Advanced Tax Strategies for Private Foundations

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There are many strategies a private foundation can employ to reduce its tax liability and preserve the value of its endowments. This white paper provides an overview of several strategies you may want to further explore.

1. Donate qualified appreciated stock to the foundation: The personal charitable deduction for donating appreciated securities or assets to a private foundation is typically limited to the donor's cost basis. However, an exception exists for donations of "qualified appreciated stock," allowing for a fair-market-value deduction. Qualified appreciated stock is defined generally as publicly traded stock held for at least one year that qualifies for long-term capital gains treatment and is not subject to restrictions at the time of donation. This exception does not apply to any other type of noncash property, such as bonds, options or partnership interests.

2. Step up your cost basis in capital assets: A private foundation is unable to carry forward capital losses to future years. Rather than allowing losses to disappear forever, a foundation can sell its appreciated capital assets and offset the resulting capital gains with the unused capital losses. Further, you may repurchase the capital asset within 30 days since the "wash sale" rules apply only to capital losses, not capital gains. This strategy has the effect of providing stepped up basis for appreciated capital assets. Since the private foundation excise tax does not differ between short- and long-term gains, there is no downside to restarting the holding period.

3. Reduce your excise tax rate: A foundation can proactively plan to cut its tax liability in half, from 2% to 1%, by making "qualifying distributions" (grants and administrative expenses) that meet or exceed a threshold that is recalculated annually. This can be done only after the year of formation and if there have been no tax penalties imposed in the past five years for failing to satisfy the annual minimum distribution requirement (the "MDR"). Here are some additional considerations:

> **a. Formation year:** Avoid "knee-jerk" sales of appreciated property contributed to the foundation during its first year of existence, when the 1% tax rate is unavailable. If timing is urgent, consider forming the foundation and contributing appreciated securities late in the tax year, then selling the securities at the beginning of the next taxable year. If it's not practical to wait until January, consider forming the foundation with a different tax year-end (i.e., not December 31), so that the sale falls into the foundation's second tax year.

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b. Prepare for the future: Any action that reduces your payout ratio (grants and qualifying expenses, divided by average assets) in the current year better positions the foundation to achieve the reduced rate over the next five years. Consider funding your foundation earlier in the year to increase average assets (the denominator). In the year of formation, fund as close to the date of incorporation as possible. In any year, if you make grants or incur qualifying expenses well in excess of the 5% MDR, it will increase your payout ratio and make it more difficult to achieve the reduced tax rate in future years.

c. Post-formation years: It is difficult to qualify for the reduced tax rate in all years as it would result in an ever-increasing payout ratio. Planning to meet the requirements in alternate years—or in years when you expect to incur large capital gains—can allow you to maintain your historic level of grants and qualifying expenses.

4. Maximize your personal charitable deductions: Except for contributions of cash and qualified appreciated stock, contributions to private foundations are generally limited to cost basis. That said, a foundation can elect for any tax year to provide its donors with a fair-market-value deduction for noncash donations (e.g., real property) by meeting the following conditions: It must make grants and other qualifying distributions during the year equal to the total value of all noncash donations made to it that year. It must also satisfy its usual MDR for the election year and the following year on an accelerated basis. This condition is often too onerous to be practical. But for foundations that have large carryforwards of qualifying distributions from prior years, it may be possible to partially or fully meet this condition by using carryforwards in lieu of actual granting. This is especially tax efficient if the foundation has carryforwards that are about to expire after five years. If the foundation also grants, in addition to the above, the value of all cash contributions received that year, the donor may also use the higher AGI limit normally available for donations to public charities (50% for cash, 30% for noncash property) and even make a tax-free gift from an IRA up to $100,000.

5. Preserve your endowment with Program-Related Investments: Many foundations choose to satisfy their MDR's by making Program-Related Investments instead of traditional grants. A Program-Related Investment ("PRI") is essentially a charitably motivated investment that often takes the form of a zero or low-interest loan, secured or unsecured, to another charitable organization. In the year a foundation makes a PRI loan, the funds advanced are treated as though they were traditional grants for purposes of satisfying the MDR. In future years, repayment of the loan principal will increase the MDR. Making PRI loans permits a foundation to "recycle" its assets by making new loans using loan funds that have been repaid. By contrast, when a foundation makes a grant, the foundation never expects to recover those grant funds.

6. Consider the potential liquidity dilemma posed by certain investments: Non-productive assets that do not generate income, such as real property and privately held stock, increase your MDR by roughly 5% of the asset's value, but do not provide the means to satisfy the increased MDR. For example, land worth $2 million will add roughly $100,000 (5% of $2 million) to the foundation's MDR. If the land produces no rental income to help satisfy the MDR, the foundation may lack sufficient cash or other liquid assets to do so.

7. Eliminate capital gain with in-kind grants: If a foundation sells a significantly appreciated capital asset, it will recognize a capital gain and be taxed at the usual 1% or 2% tax rate. Instead of selling the appreciated asset, a foundation can make an in-kind grant of that asset directly to a charity, thereby avoiding the capital gain. The value of the appreciated asset at the time of the grant will be treated as the amount of the grant for purposes of satisfying the foundation's MDR.

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We work with both established foundations and individuals interested in starting a new foundation.

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