THE NAUTILUS GROUP®

GUIDEPOST

# Private Foundations, Supporting Organizations, and Donor Advised Funds

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Organizations described in Internal Revenue Code (IRC) §501(c)(3) are commonly referred to as charitable organizations and, other than testing for public safety organizations, are eligible to receive tax-deductible contributions in accordance with IRC §170. The organization must not be organized or operated for the benefit of private interests, and no part of the net earnings of an IRC §501(c)(3) organization may accrue to the benefit of any private individual. If the organization engages in an excess benefit transaction with a person having substantial influence over the organization, an excise tax may be imposed on the person and any organization managers agreeing to the transaction. The following describes three such organizations in greater detail – the private foundation, the supporting organization, and the donor advised fund.

## Private Foundations

A private foundation (often referred to as a "family foundation") is a charitable nonprofit organization established and funded by a single source, typically a donor family or corporation. The foundation is most often established during a donor's lifetime, but also can be created and funded at death. Essentially, a private foundation is a tax-exempt repository of money and conduit between the donor and the charities to be benefited. The private foundation itself does not directly engage in charitable activities (as compared with a private operating foundation such as a food bank, which has a stated charitable purpose and carries out its own charitable programs).

A private foundation is controlled by a board of directors or board of trustees, who may be selected by the donor. The board determines issues such as the charities to be benefitted, the size of grants, and investment policy. This enables the donor to involve family members early on in the decision-making process to foster philanthropy and social responsibility in future generations. Of all the charitable planning techniques available, private foundations provide the highest level of control and flexibility to the donor in terms of how gifts will be applied to charitable causes.

Every organization that qualifies for tax-exempt status as an organization described in IRC §501(c)(3) is a private foundation unless such organization falls into one of the categories specifically excluded from the definition of that term (referred to in IRC §509(a)). In addition, certain nonexempt charitable trusts are also treated as private foundations. Organizations that fall into the excluded categories are institutions such as hospitals or universities and those that generally have broad public support or actively function in a supporting relationship to such organizations.

Even if an organization falls within one of the categories excluded from the definition of a private foundation, it will be presumed to be a private foundation, with some exceptions, unless it gives timely notice to the IRS that it is not a private foundation. If an organization is required to file the notice, it generally must do so within 27 months from the end of the month in which it was organized. Generally, organizations use U.S. Form 1023, Application for Recognition of Exemption, for this purpose.

### Tax Considerations of a Private Foundation

*Income Tax*

Under IRC §170, the donor's deduction to a private foundation of cash contributions generally will be limited to 30% of Adjusted Gross Income (AGI), and for gifts of appreciated property, the deduction generally is limited to such appreciated property's cost basis up to 20% of AGI. (Exception: for publicly traded securities, the deduction is not limited to basis where donated securities are more than 10% of the corporation's shares.)

Unlike public charities, which are generally exempt from income tax, private foundations are subject to special excise taxes of 1.39% on investment income generated in a given year.

*Estate Tax*

IRC §2055 governs the charitable estate tax deduction. The requirements for the estate tax charitable deduction differ slightly from the requirements for the income tax charitable deduction under IRC §170. If the decedent was a United States citizen or resident, the charitable estate tax deduction is not limited to gifts to trustees or domestic corporations or associations for use within the United States, and the charitable estate tax deduction is not subject to the percentage limitations that apply with respect to the charitable income tax deduction.[1]

*Gift Tax*

IRC §2522 governs the charitable gift tax deduction. The requirements for the gift tax charitable deduction differ from the requirements for the income tax charitable deduction under IRC §170.

*Excise Tax*

Because private foundations are considered more susceptible to possible operation for the private benefit of donors and managers, the IRC contains several special rules for private foundations that do not apply to public charities (see list below). Violations will result in extremely severe penalties and taxes for the foundation, and in some cases, its managers and substantial contributors.

There is an excise tax on the net investment income of most domestic private foundations. Certain foreign private foundations are also subject to a tax on gross investment income derived from United States sources. This tax must be reported on U.S. Form 990-PF, Return of Private Foundation, which must be filed annually by all private foundations (and certain nonexempt trusts treated as private foundations), and the tax must be paid annually at the time for filing that return or, if the total tax for the year is $500 or more, in quarterly estimated tax payments.

In addition, there are several restrictions and requirements on private foundations, including:

- Restrictions on self-dealing between private foundations and their substantial contributors and other disqualified persons;
- Requirements that the foundation annually distribute income for charitable purposes;
- Limits on their holdings in private businesses;
- Provisions that investments must not jeopardize the carrying out of exempt purposes; and
- Provisions to assure that expenditures further exempt purposes.

Certain nonexempt trusts that have charitable interests as well as private interests may also be subject to some of the private foundation tax provisions.

Violations of these provisions give rise to taxes and penalties against the private foundation and, in some cases, its managers, its substantial contributors, and certain related persons.

A private foundation cannot be tax exempt nor will contributions to it be deductible as charitable contributions unless its governing instrument contains special provisions in addition to those that apply to all organizations described in IRC §501(c)(3). In most cases, this requirement may be satisfied by reference to state law. The IRS has published a list of states with this type of law.[2]

## Supporting Organizations

A supporting organization is a corporation or trust formed under state law that meets the qualifications set forth at IRC §509(a)(3). Its primary purpose is to support another qualified public charity, and it is spared the more restrictive private

1 Treasury Regulation §20.2055-1(a).
2 See Revenue Ruling 75-38, 1975-1 C.B. 161.

foundation rules. A supporting organization enjoys the benefits of a public charity, which include the more expansive charitable contribution deduction limits.

There are three basic classifications of supporting organizations with classification based upon the relationship between the **supporting organization** and the **supported organization**. These are referred to as Type I (operated, supervised or controlled by the supported organization), Type II (supervised or controlled in connection with the supported organization) and Type III (operated in connection with or functionally integrated with the supported organization) supporting organizations. The relationship between the supported organization and a Type I supporting organization is similar to parent-subsidiary corporations. The relationship between the supported organization and a Type II supporting organization is similar to brother-sister corporations. The relationship between the supported organization and a Type III supporting organization is similar to a corporate division that operates autonomously within a corporation.

## Requirements of a Supporting Organization

To be classified as a supporting organization, the entity must satisfy (1) an organizational test, (2) an operational test, (3) a relationship test, and (4) a disqualified person control test.

The **organizational test** focuses chiefly on the restricted purposes set forth in the supporting organization's articles of formation. This test will be considered satisfied if the purposes set forth is the supporting organization's articles of formation are similar to, but no broader than, the purposes set forth in the supported organization's articles of formation.

The **operational test** relates to the supporting organization's activities, which must be exclusively to support one or more specific publicly supported organizations. This test is satisfied by the supporting organization engaging solely in activities that support or benefit the specified publicly supported organization.

The **relationship test** varies depending upon whether the supporting organization is Type I, Type II, or Type III supporting organization, and relationship is established in different manners for each of a Type I, Type II, or Type III supporting organization.

The **disqualified person control test** requires that the supporting organization not be controlled, directly or indirectly, by certain disqualified persons, including, but not limited to, substantial contributors, owner of more than 20% of an organization that is a substantial contributor, a family member of a substantial contributor, and government officials.

## Impact of the Pension Protection Act of 2006 on Supporting Organizations

The Pension Protection Act of 2006 (2006 Act) led to heavy scrutiny of supporting organizations, particularly Type III supporting organizations. The 2006 Act removed many of the privileges that supporting organizations had over private foundations and imposed several private foundation rules, including the self-dealing regulations, rules governing excess business holdings and the excess benefit prohibitions. The 2006 Act also tightened the tests for Type III supporting organizations requiring them to demonstrate that they in fact have a dependent supported organization and support no more than five supported organizations. The 2006 Act also made collateral attacks on supporting organizations by forbidding donor advised funds and private foundations from making qualifying distributions to Type III supporting organizations, and should they do so, the distributions would become taxable subject to their respective excise taxes.

## Tax Considerations of a Supporting Organization

*Income Tax*

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### *Estate Tax*

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### *Gift Tax*

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## Donor Advised Funds

A donor advised fund (DAF) is a separate account of a sponsoring charitable organization established by a donor who retains the right to recommend grants to be made to qualifying charities. The sponsoring organizations generally allow the donor to serve as an advisor to the fund or to name another person to serve as an advisor. DAFs are most commonly offered by community foundations that make grants to various local charities. In recent years, many established charities have begun offering DAFs in addition to their primary activities.

A DAF is a good alternative to a private foundation due to lower costs associated with formation and management, and fewer regulatory hassles.

A DAF should be considered where the donor is interested in being involved in distribution decisions but is not making the larger scale gifts usually necessary to justify the expense of a private foundation. In addition, because a DAF can be established relatively quickly, it can be a very useful year-end tax planning tool. The donor can make an immediate donation and decide which charities to benefit later.

Two options exist for using a DAF to support causes outside of the U.S. A donor can recommend a grant to an American charity that operates overseas, or a donor can recommend a grant to an intermediary charity – such as CAF America or Global Giving – that will, in turn, make a grant to the donor's preferred organization for an additional fee.

A DAF accepts a wide range of financial assets, from cash to marketable securities and even non-publicly traded assets like real estate.

- Marketable securities:
    - Publicly-traded stock
    - Closed-end mutual funds
    - Open-end mutual funds
    - Bonds, notes, and debentures
- Privately held business interests:
    - Privately held C corporation stock
    - Privately held S corporation stock
    - Limited liability company interests
    - Limited partnership interests
    - Hedge fund interests
    - Private equity
    - Pre-initial public offering shares
- Other non-publicly traded assets:
    - Life insurance
    - Restricted stock
    - Restricted stock units
    - Real estate
    - Royalties
    - Oil and gas royalty interests
    - Retirement assets

## Tax Considerations of a Donor Advised Fund

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