

# The Private Foundation: It's Not the Founder's Money Anymore

11.25.15 | Linda J. Rosenthal, JD



High-net-worth folks have lots of choices about what to do with their money – including *how* to give it away.

Many give outright, unrestricted contributions to existing public charities. Some make restricted gifts or create donor funds. Others are steered by professional and financial advisors toward establishing family (private) foundations, or decide on their own to take this route, without fully understanding the pros and cons. No one choice is the best or makes the most sense for any and all donors, but the family foundation remains a popular option.

## *A Private Foundation Isn't Private*

Perhaps the biggest lure of the family foundation format is having the family name connected with important charitable causes, and being able to continue these good works – with public recognition – through several generations.

But many philanthropists misunderstand the nature of this form of tax-exempt organization: first, a private foundation's operations are not secret or closed, and second, “[i]t's not [the founders'] money anymore.”

## *Private Foundation Duties*

Somewhat counterintuitive to the label, private foundations are *not* private. There is public oversight and scrutiny. There are filing and accountability requirements. There are tough, no-nonsense, restrictions on dealings with insiders.

Why? Because there are tax breaks and benefits. The perks for foundations are fewer and thinner than for public charities, but they are still substantial.

#### *Reporting and Accountability*

Like all tax-exempt organizations, private foundations are subject to possible periodic audits by the Internal Revenue Service, and must file annual “information returns.” The Form 990-PF asks for detailed information, including names and addresses of substantial donors. Members of the public have the right to request and receive three years of these 990-PF’s, and charity watchdog groups like [Guidestar](#) post these documents and other data on the internet.

#### *Insider Prohibitions*

In the publication “Self-Dealing: A Concise Guide for Foundation Board and Staff,” the Forum of Regional Associations of Grantmakers explains an important point:

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*Whether the donor to a private foundation is an individual, a family, or a for-profit company, it is important to understand that once cash or other assets are gifted (or bequeathed) to a private foundation, those assets then belong to a separate legal entity that is subject to many restrictions. Said as plainly as possible:*

*‘It’s not your money anymore.’*

*Many donors ... mak[e] the mistake of thinking that private foundation assets are simply another source of funds so long as any payment seems fair and charity benefits.... (emph. in orig.)*

To be sure, the creators of private foundations have the ability to control and direct which causes to support and which charitable beneficiaries will receive funds. But, in return for the tax-exemption benefits, there are limits on too-cozy arrangements with insiders.

While public charities are not given unbridled discretion either, there are fewer prohibitions than for private foundations, because the former are supported broadly by public donations and grant money. The assumption is that this financial help from outside the circle of the organization’s founders and key movers and shakers will necessarily result in accountability and safety of the charitable funds.

#### *A Little History*

All of this came about by the Tax Reform Act of 1969. For many years, the feds

had been watching private foundations abuse the generosity of the tax exemption for the benefit of their founders and their relatives, friends, and business interests. Under the 1969 law, “acts of self-dealing” are – with just a few exceptions – strictly prohibited.

The concept is straightforward: The rules “prohibit any *direct* financial relationship between the foundation and virtually all persons closely related to the foundation.” (*emph. in orig.*)

It doesn’t matter if the foundation and its ultimate charitable beneficiaries are benefited. For example, if “a member of the governing board rents out office space to the foundation at 50 percent below fair market value,” it’s still a prohibited act of self-dealing.

The reason for this harsh, black-and-white, rule is convenience: to avoid the problem of determining, on a case-by-case basis, whether a transaction between a foundation and an insider is truly fair or beneficial.

*Key Concept: “Disqualified Person”*

First things first. There must be two parties to any self-dealing transaction: the private foundation and a “disqualified person.” A disqualified person or “insider” is a person that is “closely related” to the foundation. This definition includes certain legal entities (such as corporations, partnerships or trusts) in which these closely-related people have significant interests. That is to say, these persons (and legal entities) are “disqualified’ from entering into any financial transaction with the foundation.”

*Key Concept: “Acts of Self-Dealing”*

The 1969 Congress created a list of six categories of “acts of self-dealing,” impermissible transactions between private foundations and “disqualified persons.”

Under this statute, “self-dealing’ means any direct or indirect –

(A) sale or exchange, or leasing, of property between a private foundation and a disqualified person;

(B) lending of money or other extension of credit between a private foundation and a disqualified person;

(C) furnishing of goods, services, or facilities between a private foundation and a disqualified person;

(D) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person;

(E) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and

(F) agreement by a private foundation to make any payment of money or other property to a government official (as defined in section 4946 (c)), other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90-day period.”

There it is. The official list.

Except Congress added a few exceptions to the list. Then the Treasury Department did what it's legally required to do and issued lengthy regulations interpreting and applying this statutory list. And, along the way, disputes arose. So the courts have had their say as well about what constitutes self-dealing within the meaning and intent of this landmark, 1969, overhaul of the private foundation rules. So, there's a list – but the devil is in the details.

### *Conclusion*

There are draconian penalties for failure to abide by the family foundation restrictions, so everyone connected with creating or operating one (or advising others to do so) should be thoroughly familiar with the pros and cons, and the ins and outs, of this charitable-giving format.