Starting a Private Foundation: 17 Frequently Asked Questions

1. **What is a private foundation?**
   The definition of a private foundation begins with the legal definition of a charity. §501(c)(3) of the Internal Revenue Code (“IRC”) generally defines two types of charitable organizations: public charities and private foundations. All §501(c)(3) organizations are presumed to be private foundations unless they can demonstrate to the IRS that they are a public charity.

   Public charities are entities that are organized exclusively for charitable purposes and are exempt from federal income tax. A charitable organization may qualify as a public charity if it receives enough financial support from a broad base of donors to satisfy an IRS “public support” test. The most common public support test is satisfied if an organization receives at least one-third of its annual support from the general public. This shows the IRS that the organization relies on on-going fundraising efforts to support its charitable work.

   A private foundation, on the other hand, is a tax-exempt §501(c)(3) charitable organization that does not qualify as a public charity under the public support test. Instead, private foundations are created and controlled by a small number of people - often an individual, family, or a business. The activities of private foundations are focused on making charitable grants, or in some circumstances, operating their own charitable programs. These activities are typically funded from investment assets rather than fundraising. Private foundations are organized as either charitable trusts or corporations under state law, but receive their tax-exempt status from the IRS.

2. **Is a private foundation right for me?**
   Donors create private foundations for many different reasons. Not surprisingly, the decision whether to create a private foundation or to utilize a different charitable vehicle is often a complex question that requires an analysis of numerous factors, including:
   
   • **What are the donor’s charitable goals?** Private foundations are ideal for donors wishing to create lasting impact over time.
   
   • **How important is it for the donor to be able to exert control over the charitable assets and how they are to be used?** A private foundation provides a donor the greatest control of any charitable giving vehicle.
   
   • **Is flexibility important?** A private foundation creates a charitable giving platform that can be focused or broad, general or strategic, established with strict controls by the donor or malleable by future generations. It can be governed exclusively by family members or non-family members, etc.
   
   • **Does the donor want to use this charitable vehicle to establish a lasting legacy?** A foundation can be created in the name of a donor or someone the donor wishes to honor.
   
   • **Does the donor wish to engage family in the charitable endeavor?** A private foundation enables a donor to involve family members in the philanthropic enterprise. It can also help establish a tradition of service and giving deeply meaningful to all family members, and it can create a vehicle to transmit family values from one generation to another.
   
   • **How long will the charitable enterprise last?** Although not required, foundations are often created in perpetuity.
   
   • **What are the relative tax advantages of creating a private foundation or utilizing a different charitable vehicle?** A donor may take a current income tax deduction for assets used to create a foundation. This is true even if the foundation does not make charitable gifts until a later date. Donations to a private foundation also can have positive estate planning consequences.
Discussed below, there are also several important practical questions that must be included in the above analysis, such as:

- Is there a minimum amount necessary to create a private foundation?
- How much does it cost to create and operate a private foundation?
- Who will govern the foundation now and after the donor’s death?
- How will I ensure the foundation complies with the regulatory requirements imposed on private foundations?

Due to the complex and multi-factored nature determining whether a private foundation is right for you, we strongly recommend seeking the advice of professionals knowledgeable about private foundations and other charitable vehicles, such as the experts at SunTrust Foundations & Endowments Specialty Practice as well as your legal and tax counsel.

3. What are some other charitable giving vehicles?
In addition to a private foundation, a donor can also consider making an immediate gift to a public charity, creating a donor advised fund at a community foundation (some charitable subsidiaries of financial institutions also hold donor advised funds), establishing a supporting organization (a special type of public charity that exists to support another existing public charity), or utilizing a planned future gift such as a charitable remainder trust.

4. Is there a minimum size for a private foundation?
There is no size requirement for the creation of a private foundation. However, because there are some costs involved in establishing and operating a private foundation, the traditional guideline has been that a minimum investment of $1-2 million is prudent. However, donors often create private foundations with modest initial investments with the intention of adding more assets later, pending some future financial event or as part of an estate plan.

5. How long does a private foundation last?
Donors often create private foundations that last in perpetuity. Recently, however, there have been notable examples of donors creating foundations that will last for a finite term. For example, the Bill and Melinda Gates Foundation is structured to distribute all of its charitable assets within 20 years after their deaths. It is important to note that a foundation that is created to last in perpetuity places a special responsibility on current and future board members to balance current charitable needs with future needs and to ensure that the foundation’s investment program is focused on long-term performance.

6. How do I form a private foundation?
Private foundations are created under state law as either charitable trusts or nonprofit corporations. To ensure that donations to the new private foundation are tax-deductible, an Application for Recognition of Exemption must be submitted using IRS Form 1023 within 15 months of the foundation’s creation. Upon approval of the Application, the organization’s tax-exempt status is retroactive to the date it was created.

7. What are the administration requirements of a private foundation?
Once a private foundation is established, there are some basic administrative requirements that must be met on a regular basis. First, private foundations must adhere to the relevant state laws governing charitable trusts or nonprofit corporations, including all corporate formality and registration requirements. Second, private foundations must follow the regulatory requirements imposed on them by the IRS, such as the mandatory distribution requirement, the payment of relevant excise taxes, and complying with all grant-making, investment, self-dealing, and lobbying restrictions. Meeting these requirements can be complex and time consuming. As a result, foundations often engage professionals to assist them in meeting their fiduciary and regulatory responsibilities and to allow a board to focus more on strategy, grant-making, and policy.

8. What does it cost to operate a private foundation?
The costs of operating a private foundation are based primarily on whether the foundation employs staff and, if so, how many. Also, the type of grantmaking programs the foundation utilizes can have a significant impact on expenses. A 2012 study published by the Foundation Center found that the median expense ratio (annual administrative expenses v. qualifying distributions) for foundations without staff was less than 1% while those for staffed foundations was 8%.

9. Is there a minimum amount that a private foundation must distribute each year?
Yes, a private foundation must distribute at least 5% of the fair market value of its investment assets each year for charitable purposes.
10. How is the minimum distribution requirement satisfied?
Private foundations satisfy this requirement by making “qualifying distributions,” usually to an organization that is a qualified public charity.

11. What rules apply to making grants?
Private foundations are responsible for conducting due diligence on all grant applications to ensure that the request is for a charitable purpose and that the applicant is an existing public charity. Special rules apply to grants to supporting organizations, foreign charities, grants involving lobbying, and grants for direct scholarships. If a private foundation wishes to make a charitable grant to an organization that is not a public charity, it must follow an IRS-mandated enhanced due diligence process called “Expenditure Responsibility.”

12. Are there rules that apply to transactions between a private foundation and insiders?
Yes. To ensure that private foundation assets are always used to further its charitable purpose and never used for improper personal gain, they are prohibited from any financial transactions with foundation insiders the IRS labels “disqualified persons.” Disqualified persons include donors to the foundation; directors, trustees, and certain key employees; immediate family members thereof; and businesses owned by a disqualified person. In certain circumstances, a private foundation may pay a disqualified person for professional services that are reasonable and necessary for carrying out the foundation’s charitable purpose, if the amount is neither excessive nor unreasonable. Private foundations may also reimburse a disqualified person for foundation-related expenses if such expenses are reasonable, necessary, and not excessive. Foundations that reimburse expenses should adopt appropriate policies and procedures.

13. Are private foundations taxed?
Private foundations are exempt from federal income tax. However, they are responsible for paying an excise tax on net investment income. The current excise tax rate on net investment income is 2%. A private foundation may qualify for a 1% excise tax rate if its charitable distributions in a given year are greater than the average ratio of charitable distributions to its assets during the previous five years. Private foundations are also subject to unrelated business income taxes using for-profit corporate tax rates if they earn income from a regular business activity that is not related to its exempt purpose. This can include income generated from active investments and investments financed with debt.

14. Are private foundations required to file a tax return?
Yes, all private foundations are required to submit an annual IRS Form 990PF tax return that must be filed by the 15th day of the 5th month following the close of the foundation’s tax year (May 15th if a foundation is on a calendar year). Form 990PF is a public document and it must be made available by the foundation for public inspection.

15. What kind of investments can a private foundation make?
Private foundations can generally invest in most any type of investment asset or vehicle as long as they follow the prudent investor rule delineated in the Uniform Prudent Management of Institutional Funds Act adopted by every state except Pennsylvania. Private foundations may not invest in a manner that shows a lack of prudence or that jeopardizes its ability to carry out its charitable purpose. Additionally, a private foundation and its disqualified persons (see above), together, may not own more than 20% of the voting stock of a business. A private foundation, however, on its own may own up to 2% of the voting stock in a business regardless of the amount owned by disqualified persons.

16. Who is responsible for managing the foundation’s assets?
In most cases, a private foundation’s governing board has the responsibility for ensuring that its assets are managed in a prudent manner. Because private foundations have unique investment requirements, they usually delegate this responsibility to an investment professional with expertise in managing private foundation assets.

17. Where can I go for advice on private foundations?
The professionals at SunTrust Foundations & Endowments Specialty Practice are experts on the creation, administration, and investment requirements of private foundations. For simple, clear advice on foundation matters, please contact your relationship manager.

1 Loren Renz, Benchmarking Foundation Administrative Expenses: Update on How Operating Characteristics Affect Spending (Foundation Center, 2012), p. 2
About SunTrust Foundations and Endowments Specialty Practice

SunTrust has nearly a century of experience working with not-for-profit organizations. Fiduciary stewardship is the heart of our culture. We are not merely a provider for our clients; we are an invested partner sharing responsibility for prudent management of not-for-profit assets. Our client commitment, not-for-profit experience and fiduciary culture are significant advantages for our clients and set us apart from our competition.

The Foundations and Endowments Specialty Practice works exclusively with not-for-profit organizations. Our institutional teams include professionals with extensive not-for-profit expertise. These professionals are actively engaged in the not-for-profit community and are able to share best practices that are meaningful to their clients. Team members offer guidance and advice tailored to the various subsets of the not-for-profit community, including trade associations and membership organizations. Our Practice delivers comprehensive investment advisory, administration, planned giving, custody, trust and fiduciary services to over 700 not-for-profit organizations. We administer $30.9 billion in assets for trade associations, educational institutions, foundations, endowments and other not-for-profit clients.1

1 As of September 30, 2016

For more information about charitable giving options, contact your relationship manager or call 866.223.1499. Please visit us at www.suntrust.com/foundationsandendowments or www.suntrust.com/nonprofitinsights