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Running Your Own Charity: Legal Basics of Private Foundations

Private foundations are exempt from federal income taxes but regulated more heavily than other charities, largely through the federal tax system. Various provisions of the Internal Revenue Code (the "Code") require foundations to:

- avoid transactions with their donors or parties related to their donors
- distribute or use a minimum amount of their assets regularly for their charitable purposes
- make distributions only to defined classes of beneficiaries divest themselves of large holdings in any one
- business
- avoid inappropriately risky investments
- pay an excise tax of 1 or 2 percent on their investment income
- make their tax documents available for public inspection

Private foundations, like all other charities, must acknowledge contributions in writing to allow their donors to claim charitable deductions for income tax purposes.

It helps to understand the rationale behind the rules.

- The Tax Reform Act of 1969 put the private foundation rules into place based on a concern that charities funded by one donor or one family presented generous opportunities for tax abuse.
- The IRS nightmare scenario: Donors transfer one-third of the stock in their thriving family business to their newly formed foundation. They claim a charitable contribution deduction for the gift for income tax purposes. They continue to control the stock as officers and directors of the foundation but make few distributions for charitable purposes. They and their children all serve as employees of the foundation, which pays them high salaries for their work. In case it ever becomes inconvenient to have stock in the hands of the foundation rather than the family, the other stockholders have the right to buy the stock from the foundation at a low price fixed in a buy-sell agreement.
- Although most foundation managers would never consider abusive transactions, the Code seeks to prevent through rigid private foundation rules even the possibility of situations like the one described above.
- Foundations created by corporations are subject to the same rules, although the likelihood of tax abuse connected with corporate giving may be significantly lower. In the case of foundations created by individuals, the concern the private foundation rules?try to prevent is subsidizing private transactions?--?which may be perfectly cceptable in other

contexts?-- with a charitable contribution income tax deduction to the foundation's donor. For a corporation, expenditures that run through a foundation might be deductible as business expenses or charitable contributions.