CHARITABLE GIVING >

Is a Private Foundation Right for You?

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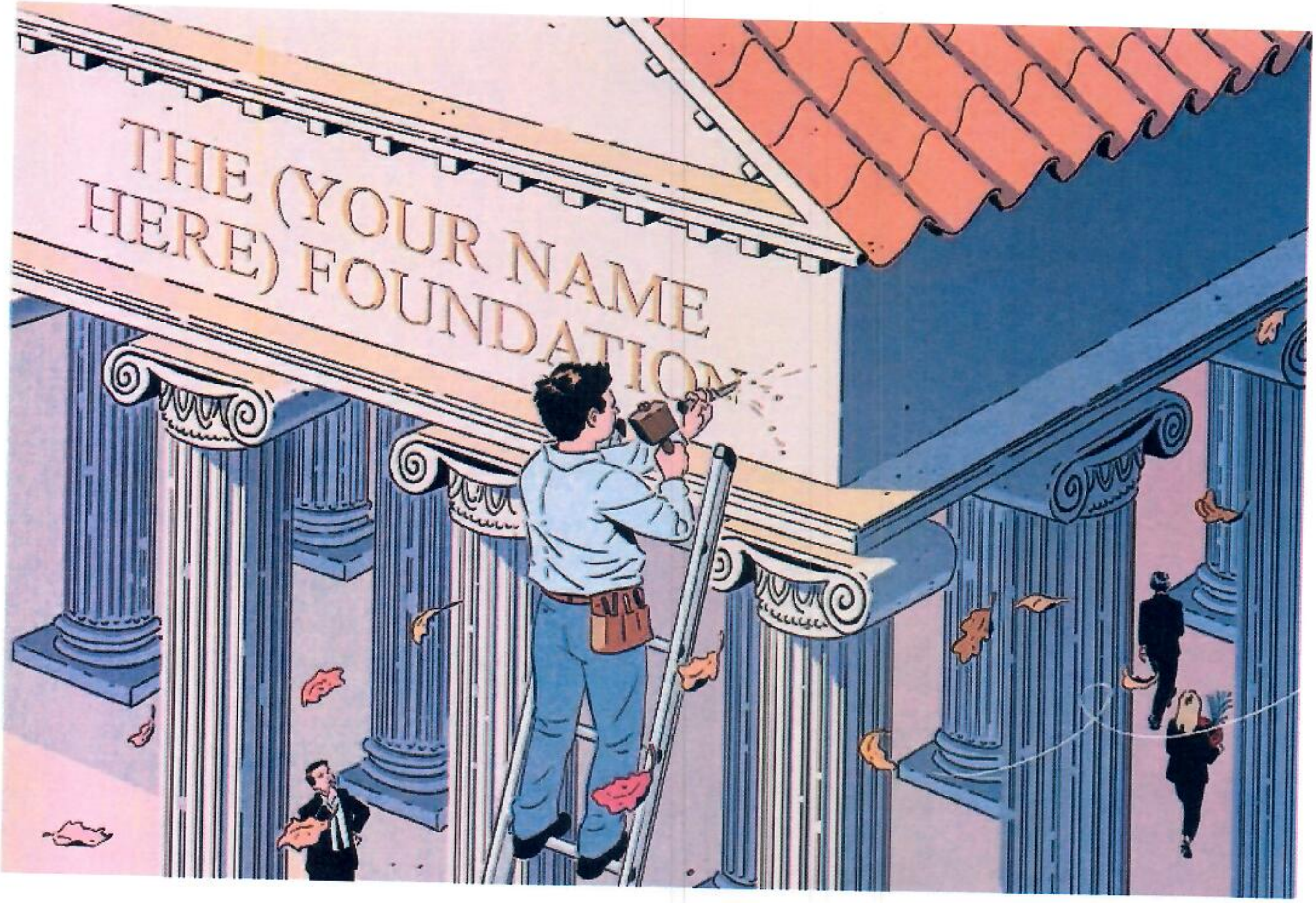
Is a private foundation the best way to further your family's philanthropic goals? Here's how to decide—and why you might consider a donor-advised fund instead.



Individuals and families with wealth often include charitable giving in their financial plans. According to a study by the Indiana University Lilly Family School of Philanthropy, roughly 85% of wealthy households give to charity each year, compared with 49% of the general population.

However, even among the wealthy, approaches to giving vary widely. While some prefer to offer support via direct donations to public charities, those who wish to effect large and lasting change may go so far as to set up a giving vehicle such as a private family foundation to further their philanthropic goals.

What is a private family foundation?

Private foundations are federally recognized tax-exempt organizations that rely on funding from a small number of sources—typically a founding individual or family—and investment income rather than donations from the broader public. Those who establish private family foundations typically do so because they have the means to make a significant impact in an area close to their hearts that may be underserved by existing institutions.

For example, the Bill & Melinda Gates Foundation—the largest private foundation in the U.S.—is dedicated to fighting poverty, disease, and inequity around the world. Not every foundation needs such ambitious goals, but creating and running *any* foundation requires considerable time and money. In many cases, other charitable solutions, such as a donor-advised fund (see "Private family foundation vs. donor-advised fund"), could be a better way to go.

With that in mind, here's a look at what's involved in establishing a private family foundation—and whether it's the right vehicle to satisfy your charitable ambitions.

How to create a private family foundation

From articulating your charitable goals to making your first contribution, here's what it takes to get a private foundation off the ground.

1. Define your vision for your family foundation

To build a successful foundation, it's essential to have a clear philanthropic mission and strategy from the outset. Who do you want to serve, and what do you hope to achieve with your giving? Will the foundation operate for a set time period or in perpetuity? If your desire is to build a legacy that will span generations, for example, it's important to include family members in the process to ensure the foundation's mission reflects your shared values. This is your opportunity to define your charitable vision and to put some guardrails around how you will use the family foundation's funds.

2. Build your foundation's team

Private family foundations are required to have a governing board of at least three people that oversees operations and sets grant-making priorities. Serving on the board is an ideal position for family members, who can help ensure the foundation's grant-making activities continue to align with the family's charitable mission. If family members occupy paid positions, you must be able to prove that each employee's work is necessary to run the foundation and that their compensation falls within established norms.

3. Make your private foundation official

Once you have your team of family members and professionals, you'll need to apply for recognition as a tax-exempt 501(c)(3) charity with the IRS, as well as file the required paperwork to obtain tax-exempt status from your state. You might also trademark your family foundation's name to protect your reputation and help prevent others from soliciting donations in its name. A qualified attorney or a philanthropy consultancy such as Foundation Source can help you navigate the foundation-creation process.

4. Fund your foundation

Once your foundation is a legal charitable entity, you can begin funding it with tax-deductible gifts. For a private family foundation to really make sense, it's best to start with an endowment in the millions, not the thousands. Be aware, however, that gifts to private foundations live by different rules than those to public charities or other nonprofit organizations:

- **Cash** given to private family foundations is deductible up to 30% of your annual adjusted gross income (AGI)—versus 60% for public charities. (The deduction for donations in excess of the annual limits may be carried over for up to five tax years.)

- **Appreciated assets** (such as stocks) given to private family foundations are deductible up to 20% of annual AGI—versus 30% for public charities. (The five-year carryover rule applies here, as well.)

When valuing your gift of appreciated nonstock property for tax purposes, the asset's original cost basis, rather than fair market value, is used. You don't get any credit for that appreciation, so if part of your charitable giving strategy is to reduce your tax bill in the year of the donation, gifts of nonstock property to private foundations aren't as attractive as gifts to public charities. Nevertheless, assets transferred to foundations generally are not subject to estate taxes. If reducing future estate taxes is part of your plan, funding a private family foundation could still be an attractive tax strategy.

Managing your private family foundation

It's common for a foundation to spend between 2% and 5% of its assets annually on management and upkeep—primarily in three areas:

1. **Investment management**: Some founders assume they can manage a family foundation's investments themselves, but these entities are subject to unique investment and tax constraints that, if managed improperly, can jeopardize the foundation's tax-exempt status. Unless you're an investment manager by trade, it's probably best to outsource this work to a professional.

2. **Record-keeping**: It's also vitally important to keep thorough records of the family foundation's operations, including fees and expenses, funding and income statements, granting history, and meeting minutes. The IRS takes these sorts of legal and tax documents seriously, and so should you.

3. **Taxes**: All private family foundations—regardless of whether they have taxable income and/or grant activity to report—must file a tax return with the IRS. What's more, if a foundation's annual investment income exceeds its deductible operating expenses, it may be subject to a 1.39% excise tax on its net investment income. The reporting requirements for private family foundations are complex, so taxes are another area where hiring professionals is recommended.

What to know about grant-making

Giving via a private family foundation allows you to significantly broaden your charitable reach.

Typically, only donations to a federally recognized 501(c)(3) charity are tax-deductible. However, grant-making via a private foundation allows you to support charitable initiatives that lack 501(c)(3) status—be it another individual, a foreign nonprofit, or a noncharitable organization—while also capturing the tax deduction on any gifts you make to the foundation within the funding limits outlined above.

Be aware, however, that private family foundations must publicly disclose all charitable contributions and grants in their annual tax filings. Foundations do not offer privacy to their creators or benefactors.

It's also important to note that private family foundations are required by law to disburse at least 5% of their assets annually in the form of charitable grants and related operating expenses—regardless of market conditions. While mandatory grant-making during periods of market decline could significantly diminish your charitable assets, sustained giving helps support your charitable mission year after year.

Private family foundation vs. donor-advised fund

Depending on a family's giving goals, a private family foundation isn't the only strategic giving vehicle to consider. In fact, a donor-advised fund (DAF) can meet all or most of their goals without the time commitment, administrative responsibility, costs, or privacy considerations that come with a foundation.

The potential advantages of DAFs include:

- **Costs**: A DAF account has no setup costs, low or no minimum contributions, and relatively low administrative fees.

- **Deductibility**: DAFs are 501(c)(3) public charities, meaning contributions to them qualify for the more favorable tax-deduction limits of 60% of AGI for cash gifts and 30% of AGI for appreciated assets (versus 30% and 20%, respectively, for private foundations).

- **Gift valuation**: The tax deduction you receive for donations to a DAF is based on the fair market value of *all* appreciated assets (not just stocks, as is the case with private family foundations).

- **Investment management**: You can invest your contributions in one of several predefined investment pools, or you can appoint an independent advisor to manage a customized portfolio.

- **Grant timing**: There's no annual minimum grant-making requirement for DAFs. Contributions are irrevocable and must be used for a qualified charitable purpose, but you decide when to recommend grants and can choose to hold off in certain years so you can make a greater impact in others. Plus, there's no capital gains tax on investment income, which helps to maximize your charitable giving potential.

- **Record-keeping**: All administrative tasks, including record-keeping and grant processing, are managed by the DAF sponsor.

- **Privacy**: DAF sponsors are required by the IRS to publicly report aggregate granting activity, but this does not include individual account information.

That said, important differences between DAFs and private family foundations include:

- **Limits on grants**: Unlike private foundations—which can work with nearly any entity, private or public, to accomplish its charitable objectives—DAFs can make grants only to federally recognized charities.

- **Lifespan**: Many DAF sponsors limit the number of successor generations to the DAF. It's important to get a clear understanding of the sponsor organization's restrictions regarding successors, if any, and whether there are rules on DAFs lasting in perpetuity.

However, that's not to say you must choose between a donor-advised fund and a private family foundation.

A family might decide to establish a private foundation to realize specific charitable ambitions *and* use a donor-advised fund for other aspects of their philanthropy. What's more, both allow you to involve family members in creating a charitable giving strategy to achieve your philanthropic goals.

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