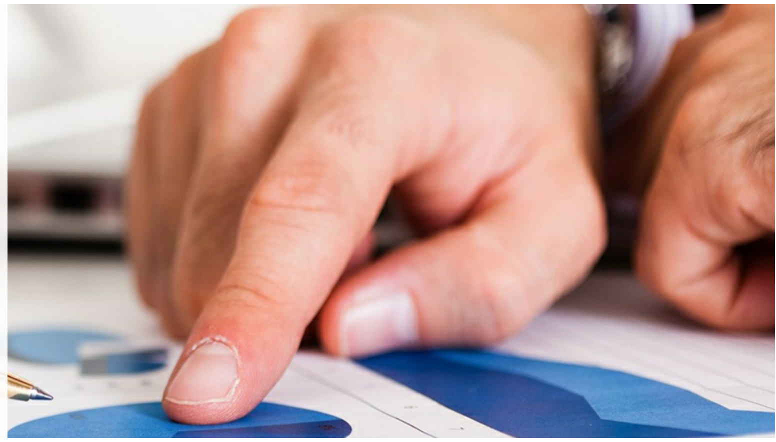
Private Foundations



Overview

A private foundation (also called 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 set up during a donor's lifetime, but can also be created upon death. In essence, a private foundation is a tax-exempt checkbook; it is a repository of money and conduit between the donor and the charity. The private foundation itself does not directly engage in charitable activities (as compared with a private operating foundation, discussed further below).

A private foundation is controlled by a board of directors or 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. For this and other administrative tasks, the directors or trustees can be paid a reasonable compensation. The ability to appoint a board of directors to manage the foundation can enable 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.

Tax Implications

Charitable Deductions

- **Income Tax – Individuals.** Lifetime contributions made by individuals to a private foundation can qualify for a charitable income tax deduction, but special limitations apply. For cash contributions, the donor's deduction will generally be limited to 30% of adjusted gross income (AGI). For short term capital gain property and ordinary income property, a deduction will be allowed for the asset's cost basis up to 30% AGI. For gifts of long-term capital gain property, the deduction is generally limited to cost basis up to 20% of AGI. (Exception: deduction is not limited to basis for publicly traded securities where donated stock is no more than 10% of corporation's shares.) Contributions in excess of the above limits may generally be carried forward to future tax returns for up to five years.

- ♦ Note that these deduction limits are lower than those for contributions made to public charities; contributions of cash to a public charity are generally deducible up to 50% of AGI and contributions of appreciated property to a public charity are generally deductible up to 30% of AGI.
- ♦ **Estate Tax.** Generally, gifts to private foundations also qualify for unlimited estate or gift tax charitable deductions.
- ♦ **Income Tax – Corporations.** Donations made by C corporations will be deductible up to 10% of corporate taxable income. A 5-year carry forward also applies to corporate donations.

Income Taxation of Foundations

Unlike public charities, which are generally exempt from income tax, most domestic private foundations are subject to special excise taxes of up to 2% on net investment income generated in a given year. This amount may be reduced to 1% of net investment income if the foundation meets a certain level for charitable distributions that year and has not been subject to penalty in the past 5 years for failure to make adequate distributions. Foreign private foundations are subject to a 4% excise tax on gross investment income derived from United States sources. Additional taxes and penalties may result upon violation of any of the private foundation rules, as described below.

Private Foundation Rules

Because private foundations are considered more susceptible to potential operation for the private benefit of donors and managers, the Internal Revenue Code contains special rules for private foundations that do not apply to public charities. Violations will result in extremely severe penalties and taxes (ranging from 5%-200%) for the foundation, and in some cases, its managers and substantial contributors.

- ♦ **Self-Dealing:** Excise taxes will apply if the foundation participates in any "prohibited transaction" with a "disqualified person." "Prohibited transactions" generally include sales, leases, or loans. "Disqualified person" generally includes a substantial contributor, a foundation manager, or any family member of either.
- ♦ **Failure to Distribute Income:** Private foundations are required to distribute out 5% of investment assets annually for charitable purposes. Qualifying distributions include those made to public charities and those made to non-charities for "charitable purposes," costs of all direct charitable activities, program-related investments, and reasonable administrative expenses.
- ♦ **Excess Business Holdings:** Private foundations are generally prohibited from owning more than 20% of a corporation or other business entity. (Exception: Foundations have 5 years to dispose of excess business holdings that were received by gift or bequest before a penalty is triggered.)
- ♦ **Jeopardy Investments:** Foundations and their managers are subject to excise taxes if investments are made which jeopardize the charitable purpose of the foundation.
- ♦ **Taxable Expenditures:** Taxes are imposed for "taxable expenditures" made by the foundation, which can include expenses for lobbying, political campaigning, and certain grants made to private individuals or for non-charitable purposes.

Private Operating Foundations

A private operating foundation is a type of private foundation which has a stated charitable purpose and actively carries out its own programs (such as a food bank). Private operating foundations are not subject to the same income distribution requirements and excise tax that apply to private non-operating foundations. In addition, contributions to an operating foundation enjoy the higher deduction limits applicable to public charities. In order to qualify for this treatment, the operating foundation must spend the less of its adjusted net income or 5% of its investment assets in the active conduct of its charitable activities, in addition to meeting special income and support tests.

Advantages and Disadvantages

While foundations provide maximum control to the donor and create an opportunity for the donor's family to participate in a meaningful endeavor, they require a great deal of maintenance and monitoring. Without heavy involvement or direction, foundations can languish, with charitable bequests made in an ad-hoc fashion, possibly contrary to the wishes of the primary founder. Further, inadequate attention and planning may even result in mismanagement or closure of the foundation.

Costs associated with establishment and maintenance of private foundations can be high. These include costs to obtain tax-exempt status and file necessary annual reports, fees for consistent monitoring by tax advisors to ensure compliance with strict private foundation rules, as well as constant potential exposure to excise taxes. Because of this, it is generally not cost effective to create a foundation unless the donor is very charitably inclined and plans to make significant gifts to charity (at least $1-$2 million, but ideally $5 million or more).

Private foundation tax rules also restrict the foundation's ability to expend funds for charitable causes to a greater extent than public charities.

As mentioned above, income tax deduction limits for private foundations are also lower than those associated with public charities.

PETROCELLI
FINANCIAL SERVICES LLC

Petrocelli Financial Services LLC

Robert Petrocelli

Phone: (212) 261-9530
Fax: (212) 261-9529
Email: rpetrocelli@ft.newyorklife.com

Website: http://www.RobertPetrocelli.com

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