Current Developments, Cases, Analysis, Planning Advice

# FAMILY FOUNDATION Advisor

November/December 2015 • Volume 15 / No. 1 • ISSN 1537-9485

## IN THIS ISSUE





CRI Civic Research Institute

# Curb Your Enthusiasm: Are Lower Investment Returns the New Norm?

**by David K. Alvarez**

### Introduction

Much has been written about the disappointing investment returns for endowments and foundations over the past year. According to Wilshire Trust Universe Comparison Service, the median return for large endowments and foundations for the year ending July 2015 is 3.6%.[1] This is well below the 7%–8% most endowments and foundations hope to achieve to cover required distributions and to protect against inflation.

Given the low interest rate environment, dropping growth expectations for emerging markets, and concern around sustainable growth in developed markets, several institutional money managers are forecasting more muted returns over the coming investment cycle. Nonprofit organizations, including family foundations, have to manage multiple objectives in the face of such industry pressures. Many, struggling to stay focused on these risks with limited resources, are turning to their advisors to help them navigate the challenges. This article suggests a few questions about three high-level asset classes that family foundations should be asking their current or prospective investment advisors and offers insight gleaned from the author's experience.

### Equities

**Is the Recent Market Volatility Unusual or Unexpected?** The summer of 2015's 12% fall from record highs is the largest correction in the U.S. stock market since 2011. From a historical perspective, however, domestic stocks have been remarkably resilient over the last four years, and a 12% drop is actually not unusual at all. Over the past 35 years, the S&P 500 has seen average intrayear declines of 14.2%, yet—even

*See LOWER RETURNS, next page*

# When Does a Private Foundation Make Sense? Initial Questions and Organizational Issues Donors Must Consider

**by John R. Wiktor**

In a recent article, it was estimated that over the next three decades at least $16 trillion of ultra-high-net-worth individuals' wealth will be passed to the next generation worldwide.[1] Within the United States alone, approximately $6 trillion will pass to the next generation. Because of the evolution in charitable planning, it is a certainty that in regard to such a large wealth transfer, charity will play a role. Certainly, charitable giving is now at the forefront of many individuals' estate planning. (For example, consider the Giving Pledge, a commitment by the world's wealthiest individuals and families to give a majority of their wealth to charity. Members of the Giving Pledge include Warren Buffet, Bill and Melinda Gates, Dan and Jen-

*See INITIAL QUESTIONS, page 7*

nifer Gilbert, T. Boone Pickens, and Mark Zuckerberg, among others.)

One increasingly popular sophisticated giving technique is the organization of private foundations. Private foundations, however, are subject to a number of complicated rules—for example, those that prohibit and tax various forms of self-dealing—and, additionally, contributions to them are subject to a number of restrictions relating to income tax deductibility. Because of the complexity, private foundations used to be considered to be a charitable giving technique only for the very wealthy. However, that is no longer the case. Today many donors are organizing private foundations with initial contributions of less than $1 million.

That is not to say one should jump in blindly. This article addresses critical initial questions that should be analyzed and answered to determine not only if a private foundation makes sense for a particular donor but also, if so, how the private foundation should be organized. Finally, in analyzing these issues, this article also discusses donor-advised funds as an alternative to private foundations.

## Private Foundation Basics

Under IRC §509(a), every IRC §501(c)(3) is assumed to be a private foundation unless it fits into one of the categories of public charities specifically listed in IRC §509(a)(1)-(4). An organization that is classified as a private foundation is further classified as one of the three basic types: a private operating foundation, an exempt operating foundation, or a grant-making foundation.

In general, a private operating foundation is a private foundation that devotes most of its resources to the active conduct of its exempt activities. In general, an exempt operating foundation is a private foundation that (1) has been publicly supported for 10 years, (2) whose governing body consists of individuals less than 25% of whom are disqualified individuals and which is broadly representative of the general public, and (3) has no officer who is a disqualified individual during the year.

A private foundation that is neither a private operating foundation nor an exempt operating foundation is classified as a non-operating grant-making foundation (also often referred to as private non-operating foundations). The majority of private foundations are labeled non-operating (grant making) foundations. A non-operating foundation generally does not carry out any charitable activity directly. Instead, it is designed to hold assets for charitable purposes, usually for distribution to IRC §501(c)(3) public charities. This article focuses on private non-operating (grant making) foundations.

## First Consideration: The Donor's Giving Personality

Effective charitable giving counsel requires more than just suggesting an asset to donate and finding a charity to give it to. The better approach is for advisors to counsel their clients holistically, first examining the client's giving personality to determine whether a gift makes sense and, if so, then determining what type of gift the client should make. Therefore, in considering whether a private foundation makes sense, the donor's giving personality should first be examined and understood.

The three common elements of any donor's giving personality are (1) the donor's family structure and dynamics; (2) the donor's desired level of control; and (3) the donor's complexity level.

Each of these elements is further explained here and should be considered in connection with deciding whether a private foundation makes sense as the charitable giving vehicle.

**The Donor's Family.** Generally speaking, a donor's family situation can have a significant impact on the donor's ideas about philanthropy. When the donor is already charitably inclined, however, a private foundation may make sense no mat-

See INITIAL QUESTIONS, next page

*INITIAL QUESTIONS, from page 7*

ter the structure and dynamics of the donor's family.

For example, if a client has no descendants, a private foundation can be an excellent vehicle to allow the donor's legacy to live on well after his or her death. Consider: Following the client's death, a one-time distribution by the estate to a public charity would be "one and done." In contrast, if the estate plan calls for contributing the assets to a private foundation upon death, distributions from the foundation may be made for years, decades or longer after the donor's death. Each time a distribution is made, the donor's legacy will live on. At the same time, a client who has no descendants should consider who will manage the foundation after his or her death.

On the other hand, a donor who has living descendants may want to use the private foundation as means for those descendants to be involved in the family's charitable giving long after the donor is gone.

In such a case, it is likely that the donor's objectives are for his or her descendants to play a major role in the administration of the private foundation and in the grantmaking process. For example, the private foundation may require that each year the donor's descendants research a charitable cause to which distributions from the private foundation will be made. This is an excellent idea to instill philanthropy in younger generations. In all of those cases, the most successful foundations are those that incorporate intergenerational planning, thus allowing the management of the foundation to easily transition from one generation to another.

**The Donor's Control Level.** The second significant part of any donor's giving personality is the donor's desire for control over the charitable gift. Donors typically are very specific as to what level of control they want to maintain over a gift. A donee charity and/or advisor who understand a donor's desired control level may, where appropriate, create a stronger relationship by suggesting steps to give the donor some level of control over the gift while still structuring it in a way that benefits, and doesn't unduly hamstring, the charity and that does not prevent the donor from claiming a charitable contribution deduction for his or her gift.

A donor's requirement for control often can be satisfied through a private foundation. For example, the donor may be on the board of the private foundation and thus for years to come have a significant voice in the administration of the foundation and in choosing what other charities or purposes benefit from the foundation assets for many years after the initial gift is made.

**The Donor's Complexity Level.** It is very important for an advisor and charity to understand a donor's comfort with a complex gift at the outset of the relationship. A donor who has no interest or does not understand the complexity that can be associated with philanthropy will quickly be turned off if presented with overly complicated gifting options. In this case, basic and convenient options should be presented. To put it simply, the most common form of philanthropy is still the outright gift. Although lacking bells and whistles, an outright gift is a simple and convenient way for a donor to realize charitable aspirations.

However, many donors have no objection to complexity, and in some cases a donor's ultimate goals may require a giving technique that necessarily involves a greater level of complexity. In those cases, a private foundation, which can for certain reasons be complex, may be a fit.

***If a client has no descendants, a private foundation can be an excellent vehicle to allow the donor's legacy to live on well after his or her death.***

## Second Consideration: The Tax Consequences

Donors have many different reasons for wanting to organize a private foundation. Frequently, a primary motivation for charitable planning is the associated income tax deduction. Whether the potential tax savings are a primary or only a secondary motivation, the attendant complex income tax deduction limitations must be considered when deciding whether a private foundation makes sense.

A donor may contribute to both public and private organizations within the same taxable year, and may contribute both cash and noncash assets. Strategic tax planning, however, is necessary to ensure that the donor's tax deduction is maximized. The ceiling for gifts to a public charity in most cases will be higher than that applicable to a private foundation. That being said, in many cases, the private foundation percentage limitations will never even come into play.

**50% Deduction Limitation.** Each year, a donor may deduct up to 50% of his or her contribution base for cash contributions to public charities. Typically, churches, certain educational organizations, hospitals, medical research centers, governmental units, and publicly supported organizations such as the American Red Cross, libraries, or community museums qualify as public charities. In contrast, the deduction ceiling for a gift to a private foundation never exceeds 30% of the donor's contribution base.

**30% Deduction Limitation.** Contributions of noncash assets to a public charity are subject to a 30% deduction limitation if the donor deducts the fair market value (FMV) of the property. However, this may be increased to 50% if the donor elects to limit the deduction to his or her basis in the property, rather than the FMV.

As noted earlier, for private non-operating foundations, cash contributions to an organization that does not qualify as a public charity are subject to a 30% deduction limitation. Accordingly, a donor may only deduct a maximum of 30% of his or her contribution base for cash contributions to private non-operating foundations. The ceiling is lower for noncash contributions to nonpublic charities.

**20% Deduction Limitation.** Alternatively, contributions of non-cash assets to organizations that do not qualify as a pub-

*See INITIAL QUESTIONS, next page*

*INITIAL QUESTIONS, from page 8*

lic charity are subject to a 20% deduction limitation if the donor's deduction is based on the FMV of the property. Where the donor elects to take a basis deduction for the property, the contribution is subject to a 30% deduction limitation. Table 1 illustrates the various deduction limitations.

**Table 1**
**Deduction Limitations for Charitable Contributions**

| | Public Charities | Private Foundations |
|---|---|---|
| Basic Deduction/Cash | 50% | 30% |
| FMV Deduction | 30% | 20% |

## Third Consideration: Choice of Entity

**Ease of Organization and Costs of Annual Compliance.** A private foundation requires many organizational steps, as well as some annual administration, that are not required when one simply makes a gift to an existing public charity. Also, there is legal work and ongoing compliance associated with the private foundation. While many donors may be amendable to the ongoing work, it is important to make sure at the outset that a donor understands what is required for setup and ongoing annual compliance.

***Initial Setup.*** A private foundation may be organized as either a corporation or a trust. If it is organized as a corporation:

- Articles of incorporation have to be filed and approved;
- Bylaws for the corporation should be drafted and approved by the board of directors; and
- Initial minutes should be compiled.

The corporation also will have to name a registered agent within the state of incorporation. This may result in additional work and fees if the private foundation is being incorporated in a state other than the donor's domicile.

A private foundation also may be organized as a trust. In that case, a trust agreement must be completed.

***Practice Point:*** There are additional formalities required with the corporate structure and trust structure. State law generally requires that a not-for-profit corporation hold annual meetings and keep detailed minutes of such meetings. There are no such formalities required for a charitable trust, but the trust document may require an annual accounting.

***Securing Tax-Exempt Status.*** Once the private foundation is organized, the foundation must apply for tax-exempt status with the Internal Revenue Service and, in many cases, must also register with the applicable state's attorney general. In addition, an annual 990-PF tax return must be filed with the IRS, and annual reports may also be required to be filed with the relevant state agencies, such as the attorney general or state department of revenue. Each of these filings generally requires preparation fees and associated filing fees.

That said, one should not confuse the work involved with initial organization of the private foundation with the speed of obtaining a charitable deduction. For example, although several steps are required to properly organize a private foundation and gain tax-exempt status, generally speaking not-for-profit articles of incorporation for a private foundation can likely be completed and filed in a day or two. Therefore, even if the foundation does not actually apply for and obtain tax-exempt status until many months later (a foundation has a maximun of 27 months from the date of formation (including an extension) to apply for tax-exempt status), IRS approval of tax-exempt status should be retroactive to the date of incorporation. Thus, assuming tax-exempt approval is formalized in the future, the donor should receive an immediate tax deduction for a contribution to a private foundation that was just incorporated. This means, importantly, that a donor who may decide only late in December to organize a private foundation prior to year-end may still be able to secure the attendant tax deduction for that same calendar year.

***Ongoing Flexibility Considerations.*** Generally speaking, a donor who establishes a private foundation can in the initial organizational documents set forth the ongoing management and charitable purpose of the organization. In considering this issue, the donor must analyze whether a corporate or trust structure makes most sense.[2]

A private foundation that is organized as a not-for-profit corporation rather than a trust will provide greater flexibility to the managers of the private foundation. State statutes and the corporate bylaws typically provide corporate directors with greater flexibility than that permitted to a trustee by state statute and the trust instrument.

Directors of a not-for-profit corporation (unless specifically limited by the articles of incorporation or bylaws) generally also will be able to alter the governing structure of the corporation by corporate resolution. Because of this flexibility, it will be easier for a board of directors to address circumstances that may affect how the private foundation is managed. For example, the foundation's directors can change on a frequent basis with new elections. In comparison, a less flexible charitable trust will allow the donor to designate who acts as trustee and successor trustees of the trust. Thus, the donor will effectively choose who will manage the private foundation.

A not-for-profit corporation also will provide greater flexibility to the board of directors with regard to the foundation's charitable purpose. State law generally will allow the charitable purpose set forth in the articles of incorporation to be amended by corporate resolution (unless specifically prescribed in the articles). Thus, the board of directors is given a means to amend the corporate purpose to adapt to the societal changes. Note, however, that, depending on state law, the private foundation may need to obtain approval from state officials before a corporate purpose may be amended.

In comparison to the corporate structure, if a private foundation is organized as a charitable trust, the trust instrument must be irrevocable, so the donor, the trustee, or a third party likely will be unable in future to modify its terms. At first blush,

*See INITIAL QUESTIONS, next page*

*INITIAL QUESTIONS, from page 9*

the donor may see this as an unalloyed "plus," ensuring that the trust's charitable purpose will remain unchanged. Over time, however, the trustee may find the trust's charitable purpose has become either limited or totally unworkable. After all, societal circumstances do change. In recent years, the inability to change a trust's limited charitable purpose has been the subject of much litigation.[3] In order to amend a charitable trust, most states' cy pres and equitable deviation doctrines will prohibit amendment of the charitable trust without a court proceeding or prior approval of the state's attorney general. The court proceeding will require the state's attorney general to be a party. Further, to be successful in modifying the charitable purpose, the trustee likely will have to show that the existing charitable purpose is impossible or impractical to fulfill.

### Not Sure a Private Foundation Fills the Bill? Consider a Donor-Advised Fund

A viable alternative to a private foundation, in the right circumstances, may be a donor-advised fund (DAF). A DAF provides donors with a unique opportunity to donate to charitable organizations and receive the maximum deduction limitation. Generally, the donor makes an irrevocable donation to a qualified charitable organization (i.e., a tax-exempt IRC §501(c)(3) organization), which then creates and maintains a DAF with the money. Although the IRC §501(c)(3) organization maintains legal control over the contribution, the donor holds advisory privileges over the DAF, which allows the donor to recommend specific grants and contributions to be made to other eligible charities using the funds held in the DAF. (Note, however, that the DAF is not obligated to follow the donor's recommendations.)

Donors may contribute a wide range of assets to DAFs, which are considered public charities rather than private foundations.

Since a DAF is considered to be a public charity, cash contributions to a DAF are subject to the maximum 50% deduction limitation and contributions of noncash assets to a DAF are subject to a 30% deduction limitation if the donor deducts the fair market value of the property (as previously discussed).

Annually, the donor advises the DAF as to where charitable distributions should be made. But, because DAFs are maintained by a sponsoring institution, the donor is not responsible for ongoing administration and maintenance. Therefore, a donor who does not want to be involved in management detail may find a DAF to be a welcome alternative.

### Fourth Consideration: The 5% Distribution Requirement and Tax on Net Investment Income

A client considering a private foundation may think that one can be organized and that thereafter the foundation's assets can grow tax-free over time without distributions. This, of course, is not the case: A non-operating private foundation is required to spend or distribute a minimum amount annually for charitable purposes, and it also will be subject to taxation on its investment income. These factors must be discussed, especially in light of the type of assets that may contributed, before a final decision to set up a private foundation is made. A donor who is informed of these issues can take proactive to steps to potentially lessen the tax burden and allow the private foundation assets to flourish.

**Distribution of Noncharitable-Use Assets.** IRC §4942 requires a non-operating private foundation to annually distribute a minimum amount of its funds, equal to approximately 5% of the average FMV of a foundation's noncharitable use assets (generally, cash and investments) for the year. Failure to distribute the required minimum amount in the following taxable year may subject the foundation to a 30% excise tax on the amount "under-distributed." Worse, the excise tax may increase to 100% of the shortfall if the foundation continues to not make the distribution. There is a potential "failsafe": If, in any year, a foundation exceeds its minimum distribution requirement, that excess may be carried over to help satisfy the minimum distributions of future years, up to five years. Thus, it is possible that the qualifying distributions in one year will be so great that no actual expenditures may be required to meet the minimum distribution requirement of a future year.

***Practice Point:*** Expenses that relate to the foundation's charitable purpose may be classified in certain ways on Form 990-PF to offset the distributable amount. Therefore, care should be taken in preparation of the 990-PF. Further, where non-liquid assets are contributed to the private foundation, the 5% distribution becomes even more of a sticky issue. Obviously, if the foundation is invested solely in illiquid, non-income-producing assets, it will be unable to make the 5% distribution without making distributions in-kind or selling a portion of its assets.

**Tax on Net Investment Income.** IRC §4940 imposes a 2% excise tax on the net investment income of non-operating private foundations. If, however, the foundation meets certain requirements under IRC §4940(e)(1), the excise tax on its net investment income can be reduced to 1%. (Generally speaking, the tax will be reduced to 1% if the private foundation met the 5% distribution requirement for the prior year.) Thus, while the tax on investment income can be lessened, it cannot be escaped.

### Fifth Consideration: Other Excise Taxes

In addition to the income tax ceiling differences between a public charity and a private foundation, federal tax law includes other provisions that impose additional excise taxes on private foundations, foundation managers, or other disqualified persons who engage in certain prohibited acts to which public charities are not necessarily subject:

1. The taxes on self-dealing between private foundations and their substantial contributors or other disqualified persons (IRC §4941);
2. Taxes on certain business holdings (IRC §4943);
3. Penalty excise taxes designed to discourage behavior detracting from a foundation's ability to further charitable pur-

*See INITIAL QUESTIONS, next page*

INITIAL QUESTIONS, from page 10

poses (IRC §§4941, 4943, and 4944); and

4. Penalty taxes on certain foundation expenditures (IRC §4945).

Violation of these provisions can result in taxes and penalties against the private foundation and, in some cases, its managers, its substantial contributors, and certain related persons. A full discussion of each of these excise tax rules is beyond of the scope of this article. That being said, however, when considering whether a private foundation makes sense for a particular donor, it is essential to analyze these excise tax rules. Failure to abide by them can create very harmful—sometimes, disastrous—results to the private foundation and, in some cases, the donor.

## Sixth Consideration: Value of the Foundation

When discussing all the considerations addressed earlier, clients regularly ask how much their initial contribution to a private foundation should be. There is no correct answer to this question. A donor may see much value in the private foundation, and be concerned with far more than just the initial and ongoing administration costs. For example, a donor who wants to make only a small contribution at the outset but intends to make larger contributions in the future may consider a private foundation very attractive.

Some donors may be more concerned about having their legacies live on through the private foundation, and about using the foundation as a means to instill philanthropic values in their descendants, than about the annual compliance costs, tax deductions, or value of the private foundation principle. Donors should be aware of the ongoing compliance costs and all the other considerations previously discussed, but there is no single one-size-fits-all right answer to whether a private foundation "makes sense." In all cases, the vast benefits associated with a private foundation must be considered.

## Conclusion

The huge transfer of wealth that is expected to occur over the next few decades will have a significant impact on charitable giving. However, for the transition of wealth to go smoothly where charity is involved, it is important that families, advisors, and charities work together to develop a clear charitable plan that will pass from one generation to another. After taking into consideration the factors discussed in this article, a donor will often find that the private foundation is an excellent vehicle to incorporate in a charitable plan.

## Endnotes

*1. Ansuya Harjani, "Coming Soon: The Biggest Wealth Transfer in History," CNBC Wealth, Jan. 13, 2015. Available at www.cnbc.com/2015/01/13/coming-soon-the-biggest-wealth-transfer-in-history.html.*

*2. See Richard M. Horwood & John R. Wiktor, "Private Foundations: Trust or Corporation? Choosing the Right Fit," 5(5) Fam. Found. Adv. 1 (July/Aug. 2006).*

*3. See, e.g., In re Barnes Foundation, 672 A.2d 1364 (Pa. Super. 1996); San Francisco Foundation v. County of Marin, 37 Cal. 3d 285, 690 P.2d 1, 208 Cal. Rptr. 31 (1984).*

*John Wiktor is a partner in the Private Client Group of the Chicago law firm, Horwood Marcus & Berk, Chtd. He may be contacted at (312)-242-3305 or JWiktor@hmblaw.com.*