

Private foundations

In brief

WHAT IS A PRIVATE FOUNDATION?

A private foundation is a charitable organization that is funded by a single donor or a small group of donors, rather than by contributions from the public. The private foundation generally is not engaged directly in charitable activity, but makes grants to public charities.

Non-tax advantages of a private foundation

Control. Unlike gifts to a public charity, gifts to a private foundation allow the donor (or someone the donor selects) to manage the foundation assets and determine which public charities receive grants each year.

Involvement of future generations. The donor can designate the donor's children, grandchildren, or other individuals to serve as trustees or directors of the foundation either during the donor's life or after the donor's death.

Current funding of future giving. A donor can contribute to a private foundation in the current year – and receive a current income tax deduction – and have the private foundation make grants to public charities in either current or future years.

Tax advantages of a private foundation

Gift taxes. There are no gift taxes on gifts to private foundations. Contributions during life qualify for the unlimited gift tax charitable deduction. Internal Revenue Code (I.R.C.) § 2522.

Estate taxes. In addition, contributions to the foundation at a donor's death qualify for the unlimited estate tax charitable deduction. I.R.C. § 2055.

Income taxes. The donor receives an income tax deduction in the year contributions are made to the foundation, subject to the following limitations:

- Deductions for cash, ordinary income property, and short-term capital gain property are limited to 30% of the donor's adjusted gross income ("AGI"). I.R.C. § 170(b)(1)(B)(i). For ordinary income and short-term capital gain property, the amount deductible is limited to the lesser of (1) the property's fair market value or (2) basis. I.R.C. § 170(e).
- Deductions for long term capital gain property are limited to 20% of the donor's AGI. I.R.C. § 170(b)(1)(D). The amount deductible is limited to basis unless it is a gift of qualified appreciated stock (publicly traded securities) in which case the amount deductible is fair market value. I.R.C. § 170(e)(5)(A).
- Deductible amounts not used in the current year because they exceed AGI limits may be carried forward up to five years. I.R.C. § 170(d)(1)).

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HOW DOES A PRIVATE FOUNDATION WORK?



Establishing the private foundation

A private foundation may be created either as a corporation or a trust.

- If it is organized as a corporation, the necessary forms must be filed with the state. Officers and directors manage the private foundation. A corporation is generally more flexible than a trust if the donor wishes to make changes to the foundation in the future.
- If a private foundation is organized as a trust, it is created by a trust agreement and managed by the trustees. A trust is generally easier to create than a corporation.

Once the private foundation has been created, the donor may contribute assets to it.

The private foundation must receive an exemption letter from the IRS in order to be tax-exempt. To request tax-exempt status, the private foundation files IRS Form 1023, *Application for Recognition of Exemption*. Form 1023 is generally due no later than 27 months after the end of the month in which the foundation is created.

Distributions to charities

A private foundation must make qualifying distributions of at least 5% of its net fair market value each year. Failure to do so triggers a 30% excise tax (that can grow to 100%) on the portion of this minimum distribution amount that's not distributed. See I.R.C. § 4942.

A qualifying distribution is generally an amount that a foundation expends for charitable purposes. Grants to public charities are the most common types of qualifying distributions.

A 20% tax is imposed on distributions that are not qualified distributions. This tax grows to 100% if left uncorrected. See I.R.C. § 4945.

Investment of foundation assets

Fiduciary duties. The trustees or directors of a private foundation are subject to state laws governing what type of investing is proper for fiduciaries.

Tax on jeopardy investments. A private foundation is subject to an excise tax of 10% (that can grow to 25%) on investments that jeopardize its charitable purpose. I.R.C. § 4944. While not specifically defined, a jeopardy investment is generally one that is not reasonable or prudent in light of the foundation's charitable function.

Examples where the IRS will scrutinize the investment include trading securities on margin, trading in commodity futures, investments in working oil & gas wells, buying put and call options, and selling short. Treas. Reg. § 53.4944-1(a)(2)(i).

Tax on excess business holdings. Generally, private foundations and its disqualified persons (officers and directors, trustees, and certain employees) cannot hold collectively more than 20% of the voting stock of a corporation or more than a 20% interest in a partnership, LLC, joint venture, or other unincorporated enterprise.

- A private foundation is subject to an initial excise tax of 10% on the value of any excess business holdings. This tax increases to 200% of the value of the excess business holdings if the holdings are not disposed of in a timely fashion. I.R.C. § 4943.
- If a private foundation receives excess business holdings in a manner other than a purchase (such as by gift or bequest), the foundation will not be subject to the excise tax if it disposes of the excess business holdings within 5 years of receipt (with a possible additional 5 year extension). I.R.C. § 4943(c)(6) and (7).
- Under the "Newman's Own" exception enacted in 2018, the excess business rule does not apply if the private foundation holds 100% of a business' voting stock via gift or bequest, receives all of the business' net operating profit, and satisfies other detailed and hard-to-meet requirements. I.R.C. § 4943(g).

Life insurance. A private foundation can hold life insurance. Owning permanent life insurance is generally a better fit when there is strong reason to believe that the foundation will hold the policy until the insured's death rather than just viewing the policy as an investment. A typical example of a good situation is when the insured is a donor who makes donations to pay the premiums.

Annual filings and taxes

Private foundations must file IRS Form 990-PF annually. This tax return reports the foundation's assets, income, expenses and charitable grants. In addition, it lists the names, addresses and compensation of its officers and directors or trustees. This form must be available for public inspection.

Private foundation must pay an annual flat excise tax of 1.39% on net investment income. I.R.C. § 4940(a). This 1.39% flat rate became effective for tax years beginning after December 20, 2019, replacing the two tier excise tax of 1% or 2% that was previously in place under I.R.C. § 4940(e).

States also may have filing requirements. Some states will accept a copy of the Form 990-PF.

Transactions with disqualified persons

Generally, substantial donors and the foundation managers (officers and directors, trustees, and certain employees) are disqualified persons.

Certain transactions between a private foundation and a disqualified person are subject to a 10% tax on self-dealing (which can increase to 200% if uncorrected). I.R.C. § 4941. Some examples of self-dealing include:

- the sale, exchange or lease of property.
- lending money or other extensions of credit.
- providing goods, services and facilities to a disqualified person at terms that are more favorable than available to the general public.
- paying compensation or reimbursing expenses to a disqualified person unless the compensation is reasonable and necessary to carry out the foundation's charitable purpose and is not excessive.

PRIVATE FOUNDATIONS AND ESTATE PLANNING

There are several estate planning techniques that can be used in conjunction with a private foundation.

Wealth replacement trust

A wealth replacement trust is an irrevocable trust holding life insurance that has the purpose of replacing the wealth that would have passed to family members, but instead was used to make charitable contributions.

A wealth replacement trust is identical to an irrevocable life insurance trust ("ILIT") in how it is designed, how it functions, and its tax considerations.

Charitable remainder trust or charitable lead trust

Charitable remainder trust. A charitable remainder trust ("CRT") is used primarily to allow a donor to make a gift to charity, while retaining an income stream for himself or a beneficiary during the trust term. At the end of the trust term, the remaining assets pass to charity. A private foundation can be named as the charitable remainder beneficiary.

Charitable lead trust. A charitable lead trust ("CLT") is used to make a discounted gift to family members, while benefiting one or multiple charities. A donor contributes property to the CLT, which pays an income stream to a charity during the trust term and the remainder to the donor's family members. A private foundation can be named to receive this front-end income stream.

ALTERNATIVES TO A PRIVATE FOUNDATION

There are many ways to give to charity, each with its advantages and disadvantages. While donors often focus on the income tax deduction, often other factors can be more significant, like the degree of control and cost to administer.

Gifts directly to a public charity

A donor may give cash or property directly to a public charity.

Gifts to public charities provided the most generous income tax charitable deduction rules. The maximum deduction is based on the type of property donated. If it is cash, the limit is 60% of the donor's AGI. If it is ordinary income or short-term capital gain property, the limit is 50% of AGI. And the deduction for long-term capital gain property is limited to 30% of the donor's AGI.

The donor loses control over the contribution once it is received by the charity.

Donor advised fund

A donor advised fund is a grant-making account held by a public charity, for which the charity agrees to consider the donor's investment and distribution requests. Some funds allow the donor's family to continue the advisory function after the donor's death.

Despite the donor's involvement, contributions to a donor advised fund are deductible as gifts to a public charity, subject to the same "type of property" and AGI limits described above.

The fund handles all financial and administrative management and files the annual tax return.

Supporting organization

A supporting organization is a charitable organization formed to support a public charity. I.R.C. § 509(a)(3). It falls somewhere in between a private foundation and a public charity.

Gifts to a supporting organization are deductible as gifts to a public charity, subject to the same "type of property" and AGI limits described above. In addition, the supporting organization is not subject to the private foundation rules, including the requirement that a private foundation distribute 5% of its net assets annually.

There are several ways to qualify as a supporting organization. The most common approach is to have the public charity appoint a majority of the supporting organization's directors. The donor can retain some control by serving as a director, appointing other directors, or both.

INCOME TAX CHARITABLE DEDUCTION CHART

When the donor's deductible amount exceeds that deduction limit due to exceeding the relevant percentage of the donor's Adjusted Gross Income (AGI), the excess generally can be carried forward and deducted over the next 5 years. See, e.g., I.R.C. § 170(d).

TYPE OF PROPERTY	PUBLIC CHARITY ^a (INCLUDING DONOR ADVISED FUNDS)		PRIVATE FOUNDATION	
	Deductible Amount	Deduction Limitation as Percentage of AGI	Deductible Amount	Deduction Limitation as Percentage of AGI ^b
Cash	Fair Market Value (FMV)	60% ^c	FMV	30%
Ordinary Income Property (e.g., life insurance) ^d and Short-Term Capital Gain Property ^e	Lower of: • FMV • Basis	50%	Lower of: • FMV • Basis	30%
Long-Term Capital Gain Property (LTCG) ^f	FMV	30% (or 50%, if donor elects to limit deduction to basis when basis is lower than FMV) ^g	Qualified Appreciated Stock: FMV ^h	20%
			All Other LTCG property Lower of: • FMV • Basis	20%

a Includes gifts to: public charities, donor advised funds, funds in community foundations, private operating foundations, flow through foundations, and supporting organizations. Gifts "for the use of" the charity rather than "to" the charity are subject to 30% of AGI limit.

b For gifts to Private Foundations, the 30% of AGI limitation for gifts of non-LTCG property is found in I.R.C. § 170(b)(1)(B); the 20% of AGI limitation for gifts of LTCG property is found in I.R.C. § 170(b)(1)(D).

c The deduction limit of 60% of AGI started in tax year 2018 and ends after tax year 2025. Starting in 2026, the deduction limit for cash gifts is scheduled to again be 50% of AGI. I.R.C. § 170(b)(1)(G)(i).

d Also includes inventory held less than one year, depreciable property, and donor created art. I.R.C. § 170(e)(1)(A).

e Includes stocks, bonds, and other capital assets which would yield short-term capital gain if sold. I.R.C. § 170(e)(1)(A).

f Includes assets which, if sold at its fair market value, would result in long-term capital gain (e.g., appreciated securities and real estate held for more than one year). I.R.C. §§ 170(b)(1)(C)(iv) and 1222(3).

g Normally, gifts of LTCG property are deductible at FMV, and are capped at 30% of AGI. But the donor can elect a 50% of AGI deduction for all charitable gifts of LTCG during the year, but in that case the donor's deductible amount for those gifts (and LTCG gifts still being carried over) will be the lower of FMV or basis. This can be useful if the basis is not much lower than the FMV. I.R.C. §§ 170(b)(1)(C)(i) and (iii).

h Donations of qualified appreciated stock (publicly traded securities) to private foundations are deductible at fair market value. I.R.C. § 170(e)(5).

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