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An Introduction to Private Foundations

Introduction

Many affluent individuals feel strongly about positively impacting their communities through charitable activities. Acknowledging the societal benefit of these efforts, the IRS has established two general categories of tax exempt charitable entities under section 501(c)(3) of the Internal Revenue Code (IRC). These entities are especially useful for charitably inclined individuals wishing to reduce their income and estate tax exposure.

Types of Charitable Entities

The first type, **private foundations**, consist of all charitable enterprises qualifying under section 501(c)(3) that have not satisfied a requirement known as the public support test. The second type, **public charities**, are IRC 501(c)(3) qualifying charitable entities that have met the public support test. The intricacies of this test are beyond the scope of this introduction, but generally speaking, public charities derive the majority of their funding from the general public, while private foundations derive their funding from individuals, families, or corporations, and do not publicly engage in fundraising.

Advantages of Private Foundations

While both types of charitable entities offer potential tax advantages for qualified contributions, there are several reasons why a private foundation can be advantageous for certain affluent individuals.

- **Control**—Many affluent donors wish to remain involved in the execution of their charitable gift—providing direction for where and how the funds will be deployed—to maximize the impact the foundation is able to have on causes important to the donor.
- **Flexibility**—Private foundations can be structured and administered to reflect the specific needs and goals of the donor, thereby offering the highest degree of customization in structure and approach.
- **Privacy or Publicity**—Private foundations allow donors to decide how public or private to make their gifts. Private foundations can be used to promote the donor's philanthropic impact; examples include building projects or scholarships that carry the name of an individual or family.

- **Perpetuity**—Private foundations can be useful during the life, or after the death, of the person establishing the entity, allowing the donor's charitable intentions to continue being exercised indefinitely.
- **Tax Planning**—Private foundations can be used to accomplish a wide variety of both income and estate tax planning goals.

Disadvantages of Private Foundations

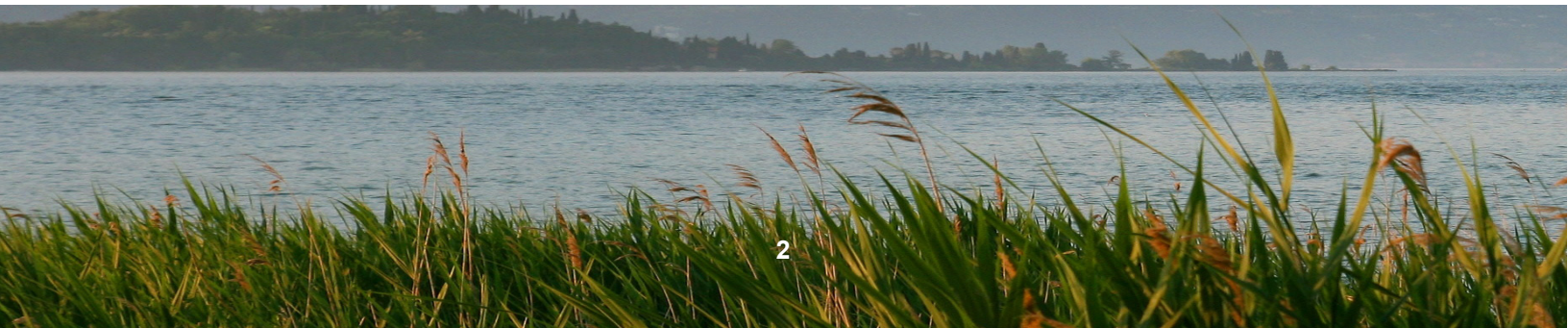
Despite their numerous advantages, private foundations also have a number of inherent drawbacks that may impede the donor's planning or charitable goals.

- Private foundations are subject to several categories of complex restrictions and tax rules. A thorough review of the relevant tax considerations should be conducted prior to the creation of a private foundation.
  - Investment income is generally subject to an excise tax of 2%.
  - Self-dealing, or acting in self-interest rather than in the interest of the foundation, can result in excise taxes with complicated rules surrounding prohibited transactions and disqualified persons.
  - Private foundations are generally required to distribute 5% of investment assets annually to charitable efforts; undistributed income can be subject to additional excise taxes.
  - Excise taxes can apply to excess business holdings, where the private foundation owns more than a specified share of voting stock in a corporation.
  - Certain high-risk investments that jeopardize charitable purposes can be subject to excise taxes.
  - Additional excise taxes may apply to certain types of expenditures, generally applying to political or non-charitable purposes.
- The ongoing professional management of a private foundation can result in significant administration costs.
- Private foundations generally restrict contribution limitations more than public charities; an individual donor is subject to a limitation on cash donations to a private foundation of 30% of their adjusted gross income (AGI), and 20% of AGI for donations of property subject to capital gains tax. Gifts to public charities are less restrictive, where donors can generally deduct gifts up to 50% of their AGI.

Life Insurance Planning Implications

Due to the fact that a properly structured private foundation is a tax-exempt organization for income tax purposes, the advantages of using life insurance as a planning tool are frequently overlooked. However, life insurance can be structured to offer a number of unique benefits that are especially useful for private foundations, in light of their long-term planning horizon and typical reliance upon a single donor or family.

- **Wealth Replacement for Beneficiaries**—The donor can give a taxable inheritance to charity, and create income to purchase a generally non-taxable life insurance death benefit designed to replace the assets that were gifted for their beneficiaries. Structures such as charitable gift annuities or charitable remainder trusts can provide an ongoing source of life insurance premium dollars while also providing an income tax benefit.
- **Key Person Coverage**—Most private foundations rely almost exclusively upon the contributions of a small group of individuals. If an insurance carrier's insurable interest requirements are met (often based upon donative history), life insurance can provide contractual liquidity to fund the ongoing foundation activities in the event of the donor's untimely death.



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- **Maximize Long-Term Foundation Assets**—Life insurance offers private foundation donors the opportunity to leverage their funds for the greatest posthumous impact. The death benefit of life insurance generally offers a very competitive internal rate of return at the insured's life expectancy when compared to other asset classes. Life insurance is unique among various types of assets, in that it provides contractual liquidity at the death of the insured. The policy death benefit can be received free of tax and is not limited by AGI contribution limits; this allows a donor to provide additional tax-advantaged funds to their foundation. Some foundations may choose to hold a portion of their overall asset portfolio in permanent life insurance, providing a level of long-term certainty of asset values within the foundation. Several approaches are available for life insurance planning, including the use of other charitable planning structures, naming the foundation as beneficiary of excess life insurance death proceeds, or gifting of existing life insurance to the foundation.

Conclusion

Private foundations can be useful for individuals seeking to maximize their philanthropic impact and influence, while concurrently meeting both income and estate tax planning objectives. The tax and operational complexity of these arrangements require knowledgeable advisors to ensure that administration and tax requirements are met. A sophisticated team of advisors can guide clients through the planning process and assist in creating and managing a private foundation that capitalizes on tax planning opportunities while increasing the client's ability to directly impact the charitable causes they care for passionately.

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