SIMPSON THACHER

FORMING AND OPERATING A PRIVATE FOUNDATION

SIMPSON THACHER & BARTLETT LLP

FEBRUARY 7, 2001

TABLE OF CONTENTS

Page

I. Choosing a private foundation 1

II. Forming a private foundation 1

A. Choosing the legal form 1
B. Defining the foundation's charitable purposes 2
C. Applying for tax exemptions 2
D. Classification as a private foundation 3
E. State registrations 4

III. Contributing to a private foundation 4

IV. Operating the foundation 5

A. The private foundation excise taxes 5
B. Unrelated business income tax 7
C. Hiring professional management and advisors 7
D. Developing grantmaking procedures 7
E. Considering an advisory board 7
F. Governance 7
G. Campaign intervention 8
H. Compensation and other expenses 8
I. Buying insurance 8
J. Employment issues 8
K. Annual filings 8
L. Inspection requirements 9

V. Terminating a private foundation 9

This memorandum outlines the advantages and disadvantages, legal steps and business issues in forming, contributing to and operating a private foundation.

I. CHOOSING A PRIVATE FOUNDATION.

The main advantage of a private foundation over a public charity is that the donor, together with family or friends whom the donor selects, can control and directly carry out the foundation's activities. Private foundations are the free agents of the charitable world, not answerable to large public memberships or required continuously to raise funds. Foundations generally have smaller staffs and lower operating costs than public charities.

The main disadvantage of a private foundation is that federal tax law subjects private foundations to the excise-tax system discussed below at Section IV, including an annual excise tax at the rate of 2% on net investment income.

Another disadvantage is that deductions for contributions to a private foundation may be subject to certain limitations that are less favorable than the limitations applicable to public charities (*see* Section III below). These laws are intended to prevent private foundations from abusing their greater flexibility.

II. FORMING A PRIVATE FOUNDATION.

A. *Choosing the legal form*

Forming a private foundation requires action at both the state and federal levels. First, a not-for-profit entity must be formed under state law. Second, the entity must apply to the Internal Revenue Service ("IRS") for recognition of its tax-exempt status and for classification as a particular kind of foundation.

Foundations are usually formed as either a trust or a corporation. A corporation's chief advantage is that it provides somewhat greater protection from liability for the organization's directors and officers because their decisions will be evaluated under the business judgment rule rather than more stringent fiduciary standards. In addition, change of management is less cumbersome in a corporation because the rules for changing directors are generally simpler than the rules applicable to successor trustees. Moreover, most potential directors will be more comfortable with the corporate than with the trust form and, therefore, more willing to serve as a director of a corporation rather than trustee of a trust. For these reasons, we encourage new charities to use the corporate form.

A not-for-profit corporation cannot issue stock or have shareholders. A corporation can either have a self-perpetuating board or have a board elected by members (the not-for-profit equivalent of shareholders). While a non-member corporation is simpler to operate, membership can give the founder and the founder's successor members control to appoint and

remove directors. A corporation may hold its annual meeting in person, by phone, or the members (if any) and directors may act by unanimous written consent in lieu of a meeting.

The trust's chief advantage has traditionally been that it can be formed in a few hours without involvement of state officials. This advantage is less meaningful now that a not-for-profit corporation can be formed in Delaware immediately upon the facsimile filing of the required documents.

Not-for-profit incorporation procedures vary from state to state. New York State may require incorporators to obtain government consents or waivers in advance of incorporation. As a result, not-for-profit incorporation in New York State generally takes two days if no consents or waivers are required but three to six weeks if they are. Consents or waivers are generally not required for a grantmaking private foundation.

There may also be nonlegal reasons for forming a foundation in a particular state. For example, a foundation formed to aid New York charities may wish to show support for the state by making grants through a New York corporation.

B. *Defining the foundation's charitable purposes*

In its certificate of incorporation, the foundation must define its purposes broadly enough to permit adjustment of its mission over time but narrowly enough to satisfy federal exemption and foundation rules. A foundation's certificate generally recites all charitable purposes described in the federal tax law, as well as the ability to make grants in furtherance of those purposes. The IRS requires purposes that are exclusively religious, charitable (e.g., relief of the poor and needy), scientific, testing for public safety, literary, educational, fostering certain amateur sports, and preventing cruelty to children or animals. These are the so-called "501(c)(3)" purposes, which refers to the Internal Revenue Code provision where they are found. That provision authorizes organizations with these purposes to be exempt from federal income taxation.

C. *Applying for tax exemptions*

A foundation must apply for recognition of its exemption from federal income taxation by filing an application with the IRS. If the foundation files within twenty-seven months of incorporation, the IRS will grant exemption retroactive to the date of incorporation if no material changes are required. The IRS generally takes four months after the application is filed to issue the exemption letter or to ask supplemental questions. During this time, the foundation is free to conduct its regular activities. Some foundations may also qualify for exemption from certain federal excise taxes and for special postal rates.

In addition, a foundation can apply for exemptions from state and local franchise taxes, real property taxes, rent taxes and sales taxes.

D. *Classification as a private foundation*

Confusion exists about what it means for an organization to be a foundation. As a practical matter, any not-for-profit organization, even a public charity, may use the word "foundation" in its name. Federal tax law, however, classifies as "private foundations" only those organizations that typically have three features: 1) a single major source of funding—usually gifts from one family or corporation, rather than funding from the general public, 2) a grant award program instead of direct operation of charitable programs, and 3) payment of grants and administrative expenses from the endowment rather than from the proceeds of a fundraising program.

If an organization intends to have many sources of funding and an on-going fundraising program, it should consider seeking classification as a "public charity" rather than a private foundation. If an organization intends to support one or more identified public charities, it should consider seeking classification as a "supporting organization."[1]

In practice, private foundations generally fall into five categories:

(1) *Endowed private foundations*. This is the most familiar type of private foundation and is usually funded by an individual or a family or a company.

(2) *Unendowed private foundations*. This type of foundation has little or no endowment and usually receives its funding annually from its funder. Company foundations may fall in this category.

(3) *Pass-through or "conduit" foundations*. This type of foundation is a short-term holding tank for certain charitable contributions. The donor's contribution (and any income earned on it) must be passed-through within two and one-half months after the close of the year in which the contribution was made. A donor to a pass-through foundation is entitled to the more advantageous deduction limitations (*see* Section III below).

(4) *Pooled common funds*. The donor and the donor's spouse may retain the right annually to designate the recipients of income earned from the donor's prior contributions. The recipients must be public charities. At the end of the donor's or surviving spouse's life the corpus goes to a charity that they have designated. A donor to a pooled common fund is entitled to the more advantageous deduction limitations (*see* Section III below).

(5) *Operating foundations*. A private operating foundation is a private foundation that behaves like a public charity in that it runs its own charitable activities (*e.g.*,

[1] The rules governing public charities and supporting organizations are beyond the scope of this outline. For further information about these options, please contact Ms. Bjorklund.

a museum, library, or historic building) instead of making grants for charitable activities conducted by other organizations. A private operating foundation's donors are entitled to the more advantageous deduction limitations (*see* Section III below).

E. ***State registrations***

A foundation's "home state" will generally require foundations to register with the state's charities bureau. Thirty-eight states also require registration if the foundation will be soliciting contributions from the public. In New York State, oversight and registration are housed in the Attorney General's Department of Law Charities Bureau. A foundation must qualify to do business in any state where it intends to have an office. If the foundation desires to become a service provider, it must obtain licenses from the departments of health, education or social services in the states where the services will be provided. A foundation should also consider obtaining trademark protection for its name, domain protection for its web address, and copyright protection for its publications.

III. CONTRIBUTING TO A PRIVATE FOUNDATION.

There are three income tax differences for the donor who gives to an organization classified as a private foundation rather than as a public charity: treatment of gifts of cash, treatment of gifts of appreciated property, and treatment of gifts of certain appreciated stock.[2] First, an individual who donates cash generally is limited to deducting as a charitable contribution in any year an amount equal to no more than 50% of the donor's adjusted gross income. This 50% limitation applies to cash gifts to public charities and to the three types of private foundations identified above at Section II D 3, 4 and 5. Cash gifts to the other types of private foundations can be deducted up to 30%. Second, the deduction limitations on gifts of appreciated property are 30% for gifts to public charities and to the three types of private foundations identified above, but 20% for gifts to other private foundations. If in any year the donor's giving exceeds either of these limitations, the excess can be carried forward for the next five years. Gifts of appreciated property can generally be deducted only in an amount equal to the donor's basis, not fair market value (except gifts to the three types of private foundations identified above).

Third, gifts of certain appreciated stock qualify for an exception to the basis-only rule for deduction of gifts of appreciated property. Specifically, the donor may deduct the full fair market value of the appreciated stock if the gift is of publicly traded stock which is long-term capital gain property, and the amount of the publicly traded stock given (including gifts by family members) does not exceed 10% ownership in any company.

---

[2] The estate tax rules do not contain the same limitations.

IV. OPERATING THE FOUNDATION.

A. *The private foundation excise taxes*

Except for the 2% tax on net investment income, the private foundation excise taxes discussed below are avoidable. Nevertheless, they cannot be ignored because they set the boundaries for all foundation operations. And, if incurred, these penalty taxes can be substantial and can be imposed on both the foundation and its managers.

The donor generally will be deemed to be a substantial contributor to the foundation. Therefore, the donor's dealings with the foundation will come under special scrutiny, as will those of other "disqualified persons." In the case of a donor who is an individual, disqualified persons include the donor's relatives (except siblings) and any corporation, trust, or partnership in which the donor directly or indirectly owns more than a 35% interest. Foundation managers (directors, officers, influential employees) and government officials are also disqualified persons subject to special scrutiny and penalties.

Benefits to the donor or to any other disqualified person that are more than incidental and tenuous can trigger excise taxes. A benefit the IRS has held to be more than incidental and tenuous is displaying a foundation's art collection in the donor's home. Similarly, a foundation generally cannot buy, sell, or lease anything from a disqualified person without penalty. If a disqualified person directly or indirectly leases office space to the foundation, the space must be leased rent-free, or else both the disqualified person and the foundation can be subject to excise taxes. Naming the foundation after the donor is permissible, however, and does not trigger excise taxes.

The specific excise taxes are:

(1) *Excise tax on investment income*. A private foundation is subject to a 2% tax on its net investment income. This is the only excise tax that is not avoidable. If the foundation donates a sufficient amount to qualified charities in a given year, it may be entitled to a rate reduction to 1% for that year.

(2) *Excise tax on self-dealing*. Subject to certain exceptions, a private foundation cannot engage in any prohibited transactions with any disqualified person. Prohibited transactions include, but are not limited to, selling or leasing property, loaning assets, and furnishing goods, services, or use of the foundation's facilities. An exception permits payment of reasonable compensation to a disqualified person only if (a) the compensation is for personal services actually rendered to the foundation and (b) the services are reasonable and necessary to the accomplishment of the foundation's exempt purposes. Whether compensation is reasonable in amount is generally determined by reference to compensation paid to persons of like title and credentials in foundations of like size. Comparability information is published

annually by the Council on Foundations and others. The self-dealing excise tax is levied on the disqualified person, not the foundation.

(3) *Excise tax on failure to distribute income*. By the end of each fiscal year, a private foundation must make qualifying distributions in an amount equal to or greater than 5% of the aggregate fair market value of the foundation's assets that are not used directly to carry out the foundation's exempt purposes. Generally, grants to other private foundations do not count as qualifying distributions. The distributable amount for the next year is computed and reported annually to the IRS and the public on the foundation's information return on IRS Form 990–PF.

(4) *Excise tax on excess business holdings*. A private foundation may own the stock and securities of a business enterprise only up to a permitted level, which is generally 20% of a corporation's voting stock less the amount of voting stock owned by the foundation's disqualified persons and their families. Similar rules apply to ownership of other business interests. If an entity derives at least 95 percent of its gross income from passive sources, *e.g.*, dividends and capital gains, it will not be a "business enterprise" for purposes of this provision and ownership limitations will not apply.

(5) *Excise tax on jeopardy investments*. A private foundation cannot invest its funds in ways that could jeopardize the foundation's ability to carry out its charitable purposes. Certain types of investments are subject to greater scrutiny, including trading in securities on margin, commodity futures, working interests in oil and gas wells, puts, calls, straddles, warrants, and selling short. An exception for program-related investments ("PRIs") permits certain charitable investments without penalty.

(6) *Excise tax on taxable expenditures*. A private foundation cannot make taxable expenditures. The term "taxable expenditures" includes payments for political campaigns and lobbying, and certain grants to individuals and to other private foundations or to non-U.S. charities. The law does contain an exception permitting distributions to another private foundation or to a non–U.S. charity but only if the distributing foundation monitors the grant. This monitoring process has four steps and is called "performing expenditure responsibility." If the private foundation intends to make certain grants to individuals (*e.g.*, scholarships, travel stipends, writing allowances), advance written approval of the selection procedures must be obtained from the IRS or the grants will be subject to tax. Initial grants to individuals and to organizations that are not U.S. public charities should be reviewed with counsel to make sure that they will be free from penalty taxes.

B. ***Unrelated business income tax***

Like other organizations otherwise exempt from federal income tax, a private foundation is liable for the unrelated business income tax ("UBIT") on its unrelated business taxable income ("UBTI"). A private foundation risks its tax exemption if it earns too much UBTI. Income in the form of dividends, interest, royalties, certain rents, and capital gains generally will be excluded from the computation of UBTI as long as that income is not earned from debt-financed property.

C. ***Hiring professional management and advisors***

A foundation may wish to hire staff or consultants to administer the foundation's programs and operations. The directors usually delegate day-to-day management to an executive committee or an executive director. A small foundation that makes grants only once or twice a year may choose to operate without staff or consultants. The directors will also want to identify and hire as needed legal advisors, accountants, auditors, and investment and insurance advisors.

D. ***Developing grantmaking procedures***

Every private foundation should develop grantmaking procedures to prevent federal excise-tax problems. For example, those procedures could address foreign grants, grants to individuals, program-related investments, and recordkeeping. Further, the persons handling grantmaking must keep records showing the name of each grantee, its address, the exempt purpose of the grant, and the grantee's tax classification (public charity, private foundation, or other). Grants to grantees other than U.S. public charities require performance of expenditure responsibility, IRS pre-approval, or other special documentation. Any new high-profile foundation will likely be inundated by grant requests as soon as its annual information return is available to the public (*see* www.Guidestar.org). Therefore, the directors and staff may desire quickly to develop and publicize application and funding guidelines. Some foundations choose to post this information on a website.

E. ***Considering an advisory board***

The directors may wish to form an advisory board to advise them on grantmaking matters. An advisory board lacks authority to govern the foundation or to bind it in legal or financial matters. Two alternatives to an advisory board are to consult informally with outside experts or to retain advisors as consultants.

F. ***Governance***

The directors may wish to adopt policies on conflicts of interest, meeting attendance, reimbursement of expenses or other matters.

G. ***Campaign intervention***

A foundation is not permitted to endorse candidates in any (even local) elections or otherwise intervene or participate in any campaign for public office.

H. ***Compensation and other expenses***

No part of the net earnings of an exempt organization may inure to the benefit of any individual. Inurement can cause an organization to lose its tax exemption. As a practical matter, the tax law recognizes that payments for a charitable purpose may also inure to the benefit of an individual. Thus, rules have evolved so that a foundation may pay reasonable compensation for personal services rendered by employees, consultants and others.

Directors of charitable organizations generally serve without compensation. However, charitable organizations often pay the premiums for directors' and officers' liability insurance and reimburse directors and officers for reasonable out-of-pocket expenses.

Federal law requires that the salaries and benefits of the foundation's highest-paid employees and all directors and officers be available to the public on the foundation's annual information return. Journalists are increasingly interested in obtaining and publishing these figures.

I. ***Buying insurance***

Foundations generally purchase general liability and property insurance if they have employees and maintain a separate office. Many also purchase liability insurance for directors and officers. While directors and officers are generally protected by state laws so long as they do not breach their duties of care and loyalty to the foundation, insurance can cover legal expenses directors may incur in proving that a plaintiff has no right to sue or has an invalid claim against them.

J. ***Employment issues***

A foundation must obtain an employer identification number ("EIN") from the IRS even if it has no employees. Like any other employer, a foundation must comply with federal, state and local employment laws. These include withholding federal and state income tax from wages and making the necessary contributions for FICA, FUTA and state unemployment insurance, as well as statutory disability and workers' compensation payments. The foundation will also have to consider providing its employees with medical, life and other insurance and benefits such as pension contributions.

K. ***Annual filings***

A foundation must make quarterly estimated payments on its 2% net investment tax liability and must file an annual federal information return or IRS Form 990-PF. Penalties may

apply if any return is not timely filed. Federal and state laws may require that a private foundation file its annual return or state forms with officials of (i) each state in which the foundation reports in any fashion concerning its organization, assets, or activities, or in which the organization has registered as a charitable organization to solicit contributions from the public, or as a holder of charitable assets; (ii) the state in which its principal office is located; and (iii) the state in which it was incorporated. In addition, if a foundation has UBTI, it may have to file a federal tax return on IRS Form 990-T and a state tax return, and pay estimated tax on the income. These filing obligations should be reviewed with the foundation's accountants.

L. *Inspection requirements*

A private foundation is required to make available at its office or an agent's office or send copies (where costs are prepaid) to anyone requesting the foundation's annual information return on IRS Form 990-PF or the foundation's application for exemption on IRS Form 1023. In the alternative, the foundation may satisfy its disclosure obligations by posting these forms on its own or another's website.

V. TERMINATING A PRIVATE FOUNDATION.

If the directors of a private foundation wish to terminate the organization's private foundation status or make a grant of 25% or more of the foundation's assets, they must follow federal tax laws or risk incurring a termination penalty tax. Directors should consult counsel before approving a termination procedure, including a pourover of assets or liquidation. In addition, several states, including New York State but not Delaware, require Attorney General pre-approval of disposition of 51% or more of the foundation's assets or the foundation's dissolution.

* * *

This outline necessarily summarizes the laws governing foundations. The actual laws and regulations are, of course, much more complex. Please direct questions about this summary or about any foundation matter to Victoria Bjorklund at (212) 455-2875, David A. Shevlin at (212) 455-3682, Jennifer I. Goldberg at (212) 455-2287, or any other attorney in the firm's Exempt Organizations Department.

SIMPSON THACHER & BARTLETT LLP