FAMILY CHARITABLE ENTITIES

Dorothy K. Foster, Esq.

FOSTER LAW GROUP, PLLC

800 Fifth Avenue, Suite 4100
Seattle, Washington 98104

355 Erickson Avenue, Suite 410
Bainbridge Island, Washington 98110

Ph: (206) 686-6862 • Fax: (206) 686-6862
dfoster@fosterlawgroup.com

Dorothy K. Foster is a principal in the Seattle and Bainbridge Island law firm of Foster Law Group, PLLC, where she practices in the areas of estate planning and tax-exempt organizations, with emphases in private foundations/ supporting organizations and international estate planning. She holds a master's degree in English from Washington State University and a master's degree in Linguistics from the University of Colorado. She graduated with distinction from the University of Nebraska School of Law where she was a Regents Law Scholar, a member of the Order of Coif and Research Editor of the Nebraska Law Review. She is a member of the Planned Giving Advisory Boards of the Nature Conservancy, Providence Hospital Systems, and Washington State University, and is a Trustee of the King County Bar Foundation. Ms. Foster is a certified mediator and is a member of the Taxation, Real Property/Probate and International sections of the Washington State and American Bar Associations

A charitable entity funded by contributions from a single individual or family and lacking broad-based support from donations by the general public (a "family foundation") is generally one of three types: a private foundation, a private-operating foundation, or a supporting organization. These organizations all serve as structures to encourage family philanthropy but differ in terms of tax advantages to the creator/donor and in terms of the donor's control over the organization.

A donor's intervivos (lifetime) gift to any of these organizations enables the donor to make charitable gifts while receiving an income tax deduction and saving significantly on capital gains and transfer taxes. The creation of an intervivos foundation offers a donor greater flexibility in grant-making over the course of his life than he would have with direct gifts to charitable organizations. By naming his foundation as the charitable beneficiary, the donor need not decide in the same year on a particular charitable recipient. A gift during life also provides a venue for the donor's charitable activities, allowing philanthropy to be a lifetime focus. At his death, his children may undertake evaluation of then-existing charitable beneficiaries using the philanthropic guidelines established by the donor.

A testamentary gift (where the charitable entity is created in the donor's Will) provides significant estate tax savings and allows the donor to direct his children to use a portion of his assets for charitable purposes. It has the disadvantage of not enabling the organization's founder to be involved in its initial years of operation. Many donors use a combination of both vehicles: creating a foundation during life, assisting with its inception and, at death, bequeathing further assets directly to that foundation.

I. Forms of Family Charitable Entities

A. Private Foundation.

A private foundation is a charitable organization established by an individual donor for the purpose of controlling the donor's charitable contributions to public charities and directly to charitable recipients. A foundation is often established to allow the donor to manage the timing of his charitable contributions and to engage in charitable purposes beyond those normally undertaken by established public charitable organizations. Those purposes are defined in the foundation's organizational documents so as to reflect and maintain the founder/donor's philanthropic values.

Contributions of appreciated property to a private foundation may be deducted to the extent of 20% of a donor's income base (basically, his adjusted gross income). Contributions of cash may be deducted up to 30% of that amount. Thus, in one year, a donor may contribute assets with a value of no more than 30% of the donor's income base for that year. This contribution limitation is more restricted than the limitations placed

upon direct contributions to a public charity (deductible at 50% and 30% rates), but it is generally not significant for most donors who may easily plan a series of contributions over the course of several years.

Contributions of appreciated property to a private foundation rather than to a public charity are limited by a further factor. Appreciated property is deductible at its full fair market value when contributed to a public charity; when contributed to a private foundation, on the other hand, the measure of the contribution deduction is equal only to the property's cost basis. This rule has been modified by legislation to allow contributions of certain qualified stock (basically, publicly traded securities) to be deductible at full fair market value. Contributions of real property, on the other hand, are deductible only at cost basis. The existing restriction fails to be prohibitive, however, for a donor with significant charitable intent.

A private foundation is subject to strict operational guidelines as well as excise taxes, and it may be subject to penalty taxes for failing to comply with federal regulations. These special rules are designed to prevent self-dealing between a foundation and its donors, to limit ownership of private businesses by foundations, to ensure that a foundation not invest in speculative investments, and to ensure that a foundation use its income only for the charitable purposes for which it was granted its original tax exemption.

A significant burden placed upon private foundations is an excise tax of 2% of the value of the foundation's net investment income. This tax is reduced to 1%, however, if a foundation maintains certain distribution patterns. The foundation also must annually distribute 5% of its assets for charitable purposes. A foundation engaged in active grantmaking should have no problem meeting any of these requirements.

B. Private Operating Foundation.

A private operating foundation is a "hybrid" of sorts between a private foundation and a public charity. Such a foundation is treated as a public charity for purposes of the charitable contribution deduction available to the donor, but is subject to many of the restrictions placed upon private foundations. It is a form of entity attractive to a donor who wishes to take an active involvement in a charitable enterprise of his own, without the added burden of soliciting additional contributions from the general public.

A private operating foundation differs from a public charity in this lack of public financial support. It differs from a private foundation in that though supported by substantial endowments from a small number of individuals, the organization actively conducts its own charitable operations and is not limited to expending its funds only for distributions to public charities.

Thus, contributions of cash to a private operating foundation are deductible at the public charity rates--to the extent of 50% of the donor's contribution base. Contributions of long-term capital gain property are deductible at fair market value to the extent of 30% of the donor's contribution base.

A private operating foundation is subject to the private foundation rules and excise taxes, with the exception of the tax placed on private foundations for undistributed income. A private operating foundation is not required to distribute any of its income to public charities (is not subject to the 5% distribution requirement), but is allowed, instead, to use those monies for its own charitable undertakings.

In order to qualify as a private operating foundation, an organization must satisfy certain financial tests over the course of three years. A new organization is given the opportunity prospectively to claim private operating foundation status, given an expectation to conduct its activities in conformance with all legal and financial requirements.

C. Supporting Organization.

A supporting organization is a third type of charitable entity suitable for establishment by one family or individual. Like a private foundation or a private operating foundation, a supporting organization receives the bulk of its contributions from just that family or individual. Although it is not publicly supported, it is still responsive to public concerns because of its close relationship with other public charities. Because of this relationship, it is granted most of the benefits afforded a public charity.

In order to establish the requisite close relationship with a public charity or charities, the supporting organization must be organized and operated exclusively for the benefit of one or more specified public charities or charitable purposes. It must be either operated in close conjunction with a public charity, supervised by that charity, or controlled by one or more members of the board of the charity. A supporting organization differs from a private foundation in this mandatory affiliation requirement and in its prohibition against distributing its assets to support any other charitable organization outside its specified purposes. A donor must take care at the time of creating such an organization to name charitable organizations with charitable purposes broad enough to encompass all charitable undertakings contemplated by the donor.

A supporting organization specifically must not be controlled directly or indirectly by the original donor and must be controlled by representatives of the public charities. Generally, this requirement is satisfied by having delegates of the public charities on the board of the supporting organization such that substantial contributors to the foundation (including the original donor) do not have majority control. Less restrictive means of establishing the necessary relationship are possible, however, affording the donor a greater degree of control.

A supporting organization is a public charity for purposes of the charitable contribution deduction available to a donor. The contribution of appreciated property to a supporting organization is deductible for income tax purposes to the extent of 30% of the donor's annual adjusted gross income. A contribution of cash is deductible to the extent of 50%. Since a supporting organization is a public charity, contributions are allowed at their full market value (rather than at their cost basis).

Though the creator of a supporting organization has less control over assets, it is generally believed that this loss of control is outweighed by a supporting organization's

freedom from burdensome foundation reporting and investment requirements and the higher public charity contribution deductions. As a public charity, a supporting organization is not subject to restrictions on its investments, distributions, and business holdings, and is not subject to an excise tax on its net investment income. Given a donor with charitable objectives closely approximating those of certain public charities and no objection to oversight and control by those public charities, a supporting organization may be the preferred form of organization.

II. Choice of Entity

One's choice of the above entities is usually dictated by the intended charitable activity and the asset to be contributed. Most clients have a common goal of preserving from taxation the greatest possible value of one's estate and of instilling in the children one's own philanthropic values. Most clients are also sincerely dedicated to improving society and intend to use their charitable entity truly for charitable purposes.

A. Grantmaking Organizations

The majority of Foster Law Group, PLLC clients who contemplate simple grantmaking (as opposed to carrying out a direct charitable activity or operating a business or other asset in conjunction with the client's for-profit endeavors) choose to form a family foundation as opposed to a supporting organization. They do so for the very simple reason that they wish to retain control over the organization. Although some supporting organization structures appear to provide a client with greater control than other forms, all supporting organizations are governed by the clear statutory mandate that the donor NOT control the organization. Nominal transfer of control to a public charity is not sufficient if the donor has actual control over the decisions of the organization.

The asset intended to be transferred to the organization can dictate a different choice. If the client, who contemplates simple grantmaking, intends to fund the entity with highly appreciated securities, he would be well advised to create a private foundation. If he intends to contribute real property, and has no intention to carry out direct charitable activities, he may choose, instead, to forego control over the organization in exchange for the ability to deduct the property's full fair market value (rather than just its cost basis). He would establish, then, a supporting organization rather than a private foundation.

A supporting organization has the advantage of a higher charitable contribution deduction as well as freedom to establish relationships that would be prohibited in a private foundation context. Those prohibited relationships of most interest to clients generally involve the co-ownership of property.

A restriction on both private foundations and supporting organizations is the prohibition against "private inurement." Generally, no nonprofit organization may engage in dealings with an individual—whether the donor or another individual—such that the individual is unfairly benefited. Our government wants to ensure that monies that have been contributed and dedicated to charitable purposes (for which the donor received a tax deduction) are, indeed, preserved for those purposes. A family charitable entity may pay

compensation to donors or the donor's family, but that compensation must be reasonable in relationship to the services provided.

This restriction is generally not a burden on most families. Some further restrictions on private foundations, that do not apply to supporting organizations, often are burdensome, however.

A private foundation may not co-own property with the donor. A supporting organization may. If a donor contemplates contributing an airplane or a boat to the family charitable entity but wishes to retain the use from time to time, he should not establish a private foundation. Similarly, co-ownership of real property by a private foundation and a family is very likely also prohibited. Neither of these restrictions applies to a supporting organization. To avoid the problem of private inurement, however, the donor (or other individual using the property for personal purposes) must provide reasonable rental value to the foundation, such rental value established at fair market value.

A private foundation is subject to another relationship restriction that sometimes deters a client from establishing such an entity. A private foundation is prohibited from owning more than 20% of a business—whether that business be owned by the donor or by any other individual or entity. A supporting organization has no such limitation. Therefore, if a client wishes to retire from a business he has been actively operating and contribute it to his foundation, he may do so only to the extent of 20% of its value. Any greater ownership will subject the foundation to tax. (Testamentary bequests of a business to a foundation are allowed to be disposed of over a period of years so as to avoid a forced liquidation of the business.) An individual who wants to keep his business in the family but wants all profits to be directed to charity (rather than directly to his offspring) would be well advised to establish a supporting organization rather than a private foundation.

B. Active Philanthropy

The majority of private foundations are established with the intention simply of funding the activities of existing public charities. Such a foundation need only establish a grant-acceptance procedure, review applications and write checks (along with maintaining careful records). Many clients have greater aspirations, but are not aware that those aspirations can be carried out in the context of a family charitable entity.

1. Private Operating Foundation

Direct conduct of a charitable activity—like running a camp or treatment center—constitutes private operating foundation activity. Private operating foundations often behave very much like a public charity and differ only in the source of funds. To qualify as a public charity (and, thus, entitle the donor to a higher charitable deduction), an organization must demonstrate (very generally) that at least 33 1/3 % of the organization's support comes from the general public; and no more than 2% of its support comes from any one individual or family. Most donors who create and fund their own family charitable entities are unable to demonstrate the requisite public support, and must carry out their activities as a private operating foundation. Because the donor to a private operating

foundation is afforded the same deduction at fair market value as is available for a contribution to a public charity, private operating foundation status is not generally a burden. Private foundation restrictions do apply, however; so great care must be taken in the case of a donor contemplating the sharing of property or business activities between the organization and the donor.

2. Private Foundation Active Philanthropy

a. Foreign Activities

Unlike an individual, a private foundation may make charitable contributions to foreign entities or individuals. The purpose of the grant or distribution must be charitable, but permissible recipients include a U.S. public charity operating overseas, a "Friends Of" organization, a foreign government, a foreign entity with 501(c)(3) status from the Internal Revenue Service, a foreign equivalent of a U.S. public charity, a foreign equivalent of a U.S. private foundation, a foreign qualifying individual, and even a foreign organization which does not qualify as equivalent to a U.S. 501(c)(3).

Grantmaking to foreign entities requires additional contracting and record keeping. Generally, the farther removed a foreign organization is from bona fide U.S. 501(c)(3) public charity status, the greater the amount of documentation a private foundation must maintain to establish the qualifying nature of a grant.

Hernshaw & Foster assists foundations with necessary affidavits, contracts and grant letters, with the expectation that the private foundation managers will be empowered to make similar foreign grants without additional "lawyering." The documentation requirements, although onerous when first encountered, are often expressions of the kind of due diligence one would normally take when giving money to someone without established credit. A review of the organization's financial records, an annual report that accounts for the expenditure of the funds, and a pledge to maintain the foundation's gift in a bank account separate from the organization's other funds can assure the foundation (and, hence, the I.R.S) that the funds are being expended for truly charitable purposes. We are fortunate in that our government affords donors to U.S. private foundations a U.S. income and/or estate tax deduction for funds that will be expended outside of the United States. The tax code—and the legislation that preceded it—contemplated philanthropy on an international scale.

b. Grants to Individuals

Also unlike U.S. individual taxpayers, a private foundation is entitled to characterize as part of its distribution amount grants to private individuals. Grants of this nature fall into basically two categories: grants for scholarship, research, study or travel, and grants that are not for scholarship, research, study or travel.

Grants in the first category require advance approval from the I.R.S. That is, a foundation that contemplates making a grant for these purposes must prepare scholarship selection criteria and application procedures and must submit them to the I.R.S. before any grant is made. The foundation must establish that the criteria are nondiscriminatory and

select from candidate pool of sufficient breadth as not unfairly to benefit one individual or class of individuals. Once the grant is made, the foundation must carry out investigations to establish that the grant was indeed used for its intended purposes. Generally, an individual who receives a grant for these purposes may exclude the amount from his income for income tax purposes.

Grants in the second category do not require the advance approval of the I.R.S. Grants of this type include prizes and awards (not related to study or travel) as well as grants to individual for economic relief. Generally, the purpose of this type of individual grant is to recognize or relieve past behavior or circumstances with no obligatory oversight required by the foundation regarding the use of the funds.

Prizes and awards are considered taxable income to the recipient (with the exception of certain qualifying "charitable achievement awards"). Grants that are not prizes or awards (nor intended for scholarship, study or travel) and are made to an individual for economic relief are considered gifts and are not taxable income to the individual. Yes, a private foundation may make grants to needy individuals and need not establish that that individual "out-qualified" all other needy individuals in order to qualify for aid.

Such grants must be made on an objective and non-discriminatory basis; but, unlike donations to public charities (by an individual) that are earmarked for a particular individual or family, a grant from a private foundation may be made directly to benefit an individual or family chosen by the foundation. Foundations must take care not to violate certain rules that forbid them from making grants to individuals who are closely related to the foundation. Generally, however, a financially impoverished person (even if just recently so) may receive grants for healthcare, rebuilding a home or meeting basic living expenses. In all cases, the grant recipients must demonstrate financial need.

b. Entrepreneurial Philanthropy

"Entrepreneurial Philanthropy" is a coined term. We use it at Hernshaw & Foster to refer to foundation grantmaking carried out on a business model. Just as a private foundation may make grants to foreign entities that have not received I.R.C. 501(c)(3) status, so may the foundation make grants to U.S. entities that are not 501(c)(3) qualified. The documentation process is similar to that required for grants to foreign entities, and, again, models the due diligence steps one would normally undertake when dealing with a "credit risk".

(1) Foundation-to-Foundation Grants

A private foundation may, indeed, make grants to other private foundations. The recipient foundation must pledge, however, to expend the funds for its charitable purposes by the end of the year following the year of receipt of the grant. The donor foundation must carry out due diligence regarding the recipient foundation and require annual reporting as to the use of the funds. A foundation-to-foundation grant, then, may not be used to increase the recipient foundation's endowment.

(2) Grants to Non-charities

Likewise, a foundation may make a grant to an organization that doesn't have 501(c)(3) status of any sort (is neither a public charity, a supporting organization nor a private foundation). If the donor foundation can demonstrate that the recipient organization will use the funds for charitable purposes, a grant to that organization is a qualifying expenditure. Demonstration of that charitable use, again, is made by means of contracting, due diligence and record keeping. There is no requirement that the recipient organization keep the funds in a segregated account. A favorite use of this type of grant is the funding of a new start-up public charity. A private foundation may provide the funds necessary for the charity to gain its 501(c)(3) status.

(3) Program Related Investments

The epitome of entrepreneurial philanthropy is the "program related investment". Through a program related investment, a foundation loans money to or takes an equity interest in a for-profit enterprise. In this sort of grant, the private foundation need not establish that the recipient organization is carrying out a charitable activity; but, rather, that the making of the grant itself will result in a charitable goal held by the foundation.

Establishing a program-related investment program enables a foundation to undertake philanthropy through encouraging entrepreneurship. If the foundation can demonstrate that investing in a for-profit enterprise would lead to some charitable benefit to the community (and is within the foundation's charitable purposes), the investment will count as a "grant" for purposes of the foundation's annual 5% distribution requirement. In order to qualify the grant as a program related investment, the foundation must generally demonstrate that no commercial funds were available to assist the for-profit and that "no principal purpose" of the foundation's investment was the making of profit.

The foundation can loan or invest money to accomplish such goals as minority entrepreneurship and job creation. Funds can be invested to improve dilapidated community areas; to fund the creation of a product that will benefit, say, children's education; to build low-income housing; to support a venture capital fund working in a depressed area; or to provide a bridge loan to public charities or community organizations with cash short falls. If a foundation's purpose is education, any sort of educational endeavor that has failed to attract commercial funding should qualify as a program-related investment. If foundation's purpose is community development, it can function as its own community development bank and avoid having to work through established organizations.

Program related investments may be carried out overseas, as long as the foundation's organizing instrument allows foreign grantmaking. Of course, careful due diligence and documentation is necessary; but the foundation need not get advance approval from the I.R.S. before making a program related investment either domestically or overseas. In addition, once foundation staff have experience in making program related investments, they often can proceed with further investing without additional legal advice.

What if the investment makes a profit? A foundation is not required to divest itself of the investment, but may simply move the investment over on its balance

sheet from "grants" to "portfolio investment." While the investment is used to satisfy the foundation's distribution requirement, some continuing monitoring is required to ensure that the investment still serves the foundation's charitable purposes. Generally, however, a foundation may quite easily carry out philanthropy in the guise of venture capital. Investing in start-up businesses broadens a foundation's ability to contribute to its community by allowing foundation assets to "be recycled" into new projects as old ones accomplish their charitable purpose.

IV. Conclusion

Of the three forms of charitable entities available, a private operating foundation provides the greatest opportunity for personal involvement with the added tax advantage of higher allowable charitable deductions in each year of operation. A supporting organization provides the least amount of personal autonomy, given the requisite control by one or more public charities; but it affords higher charitable deductions, allows co-ownership of assets and avoids the onerous regulatory and fiscal recordkeeping requirements of a foundation. A private foundation allows one to control the management of the organization and the timing of one's distributions to public charities. A foundation does restrict the donor to lower charitable deduction limits and regulatory and fiscal requirements; but once those constraints are met, a foundation enables the donor to express tremendous creativity in philanthropic endeavors.