



WRMarketplace

An AALU Washington Report

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The WRMarketplace is created exclusively for AALU Members by the AALU staff and Greenberg Traurig, one of the nation's leading tax and wealth management law firms. The WRMarketplace provides deep insight into trends and events impacting the use of life insurance products, including key take-aways, for AALU members, clients and advisors.

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TOPIC: Creating a Charitable Legacy: What to Know About Forming a Private Foundation.

MARKET TREND: Individuals can form private foundations to provide a permanent legacy for their family and a vehicle to accomplish their philanthropic goals.

SYNOPSIS: Private foundations can play an important part in achieving the philanthropic goals of the charitably-inclined. While expensive to form and maintain, private foundations create a lasting charitable legacy and can provide a family with a cohesive structure to engage in long-term charitable giving. As part of the formation process, a donor should carefully consider the contemplated charitable purposes, the intended management structure, and the anticipated charitable activities to determine the type of structure that will best suit the donor's needs. This chosen structure can affect the foundation's continued operations and efficacy. Further, as the formation and on-going operation of a private foundation can be burdensome relative to other charitable giving options, donors should review the effort and costs involved and have sufficient time and funding to warrant the administration.

TAKE AWAY: For donors who want to be actively involved and are willing to make a substantial commitment to charitable giving, a private foundation may be the solution. A donor, however, should understand the basic legal rules that govern the formation and operation of a private foundation to appreciate the commitment of time and funds that will be required relative to other planning options. Reviewing the potential benefits of, and issues with, creating a private foundation and clearly identifying the donor's intentions and goals can help advisors guide donors in the selection of the appropriate vehicle for their philanthropic vision.

PRIOR REPORTS: 13-25.

WHY FORM A PRIVATE FOUNDATION

Private foundations are tax-exempt entities managed for charitable purposes by their trustees or directors. Most families form their private foundations as "non-operating" foundations, which generally support charitable, educational, or religious causes through the making of grants to other nonprofit organizations.¹ For philanthropically-inclined families who wish to create and substantially fund a charitable legacy, private foundations can provide significant benefits:

- Control. A private foundation can provide flexibility and substantial control to a donor over the private foundation's charitable activities. The donor can be involved in the selection of the board, the choice of charities to support, and the investments of the funds.
- Family Involvement. A private foundation enables a donor to involve family members in the foundation's management. Engaging descendants early and actively in the foundation's operations can instill the family's philanthropic and business management values in future generations, as well as teach fiscal and social responsibility. Working together to manage the charitable assets also can foster an ongoing bond between generations of family members.
- Name Perpetuation and Legacy. A private foundation establishes a family tradition of giving and perpetuates the family's charitable goals for the long-term.
- Consolidated Charitable Strategy. A private foundation can create a consolidated philanthropic strategy for the entire family, pooling charitable resources for management and distribution in a unified and efficient approach.

- Creation of a Buffer. The private foundation can be used to field charitable requests and solicitations, creating a buffer between family members and charitable organizations.
- Tax Treatment of Contributions. Under longstanding and appropriate tax laws related to charitable entities, a donor can obtain an immediate charitable income tax deduction for a contribution to the foundation, while making charitable grants from the foundation at a later date. If appreciated assets are contributed to the private foundation, gain recognition on the appreciation may be minimized or eliminated.

WHAT TO CONSIDER

Private foundations are governed by a complex legal and administrative framework, so donors should carefully weigh their potential advantages against the administrative complexities of forming and operating the foundation, including:

- Costs. The costs related to starting and operating a private foundation will vary from state to state and depend on the type of entity used (as discussed below). In addition, there will be legal and administrative costs related to required tax reporting, annual reporting, maintenance of accounts, compensation of service providers or any employees, etc.
- Funding. Given the costs and technical requirements for forming and operating private foundations, and the restrictions on the type of assets that a private foundation may hold, private foundations are best suited to donors who want to allocate a fairly sizable sum for charitable purposes and have appropriate and available resources for funding.
- Tax-Exempt Status. A private foundation must apply for tax-exempt status for both federal and state purposes to obtain recognition of an exemption from income tax and to be eligible to receive tax-deductible contributions.² To maintain this exempt status as a charitable entity, the private foundation also will need to satisfy annual information reporting requirements.³
- Operational Requirements. The administration and operation of a private foundation must comply with several federal and state rules to avoid excise taxes and/or the loss of tax-exempt status. For example, some notable operational requirements under the Code include:⁴

- Minimum Distributions. A private foundation must distribute annually an amount equal to approximately 5% of the fair market value of its non-charitable assets to accomplish its charitable purposes or incur an excise tax on the undistributed amount.⁵
- Self-Dealing. Self-dealing transactions between a disqualified person and a private foundation are subject to an excise tax on the amount involved, if they occur.⁶ A “disqualified person” includes any individual who is in a position to exercise substantial influence over the affairs of the foundation and that individual’s family members; a 35% controlled entity of a disqualified person or of family members of the disqualified person; a donor, donor advisor, or donor advised fund; or an investment advisor of a sponsoring organization.
- Excess Business Holdings. Subject to certain exceptions, a private foundation and its disqualified persons cannot hold more than 20% of a business enterprise.⁷ Otherwise, a tax will apply to the value of the excess business holdings. If the foundation receives a business interest by gift or bequest, however, it generally has five years to dispose of it, subject to the restrictions on self-dealing.
- Jeopardy Investments. A private foundation’s managers must not invest its assets in a manner that jeopardizes the carrying out of its exempt purposes.⁸ The initial excise tax assessed for jeopardizing investments is 10% and increases to 25% if the investment is not corrected. The foundation managers responsible for the jeopardizing investment also may be liable for a 10% excise tax on the amount involved, plus an additional 5% if they refuse correct the investment.
- Limitations on Contribution Deductions. Generally, deductions for contributions to private foundations are subject to more limitations than contributions to public charities.
 - Cash Contributions. Cash contributions to a private foundation are limited to 30% of the donor’s adjusted gross income (“AGI”), as opposed to 50% for public charities and certain private operating foundations.
 - Contributions of Property. Property contributions, other than certain publicly-traded securities, are deductible only to the extent of the lesser of the donor’s tax basis or fair market value. Contributions of certain publicly-traded securities may be deducted up to the full fair market value. For donations of appreciated

property, the deduction is generally limited to 20% of the donor's AGI, as opposed to 30% for contributions to public charities.

- Carry-Forwards. Generally, deductions for contributions in excess of these percentage limitations may be carried forward and used to offset income over the five years following the year in which the contribution is made.

IS A PRIVATE FOUNDATION THE RIGHT CHOICE?

Given the costs and administrative requirements of forming and operating a foundation, would-be donors will need to consider whether a foundation is the best option for their charitable goals, as compared to other philanthropic planning options, such as direct charitable gifts, donor advised funds and supporting organizations, etc. Questions to consider include:

- Does the donor wish to contribute a substantial sum to his or her charitable goals?
- Does the donor and/or the donor's family want to be actively involved in managing charitable endeavors or the use of the charitable donations?
- Does the donor want to create a long-term charitable legacy that will last for years or generations?
- Is the donor comfortable with the time and effort that will be required to manage the foundation and/or delegating the required tasks to others?

If the response to the above questions is "yes," then a private foundation may be the appropriate choice for the donor's philanthropic plan.

FORMATION PLANNING

Identifying Foundation Components. At the beginning of the formation process, a donor should consider the following:

- Charitable Purpose. The purposes of a private foundation should be crafted to specify the donor's overall objectives and charitable philosophy but also be broad enough to allow for flexibility to engage in a variety of charitable pursuits as needed to adapt to changing circumstances.
- Management. The donor should decide how much control should be retained by the donor or the donor's family, as well as identify the individuals who will serve as

trustees, directors, and/or officers of the foundation (e.g., family members, employees, advisors, and other professionals).

- **Funding.** The donor will need to decide how the private foundation will be funded. Will support come solely from the donor and his or her family or from a wider range of contributors?
- **Scope of Activities.** Will the foundation engage in direct charitable activities (i.e., be an operating foundation) or make grants to other charitable organizations? And what will be the geographic scope of the anticipated charitable activities? Certain activities may require registration in multiple states. If grants to any foreign charities are anticipated, additional requirements and restrictions will apply.
- **Tax Code.** The donor should review the tax consequences of any contributions to the private foundation to determine the best way to achieve the charitable goals of the donor and the foundation.

Selecting the Entity Form. Private foundations are separate legal entities formed under state law and are generally established as a corporation or a trust. While a corporation is probably the more common structure, a donor’s goals in forming the private foundation will impact the entity selection, and should consider the following factors:

<u>Selection Factor</u>	<u>Corporation</u>	<u>Trust</u>
Flexibility	More Flexible. Most states permit the board of directors to amend the purposes of a charitable corporation (often subject to approval from the attorney general), providing flexibility to adapt to changing circumstances. In a corporate setting, board elections will determine who serves on the board and the donor may lose some control over the ongoing management of the private	Less Flexible. Trust agreements generally are irrevocable and trust provisions and purposes are more difficult to modify. Court proceedings and approval may be required, including notice to the attorney-general. However, the lack of flexibility may appeal to donors who wish to accomplish a specific charitable purpose without deviation by future generations or who want to control trustee selection and

<u>Selection Factor</u>	<u>Corporation</u>	<u>Trust</u>
	<p>foundation. In addition, directors of a corporation generally will be able to amend the bylaws of the corporation to modify the governance structure. This provides greater flexibility for the board to address circumstances that may affect how the private foundation is managed.</p>	<p>succession for a significant period.</p>
Standard of Care	<p>Less Stringent. Generally, the business judgment rule applies as the standard of care for the directors of a corporation. A director is liable only for acts of self-dealing, willful misconduct, and gross negligence. Thus, a corporation may provide stronger protection from personal liability for the directors.</p>	<p>More Stringent. In many states, the trustees of a trust may be held to a higher standard of care than corporate directors. The trust agreement may attempt to limit liability, lower the standard of care, or provide indemnification to a trustee from the trust assets, but courts may narrowly construe such provisions.</p>
Formation	<p>More Complicated. To establish a corporate private foundation, approval of the name may be required from the secretary of state, Articles of Incorporation must be filed, and bylaws must be drafted and approved by the board of directors.</p>	<p>Less Complicated. Trust formation is typically more streamlined, with fewer state required filings or notices. Trust often can be quickly organized by simply drafting and having the trustee execute the trust agreement.</p>
Operational Formalities	<p>More Requirements. Most states have an extensive statutory framework for corporate governance and require certain formalities, including annual meetings, notice of meetings, detailed minutes of meetings to</p>	<p>Fewer Requirements. Charitable trusts often have fewer statutory formalities than corporations, particularly with regard to annual meetings, minutes, etc., although accountings or other annual reports to the state</p>

<u>Selection Factor</u>	<u>Corporation</u>	<u>Trust</u>
	be taken, requirements for quorums for decisions, appointment of officers, or other record keeping.	attorney-general or other departments may be required.

NOTE ON LIFE INSURANCE & PRIVATE FOUNDATIONS

Life insurance can help ensure that the goals of the donor and the private foundation are achieved. A life insurance policy can extend a donor's gifts to the foundation beyond his or her lifetime, create certainty for the private foundation's future (thereby allowing for a long-term outlook on operations), and provide an additional asset in a private foundation's diversified portfolio. Additionally, life insurance can promote charitable activities by ensuring a family doesn't have to choose between adequately funding a charitable foundation and preserving any personal or familial bequests.

There are several options for contributing life insurance to a private foundation, such as designating the foundation as a beneficiary of a life insurance policy, giving an existing policy to the foundation, or funding premiums on a policy purchased by the private foundation. Before a private foundation acquires or receives a life insurance policy, however, a number of issues should be considered, including whether: (1) the private foundation has an insurable interest under the applicable state law (e.g., is the insured a substantial donor to the foundation), (2) any issues will arise under the self-dealing and jeopardizing investment rules noted above, and (3) the donor is receiving any personal value from the private foundation that would constitute an impermissible inurement of benefit. These potential options and issues will be explored further in a subsequent installment of the WRMarketplace.

TAKE AWAY

For donors who want to be actively involved and are willing to make a substantial commitment to charitable giving, a private foundation may be the solution. A donor, however, should understand the basic legal rules that govern the formation and operation of a private foundation to appreciate the commitment of time and funds that will be required relative to other planning options. Reviewing the potential benefits of, and issues with, creating a private foundation and clearly identifying the donor's intentions and goals can help advisors guide donors in the selection of the appropriate vehicle for their philanthropic vision.

NOTES

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¹ A private foundation can also qualify as an “operating foundation,” which directly carries out charitable activities rather than making grants. Private operating foundations are subject to the same requirements and restrictions that apply to private foundations, except for the excise tax on the failure to distribute income. As non-operating private foundations are more common, they are the focus of this report.

² For federal purposes, a private foundation must file IRS Form 1023, “Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code” and obtain a “determination letter” from the IRS. For state purposes, many states grant exemption from state taxes once they are provided with a copy of the IRS determination letter. Procedures will vary from state to state, and different types of taxes (income taxes, property taxes, sales taxes, franchise taxes) may need to be addressed separately.

³ For example, for federal purposes, private foundations must file Form 990-PF, Return of Private Foundation, with the IRS reporting the private foundation’s gross revenue, activities, expenditures and distributions and calculating certain excise taxes. Additional reporting may be required if the foundation regularly carries on a trade or business whose conduct is not substantially related to the private foundation’s exempt purpose. For state law purposes, most states have registration requirements and annual filings that must be made with the attorney general. It is important to check the state requirements in any state with which the private foundation has a connection.

⁴ These requirements represent a sample of the various Code restrictions. Other requirements include limits on taxable expenditures made and an excise tax on the foundation’s net investment income.

⁵ Code § 4942.

⁶ Code § 4941.

⁷ Code § 4943.

⁸ Code § 4944.

DISCLAIMER

This information is intended solely for information and education and is not intended for use as legal or tax advice. Reference herein to any specific tax or other planning strategy, process, product or service does not constitute promotion, endorsement or recommendation by AALU. Persons should consult with their own legal or tax advisors for specific legal or tax advice.

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