**Special Considerations for Private Foundation Investment Accounts**

By Jeffrey D. Haskell, JD, LLM

High-net-worth individuals have three choices when it comes to their estates: heirs, charity, or taxes. Naturally, everyone wants to avoid the last option. And after making financial arrangements for their families, many wealthy individuals reach a point where they want to make a difference to the causes they care about.

Increasingly, private wealth managers are helping clients achieve philanthropic objectives by including private charitable foundations in the portfolio of services they offer, an arrangement that benefits clients and advisors.

This article will help you understand some of the basic regulations that apply to private foundations and the investment of their endowments. It is not intended as investment, legal, or tax advice.

**Client Benefits of a Private Foundation**

For more than 100 years, the private foundation has been the giving vehicle of choice for prominent families in the United States. It provides unique and powerful benefits not available through other planned-giving vehicles. And today, a welcome transformation has taken place. Advanced technology and professional foundation administration firms have dramatically reduced both the cost and the complication of operating a private foundation. Whereas the old rule of thumb held that you needed $2 million to $3 million for a private foundation to make sense, it now is reasonable to start a foundation with significantly less than $1 million. In fact, when using a professional administrative services firm, the cost of running a $500,000 to $750,000 private foundation is about the same as what many community foundations charge for a similarly sized donor-advised fund.

In addition to the philanthropic benefits, private foundations provide donors and their families with many other powerful benefits.

**Tax benefits.** Clients get a tax deduction now for donations that are made in the future, up to 30 percent of adjusted gross income (AGI) for contributions of cash and up to 20 percent of AGI for appreciated securities and other assets, with a five-year carry-forward. In our experience, clients rarely reach these limits. Highly appreciated public securities (held longer than one year) can be donated at current value without triggering capital gains taxes. Clients should consult with tax advisors regarding specific situations.

**Legacy benefits.** Many founders use private foundations to establish a special link with their children and grandchildren, discovering shared values that instill a philanthropic mindset that binds the family together for generations to come. Involvement with the family foundation also can be used to pass on financial lessons in budgeting and investing.

**Control benefits.** With a private foundation, clients retain the most control of any planned-giving vehicle. This includes governance as well as the types of assets that can be contributed to the foundation, which can include restricted stock, land, hedge funds, art, jewelry, and other tangible assets, subject to restrictions.

**Giving benefits.** Clients retain full control over granting decisions made by the foundation. They also have much greater flexibility as to the types of grantmaking in which they may engage. They can provide medical emergency, hardship, and distress grants directly to individuals; and scholarships, international grants, low-interest loans, and other types of charitably motivated investments (known as program-related investments), which can include micro-financing and guaranteeing charitable loans to entities that might not otherwise be able to get financing.

**Foundation Governance**

Most private foundations are funded and governed by individual families, with family members acting as both directors (responsible for setting the direction of the foundation and overseeing management and operation) and officers (responsible for day-to-day activities and implementing the board's policies). The foundation's charter documents should define the specific duties and responsibilities of board members and officers as well as who is eligible to serve and how they are elected.

In substance and spirit, even the small, family-controlled board needs to be familiar with its duties of care and loyalty: that the interests of the foundation outweigh personal interests and that directors and officers act in good faith and use reasonable business judgment. They should develop and adopt written policies in the following areas:

- A conflict of interest policy that identifies when professional or personal interests compete, as well as sets of rules for managing potential conflicts, i.e., when to disclose, when to abstain from voting, and so on.
- An investment policy.
- A travel and expense policy that describes the types of expenses.
considered reasonable and necessary for accomplishing the foundation’s charitable mission.

- A document retention policy specifying how long to retain documents and records, especially those related to grantmaking and board decision-making.

The board should consider adopting a succession plan. Because the foundation initially may have only one director, a succession plan allows the donor to clearly direct future governance by family members or others. Otherwise, governance of the foundation could end up in court.

Finally, hold board meetings at least annually—or as required by regulations in the state where the foundation was formed. Use the meeting to review the foundation’s grantmaking activity (especially as compared to the targeted mission and any budgets), investment strategy, and performance. Keep written minutes of all meetings.

Operations and Administration

Like any organization, a foundation must set up accounting, bookkeeping, and recordkeeping systems. Solid financial controls provide the basis for accurate and complete tax returns, efficient operations, compliance with Internal Revenue Service (IRS) and self-imposed guidelines, and minimizing taxes.

- The foundation should maintain records of its charter documents, its governing instruments and policies, its application for recognition of exemption and IRS determination letter, its past tax returns, legal agreements in force, and other significant correspondence.
- The foundation should monitor for satisfaction of the annual five-percent minimum distribution requirement.
- The foundation should maintain a list of substantial contributors (who are automatically categorized as insiders) along with records of all contributions made to the foundation. Note that all foundation transactions with insiders are tightly regulated by the IRS, so knowing exactly who they are helps the foundation avoid self-dealing violations.
- For tax returns and estimated tax calculations, the foundation needs to maintain accurate records of the cost basis (usually the donor’s cost basis) and fair market value of securities and other assets on the dates they were contributed to the foundation.
- The foundation should prepare and file its annual return with the IRS and keep current with all state filings, which vary from state to state.
- Each January, the foundation should provide tax receipts to donors for contributions that exceed $250.
- Finally, if the foundation’s excise tax is estimated to be in excess of $500, the foundation should make quarterly estimated excise tax payments, ideally using a method of calculation that will shield the foundation from underpayment penalties.

Involving Family Members

A common reason families start private foundations is to involve subsequent generations as a means of passing along core values. Here are a few ideas for getting kids and grandkids involved in philanthropy at age-appropriate levels.

- Children as young as three or four can learn the value of doing good works. This is the age when children develop a sense of empathy and awareness of other people’s feelings. Parents should model philanthropic behavior for their children to reinforce the notion that “this is what our family does.” Read books about giving with your children. Encourage your kids to draw pictures about how they would make the world a better place.
- For children ages 7–12, start with areas that interest them personally, then discuss how to share these things with others. Engage in volunteer projects that involve the entire family, such as a walk-a-thon. Create family rituals, such as volunteering at a soup kitchen on Thanksgiving. Include the children in your grantmaking decisions, so they can understand the personal connections, such as giving money to a hospital that took care of Grandma. Encourage children to set aside a portion of their own funds for helping others.
- For teen-agers, you can create a junior foundation board that has its own projects, site visits, and meetings. Some junior boards are given their own funds and allowed to develop and define their own missions.
- For children who are college-age and young professionals, the training process for becoming adult members of the foundation should begin with a gradual increase in responsibilities. Some families invite the next generation to join the foundation board at a certain age. Others wait until a particular milestone has been achieved, such as attending a specified number of board meetings or volunteering for a certain number of hours. Some families use “apprenticeships” that pair young people with experienced board members as mentors. Finally, organizations such as The Council on Foundations provide formal training.

Benefits to the Private Wealth Manager

Private foundations create stable, long-term pools of assets that typically survive the client. They enable advisors to realize the promise of “doing well by doing good.”

- Private foundations often are funded from multiple sources, bringing in assets previously managed elsewhere.
- Foundation assets tend to grow over time through appreciation and additional contributions. The Boston College Center on Wealth and Philanthropy has estimated that the coming intergenerational transfer of wealth will result in $41 trillion changing hands. Much of
this is in real estate and other illiquid assets, and advisors will want to be at the table when these transfers are discussed.

- Discussions about philanthropy help you develop deeper relationships with your clients.
- Foundations provide a way for families as well as advisors to involve children and grandchildren in family wealth management.
- The ability to help clients with their philanthropy provides a differentiator in the marketplace. Clients think more highly of advisors when the services go beyond their expectations.

The balance of this article will help you understand some basic rules that apply to private foundation investment accounts and operations.

**Investment Accounts**

Private foundations have tremendous control and discretion over the investment of their assets. They are free to invest in a broad range of investment vehicles—including publicly traded securities, private stock, real estate, artwork, or other tangible assets—with few restrictions as long as they exercise fiduciary stewardship and accountability as a prudent investor. However, as investments move beyond publicly traded securities, rules do become more complex.

Because a foundation holds funds in public trust, it is prudent for the foundation to adopt an investment policy that places a reasonably high priority on protecting principal and earning enough income, with sufficient liquidity, for the foundation to carry out its mission and meet the annual 5-percent distribution requirement. The IRS requires that a foundation extend beyond the realm of cash, stocks, bonds, and mutual funds into limited partnerships, hedge funds, real estate, and other alternative assets, the foundation should consult with an advisor who has expertise in the pertinent sections of the Internal Revenue Code and Treasury Regulations, so as to avoid unfavorable tax treatment and potential violations. It is recognized that IRS rules in this area are somewhat antiquated and that alternative assets often are included in today’s foundation investment accounts. Investments that generate unrelated business taxable income (UBTI) also can be problematic and give rise to an unexpectedly heavy income tax liability.

Many larger foundations now are expanding into “mission-related investing” by investing in areas that further the foundation’s charitable mission, such as in community development or alternative energy. They may also engage in program-related investments—loans, loan guarantees, and other investments for charitable purposes—that count toward satisfying the foundation’s annual minimum distribution requirement.

**Grant Eligibility**

Most foundations exercise their philanthropy by making grants to U.S. public charities in good standing, as recognized by the IRS. This includes religious, educational, scientific, and cultural institutions; poverty relief agencies; or any other organization that qualifies as a 501(c)(3) public charity.

When private foundations are willing to follow additional—albeit often complicated—regulations, they can make grants to individuals for scholarships and awards, and to provide relief in times of economic hardship, medical distress, or natural disaster. They also can grant to international organizations and for-profit entities (for specific charitable projects) that help the foundation carry out its mission. These advanced granting activities require extensive familiarity with the Internal Revenue Code and qualified assistance from an attorney or foundation management firm.

Foundations are not allowed to make grants to political campaigns or to influence legislation.

**Excise Taxes**

While private foundations are exempt from income and estate taxes, they must pay a 1–2-percent excise tax on investment income (interest, dividends, rent, royalties, etc.) and realized capital gains. Working with a professional foundation administrator or CPA experienced in this area, the foundation should plan activities to reduce its excise tax rate from 2 percent to 1 percent in years when it realizes significant investment income, such as from large capital gains.

**5-Percent Distribution Rule**

The IRS requires that private foundations pay out at least 5 percent of their average net assets from the preceding year for charitable or administrative purposes that are reasonable and necessary. (New foundations have no payout requirement in the year they are established.) Salaries, operating expenses, and certain other costs incurred to manage the foundation generally count toward that figure, but expenses of investment management do not.

*Continued on page 31*
Common Compliance Issues

Excess business holdings. Generally, private foundations that own more than 2 percent of a family (or other closely held) business or property are subject to additional rules. Combined ownership by the foundation and its insiders must be carefully tracked by professionals to ensure that penalties do not apply. Generally, foundations, collectively with their insiders, may not own more than 20 percent of an active business.

Self dealing. The IRS strictly prohibits self-dealing. Donors, their lineal descendants, and ancestors (e.g., parents, grandparents, children, and grandchildren) and their spouses may not engage in financial transactions with the foundation, except to make donations to it, or, under limited circumstances, to receive reimbursement for reasonable, ordinary, and necessary expenses incurred in connection with a charitable activity, and reasonable compensation at fair market value for services. Examples of self-dealing include the following:

• purchasing items from or selling items to the foundation, even at a bargain price to the foundation;
• personal use of foundation assets or income, such as retaining foundation assets on personal premises;
• borrowing money from the foundation; and
• leasing or renting property to or from the foundation, even at fair market value.

Salaries. Compensation paid to founders, family members, or other insiders requires strict adherence to detailed IRS rules to establish the reasonableness of the compensation. Best practices for benchmarking compensation would be to research like-sized foundations with like-sized granting budgets in the same geographic area to see what they pay employees with similar experience, similar responsibilities, and similar number of hours worked. Further, the person being compensated and other family members should not be involved in the process, even if that necessitates bringing in an outside person. To avoid potential legal problems the foundation should consult with a professional, knowledgeable advisor.

Conclusion

A private foundation is a powerful wealth management tool benefiting client and advisor alike. While private foundations aren’t for everyone, wealthy individuals who seek an estate and tax planning tool that supports their strategic philanthropic aspirations should consider a private foundation. And for financial planners desiring to get to know their clients on a deeper, more personal level while retaining and increasing assets under management, private foundations offer many advantages.

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