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Private Foundations

Taking them beyond checkbook philanthropy.

TODAY, WE ARE SEEING more sophisticated inquiries by founders of private foundations in line with the discussions surrounding social impact investing. For many years, high-net-worth individuals have used the same formula to set up private foundations. An individual or married couple — the donors — establish an entity whose assets are to be used for general charitable purposes, qualifying it as a tax-exempt foundation. The donors transfer assets — often appreciated stock — to the foundation. This stock is then sold, allowing the donors to avoid income tax on the gain. The donors retain distribution oversight by serving on the foundation's board. The foundation essentially becomes their philanthropic checkbook.

Tax-exempt organizations must be organized and operated for an exempt purpose. A private foundation is an organization that qualifies for tax-exempt status under Internal Revenue Code ("Code") §501(c)(3) but does not qualify as a public charity under §509(a). The rules and regulations applying to private foundations are much stricter than those that apply to public charities.

Today's donors question why they would want to drain their foundation's funds, which seems to be the policy goal of the 5 percent distribution requirement.

As private foundations, the "checkbook foundations" are subject to various excise tax rules, including Code §4942, which requires private nonoperating foundations to make certain minimum annual distributions for charitable purposes. The amount required to be distributed is measured by a percentage of the private foundation's investment assets. Generally, the annual minimum distributable amount is equal to 5 percent of the aggregate fair market value of all of the foundation's assets, reduced by certain adjustments. Private foundations that fail to meet this requirement are subject to an excise tax on the undistributed income.

Today's donors question why they would want to drain their foundation's funds, which seems to be the policy goal of the 5 percent distribution requirement. What about lending funds to a charitable organization recipient or investing directly in the underlying charitable cause?

Program-related investments (PRIs) have been used for many years. Generally, a private foundation that makes investments jeopardizing its ability to carry out its exempt functions is subject to an excise tax under Code §4944. However, PRIs are an exception to that rule. Under the regulations, an investment qualifies as a PRI if: (a) its primary purpose is to accomplish the foundation's exempt purpose(s); (b) the production of income or appreciation of property is not a significant purpose of the investment; and (c) none of the purposes described in Code §170(c)(2)(D) (i.e., carrying on propaganda or otherwise attempting to influence legislation) are a purpose of the investment.

Examples in the final regulations issued earlier this year illustrate a variety of PRI investment terms and structures, including equity investments, loans, loans with equity components and guarantee arrangements. Smaller foundations take comfort that the big name foundations were using PRIs long before the regulations were final. Since 2009, the Bill & Melinda Gates Foundation has complemented its grants budget with a substantial allocation for PRIs.

Foundations are also pushing the boundaries of permissible investments in the area of mission related investments (MRIs). MRIs are financial investments that further the foundation's exempt purpose. Unlike PRIs, MRIs are included in the foundation's investment assets and are not qualifying distributions for purposes of the 5 percent distribution requirement under Code §4942. In addition, MRIs must satisfy applicable prudent investment standards, although the IRS confirmed in Notice 2015-62 that foundation managers may consider the relationship of a proposed investment to the foundation's charitable purpose when determining whether an investment is prudent.

Careful consideration of the foundation's charitable purpose, investment policy, and proper use of PRIs and MRIs allow today's foundations to take their philanthropy far beyond the checkbook-only days.

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