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M E M O R A N D U M

SUBJECT: A PRIVATE FOUNDATION PRIMER

This memorandum will attempt to outline certain reporting and compliance obligations relating to private foundations. You should also review a booklet which you may have received from the Internal Revenue Service entitled "Compliance Guide For 501(c)(3) Private Foundations" (Publication 4221PF) (available at www.irs.gov).

1. IRS Reporting and Filing Requirements
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1. <u>IRS Reporting and Filing Requirements</u>. A Private Foundation is required to file Form 990-PF by the fifth (5th) day of the fifteenth (15^{th}) month after the end of its fiscal year (for calendar year filers, May 15^{th}). Additionally, it may be required to file supplemental forms such as Form 990-T if it had unrelated business income or unrelated debt financed income (as discussed below). A Private Foundation is required to make its Form 990-PF publicly available to requestors. A number of websites (e.g., www.guidestar.org) gather and provide public information on tax exempt organizations, including copies of the Form 990-PF filings. If the organization receives solicitations from unknown parties, it is possible they may have reviewed information on www.guidestar.org or similar sites.

2. <u>State Filings.</u> Most states require that exempt organizations (including private foundations) file an annual report with the Attorney General or Secretary of State. In New York, for example, a Private Foundation is required to file an initial registration form with the New York State Department of Law, Charities Bureau, 120 Broadway, New York, New York on Form CHAR410. Under Section EPTL 8-1.4, a Private Foundation is also required to annually file Form CHAR500 with the Department of Law, and publish a notice in a newspaper of general circulation (as determined by the County Clerk) of the public availability of the report. Other states have similar requirements.

3. Treatment of Contributions. Tax exempt charitable entities are of two types: a public charity having broad based support (e.g. a school, the American Red Cross) or a private foundation, having a much narrower base of support. Subject to other limitations, the following are the general parameters on the amount of contributions that may be deducted each year:

(a) Public Charities:

i. Cash - 50% of donor's adjusted gross income

ii. Appreciated or Capital Gain Property (e.g real estate, securities , life insurance policies held for in excess of 1 year) - 30% of adjusted gross income.

(b) Private Foundations:

i. Cash - 30% of donor's adjusted gross income

ii. Appreciated or Capital Gain Property - 20% of adjusted gross income.

There is a hierarchy as to how donations are allocated if donations are made both to public charities and private foundations. Furthermore, to the extent that any of the 20/30/50% limitations are exceeded in any one year, there is a carryover for up to five years .

An important difference with respect to the treatment of private foundations and public charities is that donations of capital gains property to a "public charity" are valued at the current market value, while contributions of capital gains property to private foundations are deemed contributed at the contributor's cost or other basis (and may have recapture issues). *However, contributions of "qualified appreciated stock" (generally publicly traded securities, including mutual funds) to a private foundation are also deemed contributed at fair market value (See IRS Publication 526).*

The use of a private foundation in connection with estate planning is a valuable tool. With the possible re-enactment of a substantial estate tax and gift regime in 2011, a private foundation can be used as an estate planning tool to provide continuing support for causes that the testator supported during his life. While the estate will receive a charitable deduction, a bequest to a private foundation allows the trustees of the foundation sufficient discretion as to the amount, timing and recipients of such contributions. You may consider revising your estate and gift plans in light of these considerations.

4. Fiduciary Duty. Decisions regarding a private foundation are made by its trustees. A trustee is a fiduciary, and thus subject to the general duties of a fiduciary. The fiduciary duties of trustees are governed by state law, rather than by the Internal Revenue Code. The New York State Attorney General has summarized the duties of a trustee as follows: "The duty of care, the duty of loyalty, and the duty of obedience." These duties, which evolved from the common law, are summarized as follows:

(a) Duty of Care. The duty of care requires a director to be familiar with the organization's finances and activities and to participate regularly in its governance. In carrying out this duty, directors must act in "good faith" using the "degree of diligence, care and skill" which prudent people would use in similar positions and under similar circumstances. (This is sometimes referred to as the so-called "Prudent Man Rule").

(b) Duty of Loyalty. Directors and officers are charged with the duty to act in the interest of the corporation. This duty of loyalty requires that any conflict of interest, real or possible, always be disclosed in advance of joining a board and when they arise. Board members should avoid transactions in which they or their family members benefit personally. If such transactions are unavoidable, they should be disclosed fully and completely to the board prior to the board voting to authorize the transaction.

(c) Duty of Obedience. A board has a duly of obedience to insure that the organization complies with applicable laws and regulations and its internal governance documents and policies.

Recent events have focused the need for private foundation trustees to do due diligence and constant follow-up regarding a Foundation's investments. In addition, fiduciary duty requires that a Foundation with a large endowment to diversify its portfolio.

5. Grant Making. The Internal Revenue Service suggests that a Private Foundation should have procedures in place to evaluate and assure the grants it makes comport with its purposes. Grant making procedures can be as simple as a brief written application. Larger foundations employ staff to review and report on grant proposals to the Board of Trustees. In any event, all grants should be supported by a written record of approval by the Trustees. Donations to a Private Foundation should be supported by written receipts.

6. Special Private Foundation Rules. There are special rules of the Internal Revenue Code that affect the operation of private foundations (as distinguished from public charities):

(a) Excise Tax. A tax, now set at 2 percent, must be estimated and paid quarterly in advance on the net investment income of a private foundation. "Net investment income" includes dividends, interest, and capital gains less the foundation's expenses related directly to the production of such income. The excise tax may be reduced to one percent if charitable distributions for the year equal or exceed the average of the previous five years' payout percent plus

one percent of net investment income. In effect, the one percent tax saving must be added to the required payout for the current year, but is not considered a part of that year's total payout when figuring the next five-year average.

(b) Self-Dealing. Transactions between a private foundation and its "disqualified persons" are called self-dealing. "Disqualified persons" include trustees and foundation managers; substantial contributors[1]; owners of more than 20 percent of a corporation, trust, or partnership that is a substantial contributor to the foundation; and the family members of any of these persons. The foundation is also forbidden to deal with a corporation, trust, or partnership in which any disqualified person holds an interest of 35 percent or more. Certain government officials are also considered disqualified persons.

Acts of self-dealing that are specifically prohibited include:

A private foundation and a disqualified person may not engage in any direct or indirect sale, exchange, or leasing of property, regardless of how competitive the price. A lease between a foundation and a disqualified person under which the foundation pays rent (even at below market rates) is generally not allowed. On the other hand, if the foundation merely pays the cost for direct services (e.g. cleaning, telephone, etc.) the transaction would be allowable.

A private foundation may not lend money or extend any other form of credit to a disqualified person. However, a disqualified person may lend money to a foundation, although there must be no interest or other charge, so long as the proceeds are used strictly for charitable purposes.

A disqualified person may be paid only for limited personal services provided and for expenses incurred in carrying out the exempt purposes of the private foundation. The total amount of compensation and reimbursement for expenses must be reasonable.

NOTE: We suggest that counsel should be consulted in advance with regard to any transactions that may raise self-dealing concerns.

[1] A "Substantial Contributor" is a person whose aggregate gifts are more than $5,000 and exceed 2% of the total contributions received by the foundation from its inception.

(c) Payout Requirements. A private foundation must distribute for its charitable purpose an amount equal to its "minimum investment return." The minimum investment return is defined by law as 5 percent of the average fair market value of all the foundation's assets, as determined by periodic appraisal. Failure to make charitable distributions at the required level will result in tax liability.

(d) Limit on Stock Holding. A private foundation may not hold more than 20 percent of the voting shares of any corporation, public or private. This limitation was imposed because of past abuses that involved using foundations to hold large blocks of stock in family-run corporations in "friendly hands."

(e) Speculative Investments. A private foundation may not invest in a manner that jeopardizes the security of its principal. The Internal Revenue Service pays special attention to foundation investments in highly speculative securities or futures. Foundations that invest according to generally accepted and prudent practices experience no difficulty in complying with this requirement.

The Code provides financial and other sanctions in the event of prohibited transactions and a penalty personally assessed upon the Foundation's managers.

7. Unrelated Business Income and Unrelated Debt Financing. As a matter of fairness, Private Foundations should not take advantage of their status as an entity exempt from the payment of taxes. Accordingly, the Internal Revenue Code and regulations contain provisions governing "Unrelated Business Income" and "Unrelated Debt Financing". The key operative phrase is "unrelated." If the Foundation is engaged in managing a school, most activities relating to running of the school are not deemed "unrelated." (A famous example; the New York University Law School owned a major pasta manufacturer; the income from this activity was held to be totally unrelated and therefore was taxable). While rental income from real property is generally not deemed as "unrelated", the acquisition - with mortgage financing - of income producing property not used in the organization's activities, may generate unrelated debt financed income. Detailed rules are beyond the purview of this memorandum.

There are resources for further information available on the Web. A helpful book, "Rules of the Road: A Guide to the Law of Charities in the United States" is available for $29.00 from:

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If you have any questions regarding the matters discussed in this memorandum, please feel free to contact our office.

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