

Do You Have to be Rich for a Foundation to Make Cents?

A foundation is a not for profit entity established either as a corporation or a trust that is solely for charitable purposes, including educational, religious, scientific and literary purposes. A foundation may, in limited circumstances, benefit individuals directly such as scholarships, but more often they are established to provide resources to other charitable entities that directly benefit individuals.

For a foundation to be recognized as a charitable entity and receive the tax benefits of the same, the foundation must file an application for recognition of exemption and the Internal Revenue Service (IRS) must issue a determination letter to the charity establishing its qualification. The application must set forth the purposes for the entity and establish that the organization was organized for and will operate exclusively for its charitable purpose.

Contributions to a qualified foundation are charitable contributions and the donors are entitled to deductions for the same. There are limits on the amount one can deduct for contributions to any charitable entity. Transfers to public charities, such as religious organizations for example, are subject to a 50% Adjusted Gross Income (AGI) limitation; thus, the donor can deduct no more than 50% of his/her AGI in the year of the contribution. Unused contributions can be carried forward for five years. Contributions to foundations are subject to either a 30% AGI or 20% AGI limitation depending on the kind of property contributed and the type of foundation. The specifics are well beyond the scope of this article.

Types of foundations

There are three types of foundations. Operating foundations conduct charitable activities. Non-operating foundations merely transfer funds to other charitable entities that conduct such activities. Finally, a conduit foundation, as its name suggests, serves as a short term intermediary before the property goes to another qualified charity.

Managing a foundation is a relatively highly restricted area. The complicated rules are designed to prevent one from operating an entity for personal gain and obtaining the favorable tax treatment afforded to foundations. I will not go into detail as to the rules, but generally there are rules;

1. Prohibiting self dealing,
2. Requiring a certain level of distributions annually,
3. Restricting excess business holdings,
4. Restricting investments that jeopardize the entity's charitable purpose, and
5. Restricting expenditures.

Foundations are not subject to income tax; however, they are subject to an excise tax on net investment income at a rate of 2%. This rate can be reduced to 1% if a certain level of distributions is satisfied, which is often the case. A foundation must file an annual income tax return and other documents required to continue to operate as a charitable entity. The maintenance of a foundation becomes routine with experience.

Most often an accountant and/or attorney will be retained to fulfill all of the requirements.

From a practical perspective, foundations are often created as part of a comprehensive estate plan. The foundation is often funded during the lifetime of the creator and the creator serves as a Trustee, if the organization is established as a Trust, or a Director, if the entity is established as a corporation. The creator usually satisfies his/her “usual” charitable contributions from the foundation. In other cases, the foundation funding comes at the death of the creator and family members serve in the managerial roles.

Benefits of foundations

There are a number of benefits to a private foundation both during life and at death. During life, charitable contribution deductions can save substantial income taxes. The property does not leave the hands of the creator of the entity; however, it must be used solely for charitable purposes. Such a foundation can centralize a family’s charitable giving which serves to reduce those annoying phone calls from every school ever attended. They also serve to teach younger family members about money management and charitable giving and provide the opportunity for generations of the family to continue charitable deeds.

From a tax standpoint, in addition to deducting a charitable contribution, other taxes can be avoided. In a recent article, I explained the high compound tax rates that can be applied to qualified retirement plans. If a foundation were the beneficiary of such a qualified plan, all income and estate taxes would be avoided. Often a foundation receives substantial funding at the death of a surviving spouse to avoid estate tax on the remaining property. More often than not, the favorite charity of my clients is not the federal government; therefore, funding a foundation is often an attractive alternative to paying a substantial amount of estate tax.

Another reason for the popularity of foundations is that they can better address specific charitable intentions. For example, I have a client who desires to help land banks purchase land for conservation. If she contributes directly to various charities, the funds will likely be used for maintenance of the land. That is not her desire. She wants the funds to be used for the acquisition of land. Such land purchases do not arise daily or even annually; thus, with a foundation, if appropriate land is not available upon her death, the foundation can defer the purchases. Foundations are excellent vehicles for clients who wish to champion a specific cause, have a particular mission or a vision for social improvement.

Other clients like to leave a legacy. Annual giving to a chosen charity from a foundation is often more satisfying than a single contribution either during life or at death because it keeps the family’s name as an active contributor. However, the benefit most clients seem to cling to is control. There is a certain attachment of people to their money, even those with the greatest of charitable intentions.

This brings this article to its title. Foundations are relatively inexpensive to create and maintain. Does it make sense for a \$50,000 total contribution? No, because the annual maintenance costs would consume too great a percentage of the charitable property. However, when the total contributed during life and at death exceeds \$200,000, the foundation certainly makes economic sense. For amounts in between, the actual costs and the charitable purposes should be carefully examined.

In next month's article, I will explore Donor Advised Funds as a simpler but less flexible alternative to foundations. As always, you should seek competent legal and tax counsel to explain the benefits and detriments of creating and maintaining a foundation in consideration of your financial circumstances and estate planning objectives.

The author of this article, Joseph G. Imbriani, Esq., CPA/PFS, practices in the areas of taxation and estate planning and is a partner of the Boston law firm of Taylor, Ganson & Perrin, LLP.