**Understanding Private Operating Foundations**

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The Council on Foundations defines a foundation as an entity that supports charitable activities by making grants to unrelated organizations or institutions or to individuals for scientific, educational, cultural, religious, or other charitable purposes. While foundations are often primarily engaged in grantmaking activities, some may engage in their own direct charitable activities or programs. (Council on Foundations).

Foundations in the United States were initially formed in the late 1800’s for the benefit of individual charitable institutions. During the past 120 years Private foundations have grown in number (approximately 103,000 in existence as of 2015) and impact approximately $55 billion in grants alone (in 2013). Private foundations are organized either as a nonprofit corporation or a charitable trust and are defined as tax exempt under 501(c)(3) of the Internal Revenue Code.

Generally, private foundations are supported by one or a small handful of funding sources, such as an individual, family, or a corporation.

The benefit of forming a private foundation, in addition to a charitable purpose, is the reduction of income taxes and an individual’s taxable estate while maintaining the control of individual of assets used to form the foundation. In addition upon death, control of the foundation can pass to the founder’s family members or other persons of trust.

The Tax Reform Act of 1969 defined the *Private foundation* and imposed the present day legal framework. These restrictions were implemented as a reform effort to remedy perceived abuses of Private foundations i.e. the charitable purpose of these foundations were not always clear. Under the act three types of private foundations were defined:

* Family foundations (funds come from an individual family),
* Private Operating foundations (run charitable programs directly)
* Corporate foundations (funds come from an individual corporation).

**Private Operating Foundations**

Private Operating foundations as defined under Section 4942(j)(3) or (j)(5) of the Internal Revenue Code are Private foundations that use the majority of their income to manage and operate charitable programs of their own. This differs from a non-operating private foundation which accomplishes its charitable purpose by distributing grants to other charitable organizations.

Private Operating foundations file Form 990-PF annually to;

1. verify legal status,
2. report on basic organization details,
3. detail reports on mission, governance and finances, salary and other forms of compensation.

Even though Private Operating foundations are defined as tax exempt under Section 501(c)(3) of the Internal Revenue Code, They are subject under Code Section 4940 to a 2% (reduced to 1% if certain tests are met) excise tax on investment income.

For new Private Operating foundations the IRS will initially grant private operating foundation status based on data submitted in the Form 1023.

Under IRS guidelines a private foundation will qualify as a private operating foundation by satisfying two numerical tests. These tests are to ensure that the private operating foundation is conducting its exempt activities directly and not simply making grants to other organizations.

The first test is an income test which requires the Organization to spend 85% of the smaller of its adjusted net income or minimum investment return directly in carrying out charitable activities.

The second test which is actually made up of three sub tests (meeting any one will satisfy the requirement) which include an asset test (65% of the Foundation’s assets are devoted directly to carrying out charitable activities), an endowment test (The foundation makes qualifying distributions equal to 2/3 of its minimum investment return), and a support test (the foundation normally receives 85% or more of its support from the public). These tests help to ensure that the private operating foundation meets the requirement of conducting direct charitable activities.

Both tests which are scheduled out on page 10 of the Form 990-PF need to be met for any 3 years during a 4-year period consisting of the tax year in question and the 3 preceding tax years or in aggregate.

In general, an individual who itemizes deductions may deduct contributions to most charitable organizations up to 50 percent of the taxpayer adjusted gross income. For private operating foundations this amount is limited to 30 percent of taxpayer adjusted gross income.

Listed below are some of the transactions which are prohibited under the internal revenue code and will result in steep excise taxes:

1. IRC Section 4941 prohibits all acts of self-dealing, which are generally defined as financial transactions which benefit disqualified persons (such as substantial contributors, foundation board members and their families). A 10% initial excise tax is imposed on the self-dealer. In addition a 5% tax is imposed on foundation managers who participated in the transaction capped at $20,000.

2. IRC section 4943 prohibits a foundation in conjunction with all of its disqualified persons from having excess business holdings. The first tier excise tax is 10% of the fair market value of excess business holdings (held for more than 5 years).

3. IRC Section 4944 imposes a penalty on the foundation and its managers for any investment that might jeopardize the carrying out of the foundation’s exempt purposes the tax of 10% capped at $10,000.

The following is a checklist of some of the items required for a Private Operating foundation to comply with relevant legal requirements: Note: consult with your attorney for possible additions.

1. Articles of Incorporation.

2. Bylaws – Rules that govern a corporations’ day-to day operations, meetings and the election of officers and directors.

3. Form 1023 - application for recognition by the IRS as a tax- exempt organization.

4. The IRS’s favorable determination letter certifying that your foundation is exempt from income tax and specifying that it is a private operating foundation.

5. Form SS-4 – Application for employee identification number.

6. Documents relating to State tax and State sales tax exemption.

7. Records required under Section 170 for all of its charitable contributions.

Private Operating foundations can be used to satisfy income and estate tax planning needs, in addition to engagement of a charitable activity. If you have any questions regarding IRS compliance of your private operating foundation, please call our tax department at 215-343-2727 to schedule an appointment.

WHAT ARE SOME DIFFERENT KINDS OF PRIVATE FOUNDATIONS?

Once a foundation has been classified by the IRS as a private foundation, there are ways to describe it based on how the foundation is funded and governed. Most of the following terms are not legal classifications, but rather descriptive terms used within the field of philanthropy to help others understand how the foundation operates. What these foundations have in common is that they are established to aid social, educational, religious, or other charitable needs. Generally, there is a board of directors that makes discretionary giving decisions, often within specific guidelines as to charitable field of interest and/or geographic area.

Independent foundations are distinct from other kinds of private foundations like family or corporate foundations, in that they are not governed by the benefactor, the benefactor’s family, or a corporation. They are usually funded by endowments from a single source such as an individual or group of individuals.

Family foundations are usually funded by an endowment from a family. With family foundations, the family members of the donor(s) have a substantial role in the foundation’s governance.

Corporate foundations (or company-sponsored foundations) are philanthropic organizations that are created and financially supported by a corporation. The foundation is created as a separate legal entity from the corporation, but with close ties to the corporation. Companies establish corporate foundations and giving programs to have a positive impact on society. Corporate foundations tend to make grants in fields related to their corporate activities or in communities where the corporation operates, or where their employees reside. Corporate foundations are usually set up as private foundations, but can be created as public foundations, particularly if they will be largely publicly supported. Rather than establish a separate foundation, a company can also make gifts and grants directly to charitable organizations through a program within the company itself. This is called a corporate giving program

International foundations typically are foundations based outside the United States that make grants in their own countries and overseas. The term “international foundations” also can refer to foundations in any country that primarily engage in cross-border giving. Not all foundations that engage in cross-border giving are private foundations; many are established as public charities. Under U.S. law, contributions from U.S. donors and corporations are not eligible for a charitable deduction if the organization is not formed in the United States or recognized by the United States as charitable.

Private operating foundations are private foundations that primarily operate their own charitable programs, although some also make grants. Private operating foundation is a legal classification under the Internal Revenue Code, and these foundations must follow many of the private foundation rules. Unlike private foundations that are not operating, a private operating foundation is required to spend a certain portion of its assets each year on charitable activities. By contrast, private non-operating foundations are required to pay out 5 percent or more of their assets each year in grants.

- See more at: http://www.cof.org/content/foundation-basics#different\_types\_public\_charities