Private Foundations in Estate Planning: Structuring Tax-Efficient Charitable Legacies
Minimizing Tax in Diversified Estates, Maximizing Charitable Impact, Navigating IRS Private Foundation Rules

TUESDAY, SEPTEMBER 5, 2017
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FOR LIVE EVENT ONLY
Private Foundations:
Income and Transfer Tax Benefits and Treatment of Contributed Property

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September, 2017
Private Foundation - Background

- One of the major objectives in establishing a foundation is to create an organization to which tax deductible contributions can be made.

- The amount and value of the income tax deduction depends on whether the donee organization is classified as public or private.

- The complicated income tax rules do not apply for gift and estate tax charitable deduction purposes.

- Thus, the complexity revolves around the income tax charitable deduction.
Private Foundation - Definition

• The IRC presumes that all §501(c)(3) organizations are private foundations unless the organization can prove otherwise. §509(a).

• Proving otherwise means demonstrating to the IRS that the organization fits into one of the four types of organizations described in §509(a)(1) through (4).

• Rather than define private organizations directly, §509(a)(1) through (4) define what type of §501(c)(3) organizations are not private foundations.
Private Foundation - Definition

- Any organization exempt from income tax under §501(c)(3) other than:
  - Traditional public charities (50% charities) e.g. churches and their integrated auxiliaries, formal educational organizations, hospitals and medical research organizations, governmental units and certain other organizations that receive a substantial amount of support from government or the general public. §509(a)(1). These organizations are defined in §170(b)(1)(A)(i)-(vi).
  - Organizations with a broad base of public support. §509(a)(2).
    - Receives more than 1/3 of its annual “support” from its members and the general public (not including “disqualified persons”) and
    - Not more than 1/3 of its annual support from its “gross investment income” and after-tax UBTI
    - Examples: museums or symphony orchestras that charge admissions
  - Organizations organized and operated exclusively for the benefit of organizations described above and operated, supervised or controlled by or in connection with such organizations i.e. supporting organizations. §509(a)(3).
  - Organizations organized and operated exclusively for testing for public safety. §509(a)(4).
Private Foundation

• Types
  – Subject to lower contribution limit for income tax charitable deduction
    • Private non-operating foundation
  – Treated as public charity for purposes of income tax percentage limitations and ability to take deduction for FMV
    • Private operating foundation
    • Pass-through foundation
    • Pool fund foundation
Percentage Limitations - Overview

• Individual’s charitable contribution deduction base = Adjusted gross income without regard to any net operating loss carryback to the year. §170(b)(1)(G).

• The amount of the income tax charitable deduction depends on:
  – The type of organization
    • Public charity v. private charity (private foundation)
  – The type of property
    • Long-term capital gain v. ordinary income v. tangible personal property
  – The use of the property by the donee
    • Related use or non-related use (in case of tangible personal property)
Percentage Limitations - Overview

• **GR: Individual** income tax deduction are limited to a percentage of a donor’s adjusted gross income (AGI)
  – There is no limitation for estate and gift or fiduciary (trust and estate) income tax purposes
• Contributions to 50%-type organizations – public charities
  – General limitation – 50%
  – Long-term capital gain property limitation – 30%
  – Election to deduct cost basis long-term capital gain property and increase limitation to 50%
• Contributions to 30%-type organizations – private non-operating foundations
  – General limitation – 30%
  – Long-term capital gain limitation – 20%
• Contributions “for the use of” – 30% limit
• Charitable contribution carryover – 5 years
Private Non-Operation Foundation

• GR: Contribution of long-term capital gain property given to a private non-operating foundation must be reduced by the amount of any gain that would have been long-term capital gain had the property been sold at its FMV. §170(e)(1)(B)(ii).
  – Translated: deduction is limited to the property’s cost basis.
  – Does not apply to a private operating foundation, pass-through foundation or pooled fund foundation (grant making foundation) that qualifies as a 50% type organization.
  – Example: Donor contributes property other than stock with a FMV of $10,000 and a cost basis of $2,000 to a private non-operating foundation. The charitable contribution deduction is $2,000, ($10,000 less $8,000 gain that would have been taxed as long-term capital gain) i.e. the deduction is limited to the $2,000 cost basis of the property.
  – Exception to the GR: gifts to private non-operating foundations of “qualified appreciated stock.” §170(e)(5)(A).
Private Non-Operation Foundation

• Exception for qualified appreciated stock
  – No reduction required for amount that would have been taxed as long-term capital gain
  – Translated: the deduction is equal to FMV of stock

• Qualified appreciated stock - definition:
  – (1) Market quotations readily available on an established securities market as of the date the stock is contributed, and
  – (2) Was long-term capital gain property i.e. sale of stock would have resulted in long-term capital gain on the date of contribution. §170(e)(5)(B).
  – Limit: stock of any one corporation is considered “qualified appreciated stock” only to the extent the cumulative amount of such stock contributed by a donor to all private foundations that are not 50% type does not exceed 10% of the value of all outstanding stock of the corporation. §170(e)(5)(C)(i).

• Attribution rules: contributions of stock by any member of the donor’s family (brothers and sisters, spouse, ancestors and lineal descendants) are attributed to the donor. §170(e)(5)(C)(ii); §267(c)(4).
Private Non-Operation Foundation

- Qualified appreciated stock
  - NYSE listed stock subject to Rule 144 limitations on selling the stock before a prescribed date is not “qualified appreciated stock.” PLRs 9247018 and 9734034.
    - Gift of such stock to a private foundation is limited to its cost basis
    - Reason: Rule 144 stock precludes readily market quotations required to qualify as qualified appreciated stock

- American Depositary Receipts (ADRs), which represent interests in underlying shares of non-U.S. company stock, are qualified appreciated stock. PLR 200322005 - 20022011

- Open-ended mutual funds are considered to be “qualified appreciated stock” because market quotations are available for them in general circulation newspapers. PLRs 9511041 and 199925029.
<table>
<thead>
<tr>
<th>Cash and Ordinary Income Property</th>
<th>Private Foundation</th>
<th>Public Charity</th>
</tr>
</thead>
<tbody>
<tr>
<td>30% of AGI, gifts of ordinary income limited to basis, with 5 year carryover</td>
<td>50% of AGI, gifts of ordinary income limited to basis, with 5 year carryover.</td>
<td></td>
</tr>
<tr>
<td>Capital Gain Property</td>
<td>20% of AGI, limited to basis for appreciated property and tangible personal property not put to a related use with 5 year carryover. Exception: qualified appreciated stock deductible at FMV.</td>
<td>30% of AGI. Appreciated property deductible at FMV unless tangible personal property put to an unrelated use which is limited to basis. 5 year carryover. Taxpayer can elect under §170(b)(1)(C)(iii) to have 50% of AGI limit apply but the value of the contribution is limited to the property’s basis.</td>
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Private Non-Operation Foundation – Transfer Tax

- The complicated income tax rules do not apply for gift, estate and fiduciary income tax purposes

- No percentage limitations

- FMV is deductible

- No distinction between public and private charity

- Distributions from trust or estate to a private non-operating foundation governed by Section 642(c)
Ideal Assets to Contribute and Not to Contribute to a Private Foundation

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September 2017
Ideal Assets to Contribute Anytime

• Cash
  – Simple
  – Higher limit for deduction (30%)

• Qualified appreciated stock
  – Full FMV deduction – IRC § 170(e)(5)
Bad Assets to Contribute Anytime

• Encumbered Property, e.g., Real Estate
  – Deduction limited to the lesser of the real estate’s fair market value or the donor’s cost basis – IRC § 170(e)(1)(B)(ii)
  – Bargain Sale – IRC § 1101(b); Treas. Reg. § 1.1011-2
  – Debt-Financed Income – IRC § 514(c)(2)(A)
  – Self-Dealing – IRC § 4941(d)(2)(A)

• Assets that will trigger Excise Taxes, e.g., UBTI, Excess Business Holdings or Self-Dealing
Bad Assets to Contribute During Life

• IRA/401K
  – No “qualifying charitable distribution” for private foundations – IRC § 408(d)(8)

• Partnership Interests
  – Reduced deduction – IRC § 170(e)(1)(A); Treas. Reg. § 1.170A-4
  – Excise taxes
  – Suspended PALs – IRC § 469(j)(6)

• S Corporation Interests
  – Reduced deduction – IRC § 170(e)(1)(A); Treas. Reg. § 1.170A-4
  – Excise taxes
Good Assets to Contribute at Death

• IRA/401K
  – Income never subject to income tax
  – Full FMV estate tax deduction – IRC § 2055
  – No percentage limits
Possible Assets to Contribute at Death or by Surviving Spouse

• Real Estate

• Partnership Interests

• S Corporation Interests
  – Full FMV estate tax deduction – IRC § 2055
  – No percentage limits
  – Step-up basis
Estate Planning
Business Planning
Income Tax Planning
Charitable Sector
Mergers & Acquisitions

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**Mergers & Acquisitions**
Our Mergers & Acquisitions department represents entrepreneurs and business owners in their quest to sell or acquire a company
Casey S. Hale is a member of Brown & Streza’s exempt organization department. He advises charities on their general tax and corporate legal issues; guides private and family foundations through complex Internal Revenue Service and state regulations; and serves as general counsel to numerous nonprofit corporations. His representation includes counsel regarding property tax, employment, intellectual property, international grantmaking and operations, structuring subsidiaries and joint ventures. Casey routinely advises charity executives and boards of directors on executive compensation/intermediate sanctions and corporate governance matters. Casey recently established the first L3C under Wyoming law.

In 2009 - 2012, Casey was named a “Southern California SuperLawyers-Rising Star” by Los Angeles Magazine – a distinction recognizing just 2.5% of attorneys under age 40 for excellence in the practice of law.

Casey also serves on the board of Enlace USA. Enlace USA equips local churches in El Salvador to become leaders in their communities and to collaborate with the local community to build enduring solutions to poverty.

Casey received his undergraduate degree from Vanguard University and attended Whittier Law School on a merit scholarship where he earned a Juris Doctorate.
Establishing a Private Foundation and Reporting Requirements

Presented to:
Strafford Continuing Education Webinar

September 5, 2017

Presented by:
Casey Hale
Attorney
Brown & Streza LLP
Introduction

Welcome
Private Foundations

- Formation
- Exemption
- Reporting
- Chapter 42 (§4940 and §4946)
Private Foundations

• Formation
• Exemption
• Reporting
• Chapter 42
Formation

• Initial Considerations

Purposes

Nonprofit Corporation vs. Trust

Non-Operational vs. Operational

Jurisdiction
Formation

- Flexibility
- Standard of Care
- International Grantmaking/Source of funds
- Unrelated Business Income Tax
• Nonprofit Corporation
Formation

• Nonprofit Corporation
Formation

- Nonprofit Corporation

- Articles of Incorporation
- Corporate Documents
- Policies
- Bylaws
Formation

• Nonprofit Corporation

Corporate Documents

- Articles of Incorporation
- Bylaws
- Policies
Private Foundations

- Formation
- Exemption
- Reporting
- Chapter 42
Exemption

- Internal Revenue Service Form 1023
- Registration with State Charity Official (when required)
- Exemption with State Tax Authority (when required)
Private Foundations

• Formation
• Exemption
• Reporting
• Chapter 42 Rules
Federal Reporting Requirements

| IRS Form 990-PF: Return of Private Foundation | IRS Form 4270: Return of Certain Excise Taxes under Chapter 41 and 42 |
State Reporting Requirements

| Annual Filings: State Tax Authority | Annual Report: State Charity Official |
Private Foundations

- Formation
- Exemption
- Reporting
- Chapter 42
Chapter 42

IRC § 4940 – Excise Tax Based on Investment Income

• Annual 2% tax on net investment income

• Applies to interest, capital gains, etc.

• Reduced to 1% if certain required distributions are made for charitable purposes.
Chapter 42

IRC § 4946 – Disqualified Persons

1. Substantial contributor

2. Foundation manager
Chapter 42

IRC § 4946 – Disqualified Persons

3. Owner of more than 20% of:
   • Total combined voting power of a corporation,
   • Profits interest in of a partnership, or
   • Beneficial interest in a trust,
   any of which is a substantial contributor.
Chapter 42

IRC § 4946 – Disqualified Persons

4. Member of the Family of:
   • Substantial Contributor
   • Foundation Manager (who is a DP)
   • Owner of more than 20% in an entity that is a Substantial Contributor

• Includes: Spouse, Ancestors, Children, Grandchildren, Great Grandchildren (and their spouses), Legally-Adopted Children
• Excludes: Brother or Sister
IRC § 4946 – Disqualified Persons

5. Corporations, partnerships, trusts, and estates in which a DP owns more than a 35% interest
Private Foundation Rules: IRC Chapter 42

• Excise tax on net investment income (§ 4940) (Already discussed)
• No self-dealing (§ 4941)
• Annual mandatory distributions (§ 4942)
• No excess business holdings (§ 4943)
• No jeopardizing investments (§ 4944)
• No taxable expenditures (§ 4945)
Self-Dealing Transactions (IRC 4941)

• Sales, exchanges, leases
• Loans, extensions of credit
• Furnishing of goods, services, facilities
• Compensation or expense reimbursement
Self-Dealing Transactions (IRC 4941) (cont’d)

• Transfer to, use by or for benefit of, a DP of income or assets of a PF
• Payments of money, transfers of property to a government official
Sales, Exchanges, Leases: Exceptions

• DP can provide use of property (office space) if *free*
• DP can donate property (*free*)
• PF may **not** assume mortgage
Loans or Extensions of Credit: Exceptions

• DP may loan money to PF if:
  - loan is *free* (without interest, fees)
  - $$ used exclusively for 501(c)(3) purposes
Furnishing of Goods, Services, Facilities: Exceptions

• DP provides free
• PF furnishes goods, services, or facilities on basis no more favorable than to public
• Furnishing of facilities to foundation manager if
  - value is reasonable and
  - facilities necessary for execution of manager’s duties
Compensation or Expense Reimbursement: Exceptions

Compensation or payment/reimbursement of expenses for:
1. Personal services
2. Reasonable and necessary, and
3. Amount of compensation, reimbursement is not excessive
Personal Services

• Professional or managerial in nature
• Includes:
  - investment counseling
  - legal, accounting, tax banking
  - grant administration
  - payments to an entity as well as to an individual
Necessary

• Document valid business reason for activity
Amount of Compensation Reasonable

• Compensation surveys
• Document time spent
• Cross-reference to Treas. Reg. Section 1.162-7
• Section 4958 standards helpful
Expense Reimbursements Only For Personal Services

• No reimbursements for expenses not connected to personal services, including rent, equipment, supplies
• Document expenses and reason
• Careful about dual purpose expense reimbursement
Sharing Employees

• PF can pay for time of DP employee
  - Need careful record-keeping
• PF employee can’t work for DP
  - even if paid FMV
• Careful about DP employees volunteering for PF: keep different hats straight
• DP can volunteer (free)
Self-Dealing Taxes

Initial:
• 10% of amount involved on self-dealer, \textit{plus correction}
• 5% on foundation managers who knowingly participated ($20k cap)

Second-tier
• 200% of amount involved on self-dealer
• 50% on foundation managers who knowingly participated ($20k cap)
Annual Mandatory Distributions (IRC 4942)

A PF must distribute 5% of FMV of its non-charitable assets for the preceding year
Distributions: What Qualifies?

• Grants, charitable distributions
• Reasonable, necessary administrative expenses
• Payments for assets used in exempt purposes
• Professional fees for advice on program activity
Controlled Grantees

If a grantee is controlled by the PF or DPs to the PF:

Grant does not count as a qualifying distribution unless the “out of corpus” rules are followed
Taxes for Failure to Distribute

Initial:
• 30% of undistributed income, *plus correction*

Second-tier:
• 100%
No Excess Business Holdings (IRC 4943)

• PF and DPs together can only own up to 20% of voting, ownership interest in a business
• Exception: 2% *de minimis* rule
• Exception: PF and DPs can own up to 35% if a third party effectively has control
Tax on Excess Business Holdings

Initial:
• 10% of the value of the excess holdings (when they were greatest during that tax year) *plus correction*

Second-tier
• 200%
No Jeopardizing Investments (IRC 4944)

PF may not invest in a manner likely to jeopardize its ability to carry out its exempt purposes
Portfolio Approach

• Look at each investment, taking into account foundation’s portfolio as a whole
• Diversification helps
• Reliance on investment professionals helps
Jeopardizing Investment Taxes

Initial:
• 10% of amount so invested, *plus removal from jeopardy*
• 10% on foundation managers who knowingly participated ($10k cap)

Second-tier
• 25%
• 5% on foundation managers who refuse to agree to removal of investment from jeopardy ($20k cap)
Taxable Expenditures (IRC 4945)

- Not for charitable purposes
- Lobbying or campaigning
- Most voter registration drives
- Most grants to individuals for “travel, study or other similar purposes” unless grantee selection process satisfies certain requirements
Taxable Expenditures (IRC 4945)

• Grants to organizations that are not public charities, unless expenditure responsibility
• Grant to certain supporting organizations, unless expenditure responsibility
• Foreign charities: expenditure responsibility or equivalent of U.S. public charity
Taxable Expenditure Taxes

Initial:
• 20% of taxable expenditure, \textit{plus correction}
• 5% on foundation managers who knowingly agreed ($10k cap)

Second-tier
• 100%
• 50% on foundation managers who refuse to agree to correction ($20k cap)