Private foundations aren’t only for the rich and famous

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If creating a family legacy of charitable giving is important to you, a private foundation might be the right estate planning vehicle. This option isn’t just for billionaires.

Tax impact

A private foundation is a tax-exempt entity that’s typically structured as a not-for-profit trust or corporation and established to accept charitable contributions. It’s private because it doesn’t solicit public contributions. One of its primary benefits is that it allows you to control your giving. As a member of the foundation’s board of directors, you manage the foundation’s assets and direct grants to charities.

Contributions to a private foundation are deductible for federal income tax purposes. You can deduct cash contributions to a nonoperating foundation (the most common type) up to 30% of your adjusted gross income ("AGI"). For noncash contributions, the limit typically is 20% of AGI. The deduction for any contribution in excess of AGI limits may be carried forward and used for up to five years.

Know the drawbacks

Creating a foundation can be costly — between $5,000 and $10,000. Annual administrative costs can be high, too, depending on factors such as the size of the foundation and whether you plan to hire staff to operate it.

In addition, private foundations are highly regulated. For example, though tax exempt, a foundation’s net investment income is subject to an excise tax of 1% if all required distributions to charity have been made; otherwise 2%. Foundations that fail to make qualified distributions of at least 5% of their net assets each year must pay a 15% excise tax on the shortfall.

The biggest risk for private foundations, however, is the prohibition against self-dealing. This forbids transactions between a foundation and “disqualified persons,” such as the founder and members of his or her family. The reason: because the founder and family members control the foundation but receive income tax charitable deductions, the rule is designed to prevent the foundation from being used as a "personal piggy-bank" where funds can be diverted for non-charitable uses. The self-dealing rule dissuades such temptation through imposition of severe excise taxes.

The self-dealing rule is tricky because a person can violate it unknowingly and despite the best intentions. A violation can result in significant penalties and even the loss of the foundation’s tax-exempt status.

Weigh the costs

Although complex rules and regulations govern private foundations, these entities also have their perks. Please contact us for additional details.

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