



## STARTING A PRIVATE FOUNDATION

*Doing It Right*

by Layne T. Rushforth

1. **FOUNDATION BASICS:** A foundation can be formed as a nonprofit corporation or as a trust. No one is the “owner”, “shareholder”, or a “named beneficiary” of a foundation, but it is operated by a board of trustees or board of directors. The foundation exists as a charitable organization if it is formed and operated correctly. If a nonprofit corporation is properly formed, the personal assets of the foundation’s officers or trustees are not subject to the corporation's creditors, including judgment creditors<sup>1</sup>, except to the extent one or more of the officers or trustees agree to be personally liable, such as by signing a personal guarantee, by signing an agreement or note as a co-obligor, or by providing personally owned assets as security.
  - 1.1 **Trustees and Officers.** The trustees elect the foundation’s officers, such as President, Vice-President, and Secretary-Treasurer, and they can remove and replace trustees. The trustees are the policy makers, and the officers are employed by the foundation to put the trustees' policies into effect.
  - 1.2 **Multiple Roles.** Under Nevada law, one person can be the sole officer and sole trustee of a foundation, but that is usually not advisable if you want the foundation to have longevity.
2. **FORMATION:** A nonprofit corporation's formation is governed by state law. If a corporation formed in one state wishes to legally operate in another, it must qualify to do business in that other state according to the laws of that state.
  - 2.1 **Articles of Incorporation.** A nonprofit corporation is formed by filing "articles of incorporation" with the Secretary of State. The “articles” are usually brief, containing only the most basic information about the corporation that is being formed. The articles set forth the name of the corporation, the location of the principal office, the name of the agent for service of process, the names of the initial officers and trustees, etc. The articles of incorporation are simple, but they are only a part of the corporate formalities that must be followed in order to be entitled to the benefits of corporate status.
    - (a) **Registered Agent.** The corporation must appoint someone to serve as the "registered agent" or "agent for service of process". This is a person or business in Nevada that agrees to be served with papers in the event of a lawsuit. This agent must accept that position in writing, and that written acceptance must be filed with the articles of incorporation.
    - (b) **"Initial List" of Officers and Trustees.** On or before the last day of the first month following the filing of the articles of incorporation, an officer of the

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<sup>1</sup>The corporation does not protect a trustee from liability arising from his or her own negligence, nor does it prevent claims against an individual who personally guarantees an obligation of the corporation.



corporation must sign the initial list containing the names and mailing addresses for all officers and trustees of the corporation.

- 2.2 **Bylaws.** The bylaws outline the government of the corporation. The bylaws specify the duties and responsibilities of the corporation's trustees and officers. While the articles of incorporation are usually very brief, the bylaws are usually much more detailed, including information regarding meetings and the corporation's technical operations. Sometimes the articles will contain provisions that may be modified by the bylaws, but the general rule is that a provision in the articles of incorporation will take precedence over a contrary provision in the bylaws.
- 2.3 **Organizational Meetings.** Once the corporation has been legally formed by filing the articles of incorporation, the corporation must be organized. The trustees named in the articles must meet to elect officers and adopt the bylaws. The trustees may also want to authorize the opening of one or more bank accounts, authorize the engagement of an accounting firm to prepare the appropriate IRS Forms for recognition of the foundation as a qualified charitable organization under Internal Revenue Code 501(c)(3), and make other decisions relating to the start up of the foundation.
- 2.4 **Foundation as a Trust.** A foundation may also be formed as an irrevocable trust. If it is formed that way, the trust agreement would contain many of the same provision found in the articles of incorporation and bylaws of a foundation formed as a nonprofit corporation.
- 2.5 **Federal Tax Identification Number.** Whether formed as a nonprofit corporation as a trust, the foundation should apply for a federal tax identification number ("TIN", also referred to as an "employer identification number" or "EIN"). This is usually done by your accountant, but we can also do this for you. You can apply for a TIN yourself online on the IRS' web site.<sup>2</sup> By doing it online, the number is usually given immediately, without having to wait for a fax or a letter. We recommend getting this number immediately because you will not be able to open a bank account or complete other registrations for the foundation without a federal tax identification number.
- 2.6 **Business Registration.** Qualified 501(c) charities are exempt from the State Business License, and any private foundation formed as a nonprofit corporation should file a Declaration of Eligibility for State Business License Exemption.<sup>3</sup> If the foundation is formed as a trust, this is not required.
- 2.7 **Business Licenses.** You must comply with all applicable local ordinances in the operation of the foundation.

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<sup>2</sup><http://www.irs.gov/businesses/small/article/0,,id=102767,00.html>.

<sup>3</sup><http://nvsos.gov/Modules/ShowDocument.aspx?documentid=2037>



- 2.8 **Employees.** You must follow federal, state, and local laws relating to employment, payroll taxes, workers' compensation insurance, occupational safety, and all other laws and regulations relating to employees. If you have Nevada employees, you must register with the Employment Security Division. For many companies, this can be done online at [https://uitax.nvdetr.org/er\\_welcome](https://uitax.nvdetr.org/er_welcome).
3. **OBTAINING RECOGNITION AS A 501(C)(3) CHARITY:** An income tax deduction is available for contributions to a foundation that is a charitable organization under Internal Revenue Code § 501(c)(3). Similarly, death-time transfers to a foundation that is a 501(c)(3) charity will qualify for a deduction for estate tax purposes.
- 3.1 **Public Charity or Private Foundation.** There are many organizations that are considered 501(c)(3) charities, but most people form either a private foundation or a public charity. If the primary source of funding is from the general public, the organization should qualify as a public charity. If the primary source of funding comes from one person or members of the same family, then the organization will be considered a private foundation. The public charity has fewer restrictions on its operations, and contributions of up to 50% of the donor's adjusted gross income can qualify for a charitable deduction. The private foundation is subject to: rules against self-dealing; penalties for unrelated business taxable income; an excise tax on trust income; and a minimum distribution requirement. In addition, contributions to private foundations can only be deducted if they do not exceed 30% of the donor's adjusted gross income.
- 3.2 **IRS Form 1023.** To apply for recognition, the foundation must submit IRS Form 1023<sup>4</sup> or Form 1023-EZ<sup>5</sup>. Form 1023-EZ was created in July of 2014, but it is very limited, because it only applies to foundations that have less than \$250,000 in assets and annual receipts of under \$50,000. Not too many people form foundations that meet those requirements. IRS Form 1023 requires a disclosure of personal information regarding the key officers and trustees of the foundation, as well as an estimated budget. We encourage you to engage a CPA to assist in the preparation of this form. It is a lot more complex than a standard tax return.
- 3.3 **Provisional Recognition.** If IRS Form 1023 is filed within 27 months of formation of a new foundation, the exemption ruling (when issued) will be retroactive to the date of formation.
- (a) That means that donors can take an income tax deduction for donations made before the exemption ruling is issued if they are willing to gamble that the ruling will be issued. If the exemption ruling is denied, any income tax

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<sup>4</sup><http://www.irs.gov/uac/Form-1023,-Application-for-Recognition-of-Exemption-Under-Section-501%28c%29%283%29-of-the-Internal-Revenue-Code>

<sup>5</sup><http://www.irs.gov/uac/About-Form-1023EZ>



return that claimed a deduction would have to be amended to remove the deduction.

- (b) An alternative would be to file a tax return without the deduction, and then to amend the tax return to add the deduction once the exemption ruling has been granted.
- (c) If you are going to solicit contributions, you may want to include a “disclaimer” that says something like this AFTER you have filed the IRS Form 1023:

<NAME OF FOUNDATION> (the "Foundation") is a Nevada nonprofit corporation. The Foundation was formally incorporated on <date>. The Foundation was formed to qualify as a public charity for federal tax purposes under Section 501(c)(3) of the Internal Revenue Code. The Articles and Bylaws were written and the Foundation is managed so that contributions to the Foundation are deductible for federal income tax purposes, and so that the Foundation would qualify as a “30% limit organization” and not as a “50% limit organization”. For your records, the tax identification number for the foundation is ##-#####.

An application for formal recognition of the Foundation’s status as a charitable organization under Section 501(c)(3) of the Internal Revenue Code (IRS Form 1023) has been submitted to the IRS, and we are awaiting a formal determination. The law does not preclude the taking of a charitable deduction before the formal determination is made, but it does preclude the taking of a charitable deduction when an application is required but has not been submitted. Charitable organizations are required to file such an application within 27 months of formation, and we have filed the Foundation’s application well before that deadline.

If you take a deduction for your contribution to the Foundation on a federal income tax return, you will be required to amend that return if the Foundation's application for recognition as a 501(c)(3) organization is denied. If you do not take a deduction for your contribution, you will have up to three years to file an amended return to claim the deduction (and presumably a refund) after the application is accepted and approved.

More important, please consult your own CPA or other qualified tax adviser before making a decision as to the tax deductibility of your contribution to the Foundation.

**4. MAINTENANCE:** A foundation requires maintenance. If it is not properly maintained, it may be ignored. If you need assistance with any of this, please contact us or another qualified professional.

**4.1 Financial Records.** A foundation’s most important records are its financial records. The foundation’s accounting records should be kept current, and all



appropriate tax returns should be filed. The corporation's financial records must be maintained separate from those of any trustee or officer. The corporation must have a separate tax identification number, which should be used for all corporate transactions and tax returns. Corporate assets, including bank accounts, investments, real property, and vehicles should be titled in the name of the corporation. An employee of the foundation should never use foundation assets for personal use. Once the corporation is formed and officially recognized, no one should ever pay a corporate obligation with a personal check, and no one should pay a personal obligation with a corporate check.

4.2 **Meetings.** The trustees should meet as often as necessary to hold elections and make decisions, not less than once a year.

- (a) Minutes of the meetings are kept to record the decisions that are made, usually documented in the form of "resolutions" that are adopted pursuant to parliamentary procedure.
- (b) Nevada law permits resolutions to be adopted in the absence of a formal meeting, if a "consent resolution" is signed.
- (c) We recommend that at least once a year trustees elect the officers. Of course, the officers and trustees can be elected for more than a one-year term, and the election of various trustees and officers can be staggered so that all are not elected during any one election. These elections may be done at a meeting or by consent resolution.

4.3 **Compliance with Tax Laws.** The tax forms that are required for a foundation depend on whether it is classified as a public charity or a private foundation. Most organizations are required to file an annual information return (Form 990, Form 990-EZ or Form 990-PF) or electronic notice (Form 990-N). If the organization has unrelated business income of more than \$1,000, it must also file a Form 990-T. The IRS has published a number of helpful publications regarding foundations:

- (a) Publication 557<sup>6</sup>;
- (b) Publication 4220<sup>7</sup>; and
- (c) Publication 4221-PC<sup>8</sup> or 4221-PF<sup>9</sup>.

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<sup>6</sup>[http://www.irs.gov/file\\_source/pub/irs-pdf/p557.pdf](http://www.irs.gov/file_source/pub/irs-pdf/p557.pdf)

<sup>7</sup>[http://www.irs.gov/file\\_source/pub/irs-pdf/p4220.pdf](http://www.irs.gov/file_source/pub/irs-pdf/p4220.pdf)

<sup>8</sup><http://www.irs.gov/pub/irs-pdf/p4221pc.pdf>

<sup>9</sup><http://www.irs.gov/pub/irs-pdf/p4221pf.pdf>



4.4 **Prohibited Transactions for a Private Foundation:** The following transactions (whether direct or indirect) between a private foundation and a “disqualified person” (which includes the primary donor and the family members of the primary donor) result in a prohibited transaction:<sup>10</sup>

- (a) Sale, exchange or lease of any property.
- (b) Loans or extensions of credit.
- (c) Furnishing of goods, services or facilities.
- (d) Transfer to, or use by or for the benefit of, a disqualified person of any income or assets of the foundation.
- (e) Dealings by a fiduciary with the income or assets of the foundation for his/her own interest or account.
- (f) Receipt by a fiduciary of any consideration, from a party dealing with the foundation in connection with a transaction involving income or assets of the foundation.

4.5 **Other inappropriate transactions:** The following transactions are also to be avoided by a private foundation:

- (a) The payment of excessive compensation.
- (b) Making distributions to individuals, even if made as scholarships or for disaster relief.
- (c) Making distributions to an organization that is not a 501(c)(3) organization.
- (d) Failing to make an annual distribution of at least 5% of the fair market value of the foundation’s net investment assets to one or more 501(c)(3) organizations or other permitted exempt purposes.
- (e) Making an investment in a private business (e.g., partnership, S corporation, or LLC) or operating a for-profit business.
- (f) Making investments that jeopardize the foundation’s charitable purpose, which include speculative and leveraged investments.

5. **PROTECTING AGAINST LIABILITY:** As stated above, a foundation is normally liable for its own obligations, but under some circumstances, the officers and trustees can be personally liable.

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<sup>10</sup>[http://www.irs.gov/irm/part4/irm\\_04-072-011.html](http://www.irs.gov/irm/part4/irm_04-072-011.html)



5.1 **The "Alter Ego" Rule.** A legal entity, including a corporation or a trust, will be ignored by the courts if it is deemed to be nothing more than the "alter ego" of its trustees or its officers.

(a) The "alter ego" argument can be used by the foundations' creditors (whether businesses or individuals) who are owed money by the foundation that the foundation itself is unable to pay. Such creditors want the foundation to be ignored so that they can seek payment from the foundation's officers or trustees, and they can be successful in having the foundation disregarded as a legal entity if the legal formalities are not observed, if personal and foundation assets are commingled, if personal obligations are paid for out of the foundation's funds, if foundation assets are used for personal use without payment or without being treated as part of an employee's compensation, and/or if the foundation's financial records are not properly kept.<sup>11</sup>

(b) The "alter ego" will not be applied to a foundation that keeps accurate records of its meetings of trustees, that keeps its financial affairs completely separate from those of its officers and trustees, that has its financial records regularly maintained or at least reviewed by a certified public accountant, and that makes sure that all activities are conducted in the foundation's name.

6. **CONCLUSION:** If you are going to establish a foundation, do it right. This will involve the observance of proper legal formalities, and it generally requires the advice of qualified financial and legal advisors.

6.1 **Business Formalities.** A foundation should not begin operation until it has been properly formed under state law. This means, at a minimum, that either:

(a) The articles of incorporation must be accepted by the Secretary of State, that the trustees have met to adopt bylaws, to select officers, and to adopt resolutions regarding the operation of the foundation; or

(b) The irrevocable trust agreement forming the trust has been properly signed by the person creating the trust and each of the trustees.

6.2 **Legal Matters.** Foundation operations rely on compliance with the law, and consulting with an attorney periodically can assist in keeping abreast of the law and its requirements. It is prudent to consult an attorney when contract negotiations or contract disputes are involved, and it is imperative to engage an attorney if litigation is involved. Sometimes, an attorney with special expertise is required to deal with a specific legal problem.

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<sup>11</sup>Legally disregarding a corporation is sometimes referred to as "piercing the corporate veil" to make trustees or officers personally liable for foundation obligations. If the trustees or officers ignore the corporation and use foundation assets for personal benefit, the IRS may determine that the foundation is not a qualified 501(c)(3) entity.



- 6.3 **Financial and Tax Matters.** The most important advisor for a foundation is its accountant. The first task will be to apply for 501(c)(3) status. On an ongoing basis, making sure that financial records are properly kept and tax returns and forms are timely filed will go a long way to preserve the foundation's good standing and continued legal existence. Of course, if investments are to be made and maintained, investment advisors who are familiar with the investment restrictions that apply to your foundation should also be consulted.

[END: Version of August 13, 2014]

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