Structured Philanthropy: Private Foundations and Selected Alternatives

To give away money is an easy matter in any man’s power. But to decide whom to give it, and how large and when, and for what purpose and how, is neither in every man’s power nor an easy matter. And hence it is that excellence herein is rare and praiseworthy and noble.

Aristotle, Nicomachean Ethics, Book II

Introduction

Families of means and social vision often establish independent structures to fulfill their charitable goals, as they do in pursuit of their overall capital management, wealth transfer, and other legacy goals. Some charitable goals are simple and immediate and may be accomplished with little effort or overhead. Others require planning and ongoing administration and should be implemented with eyes wide open (for example, donor-controlled foundations). Naturally, donors want to get results by means they can understand and manage with the fewest complications.

In getting onto the straightest line from vision to results, some relevant questions for a would-be donor to consider include:

- Philanthropic purpose(s): What do you want your gift to accomplish for society?
- Personal purpose(s): What do you want to accomplish for your family?
- How much time, effort, and capital are you willing to commit?
- When do you want to fund the plan?
- Do you want other family members to have input or make decisions?
- How much ongoing control do you want for yourself or family members?
- What assets should you give?
- How important are tax considerations?

We begin with a hypothetical family situation, followed by a brief overview of private foundations, one choice for donor-controlled charitable entities. We look at selected private foundation alternatives, including donor-advised funds, Type III supporting organizations, and charitable lead trusts. These structures are not private foundations but rather have foundation-like attributes, at least in part. Private foundations have played an important role in society and donor families, but they come with complications and tax challenges that have caused some donors to choose simpler vehicles such as donor-advised funds.1

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1 See “Time to convert?”, Wall Street Journal, November 9, 2009.
The Hypothetical Example of Constance Threepwood, Her Family, and Their Concerns

We begin with the hypothetical scenario of Constance Emsworth Threepwood, a 66-year-old heiress, and her husband, Clarence, age 70. They have two children. Their annual income more than supports them. Their assets consist chiefly of $40 million of investments; their residence, Blandings, in the Hudson Valley region; a small Manhattan apartment; and a collection of valuable artwork that Constance inherited long ago from her mother but does not really like or enjoy. She retains the artwork at Blandings because selling it would be complicated and taxable. She would prefer to donate the artwork to charity for the tax benefits because her son informed her that it has significant value. Constance is active in the community and considers herself charitable-minded. She has thought about earmarking a substantial portion of her estate for charity through her will, but she has had difficulty making concrete decisions regarding charitable and legacy planning. Her annual charitable gifts total about $300,000, mostly in favor of ten local organizations in fairly consistent amounts. Knowing that she and Clarence enjoy a high income, she believes charitable gifts provide meaningful tax savings.

Gift to Constance’s Alma Mater

Constance recently met with a development officer of Decrepit University, Constance’s beloved alma mater, and was shocked to hear herself agree to make a $1 million gift to the university’s capital campaign. She and Clarence decided they are wealthy enough to part with $1 million in this special instance. Constance was determined to formalize a pledge so that the university could commence its initial project to refurbish its president’s residence and the faculty club.

Soon after, Constance attended a local fundraising gala. During dinner she listened intently as her tablemate, a venture capital billionaire, described the various organizations, causes, and relatives supported by his family foundation.

Creating a Charitable Foundation

Constance determined that she and her family would create and manage a charitable foundation of their own. The foundation would engender a sense of mission and common purpose among family members. It would fund important causes, beginning with her gift to the university. It would provide her son the means to supplement his income as a writer-professor. She could rid Blandings of the artwork, making it the foundation’s problem, and achieve a nice tax deduction as well. A family foundation seemed to be the complete answer. The next day Constance phoned her long-time adviser, Mortimer Rumpole, Esq., instructing him to set up the foundation.

Rumpole cautioned Constance. In her newfound enthusiasm for “institutionalized philanthropy,” as her billionaire acquaintance called it, she may not have considered simpler plans than a private charitable foundation. Nor has she determined whether her family shares her collaborative vision or agrees on the

2 The family names are taken from P.G. Wodehouse’s hilarious Edwardian-era short stories about life at Blandings Castle. Since Wodehouse’s lawyers are buffoons, Rumpole is John Mortimer’s barrister character who wins every time.
causes the family foundation should support. Heeding these cautions, Constance set aside an afternoon to discuss her ideas with Clarence, daughter Mildred, and son Frederick during the children’s annual summer visit. Their conference brought many things to light.

The Family

Millie, 35, is a pediatrician in San Diego. She and her husband, Antony, a pharmaceutical executive, have three children under the age of 12. They enjoy a good income but no free time. Millie is closely involved with her hospital’s youth wellness clinic, providing 15–20 hours of uncompensated care per month to children of low-income families. She and Antony also devote personal effort, travel time, and some money to a similar clinic near Johannesburg, South Africa, Antony’s birth place. From Millie’s point of view, a family foundation’s most valuable use would be to support the San Diego and Johannesburg clinics. Though she and her mother are close, Millie is skeptical that their charitable priorities coincide at all. She also feels she lacks the time to participate meaningfully in the foundation’s management.

Freddie, 39, is an Ivy League-educated art historian and critic of acknowledged ability, though his chosen profession puts at his disposal the low income generally enjoyed by writer-teacher intellectuals. A part-time professor, he lives in Philadelphia and is a confirmed city-dweller. In contrast to his sister, Freddie is well-disposed to the basic idea of a family-run foundation and to having a role in it, including a paid role. Beyond the salary, he sees the foundation as providing a means to promote artistic excellence by identifying and supporting promising artists through scholarships and academic aid.

Clarence is a retired civil engineer whose passion is horticulture. His tireless work has transformed 20 of the 95 acres at Blandings into a required stop for like-minded visitors. Clarence’s vision for a family foundation is to endow the transformation of Blandings into a nonprofit center for the preservation and extension of his gardens, as well as for research, study, and teaching of all things horticultural. This would eventually include the residence as well, since the children are unlikely to want it. His worst nightmare is that Blandings will be purchased and developed for profit.

Constance (though not Rumpole) was taken aback by the diversity of visions unleashed by her children and her husband. She sees great merit in everyone’s ideas and is open to supporting them to the extent feasible, effective, and affordable.

Issues

There are several primary, or strategic, issues in this hypothetical scenario. First, can Constance afford to fund these goals? Is her founding vision of the family united in a cooperative charitable endeavor realistic, given the diversity of their circumstances? Is a single-structure plan, such as a family-controlled foundation, the best choice from a tax standpoint? Should one or more additional or alternative arrangements be considered?
Should grant-making activities be conducted through the same entity as active or asset-intensive activities? Assuming that Constance shares Clarence’s desire to preserve Blandings as an operating nonprofit horticulture center, is it realistic to expect that such an endeavor could or would be administered effectively from afar by the children following their parents’ deaths or incapacity? Would it be wise to consider another structure such as cooperative charitable partnership or joint venture with one or more local organizations?

Several technical tax issues are also present, including:

- **There is potential for self-dealing.** A foundation’s payment of Constance’s personal pledge to the university (if she has already made one) is inadvisable because it may constitute self-dealing. The payment would clearly be self-dealing if the university could have enforced the pledge against Constance personally under applicable state law. The foundation’s payment would constitute a use of its income or assets for her benefit by relieving her of a personal obligation to pay the pledge.

- **Income tax deduction for gifts of tangible property is generally limited to basis.** A gift of tangible assets to a private foundation results in the donor receiving an income tax deduction of the lower of each asset’s market value or tax basis, unless the foundation is an active operating foundation. Donors of such property to a nonoperating foundation may suffer a substantial loss of an anticipated income tax deduction if the property has appreciated in value.

- **Grants by a U.S. foundation to a foreign charity require special care.** A U.S. individual cannot receive a U.S. income tax deduction for a gift to a charity unless that charity was created under the laws of the United States, a state, or a U.S. possession. An individual can, however, effect gifts to foreign charities through U.S.-based charities such as “friends of” funds and international donor-advised funds. U.S. private foundations can do likewise, but they can also make grants directly to foreign charities if they follow certain procedures discussed below.

- **Grants to individuals require special care.** Grants by a private foundation to individuals for study, travel, and similar purposes are taxable expenditures subject to an excise tax penalty unless the foundation adopts appropriate policies and preclears its grantmaking process with the Internal Revenue Service (IRS) prior to making any such grants. Individuals are not tax exempt per se, no matter how needy or deserving, and the statutory policy is that grants to individuals must be closely regulated because of the potential for abuse.

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3 Internal Revenue Code (IRC) Section 4941(d)(1)(E); Private Letter Ruling (PLR) 8534001
4 IRC Section 170(e)(1)(b)
5 IRC Section 170(c)(2)(A)
6 IRC Section 4945(d)(3); Treas. Reg. Section 53.4945-4
Private Foundations and Selected Alternatives

Following is a brief review of private foundations and other charitable arrangements that provide some or many of the same benefits as foundations and which may be acceptable alternatives in a given instance.

Private Foundations

Most private foundations fall into two categories: operating and all other. Most family foundations fall into the “other” category—nonoperating entities that do not directly carry out charitable activities. Instead, these nonoperating grantmaking foundations make distributions that fund the programs and activities of operating charities. Private operating foundations traditionally devote most of their income and assets to operating charitable programs directly. Examples of operating foundations are privately run museums, libraries, and youth programs.

All private foundations are 501(c)(3) tax-exempt entities. Private foundation status is a catch-all: a charitable entity is a private foundation unless and until it demonstrates that it is a public charity. That is, it is a public charity either by the nature of its activities (for example, churches, schools, hospitals, governmental units) or by the proportion of its support it receives from the general public or governmental entities (for example, the Red Cross, United Way). Therefore, a private foundation, in our view, is defined less by what it is than what it is not. The policy underlying the public/private distinction in the tax code is to provide more liberal tax treatment for publicly supported charities, which are deemed more likely to be responsive to public as opposed to private interests.

Donors establish private foundations to realize certain advantages, among them:

- to maintain a level of control over the management and distribution of charitable capital that cannot be achieved with other vehicles;
- to institutionalize philanthropic activity indefinitely within the family and/or a closely regulated group of like-minded trustees;
- to publicly associate the family’s name with charitable endeavors;
- to bring children and later generations into the philanthropic process in an orderly fashion;
- to educate children regarding the family’s values and to help them develop a philanthropic esprit guided by those values;
- to employ children and other family members, either part- or full-time;
- to facilitate charitable gifts that would not be tax deductible if made directly by an individual to certain donees; and
- to obtain current tax deductions for gifts while being able to decide later how to disburse funds for charitable purposes.

7 IRC Section 509(a)(1) and 170(b)(1)(a)
The principal disadvantages of private foundations include:

- Private foundation must navigate around an array of expensive potential federal excise tax penalties for various infractions (Table 1, page 7).
- Donors to nonoperating (grantmaking) foundations face more restrictive income tax deduction limitations for their gifts than if the same were made to an operating foundation or a public charity (Table 2, page 8).

**Donor Tax Deductions**

Gifts by an individual to a nonoperating foundation are tax deductible only to the extent of 30% of the donor’s adjusted gross income (AGI) for the year. For gifts of qualified appreciated stock, the limit is 20% of AGI. Further, a donor’s deduction for gifts of tangible property to a nonoperating foundation is capped at the lower of cost basis or market value. In all cases, deductions limited by AGI can be carried over five additional years subject to the same percentage of AGI limits.

By contrast, the general annual limitation on the charitable deduction for gifts to operating foundations is 50%/30% of AGI. This is the same tax treatment afforded gifts to public charities. This is a major tax distinction between regular nonoperating foundations and operating foundations. The charitable income tax deduction for gifts by individuals to public charities is limited to 50% of an individual’s AGI for the year. This means an individual cannot give away 100% of his income and expect to erase his entire income tax bill. The exception is that the limitation on the individual’s tax deduction is lowered to 30% of the individual’s AGI if the gift is in the form of property, such as stocks, real estate, or artwork, that would have generated long-term capital gain income if the property had been sold rather than donated. This is so even though the gift is made to a public, “50%-type” charity. The underlying statutory policy seems to be that since the donor gets a double tax benefit for such gifts, valuing the deduction at the property’s full market value and being relieved of any long-term capital gain tax, the AGI-based limitation is stricter.

Another distinction, relevant to would-be donors of tangible property such as real estate and artwork that has appreciated significantly in value, is that donors of such assets to nonoperating foundations could lose a substantial portion of their expected deduction because of the “reduction rule” applicable to these gifts. The rule essentially limits the amount that can be deducted to the donor’s cost basis. (Table 2, page 8 displays the income tax deduction limitations applicable to gifts by individuals.) In our hypothetical example, if Constance and Clarence desire a market value-based income tax deduction for contributions of artwork or acreage contributed to a family foundation, their advisor should advise them of these limitations.

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8 IRC Section 170(b)(1)(B)
9 IRC Section 170(b)(1)(D)
10 IRC Section 170(e)(1)(B)(ii)
**Table 1**
Penalty Excise Taxes Applicable to Private Foundations and Disqualified Persons (DQPs)*

<table>
<thead>
<tr>
<th>Transgression: Self-Dealing (IRC Section 4941(a) and (b))</th>
<th>Penalty on the Self-Dealing DQP*</th>
<th>Penalty on the Manager</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions between the foundation and a DQP include:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>▪ sale, exchange, or leasing of property;</td>
<td>Initial Tax: 10% of the amount</td>
<td>Initial Tax: 5% of the</td>
</tr>
<tr>
<td>▪ transfer of foundation income or assets to or for</td>
<td>involved each year the</td>
<td>amount involved each</td>
</tr>
<tr>
<td>the use of the DQP;</td>
<td>transaction is uncorrected.</td>
<td>year the transaction is</td>
</tr>
<tr>
<td>▪ lending or credit arrangements, with limited</td>
<td>Additional Tax: If the</td>
<td>uncorrected.</td>
</tr>
<tr>
<td>exceptions;</td>
<td>transaction is not</td>
<td></td>
</tr>
<tr>
<td>▪ furnishing of goods or services, with exceptions;</td>
<td>corrected, 200% of the</td>
<td>Additional Tax:</td>
</tr>
<tr>
<td>▪ payment of compensation or reimbursement of</td>
<td>amount involved.</td>
<td>If the transaction is</td>
</tr>
<tr>
<td>expenses by the foundation to a DQP, unless</td>
<td></td>
<td>not corrected, 50% of</td>
</tr>
<tr>
<td>necessary and reasonable.</td>
<td></td>
<td>the amount involved.</td>
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<td></td>
<td></td>
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<tr>
<td>Transgression: Failure to Distribute Income (IRC</td>
<td></td>
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<tr>
<td>Section 4942)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Failure to make qualifying distributions of the</td>
<td>Initial Tax: 30% of the</td>
<td></td>
</tr>
<tr>
<td>foundation's &quot;distributable amount&quot; (generally 5%</td>
<td>undistributed amount, each year</td>
<td></td>
</tr>
<tr>
<td>of investment assets, less certain expenses)</td>
<td>it remains undistributed.</td>
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<tr>
<td></td>
<td>Additional Tax: 100% of the</td>
<td></td>
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<tr>
<td></td>
<td>undistributed amount.</td>
<td></td>
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<tr>
<td>Transgression: Taxable Expenditures (IRC Section 4945)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Taxable expenditures are distributions:</td>
<td></td>
<td></td>
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<tr>
<td>▪ for political lobbying or attempting to influence</td>
<td>Initial Tax: 20% of the</td>
<td>Initial Tax: 5% of the</td>
</tr>
<tr>
<td>an election;</td>
<td>amount involved each year the</td>
<td>amount involved each</td>
</tr>
<tr>
<td>▪ to an individual other than to pay for travel or</td>
<td>transaction is uncorrected.</td>
<td>year the transaction is</td>
</tr>
<tr>
<td>study, awarded in a nondiscriminatory manner under</td>
<td>Additional Tax: If the</td>
<td>uncorrected.</td>
</tr>
<tr>
<td>procedures approved in advance by the IRS;</td>
<td>transaction is not</td>
<td>Additional Tax:</td>
</tr>
<tr>
<td>▪ to any organization that is not a public charity,</td>
<td>corrected, 100% of the</td>
<td>If the transaction is</td>
</tr>
<tr>
<td>unless the funds are used for a charitable purpose</td>
<td>amount involved.</td>
<td>not corrected, 50% of</td>
</tr>
<tr>
<td>and the distributing foundation either obtains an</td>
<td></td>
<td>the amount involved.</td>
</tr>
<tr>
<td>equivalency determination or exercises &quot;expenditure</td>
<td></td>
<td></td>
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<tr>
<td>responsibility.&quot;</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transgression: Jeopardizing Investments (IRC Section 4944)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foundation manager(s) make an investment having</td>
<td>Initial Tax: 10% of the amount</td>
<td>Initial Tax: 10% of the</td>
</tr>
<tr>
<td>knowingly failed to follow prudent investment</td>
<td>involved each year or part-year</td>
<td>invested amount each</td>
</tr>
<tr>
<td>standards, thereby jeopardizing the foundation's</td>
<td>until corrected.</td>
<td>year or part-year until</td>
</tr>
<tr>
<td>tax-exempt purpose.</td>
<td>Additional Tax: 25% of the</td>
<td>corrected.</td>
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<td></td>
<td>invested amount if not corrected.</td>
<td></td>
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<tr>
<td></td>
<td></td>
<td>Additional Tax: 5% of</td>
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<tr>
<td></td>
<td></td>
<td>the invested amount if</td>
</tr>
<tr>
<td></td>
<td></td>
<td>not corrected.</td>
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<td></td>
<td></td>
<td></td>
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<tr>
<td>Transgression: Excess Business Holdings (IRC Section 4943)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foundation holds more than 20% of a business enterprise.</td>
<td>Initial Tax: 10% of the value of</td>
<td></td>
</tr>
<tr>
<td>Limit is 35% if enterprise is controlled by non</td>
<td>the excess holdings each year</td>
<td></td>
</tr>
<tr>
<td>DQPs. (Does not apply to holdings of any entity if</td>
<td>the excess exists until</td>
<td></td>
</tr>
<tr>
<td>more than 95% of the entity’s income is passive</td>
<td>corrected.</td>
<td></td>
</tr>
<tr>
<td>investment income, for example, many family limited</td>
<td>Additional Tax: 200% of the</td>
<td></td>
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<tr>
<td>partnerships.)</td>
<td>excess business holdings as of</td>
<td></td>
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<tr>
<td></td>
<td>the end of the &quot;taxable period.&quot;</td>
<td></td>
</tr>
</tbody>
</table>

* Disqualified persons, defined in IRC Section 4946(a)(1), include, among others:
  ▪ substantial contributors: generally, donors of more than $5,000 if their contribution is also more than 2% of the foundation’s contributions received during the year (IRC Section 507(d)(12)(A));
  ▪ foundation managers: officers, directors, trustees, and persons in similar positions, also, certain key employees; and
  ▪ spouses and lineal ancestors of the above persons, descendants of the above persons, and those descendants’ spouses.

Source: Hawthorn
Table 2
Charitable Income Tax Deduction Bases and Income-Based Limitations for Gifts by Individuals

<table>
<thead>
<tr>
<th>Type of Asset Contributed</th>
<th>50% Charities,</th>
<th>30% Charities,</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Public Charities,</td>
<td>Private Nonoperating Foundations</td>
</tr>
<tr>
<td></td>
<td>Private Operating Foundations</td>
<td></td>
</tr>
<tr>
<td>Cash</td>
<td>FMV</td>
<td>FMV</td>
</tr>
<tr>
<td>Cash</td>
<td>50%</td>
<td>30%</td>
</tr>
<tr>
<td>Ordinary Income Property (if sold would produce ordinary income)</td>
<td>Cost 50%</td>
<td>Cost 30%</td>
</tr>
<tr>
<td>Short-Term Capital Gain Property</td>
<td>Cost 50%</td>
<td>Cost 30%</td>
</tr>
<tr>
<td>Long-Term Capital Gain Property:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Publicly Traded Securities</td>
<td>FMV 30%</td>
<td>FMV 20%</td>
</tr>
<tr>
<td>Private/Nontraded Securities</td>
<td>FMV 30%</td>
<td>Cost 20%</td>
</tr>
<tr>
<td>Tangible Property Put to Related Use by Charity</td>
<td>FMV 30%</td>
<td>Cost 20%</td>
</tr>
<tr>
<td>Tangible Property Not Put to Related Use by Charity</td>
<td>Cost 50%</td>
<td>Cost 20%</td>
</tr>
</tbody>
</table>

* Fair Market Value

Source: Hawthorn

**Excise Tax on Foundation Income**

Private foundations are exempt from income tax but must pay an excise tax of 2% on their net investment income. For a particular tax year, the tax is reduced to 1% if the foundation pays out a sufficient amount of qualifying distributions.\(^{11}\)

**Foundation’s Dealings with Insiders**

Donors, trustees, managers, and members of their families are disqualified persons (DQPs).\(^ {12}\) As such they must be careful in their dealings with the foundation, its income, or its assets. Self-dealing can result in harsh tax penalties on the individuals involved. One possible nonobvious form of self-dealing occurs when the foundation pays off a DQP’s enforceable personal charitable pledge (PLR 8534001). That is the use of the foundation’s assets for the benefit of a DQP. Thus, Constance Threepwood is likely to receive counsel from her attorney that she should pay the pledge to the university from her own funds and not look to the family foundation to satisfy it.

A foundation may reimburse bona fide expenses of a DQP or compensate a DQP for “personal services which are reasonable and necessary to carrying out the exempt purpose of the private foundation...if the compensation (or payment or reimbursement) is not excessive,” according to IRC Section 4941(d)(2)(E). Absent this statutory carve-out, all such payments would be pure self-dealing. Under this statutory standard, if a family foundation’s activities were to include distributions

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11 The mechanics of the computation are such that in its first year a foundation cannot qualify for the reduced rate. Foundations often select a short initial first year to avoid this result, particularly if appreciated assets are contributed and are to be sold soon after. The gain, if recognized in the second tax year, could qualify for the reduced rate.

12 IRC Section 4946a
for Freddie Threepwood’s special program, and Freddie’s work on the foundation’s behalf were necessary, there should be no problem with his receiving a reasonable salary from the foundation.

**Other Penalty Excise Taxes**

In addition to self-dealing penalties, operating and nonoperating private foundations and, depending on the facts, the individuals involved are subject to other penalty-type excise taxes. These taxes are levied on the foundation and/or their insiders for infractions including failure to distribute enough to qualifying charities, investing foundation assets in a manner that jeopardizes its tax-exempt purpose, making distributions to nonqualified recipients, and for causing the foundation to hold too great a percentage of certain closely held businesses. These excise tax rules apply to operating and nonoperating foundations alike and are summarized in Table 1 (page 7).

**Distributions to Foreign Charities**

As noted above, there are several ways U.S. private foundations can make qualifying distributions in support of foreign charities. For example, some U.S. public charities operate “friends of” funds and donor-advised funds that support overseas organizations. Effecting grants through such funds could be a practical solution for domestic private foundations in supporting foreign charitable activities. U.S. charities operating international funds include United Way International, the King Baudouin Foundation United States, and the International Community Foundation. “Friends of” funds and international donor-advised funds have administrative expertise in pregrant diligence, monitoring, and reporting and can significantly reduce the headaches experienced by U.S. donors and grantmakers.

Unlike individuals, domestic private foundations are authorized to make distributions directly to foreign charitable organizations, if they follow certain procedures. Failure to comply with these rules renders grants by a U.S. private foundation to a foreign organization taxable expenditures subject to excise tax penalties under IRC Section 4945. In addition, such grants would fail to be qualifying grants for purposes of the minimum distribution rules, subjecting the foundation to IRC Section 4942 excise tax for failure to make the required distribution. To avoid these harsh results, the U.S. private foundation making direct grants has three options:

- obtain a good faith determination from a qualified tax practitioner that the foreign organization is the equivalent of a U.S. public charity;\(^{14}\)

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\(^{13}\) For an informative read on real-life potential for the application of penalties to private foundations, see http://www.washingtongrantmakers.org/s_wash/images/client/TopTenTrouble.pdf

\(^{14}\) Under Treas. Reg. Section 53.4945-5(a)(5)
- exercise expenditure responsibility with respect to the grant to ensure its use for exclusively charitable purposes\(^\text{15}\) and require the foreign charity to maintain the grant funds in a separate account\(^\text{16}\); or

- ascertain that the foreign organization has received a ruling from the IRS recognizing it as a U.S. operating foundation or public charity (that is, a 50% charity).\(^\text{17}\)

Option 1, obtaining an equivalency determination, can be time-consuming and expensive. However, if the U.S. foundation’s connection with the foreign organization is anticipated to be ongoing and substantial, an effort to obtain a good-faith equivalency determination may be warranted. Option 3 is usually ruled out because it is uncommon for foreign charities to have obtained an IRS determination letter.

Often, the most practical course appears to be for the U.S. foundation to enter into an agreement with the foreign organization to follow expenditure responsibility procedures. This means that the U.S. foundation must, under IRC Section 4945(h):

- see that the grant is spent solely for the purpose for which it is made;
- obtain full and complete reports from the grantee on how the funds are spent; and
- make full and detailed reports with respect to such expenditures to the IRS.

**Foundation Distributions to Individuals**

A private foundation may make grants to needy individuals, disaster victims, etc., if such grants are in furtherance of the foundation’s exempt purpose. Grants to needy individuals must be made according to objective, nondiscriminatory criteria. Eligible individuals must be drawn from a class sufficiently broad as to not be pretargeted as selected individuals and thereby serve private purposes.

In addition, special rules apply to grants to individuals for study, travel, and similar purposes. Such grants are not authorized and constitute taxable expenditures, unless the foundation obtains IRS approval of the foundation’s procedures and decision-making process with respect to such grants. Approval must be obtained prior to the making of any such grants.\(^\text{18}\)

Thus, in our hypothetical example, Freddie Threepwood’s desire to provide financial assistance to deserving artists appears to fall under the “study…and similar purposes” provision of the IRC but must be carried out by the family foundation in compliance with the procedural rules.

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\(^\text{15}\) Treas. Reg. Section 53.4945-5(b)
\(^\text{16}\) Treas Reg. Section 53.4945-6(c)(1)
\(^\text{17}\) IRC Section 4945(d)(4)(A)
\(^\text{18}\) The Senate Report on the 1969 Tax Reform Act includes a statement that these requirements were added to crack down on the use of tax-deductible funds in “…financing vacations abroad and paid interludes between jobs.”
Although the legal and compliance costs, management responsibilities and the excise tax risks of private foundations deter some families from creating or continuing foundations, others have found these constraints an acceptable price to pay for the degree of discretion and control available to private foundations. “A donor who knows the general rules, respects their purpose, and consults with a tax advisor when in doubt can use a private foundation to good effect.”¹⁹ Donors who nevertheless wish to pursue another route have several possible options, some of which are discussed in the next section.

**Alternative: Donor-Advised Fund**

A donor advised fund (DAF) is not a separate charity but rather a segregated fund maintained by a sponsoring public charity such as a community foundation. With or without advice from the individual donors, a DAF can make qualifying distributions to public charities, its own sponsoring organization, and to another DAF. If it exercises expenditure responsibility as described earlier, a DAF can also make a distribution to a private nonoperating foundation.²⁰

The Pension Protection Act of 2006 created a tax definition of DAFs and imposed some new limitations. A DAF has three defining characteristics, according to IRC Section 4966(d)(2)(A):²¹

- The fund is identified on the books of the charity by reference to gifts of a specific donor or donors.
- The fund is owned and controlled by the sponsoring public charity.
- The donor or an appointee reasonably expects to have advisory privileges with respect to charitable distributions from the fund.

**Distributions to Foreign Charities Allowed**

A U.S. donor-advised fund is authorized to make distributions to foreign charitable organizations if it exercises expenditure responsibility or obtains an equivalency determination as described above.²² Due to the administrative hassles and potential excise tax risks, however, many DAF sponsors will be reluctant to accommodate requests to make distributions to organizations outside the United States.

**Distributions to Individuals Not Allowed**

A DAF cannot make a distribution to any individual for any purpose.²³ This prohibition extends even to reimbursement of a donor’s expenses incurred in activities on behalf of the fund. The penalty on the donor or advisor receiving such

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²⁰ IRC Section 4966(c)(1)(B)
²¹ Even though it may otherwise look like and be called a DAF, a fund is not a DAF if it can make distributions only to a single charitable organization. Nor is any fund a DAF if it can make grants to any individual for study, travel or similar purposes using the procedural rules for such grants described earlier (IRC Section 4966(d)(2)(B)).
²² IRC Section 4966(c)(1)
²³ IRC Section 4966(c)(1)(A)
an excess benefit is 25% of the amount involved plus, if not corrected, a second tier tax of 200%. The penalty on the fund manager is 10% of the payment subject to abatement. Note that by contrast private foundations are not penalized for paying reasonable compensation to, or reimbursing reasonable expenses of, contributors and related individuals who provide services to the foundation. As concerns Freddie Threepwood in our hypothetical example, a DAF would be an inappropriate vehicle either to provide assistance directly to aspiring artists or to compensate him in any way, even for bus fare.

Although the tax rules governing them have become stricter since the 2006 Pension Protection Act, DAFs remain a popular alternative to nonoperating foundations in the view of many donors. DAFs provide several actual or potential advantages over private foundations:

- DAFs are easy, quick, and inexpensive to establish.
- Gifts to a DAF are gifts to the sponsoring public charity, for which donors receive more favorable tax deductions, particularly for gifts of tangible property and certain securities (Table 2, page 8).
- Tax deductible gifts to a DAF, like gifts to a private foundation, can be front-loaded; unlike traditional nonoperating foundations, however, DAFs have no annual minimum distribution requirements. (However, the Treasury Department is currently studying whether to impose distribution requirements on DAFs.)
- Since public charities need not disclose their donors’ identities, a DAF can provide donor anonymity. Most donor contributions to private foundations are publicly disclosed in tax filings.
- DAFs relieve donors of the burden of funds management and administrative functions through a platform which, while not free, can be more cost-effective per dollar of capital than with a private foundation, especially smaller foundations.
- Many sponsoring charities such as community foundations also provide grantmaking advice to donors seeking guidance in making effective distributions.

These advantages notwithstanding, donor families who want to retain full legal control of charitable capital indefinitely will likely find DAFs unsuitable. DAF funds are controlled by the sponsoring charity, not by the donor or any other individual, who possesses solely advisory rights. The donor cannot legally have the final say in distribution decisions. In addition, the sponsoring charity may insist on terminating all advisory rights after one or two generations.

24 IRC Section 4958(a)
**Alternative: Charitable Lead Trust**

A charitable lead trust (CLT) can function as a temporary substitute for a traditional family foundation. A CLT can also function as an efficient funding adjunct in a plan where a private foundation or a DAF is the primary donative structure. In either case, a CLT can enhance family wealth transfer goals and play a role in a plan for short- or long-term family philanthropy.

A CLT is an irrevocable trust that pays a charity a defined annuity or unitrust amount, at least annually, for a defined period of time. At the end of the charitable “lead” term, the trust’s remaining assets, if any, are transferred to noncharitable beneficiaries, usually the grantor’s children. Eligible charitable recipients during the lead term may include publicly supported organizations, DAFs, and private foundations.

CLT planning is commonly tax-driven, with primary emphasis on gift and estate tax management. Hawthorn has written recently on the use of CLTs in intrafamily wealth transfer planning, and why they can be particularly useful in these times of unusually low interest rates.\(^{25}\)

**Distributions to Foreign Charities Allowed**

A CLT is expressly authorized to make distributions to foreign charitable organizations.\(^{26}\) At least one commentator has stated that the expenditure responsibility rules do not apply to such distributions.\(^{27}\)

**Distributions to Individuals Not Allowed**

A CLT’s lead interest must be payable to exempt organizations.\(^{28}\) The CLT instrument can leave it to family members to decide which charities are to receive what portion of the amount distributed each year from the trust.\(^{29}\) This “spray” power can add a great deal of flexibility to the plan. Family members can be given trustee powers to select charitable recipients, or they can be given lesser DAF-like advisory rights. The grantor should, with planning, be able to participate as a co-trustee in charitable distribution decisions without causing the trust assets to be a grantor trust or includible in the grantor’s estate.\(^{30}\) However, if lead payments are made to a private foundation of which the CLT grantor is a director or trustee, the assets of the CLT could be included in the grantor’s estate.\(^{31}\) IRS has ruled that CLT assets will not be included in the grantor’s taxable estate if the foundation segregates funds received from the CLT and the CLT grantor has no power to direct the foundation with respect to those funds.\(^{32}\)

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25 See the July 2012 Hawthorn white paper, Charitable Lead Trusts: An Underappreciated and Underutilized Planning Tool.
26 IRC Section 642(c)(1)
28 IRC Section 642(c)(1)
29 Rev. Rul. 78-101, 1978-1 CB, 301
30 IRC Section 674(b)(4); PLR 9223040
32 PLRs 200138018, 9822019, 9822021
Most CLTs are structured as nongrantor trusts. A transfer of assets to a nongrantor CLT does not yield a current income tax charitable deduction for the donor. In addition, a nongrantor CLT is not itself tax-exempt. Rather, the trust receives an income tax deduction for its required charitable distributions. With careful management by the trustee, a nongrantor CLT should escape tax on much or all of its income during the lead term because the income will be paid to charity. Removing income from the family’s tax base in this manner can have substantial economic value, but it should not be confused with receiving a current income tax deduction for the initial principal transferred to the trust.

CLTs are subject to many of the same excise tax penalties that apply to private foundations. These include penalties for self-dealing, excess business holdings, jeopardizing investments, and taxable expenditures.

**Alternative: Type III Supporting Organizations**

A supporting organization (SO) is a limited-purpose public charity. It is established to support (that is, make distributions to or on behalf of) one or more other designated public charities. SOs are not literally publicly supported, but an SO is treated as a 50%-type public charity by virtue of its connection with the actual public charity which it supports. For purposes of limiting an individual’s annual income tax deduction for gifts, charitable organizations are divided into two types: 50%-type and 30%-type. These are terms used in the trade, not in the statutes. Contributions most favored by tax law are those made to organizations expressly described at IRC Section 170(b)(1)(A). These are typically referred to as 50%-type organizations. If the organization is defined in Section 170(b)(1)(A), then the AGI limit is 50% per the final sentence of that Section. If an organization is a charity but does not fall within IRC Section 170(b)(1)(A), then it is a “30%-type organization” for tax deduction purposes, meaning the limitation on an individual’s income tax deduction for gifts to the organization is 30% of the individual’s AGI.

The 50% and 30% limitations represent maximums in terms of donor income tax deductions. There are three basic types of SOs. Each type is majority-controlled by persons other than the SO’s substantial contributors and their family members, meaning that the donor family must be a minority of the SO’s board. Only Type III SOs are considered in this paper because Type IIIs come closest to private foundations in the degree of control (which must be less than 50% in

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33 IRC Section 170(f)(2)(B)
34 IRC Section 642(c)
35 IRC Section 509(a)(3)
36 IRC Section 170(b)(1)(B)
37 IRC Section 170(b)(1)(B)
38 IRC Section 170(b)(1)(B)
any case) that can be retained by their creators. (Type I, parent-subsidiary, and Type II, brother-sister relationships, are generally too closely controlled by the supported public charity to be an attractive alternative to private foundations in the eyes of donors who desire maximum permissible control.) Type III SOs need only be operated in connection with the supported public charity, a more relaxed nexus standard, in our view, than pertains to Types I and II SOs. We believe it was this relaxed standard, plus some unfavorable publicity, that motivated legislators to tighten the rules relating to SOs, particularly certain Type III SOs, in the Pension Protection Act of 2006 and Treasury regulations issued in December 2012.\(^{39}\)

In our opinion, the chief advantages of SO status are:

- the 50% limitation on income tax deductions for their individual donors; and
- the ready availability of grantmaking assistance and administrative and operational services from the supported organization.

A special rule, of possible interest to family in our hypothetical example, enables a supporting organization to support certain noncharitable exempt organizations, including an exempt horticultural organization, as long as the supported organization derives at least a third of its support from the public.\(^{40}\)

Disadvantages of Type III SOs include:

- SO substantial contributors or family members cannot be a majority of the SO governing body.\(^{41}\)
- SO substantial contributors or family members cannot control the supported public charity.\(^{42}\)
- An excise tax penalty applies to payments of any kind by the SO to the donor or any family member.\(^{43}\) This precludes compensation and even reimbursement of reasonable expenses on behalf of the fund.
- Additional reporting requirements apply to nonfunctionally integrated Type III SOs.\(^{44}\)
- The requirements also provide that Type III SOs that are nonfunctionally related to the supported charity must also make minimum annual distributions to or on behalf of the supported public charity.\(^{45}\)
- Type III SOs cannot make distributions to foreign charitable organizations.\(^{46}\)

The Pension Protection Act of 2006 placed a number of new requirements and restrictions on SOs, particularly Type III nonfunctionally integrated SOs that were formerly a favorite choice of donors desiring to escape the income tax deduction limitations applicable to gifts to private foundations while retaining a level of control over the SO that was acceptably close to that which could be had with a private foundation.

\(^{40}\) Treas. Reg. Section 1.509(a)-4(k)
\(^{41}\) IRC Section 509(a)(3)(C)
\(^{42}\) IRC Section 509(f)(2)
\(^{43}\) IRC Section 4958(c)(1)(3)
\(^{44}\) Treas. Reg. Section 1.509(f)(1)(A)
\(^{45}\) for example Treas. Reg. Section 1.509-4(i)(3)
\(^{46}\) IRC Section 509(f)(1)(B)
Toward Solutions

Donors intent on making charitable bequests at death should consider making some of those gifts during their lifetime, to the extent they can afford to, in order to save income tax and estate tax. In our hypothetical scenario, Constance’s willingness to devote a substantial portion of her estate to charitable causes does not mean, however, that she can afford to fund all of the family’s goals, nor can she do so currently or within any particular time frame. A sufficiently rigorous analysis of her and Clarence’s personal cash flow and capital needs will help determine the extent and pace of funding during her and Clarence’s lives.

Next, Constance and her family need to make some decisions that only they can make regarding primary concerns, namely, whether and to what extent they (particularly the children) are willing to act in concert in philanthropic matters. The involvement of the entire family, while often an important component of a parent’s vision, may not always be a goal shared by other family members.

Since Constance’s history of charitable giving seems to be of the checkbook variety, she might consider separating her funding of such gifts from the funding of other elements of the overall plan. For example, if tax considerations lead Constance to decide to prefund some of her recurring charitable gifts, she might consider using a donor-advised fund (a 50%-of-AGI charity) rather than creating and funding a nonoperating, grantmaking foundation (a 30%-of-AGI charity). She could establish the fund so that she, Clarence, and the children could all be advisors. Or the DAF agreement could provide that the children would become advisors following their parents’ deaths.

In our view, a private foundation and, in most cases, foundation substitutes discussed above can be designed so that different family members are given decision-making authority for distributions of a defined portion of the entity’s foundation’s assets or income. Thus, if desired, the family could establish a single foundation that provides for Constance and Clarence, Millie and Anthony, and Freddie to use “their” designated pool of funds to accomplish their separate priorities.

There is almost always more than one way to achieve a charitable vision. The best plans are fact- and goal-driven, not prepackaged, one-size-fits-all solutions. Donors can be confident that if they discern their priorities thoughtfully, plan carefully, and implement systematically, they can achieve the “excellent and praiseworthy” results lauded by the philosopher.
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