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Estate Planning with a Private Foundation

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Benefits of a Private Foundation

Estate planning, a project for the living, can end with the administration of your estate or it can continue on for generations. If you are charitably minded, but would like more control over your charitable contributions and want your charitable impact to extend past your death, setting up a private foundation can be an important part of your estate planning. If your only goal is to reduce your overall tax liability, then contributing to one or more public charities of your choice can be effective. But, if control over your charitable contributions is important to you, and you have the desire to make an impact on society as a whole, then you should set up a private foundation.

In addition to reducing your annual income tax liability and eliminating assets from your taxable estate, a private foundation will provide important intangible benefits to you and those you choose to involve. Establishing a private foundation gives you the ability to (i) create a legacy focused on your philanthropic interests, (ii) control how your charitable funds are invested over time, (iii) participate in the management of charitable projects, (iv) encourage others, including but not limited to family members, to appreciate the value of engaging in and supporting charitable projects, (v) teach your children and grandchildren how to manage wealth more efficiently and effectively, (vi) make lasting and impactful changes in areas of needs, such as poverty, education and health, and (vii) contribute to organizations that helped shape you and your charitable interests, such as cultural, religious and educational institutions.

Private foundations allow you to do far more than just write checks to public charities. You can make grants directly to individuals and families in need, award scholarships and prizes, use assets to support international charitable organizations, run your own charitable activities, and engage others in philanthropy by involving your family in the management of the foundation and by hiring and compensating foundation staff. Managing a foundation involves philanthropic research, asset management, presentation of ideas to others within and outside the foundation's infrastructure, and participation in determining suitable grantees and then tracking the outcomes of those grants.

Furthermore, because private foundations have limited tax exposure (there is a 1% or 2% tax on net investment income that is payable each year) and are only required to distribute approximately 5% of its assets each year, the foundation's assets can be invested for long-term goals and projects.

During Life or Upon Death

Once you have decided to set up a private foundation, you need to determine whether you should do so during your life or upon your death. If you are engaged in charitable giving and want to set the stage for others to continue your charitable legacy, you will want to set up a private foundation during your lifetime. Furthermore, setting up a foundation during your lifetime will give you the opportunity to provide a smooth transition and training for those who will manage the foundation after your death. Once created, those you designate will be able to use the private foundation as a means to carry out your philanthropic goals.

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In many cases, the foundation serves a function and purpose similar to that of a family business. If set up during your lifetime, you can be the manager of the "business." Like a family business, different generations can work together toward common goals. Additionally, the foundation can be a means to transmit both family values and critical life skills, such as wealth management. If you set up the foundation during your lifetime, it will not only reflect your charitable goals, but also your management and administration style.

Maybe you are not deeply involved in charitable giving right now, or maybe you do not have, or wish to invest, the time. You may not be ready to make the commitment to setting up and managing a private foundation, but a private foundation is appealing to you as a way to carry out some of your charitable goals. If that is the case, and you want to create a philanthropic legacy, you can direct that a private foundation be created upon your death. You will need to incorporate your charitable desires into a properly drafted estate plan, and designate individuals who you trust to manage the foundation.

Which Assets to Contribute

When making gifts either during life, or at death, you must determine which assets to contribute to family members and which to charity. Some assets are better suited for charitable contributions than gifts to individuals, while some are better suited for testamentary gifts as opposed to lifetime transfers. Quantity and quality of assets are not always equal. Assets that are characterized as income in respect of a decedent, which will give rise to an income tax liability, are ideally suited for charitable contributions. If a pension, an IRA, or an individual's right to deferred compensation is donated to charity during life, then that contribution will be deemed a distribution to the individual and the individual will have to include the income as part of his or her taxable income. On the other hand, if such assets are contributed to charity at death, the income will never be subject to income tax.

If you want to leave part of your estate to charity, specifically your private foundation, and part to your family and other loved ones, you need to consider which assets should be left to which beneficiaries. If you want to minimize the income and transfer taxes payable overall, you need to evaluate your assets and make your decisions carefully. Leaving a pension or IRA to a private foundation (or any type of charitable organization) is more tax-efficient than leaving it to an individual, whether outright or in trust. The same is true with respect to any deferred compensation to which your estate might be entitled and any other income in respect of a decedent. For example, if you designate an individual as the beneficiary of your pension/IRA, its full fair market value will be includible in your taxable estate. Additionally, as the beneficiary withdraws the funds (assuming it was funded strictly with pre-tax contributions), he or she would have to include the distributions as taxable income.

By designating a private foundation as the beneficiary of your IRA, the full value of the pension/IRA stays intact. Under current rules, your estate would be entitled to a full estate tax charitable deduction, and the foundation would not pay income tax when the funds are received or distributed. By designating a foundation as the beneficiary you can maximize the amount available for charitable purposes. You will then have other assets available, which are not characterized as income in respect of a decedent, to leave to your loves ones, maximizing the amount available to them as well.

If you create a foundation while you are living, contributing appreciated publically-traded stock ("stock") to the foundation will enable you to obtain a full fair market value income tax charitable without reducing the amount that can be used by foundation by the capital gains tax payable. Although the foundation will have to pay the 1% or 2% excise tax on the gain, capital gains tax at rates much higher than the excise tax would not apply. On the other hand, if you gave the stock to your individual beneficiaries, they would pay the capital gains tax and it is currently (and historically) much higher than the excise tax rate. A better plan would be to contribute the appreciated stock to the foundation and give cash to your individual beneficiaries. As with other assets, contributing appreciated stock to a foundation at death eliminates all income and capital gains tax because the securities receive a step-up in basis.

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Other assets, such as real estate and tangible property, can be contributed to a private foundation and used to further the exempt purposes of the foundation. For example, if your foundation is dedicated to supporting fine arts, you might want to donate your collection of paintings rather than having it sold and dispersed. If your foundation is engaged in promoting the development of new techniques for sustainable farming and you own farm land, you might want to donate that land to your private foundation. Real estate held for charitable purposes may be exempt from property tax, and the foundation may attain tax benefits by virtue of holding property utilized for charitable purposes. If you gave the foundation real property that it did not wish to retain, or wanted to sell at some point in the future, the foundation will only have to pay a 1% or 2% excise tax on the net income when it sells the property. In contrast, if you transferred the real property to an individual during your life, the recipient of your gift would pay a much higher capital gains tax on sale. Furthermore, if the property was contributed to the foundation upon your death, it would be entitled to a step-up in basis and would not pay any tax on sale.

Conclusion

In conclusion, a private foundation can be a very important part of your personal wealth planning. If you give to charity and/or intend to do so at death, creating a private foundation will provide you with not only income and estate tax benefits, but also with an opportunity to create a long standing philanthropic legacy. As discussed herein, a private foundation provides many intangible benefits that making outright charitable gifts to public charities does not. The intangible benefits, such a wealth management opportunities, family engagement in philanthropic matters, and the ability to work on long-term charitable projects, are what sets private foundations apart from outright charitable gifts.

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