A Private Foundation or a Fund in a Community Foundation: Weighing the Options

In the previous issue of Professional Notes, we discussed the reasons a donor might terminate a private foundation and the steps for transferring it to a fund in a community foundation. This issue explores the factors you and your client should consider when first deciding on a vehicle for charitable giving.

Donors today have a number of options for their philanthropy. Community foundations are public charities that are geographically based; they know about local needs and the organizations that can best fill them. Donors establish a fund in the community foundation to carry out their charitable objectives.

Commercial gift funds—donor-advised vehicles offered by financial firms—offer fast online service and are a convenience for the transactional donor. But because they are national and don’t have staff who live in the donor’s community, they can’t offer donors information about local charities. And because they are essentially online services, there is little in the way of personal service.

Private foundations are another popular option for today’s donor, and for some donors they are the right option. But as the Wall Street Journal reported on April 22, 2009, there is an increasing trend toward terminating them and transferring the assets to...
community foundations or commercial gift funds, suggesting that they weren’t the correct vehicle in the first place. And the president of the Foundation Center, which recently surveyed family foundations, said: “As these young foundations face transition in leadership from the first to the second generations, questions about sustainability, family capacity or commitment, donor intent, and foundation impact may lead them to consider their options.”

Below we compare some of the costs and benefits of a fund in a community foundation with a private foundation.

**Administrative Considerations**

**Expertise & Support.** The New York Community Trust, with assets of $1.5 billion, is staffed by a group of seasoned professionals, all experts in their fields. Our grantmaking staff have worked in the areas in which they make grants and know the issues, trends, and effective players in the City; they are connected to grantmakers all over the country. They are charged with ensuring that grants from our permanent funds carry out the donor’s purpose effectively while meeting contemporary needs.

Our grantmaking staff have worked in the areas in which they make grants and know the issues, trends, and effective players in the City; they are connected to grantmakers all over the country. They are charged with ensuring that grants from our permanent funds carry out the donor’s purpose effectively while meeting contemporary needs.

and sound advice on tax and estate planning, support that only a large organization can offer.

**Permanence.** Community foundations such as The New York Community Trust are permanent endowments. Community foundations allow family involvement following a donor’s death, but also can carry on in his or her absence. The community foundation’s variance power allows for flexibility should a fund’s purpose become outdated over time.

**Cost Effectiveness.** Private foundations can be costly to establish and maintain, reducing the amount available to charity. Even for the simplest private foundation, initial filing and approval can take months and cost thousands of dollars. Routine operating items such as auditing, bookkeeping, and government reporting can add significantly to the cost.

Funds in community foundations are typically far less costly to operate. A fund at The New York Community Trust can be established quickly. The quarterly service fee and investment fees are modest. As a result, more money is available for grantmaking.

**The Choice of Anonymity.** As a public charity, community foundations are generally not required by the IRS to disclose the names of their donors. Donors who do not desire publicity and wish to keep their
gifts anonymous can accomplish this through a community foundation. Private foundations, on the other hand, are required to make public the names of their donors.

**Flexibility.** Almost any philanthropic purpose can be accomplished through a community foundation, which is structured to meet a broad and evolving set of charitable needs in a geographic region, while allowing donors who choose to create donor-advised funds to suggest grants to qualified nonprofit organizations throughout the country. Donors have a variety of funds to choose from:

- An **unrestricted fund** leaves discretion to the foundation’s governing body to use the donor’s gift to meet contemporary needs.

- A **field-of-interest fund** names a broad or narrow area or areas of interest, such as public education, the environment, or homelessness, and the community foundation identifies the nonprofit organizations best suited to carry out the purpose.

- A **designated fund** names specific nonprofits to receive grants, subject always to the board’s variance power, which allows it to vary the purpose of a fund should circumstances so change as to make it “unnecessary, undesirable, impractical, or impossible” to continue making grants for the purpose.

- A **donor-advised fund** is an unrestricted fund that allows donors to suggest the organizations to which they wish grants to be made, wherever they are located. At The New York Community Trust, program and financial staff investigate all donor suggestions to ensure that the recommended organization meets broad charitable guidelines and that its fiscal affairs are in order.

**Tax and Regulatory Issues**

Funds in community foundations enjoy preferential tax treatment in a number of ways:

**Deductibility of Charitable Gifts.** Even though community foundations are aggregations of separate funds, they qualify as publicly supported charities under Internal Revenue Code sections 501(c)(3) and 170(b)(1)(A)(vi). That status entitles community foundation donors to tax deductions that are often superior to those accorded private foundation donors. These differences particularly affect clients who make large inter vivos gifts relative to income or who contribute appreciated property other than publicly traded stock.

For example, for gifts of cash, donors to community foundations may deduct up to 50 percent of adjusted gross income (AGI) in the year of gift, with a five-year carryover for excess contributions. Private foundation donors may deduct only up to 30 percent of AGI with the same carryover.
Community foundation donors who contribute gifts of appreciated property (other than tangible personal property) can deduct them at full fair market value up to 30 percent of AGI. Private foundation donors may deduct only gifts of publicly traded stock at fair market value up to 20 percent of AGI; all other forms of appreciated property, including closely held stock and real estate, are deductible at cost only.

**Other Rules Governing Private Foundation Activities.** The Internal Revenue Code and regulations embody numerous provisions that constrain private foundations. Generally, these restrictions do not apply to public charities, including community foundations. Private foundations that fail to properly abide by these requirements may be subject to penalty taxes.

**Excise tax.** Private foundations pay a 2 percent excise tax on net investment income, effectively reducing funds available for grants. The tax may be reduced to 1 percent if certain payout conditions are met.*

**Minimum payout.** A private foundation must spend on grants and charitable expenses an annual amount equal to approximately 5 percent of assets, whether or not that much is earned. This can limit the private foundation’s ability in some circumstances to hold low-yielding assets for later gain, or to accrue income for a major project.

**Excess business holdings.** In general, the private foundation and those who manage, control, or make large gifts to it (and other related entities) may not together own more than 20 percent of the equity interest in a business. The foundation’s “excess business holdings” generally must be disposed of within five years of receipt. While this rule generally does not apply to public charities, including community foundations, its scope has been expanded to apply to assets held in donor-advised funds.

**Awards to individuals.** In order to award scholarships, fellowships, or other grants to individuals, a private foundation must first apply to the Commissioner of Internal Revenue for approval of its grantmaking procedures. Then it must obtain pre-grant and post-grant reports from each recipient and report the results to IRS.

**Grants to organizations that are unincorporated or lack 501(c)(3) status.** Private foundations must meet a series of statutory and regulatory requirements in order to make grants to charities that have not yet attained public charity status. This

---

*S.676 was introduced in the U.S. Senate in March 2009 and is intended to stimulate grantmaking by private foundations by replacing the two-tiered excise tax structure with a single, flat tax. The legislation contemplates an applicable rate of 1.32% to assure no loss of revenue to the U.S. Treasury.
can inhibit response to civic emergencies, new organizations, and small neighborhood groups.

**Grants to foreign charities.**

Although private foundations are permitted to support the work of charities located overseas, they are subject to a complicated set of rules for exercising expenditure responsibility.

We note that the Pension Protections Act of 2006 imposed limitations on grants from donor-advised funds to individuals, foreign organizations, and organizations that are not charities described in Code Section 170(b)(1)(A), treating them as taxable distributions. Taxable distributions may subject sponsor charities, their managers, and the donor or advisor to penalties similar to those imposed on private foundations.

For further reference:
- IRC Section 170: Income tax deductions for charitable contributions and the limits on such deductions.
- IRS Section 501(c)(3): Charitable organizations defined.
- IRS Section 509: Private foundations defined.
- IRS Sections 4940-4946: Rules governing private foundations.

For more information, call our general counsel, Jane L. Wilton, at (212) 686-2563.

Before recommending a private foundation to clients, professional advisors should weigh both their immediate costs and long-term viability. The continuing turmoil in the financial markets has taken a huge toll on family foundations. It has also reduced the assets of community foundations. But as one of the nation’s largest and oldest community foundations, The New York Community Trust can weather downturns and continue to make grants that make a difference.
If you know a colleague who would like to receive complimentary copies of Professional Notes, or if you wish to obtain past issues, please call our receptionist at (212) 686-0010 Ext. 0 or visit www.nycommunitytrust.org. To receive Professional Notes by e-mail, please send your name, e-mail, and “Pro Notes” in the subject to pronotes@nyct-cfi.org.

About The Trust

For 85 years, The New York Community Trust has served the needs of donors and nonprofits in the New York area. One of the oldest and largest community foundations, The Trust is an aggregate of funds created by individuals, families, and businesses to support the voluntary organizations that are crucial to a community’s vitality.

Grants made from these funds—which now number nearly 2,000—meet the needs of children, youth and families; support community development; improve the environment; promote health; assist people with special needs; and bolster education, arts, and human justice.

In addition to reviewing proposals from nonprofit agencies and responding to the grant suggestions of donors, The Trust is alert to emerging issues and develops strategies to deal with them, works collaboratively with other funders and with government, and gets out information to the public. Recent initiatives have included programs that address youth violence, managed health care, immigration, child abuse, and public school reform.

The Trust is governed by a 12-member Distribution Committee composed of respected community leaders. Its staff is recognized for its expertise in grantmaking, financial administration, and donor services. Local divisions are located on Long Island and in Westchester. In 2008, The Trust made grants of $168 million from $1.5 billion in assets.

For more information call Jane L. Wilton, general counsel, at (212) 686-2563.
June 2009

NOTES

TAX & ESTATE PLANNING

PROFESSIONAL

A Private Foundation or a Fund in a Community Foundation: Weighing the Options