

# Pros and Cons of a Private Charitable Foundation

**Aufman Associates Inc.**

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A private foundation is a great way to capture income tax savings currently, while forming a pool of assets for charitable giving. This is not for everybody, and there are alternatives. But, for clients who are philanthropic and who have significant “excess” assets, high tax rates, and appreciated securities, the stars can align.

The following is a not a “legal” discussion of the detail, but rather a practical discussion of how it usually works to establish and run a private foundation. Our firm manages many foundations, both large and small, so we have perspective on the day-to-day / ongoing aspects.

## **The Structure**

The first step is to form an entity. This could be in the form of a trust or corporation. Both of these are easy structures to create. An attorney is needed for this step.

The trust document or corporate by-laws will outline how the foundation functions. The terms must be very clear that the foundation is for charitable purposes. The simplest and cleanest approach is to restrict that all distributions from the foundation must go to approved 501(c)(3) organizations. Most charities, schools, and churches are 501(c)(3) status, so this works well for most people.

In some cases, there is a desire for the organization to make broader distributions. A very good example of this is for international giving. Foreign charitable organizations often do not have U.S. 501(c)(3) status. Additional language can be included in the operating documents to permit granting to charities without IRS status. The

document would require that a due diligence process be completed by the trustees/officers of the foundation to verify that the funds are being used for charitable purposes.

Operating documents can also provide for scholarship grants. However, this becomes complicated. There must be an independent board to approve the scholarships, so this is not a way to grant scholarships to friends/families. Considering the complexity/regulations, the foundations that we have created have not been drafted to allow scholarships (although it would be possible). However, a foundation could still choose to make a donation to a University scholarship fund, or endowment. The University would then be responsible to follow the regulations.

In some cases a client desires that funds be used for a certain charitable cause. This can be incorporated into the operating documents.

A foundation needs a name. This can be “The John and Jean Sample Foundation,” “The Sample Foundation,” or some other creative name. We just need to make sure the name has not already been used.

## **Gaining Approval**

Once formed, the foundation must complete IRS Form 1023, Application for Recognition of Exemption. This is the process that grants 501(c)(3) nonprofit status to the foundation. There is an IRS application fee of \$850.

Aufman Associates assists with the preparation of the application. Usually, nonprofit status is received in a couple/few months.

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### Funding the Foundation

Appreciated securities is the best way to fund a foundation. This provides a significant tax benefit.

For example, let's say \$100,000 of a stock or fund position is contributed to the foundation and it has a tax basis of \$20,000. The tax on the capital gain would have been \$19,000 if sold, considering the long-term tax rate of 20% and the net investment tax of 3.8%.

The entire \$100,000 is deducted against ordinary income, reducing current year taxes by \$43,000.

So... total direct and indirect tax savings is \$62,000.

In the above scenario, \$100,000 of value is received to the foundation but it only "costs" \$38,000 in real after-tax terms. This example assumes the highest tax rates combined with low basis stock, so it is the optimal conditions... but this is quite common for anybody in a position to create a foundation.

The amount that can be deducted is based on Adjusted Gross Income (AGI). Donations of appreciated securities can be deducted as long as the value does not exceed 20% of AGI. In the case of cash, the deduction limit is 30% of AGI. Amounts that cannot be deducted would carry to the following year (can carry forward for up to ten years).

When funding, it is important to review projected taxes for the current year and future years. The idea would be to make multiple smaller contributions so that the deduction is always against the marginal income that is taxed at the highest rates. We would not want to contribute and deduct against lower rates if we could otherwise simply wait until the next year and get the deduction against the highest rates.

A foundation can be funded any time. For example, it could be initially funded, and then funded again ten years later.

### Foundation Operations

Operating the foundation is not complicated. The foundation can consist of an investment account with a checkbook. The foundation can be invested in the usual way.

Make sure you contribute only to charities or otherwise follow the rules within the operating document. Keep records on each gift including the amount, payee, purpose of grant, and nonprofit status of organization. This information is needed for the foundation tax filing each year.

At least 5% of the value of the foundation must be distributed each year. There is an annual calculation that specifically identifies the 5% value. If more than 5% is distributed, the excess carries forward. So, if 6% is distributed, the next year's required distribution will be lower.

There is an annual tax return, form 990PF. The form is complicated. Aufman Associates prepares special reports for the accountant. The accounting fees are usually about \$500 per year, or a little higher if there is something more complicated. The return is due May 15.

The form 990PF is a public document. The 990 will be visible on websites such as [guidestar.org](http://guidestar.org). The names of major contributors are included on the 990PF.

The tax rate on income in a foundation is 2%. However, if distributions are large and exceed the average of prior years' distributions, the tax rate is reduced to 1%. Either way, the tax is extremely low. This is an additional tax benefit.

### **Alternatives and Other Comments**

A simple alternative is doing nothing. For example, appreciated stock can continue to appreciate and then can be donated directly to a charity. In this case the position is growing tax-free (because the gains are not taxed if the position is not sold), and the deduction is ultimately received when donated. However, this does not allow you to take the deduction “now” and make the distribution later, as a foundation would allow.

Another alternative is a donor advised fund. The Pittsburgh Foundation and Vanguard Endowment are two examples. Donor advised funds can make sense for smaller funds because there is not an initial setup and there is not an annual tax filing expense. However, the ongoing fees are higher and can sometimes exceed 2%.

Donor advised funds have slightly higher contribution amounts relative to Adjusted Gross income. For example (as mentioned earlier), a contribution of appreciated securities to a private foundation is limited to 20% of AGI... it is 30% for a donor advised fund. And, cash is 30% for the private foundation vs. 50% for the donor advised fund. A donor advised fund also does not have the 1-2% income/excise tax that the private foundation is subject to.

However, the higher ongoing fees in a donor advised fund usually make the private foundation a better choice once we are planning on a couple hundred thousand of funding. Also, clients typically favor the private foundation because there is more control/flexibility. We usually end up concluding that a private foundation is a better approach.

Having a “pool of money” in either a private foundation or donor advised fund is appealing because that pool can be used for small gifts or large gifts. If we compare this to personal giving, clients often donate appreciated securities for the larger gifts but not the smaller gifts. So, if we form

a foundation with appreciated securities, there is now a pool of funds that captured all the tax benefits and this can be used for all giving... big and small. The small gifts can add up, so this can be meaningful compared to the alternative of using personal cash.

Foundations often require organizations to submit grant requests and provide reports on the use of the funds. While this level of reporting is not required, some clients like this formal process.

### **Conclusions**

A private foundation is a great planning vehicle provided a client meets the following criteria...

- 1) Has money that is clearly not needed personally. The transfer is irrevocable.
- 2) Has a high income tax bracket.
- 3) Ideally, has appreciated securities to contribute.
- 4) Has a desire to support charitable organizations.
- 5) Has somebody to assist with the administrative aspects (like Aufman Associates). This helps to keep costs down because we manage it cost effectively with your other accounts.

I suppose that some of this appears “complex.” But, it really is not complicated once it is up and running. And we oversee the tax filing process etc. So, it is not too much burden and provides a great giving vehicle and can form an ongoing legacy.

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This review was prepared by Edward B. Aufman, CFP and Edward J. Aufman, CFP.

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