrelated business income.	No, unless there is unrelated business income. Then, Corporate or Trust income tax rates apply on net unrelated business income.
Organization subject to excise tax for prohibited actions?	Yes. Potential excise tax due for engaging in acts of “self-dealing,” having “excess business holdings,” and making “jeopardizing investments” or “taxable expenditures.”	Yes. Potential excise tax on excess business holdings, taxable distributions, and excess benefit transactions.	Generally, no. (Potential excise tax on political activities.)
Organization required to file an annual tax return?	Yes (Form 990-PF and Form 990-T to report unrelated business income)	No. An annual filing by sponsoring organization, not each separate donor advised fund.	Yes (Form 990 and Form 990-T to report unrelated business income)

\*Adjusted Gross Income (AGI)



# Tax impacts:

## The tax timing advantage

Understanding the tax implications of a private foundation can help you determine if it is the right charitable vehicle for you.

### The tax timing advantage

Most charitable donations create an income tax benefit to the donor. A donation to a private foundation is one of several forms of charitable giving that permits a taxpayer to retain a level of control over donated assets, while at the same time creating a deduction to offset taxable income in the year of the donation.

Donating to a foundation, the taxpayer maintains control over:

- Timing of charitable deduction. The taxpayer can make a donation to the foundation in a tax year when the taxpayer has significant personal taxable income (e.g., a deduction can offset a large gain due to the sale of an appreciated asset).
- Timing of disbursements out of a foundation. The taxpayer can disburse donations over multiple years to public charities.
- Investment decisions. The taxpayer can direct how the foundation invests donations until they are disbursed.

### TIP:

### Donation of appreciated stock

A donor who contributes appreciated stock (i.e., publicly traded stock held for more than one year and not subject to any resale restrictions) to a private non-operating foundation receives an income tax charitable deduction equal to the full fair market value of such stock. Contributions of other property are typically deductible only to the extent of the donor's adjusted basis.



# Tax impacts:

## What can you donate?

### Eligible Assets

There are restrictions on the types of assets that can be donated to a private foundation. Advisors can help determine which assets can be used to fund a private foundation, as well as help avoid potential pitfalls.

What assets can I contribute to a private foundation?

- Cash
- Publicly traded securities
- Mutual funds
- Closely held business stock
- Non-publicly traded stock
- LLC or LP interest\*
- Life insurance policies
- Artwork
- Real estate\*
- Other unique assets

**Before donating an asset, consider the following questions with your tax advisors:**

#### Questions & tax considerations

##### Are there limits to my deductions of charitable contributions?

In general, cash is subject to a 30% of adjusted gross income limitation while other assets are subject to a 20% of adjusted gross income limitation.

##### What determines the value of my deduction?

The deduction for cash and qualified appreciated publicly traded securities equals fair market value, while the deduction for other assets is limited to cost basis. (For exceptions to this rule, discuss with your tax advisor.)

##### How long is the foundation allowed to hold the asset?

Certain types of assets, such as closely held businesses, may be considered “excess business holdings” if the foundation and related persons own more than 20% of the voting stock of the closely held business. Generally, these closely held businesses may only be held by the foundation for a limited time (5-10 years), or they may be considered an excess business holding. Planning should be done upfront to facilitate the disposition of restricted assets. The foundation may be subject to an excise tax if excess business holdings are held too long.

##### Will the asset generate unrelated business income for the foundation?

Assets, such as closely held businesses or LLC/LP interests, may generate ordinary income that is taxable as unrelated business income – taxed at the standard corporate or trust income tax rates rather than the 1.39% private foundation excise tax rate.

As of January 1, 2018, tax law changes now allow a private foundation to hold 100% of the voting stock of a closely held business without creating an “excess business holding.” In order to qualify for this new exception, certain requirements must be met:

- ✓ 100% of the voting stock must be owned by the foundation and all of the stock must have been acquired through gift or bequest
- ✓ The business must annually distribute all net operating income to the foundation
- ✓ The donor and their family may not serve as directors, officers, employees or contractors of the business
- ✓ At least a majority of the foundation board members must be independent persons.

If you are interested in leaving your closely held business to charity, consult with your tax advisor.

\* These assets may have debt which could result in self-dealing. Consult with your advisor as to exceptions and the value of deduction and potential gain associated with such gifts.



# Tax impacts:

## Tax reporting

### Excise tax on net investment income

Private foundations are subject to a 1.39% excise tax on investment income (i.e., interest, dividends, rents, royalties and net capital gains).

### Tax reporting

A private foundation needs to complete and file IRS Form 990-PF – Return of Private Foundation each year. This comprehensive filing requires certain calculations and disclosures intended to provide transparency of the foundation's charitable assets and operations (e.g., foundation must list the name and address of each donor and each charity that receives grants from the foundation, as well as the amount donated). The Form 990-PF must be publicly disclosed and is available for viewing on the Internet.

Mistakes can expose the private foundation and its board members to penalties for tax code violations, as well as public scrutiny and commentary as such returns are publicly available online.

We strongly encourage private foundations to identify advisors who can either advise them on the preparation of the foundation return or can prepare the return on their behalf.



# Tax impacts:

## Investment choices

### Minimum distribution requirement

A private foundation is required to annually spend or pay out for charitable and certain administrative purposes at least 5 percent of the average fair market value of its non-charitable use assets.

### Investment choices

The IRS imposes certain limitations on investments of private foundations and requires that all investments be made following a prudent investment standard. To protect charitable assets, the IRS restricts private foundations from making “jeopardizing investments” that are unusual or speculative, examples included in the Regulations include warrants, commodity futures and options.

In choosing prudent investments, the foundation may consider the expected rate of return, the need for diversification, and the degree of risk. Private foundations often adopt an investment strategy and continually monitor investment decisions.

### Co-investing

Caution should be taken before a private foundation co-invests with its donor, donor's family or related entities. Without proper planning, co-investments (such as family investment partnerships) could trigger excise taxes related to self-dealing or excess business holdings. Before entering into co-investment opportunities, consult a tax advisor.



# Tax impacts:

## Prohibited transactions

### Self-dealing and prohibited transactions

Private foundations are restricted from entering into certain transactions with their donors, family members or closely held businesses. Prohibited transactions (known as “self-dealing”) with disqualified persons include:

- The sale or lease of property
- Lending money
- Providing goods or services
- Paying excessive compensation
- Allowing use of foundation income or assets

If an act of self-dealing occurs, the transaction must be corrected. There will also be an excise tax of 10 percent imposed upon the person or business involved in the transaction. There may also be an excise tax of 5 percent imposed upon foundation managers.

Examples of prohibited transactions to avoid:

- **Fulfilling personal charitable pledges:** A private foundation cannot satisfy a legally binding charitable pledge of the donor or related persons
- **Use of Foundation Assets:** Disqualified persons should not use foundation assets for personal benefit unless the benefit is deemed to be tenuous and incidental; such as enhancing the reputation of the donor by providing naming rights to the family on a building the Foundation funded through a grant
- **Paying for spousal or family travel:** A private foundation should not pay for travel costs unless the spouse or family member independently performs services on the foundation's behalf
- **Use of credit cards:** Private foundation credit cards should never be used for personal expenses
- **Paying rent:** A private foundation should not pay to rent space from the donor or related persons

# Tax impacts:

## What you need to know

### Grantmaking

Once a private foundation is established and announces its philanthropic intentions, potential charitable beneficiaries will seek its support. Grant guidelines must be established, and administrative support is required to handle charitable inquiries. A grants officer might be needed to review funding applications, correspond with applicants, make grant recommendations, and conduct site visits to confirm funds are spent appropriately.



Schools



Colleges and universities



Hospitals



Medical research organizations



Churches and religious organizations



Museums



Certain social service organizations

### Taxable expenditures

Private foundations must be mindful of restrictions on choosing grant recipients. Private foundations are restricted from making certain expenditures, such as:

- Expenditures to influence legislation or public elections
- Grants to individuals, unless for pre-approved qualified scholarships
- Grants to organizations other than public charities, private operating foundations, and certain foreign organizations unless the foundation conducts expenditure responsibility oversight

Documenting a formal grantmaking process may be helpful (unless expenditure responsibility is performed), particularly as a private foundation grows or as grantmaking becomes more complex (e.g., giving internationally). In choosing prudent investments, the foundation should consider the expected rate of return, the need for diversification, and the degree of risk. Private foundations should adopt an investment strategy and continually monitor investment decisions.



# Forming a private foundation:

## Steps to consider

Planned giving option:	Step 1: Formulate mission statement	Step 2: Organize board of directors or trustees	Step 3: Choose professional advisors
<b>Who</b>	<p>A mission statement provides a clear vision of the donor's charitable vision. It conveys the foundation's guiding principles to:</p> <ul style="list-style-type: none"> <li>• Private foundation board members</li> <li>• Donor's family members</li> <li>• Foundation staff</li> <li>• Community members and the public</li> </ul>	<p>The board of directors or trustees may include a combination of:</p> <ul style="list-style-type: none"> <li>• The donor</li> <li>• The donor's family members</li> <li>• Trusted advisors</li> <li>• Independent parties</li> </ul>	<p>Consult with professional advisors to plan and execute the formation of a private foundation:</p> <ul style="list-style-type: none"> <li>• Attorneys</li> <li>• Tax advisors</li> <li>• Investment advisors</li> </ul>
<b>Why/Reason</b>	<p>Form a clear mission statement to establish the goals and principles of the foundation. A mission statement tells the board members and the community what to expect from the foundation.</p> <p>It also helps the foundation stay grounded to its values and the basic principles on which it was founded.</p>	<p>The board of directors or trustees is the foundation's governing body. It carries out the charitable mission of the foundation and oversees its activities. It is crucial to choose a trusted board that is committed to fulfilling the mission statement.</p>	<p>Forming a private foundation requires specific legal and tax documents to be filed with regulatory and tax authorities. Professional advisors can assist the donor in planning and executing the steps needed to create the foundation:</p> <ul style="list-style-type: none"> <li>• Attorneys can draft the required documents to create a private foundation legal entity.</li> <li>• Tax advisors can assist with the application for recognition of tax-exempt status.</li> <li>• Investment advisors can consult on the appropriate investment strategy for the foundation's charitable assets.</li> </ul>
<b>TIP/Things to consider</b>	<p>The mission statement should be specific enough to convey the donor's true charitable intentions. Be as clear as possible to avoid leaving questions unresolved.</p> <p>For example, defining a mission as "to support education" is too vague. It is more effective to define a mission statement, such as "to support primary and secondary education programs in Chicago, Illinois."</p>	<p>Choose board members who are committed to the foundation and are qualified to carry out the foundation's charitable mission.</p> <p>For example, a private foundation focused on improving living conditions in the community where the family has built its legacy may not require extensive outside input. The donor may choose to fill the board with family members.</p> <p>However, if the mission is to fund cutting-edge research, the involvement of scientific experts can be crucial to managing grant requests. The donor may invite independent parties with scientific backgrounds to bring expertise to the board.</p>	<p>Professional advisors can consult on the charitable and operational aspects of the foundation.</p> <p>Advice from professional advisors is particularly important if your foundation engages in activities other than simply grantmaking, such as establishing a scholarship program or pursuing international philanthropy.</p>

# Forming a private foundation:

## Legal structure

A private foundation is a legal entity that can be organized as a corporation or a trust. Each structure has advantages and disadvantages:

### Corporation

In general terms, a corporate structure provides more flexibility than a trust.

- Corporations are organized under state law and are governed by Articles of Incorporation and Bylaws.
- Corporations have the flexibility to amend their articles and bylaws if they require changes to their charitable purpose or governance structure.

For example, a corporate resolution could be passed to modify the charitable purpose, change the number of board members, amend the process for electing board members, etc. Because of this flexibility, the board of directors may more easily be able to respond to circumstances that affect how a private foundation is managed.

### Trust

A charitable trust is organized under state law by an irrevocable trust agreement.

- Once a trust agreement is in place, generally there will be no modifications to the terms of the trust agreement. This may result in a trust structure providing less flexibility than a corporate structure.
- A trust structure that grants the trustee limited discretion may be a more appropriate governance structure.

Some donors find the trust structure to be appealing, particularly when a foundation is organized to benefit a very specific charitable purpose and one of the donor's objectives is to limit the ability of future generations to deviate from that specific charitable purpose.

"I built my business in my community, and thought it was time to give back to the very people that supported me all these years. I established a private foundation to support charitable causes in my town."

# Forming a private foundation: Lifespan

Families typically want a private foundation to last in perpetuity. Establishing a private foundation with a clear mission can create a charitable legacy for donors and their descendants. The private foundation structure can ensure that a founder's charitable vision will live on, well past the founder's lifespan.

Some families, however, prefer to have an established end date for their foundation. Many private foundations are created with a sunset clause designating that all funds must be spent within a specified time period following the benefactor's death.



As previously noted, if the private foundation's vision is a clear representation of a founder's charitable goals, one way to ensure that the benefactor's charitable goals are maintained might be to dissolve the private foundation at a certain point, usually within a short time period after the benefactor's death, according to a plan established by the benefactor.

Also, it is not uncommon for a benefactor to direct a complete payout of a private foundation's assets prior to the benefactor's death. Several private foundations over the last century were deliberately paid out and dissolved because the benefactors wanted the foundation to last for a single generation.



# Forming a private foundation:

## Controls

	<b>Legal controls</b> ensure that board members recognize their fiduciary responsibility as a steward of the private foundation.	<b>Tip</b> Consider having an attorney help you understand the legal and tax requirements necessary to maintain tax-exempt status.
	<b>Purpose controls</b> establish the mission statement and provide guiding principles for the foundation.	<b>Tip</b> Define the foundation's "purpose" in the governing documents to lay the founding principles of the foundation.
	<b>Grant controls</b> document a formal grantmaking policy and establish how grants can be vetted and approved.	<b>Tip</b> Consider using grant agreements for complex grant transactions.
	<b>Financial controls</b> ensure that assets are being spent in furtherance of a charitable purpose.	<b>Tip</b> Certain states mandate that private foundations obtain annual, audited financial statements from an external advisor.
	<b>Investment controls</b> establish a process for monitoring investments and help to avoid prohibited "jeopardizing investments" or "excess business holdings."	<b>Tip</b> Establish an investment policy and consult with professional investment advisors.
	<b>Transaction controls</b> establish a process for monitoring investments and help to avoid prohibited "jeopardizing investments" or "excess business holdings."	<b>Tip</b> Establish a conflict of interest policy for board members, officers and employees.



# Forming a private foundation:

## Succession planning

Succession is one of the final items to consider once you have a mission statement, an actively involved and engaged board, a legal and tax structure, and appropriate back-office functions for grant administration. Formalizing the succession process is a key step in the maturity of an ongoing private foundation – not just bylaws and mechanics of succession, but philanthropic training for the next generation.

When establishing a private foundation, one of the toughest questions founders should answer is: “Who will run the private foundation after we’re gone?” Perhaps because it’s a difficult question, founders often decide to defer the decision – sometimes indefinitely. The alternative is waiting until a crisis occurs and then responding, but the issue of a successor’s control and management of a private foundation is better addressed before anything happens.

Thoughtful founders have reached many different conclusions over the years as to what is “best” for their private foundations. Some founders focus on the family legacy: raising their children and grandchildren to take over. Some founders expect that their descendants will follow their grantmaking philosophy. Others founders expect that their descendants will adapt their

grantmaking philosophy to changing times through the generations. A “family legacy” approach can succeed with:

- Clear criteria, in writing, as to when a family member is to be added to the board (this doesn’t have to be in the by-laws, but it should be written so everyone understands the rules)
- By-law provisions for implementing the admission to the board when the criteria are met
- Hands-on training in philanthropy (which could include: site visits, grant application review, volunteering, junior board and committee participation, and formal training)

### TIP:

#### Establish a junior board

Encourage children, grandchildren and other interested parties to participate in the family’s charitable activities.

# Wherever you are on your philanthropic journey, Deloitte can guide you to your next waypoint.

Guiding Startups

Reimagining Impact

Refreshing Strategy & Vision

- **Philanthropic Strategy and Education**—Whether the philanthropic investor is an individual who has been making individual gifts focused on particular areas of need or a business who is desiring to establish a purpose driven model of operation, Deloitte can provide a baseline of philanthropic purpose strategy and education.
- **Tools for Success**—The strategy is inquiry based. Utilizing survey tools, we gather information to discern what matters to the individual(s) and stakeholders we are guiding through the process. Then in the first of two labs we open the aperture to explore the realistic possibilities for making the desired impact. During this lab we explore options, gather feedback, and explore possibilities. The second lab is designed to focus and educate on options for philanthropic tools for success.
- **Unique Journey**—Each journey is unique and dependent upon the goals of the individual or organization under taking the mission.

- **Experienced Philanthropist**—For the more experienced philanthropist and impact investor, today's challenges can feel especially daunting. The tools and vehicles utilized in the past may not feel nimble or expeditious enough for today's challenges.
- **Realistic Possibilities**—A similar lab process used for new philanthropists is used for our more experienced givers. We begin by understanding the existing strategy, what is working, what is not working, and where there may be blockages or barriers. In addition, taking a look at the broader scope and opening the aperture to view realistic possibilities for improving desired outcomes.
- **Renewed Focus**—Following up with renewed focus and choices for reimagining success and impact. This may be accomplished by addition, subtraction or renewal of focus.
- **Customized Journey**—As with new philanthropists, each journey is customized, and the map is written anew each time.

- **Renewal**—Part of the renewal of a philanthropic journey often will involve adding new members to the team. When this occurs, it is vital to organizational success for all leaders to understand and invest in the strategy. This is the case whether the new members are next generation board members, new management, or other fiduciaries.
- **Refresher**—Refreshing strategic vision is a hallmark of vibrant and growing exempt organizations. They look to engage, educate, and integrate new fiduciaries so the organization is getting the individuals best efforts dedicated to their service to the organization.
- **Philanthropic Vehicles**—Deloitte provides basic board education on private foundation tax laws to review of operational systems to long-term strategic planning and legacy planning for the principals who are including philanthropic vehicles in their estate plans.
- **Strategy and Vision**—This last category of strategy and vision refreshing often has the broadest scope. It may involve many philanthropic tools and assessing how effectively they fit into a cohesive long-term philanthropic plan.

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