

Going Beyond Preserving a Collection – the Private Operating Foundation

Many times, an artist or collector wishes to preserve their collection by donating the collection to a museum or other public charity. Often the museum, university or other organization is unwilling or unable to integrate, preserve, store and display the entire collection along with the associated documents. Even if there is a financial gift to sufficiently endow the collection today, there is no certainty that the endowment will be able to fund the charity indefinitely into the future. Furthermore, charities are not immutable, they change their focus and mission. What fits their mission today, may not fit with the charitable purpose of the charity in the future. When there is no charity willing to preserve the collection, the artist or collector should consider using a private foundation; especially, now as the future of museums is moving away from the brick-and-mortar and toward a virtual institution.

WHAT IS A PRIVATE OPERATING FOUNDATION?

A Private Operating Foundation is a tax-exempt organization, funded primarily by one or a few donors, that directly or indirectly operates one or more charitable programs, and can own tangible assets, such as real estate and art, used for its charitable purpose. It can carry on grant making activities as well, including grants directly to individuals. They straddle the line between a public charity (that is publicly supported, has program related assets, and can make direct grants to individuals) and a private foundation (which has one or more funders, cannot hold art or other “jeopardizing investments”, and is limited to only making grants to public charities).

WHY USE A PRIVATE OPERATING FOUNDATION?

People create and fund a Private Operating Foundation because they want the highest degree of control over the foundation’s assets and programs possible, while still maximizing the tax benefit of a donation to charity. This control means that the foundation does not have to make grants to public charities of at least 5% annually nor does it have to restrict its investments to just liquid investments, like a private foundation. It also does not have to show public support and can provide the donor and family on its staff, a reasonable salary for personal services, unlike a public charity. Additionally, a Private Operating Foundation can:

- Accept contributions in cash or in kind from non-family donors, for support of its programs or services; and give the donors the same tax benefits they would get if they gave the assets to a public charity, that is the current value of cash and appreciated property are counted. The limits per year is 60% of the donor’s Adjusted Gross Income,

- The donor or their family can manage its activities and align them with their philanthropic mission,
- Can directly and regularly interact with the community, through support of individuals and businesses in furtherance of its charitable mission, and
- Encourage others to invest in the philanthropic mission, so leveraging a family's investment.

WHAT ARE THE REQUIREMENTS FOR A PRIVATE OPERATING FOUNDATION?

To become a Private Operating Foundation, a foundation must demonstrate that the majority of its income is used to provide a charitable service or operate a charitable program. To do this, a foundation must first demonstrate to the IRS that it spends at least 85% of its adjusted net income, or its minimum investment return (whichever is less), on the active conduct of its exempt activities, excluding grants to public charities.

Additionally, the foundation must pass one of the following 3 tests for three out of the last four years:

- The assets test: the foundation must use 65% of their assets to actively conduct exempt activities (which includes stock in a corporation controlled by the foundation where the at least 85% of the corporation's assets are used for the foundation's charitable programs).
- The endowment test: the foundation must spend two-thirds of the minimum investment of return towards exempt activities, or
- The support test: at least 85% of its financial support must come from the general public and 15% from unrelated exempt organizations.

Meeting these tests can be difficult when the Private Operating Foundation has a diverse, non-program-related, portfolio of investment assets. It is critical that you understand these requirements before exploring the Private Operating Foundation alternative.

WHAT EXCISE TAXES IMPOSED ON PRIVATE FOUNDATIONS APPLY TO PRIVATE OPERATING FOUNDATIONS?

Private Operating Foundations are subject to the same excise taxes applied to private foundations, except for two excise taxes:

- Minimum Distribution Requirement Excise Tax: Private Operating Foundations are not required to make annual 5% minimum distributions. In order to avoid this excise tax though, it does have to spend a similar amount on their charitable programs, staffing and so on.

- The Net Income Tax though a Private Operating Foundation may claim exemption from the net investment income excise tax, if it qualifies as an exempt operating foundation.

WHAT ARE THE MAJOR MISTAKES DONORS AND THEIR FAMILIES MAKE WHILE OPERATING A PRIVATE OPERATING CHARITY?

The most common mistake the donor or family of a private foundation makes is violating the self-dealing rules. Foundations are prohibited from any transactions with the donor, their family, or other disqualified persons, such as an officer, a trustee or a relative of one of those persons. If a person has influence over the decisions of the private foundation, they are a disqualified person.

Six types of transactions between the foundation and the disqualified person are specifically prohibited. These are:

- The sale, exchange or leasing of property,
- The lending of money or other extension of credit,
- The furnishing of goods, services or facilities
- The payment of compensation or payment or reimbursement of expenses (other than reasonable compensation for personal services to the foundation), or
- The transfer to, or use by or for the benefit, of a disqualified person any income or assets of the private foundation.

The prohibited transaction rules are all encompassing and are strictly interpreted by the Internal Revenue Service (IRS). As a result, private foundations have been surprised when they are faced with the consequences—including severe excise taxes and correction requirements—of a transaction they didn't think was subjected to these rules.

The next most common mistake is to confuse the Endowment Investment with the Program Related Investment. Endowment investments must be made to avoid both the Jeopardizing Investment Excise Tax and the Unrelated Business Income Tax.

A Jeopardizing Investment is any investment that is considered "speculative:" that is any investment other than publicly traded stocks and bonds, hedge funds or other investment vehicle. Program Related Investments are excluded from this rule.

Unrelated business income earned by the foundation is taxed as if the foundation was not tax-exempt but was a for-profit business. The example, often cited, is the museum gift shop. Proceeds from the sale of posters or other reproductions of the museum's artwork, or books on the museum's collection, is Related Business Income. Proceeds from the sale of food and drink at the gift shop, or the museum's café, is Unrelated Business Income.

HOW DO YOU AVOID MISTAKES AND TAKE FULL ADVANTAGE OF THE PRIVATE OPERATING FOUNDATION STATUS?

The best way to operate a Private Operating Foundation is to divide operations into three parts: the direct program related operations within the foundation; the direct or indirect program-related grants or services provided to individuals, businesses or communities outside of the foundation; and, the third is both program-related and endowment investment operations. This is because the rules and excise taxes imposed on a foundation vary based on whether the activity of the foundation is related to its internal programs (i.e., operating a museum, library or community center), its external programs (i.e. making grants, loans or investing in people or businesses for the charitable purpose), and whether the assets of the foundation are Program Related Investments (which can be passive but speculative, such as art or real estate, or active, such as direct investment in a private business, related to the charitable program) or are endowment related investments (which must be passive and not speculative).

HOW DOES THIS INTEGRATE INTO THE MUSEUMS OF THE FUTURE?

Since COVID-19 struck, physical museums have closed or only reopened on a limited basis. Issues raised by the Black Lives Matter and other social justice groups apply to museums. Traditionally, museums are located in neighborhoods far distant from where people of color live. When museums are tied to one physical location, it is difficult to serve people who are disabled, institutionally discriminated against, who also lack access to private transportation or reliable public transportation. While traveling shows can bring artwork to other locations, they are still restricted to physical locations and the requirements for social distancing.

Now, technology can deliver on the promise of a virtual museum. The display capabilities of basic internet service and the 5G technology for mobile devices is beginning to equal the quality of the recording and digitization of artwork. Virtual masks and mobile devices enable a person to take a virtual tour of an art gallery even if the gallery is remote (or even if the gallery does not exist at all). Combined with tactile gloves or even full body suits, the virtual tour will allow visitors to “feel” the artwork in ways that they cannot experience with the actual artwork. Licensing the reproduction of the artwork so that 3-D printers could, with the correct license, print an exact replica of the artwork widens the access even farther. Already, large online archives of data at such places as web.archive.org exist.

HOW DO PRIVATE OPERATING FOUNDATIONS INTEGRATE INTO THE MUSEUM OF THE FUTURE THAT PUBLIC CHARITIES OR PRIVATE FOUNDATIONS ALREADY SUPPORT?

The Private Operating Foundation is uniquely situated to integrate into the museums of the future because it straddles the line between a public charity and a private foundation. It can make direct grants to individuals in furtherance of its charitable mission, to invest in businesses where 85% of the business's assets are committed to the foundation's charitable purpose and even supply the virtual masks, tactile gloves and other equipment to allow full access to the virtual museum. A Private Operating Foundation can drive technological development of the virtual museum by making grants to engineers and developers for the hardware and software needed; and, it can back the start-ups and entrepreneurs needed to make the technology a commercial reality. It can be the vehicle for artists and collectors to donate art without loss of control, while providing the same tax benefits as donations to a public charity.

So, if you are an artist or a collector wanting to preserve your collection, consider a Private Operating Foundation, as the Private Operating Foundation can be used not only to preserve a legacy, but to define and shape the future.



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