Proskauer

Personal Planning Strategies

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With over a century of combined experience, the lawyers of Proskauer's Private Client Services Department regularly provide their diverse clientele – from business entrepreneurs and corporate executives to sports figures and performing artists – with their Personal Planning Strategies Newsletter, a critical source of information which identifies significant issues of interest to Proskauer's clients. The Personal Planning Strategies Newsletter provides articles addressing the latest statutory changes and developments affecting retirement, estate, insurance and tax planning, as well as cutting-edge corporate, real estate and tax concepts.

Lessons for Running a Foundation from the Complaint against the Donald J. Trump Foundation

On June 14, 2018, the New York Attorney General (the "AG") filed a complaint (the "Complaint") against the Donald J. Trump Foundation (the "Trump Foundation"), together with its directors and officers, for violations of New York's laws applicable to foundations. The rules at issue in the AG's complaint apply to all New York private and family foundations. Moreover, the violation of New York's laws could lead to dissolution of the foundation, as well as personal financial liability on the part of foundation leadership.

Accordingly, following these rules, outlined below, can save time, preserve foundation resources, avoid embarrassment and minimize the risk of personal liability for a foundation's donors, officers and directors:

1. **New York foundations must adopt legally required policies.** The Complaint alleges that the Trump Foundation failed to adopt legally required policies. All New York foundations must adopt certain legally required policies, including a Conflict of Interest Policy, an Investment Policy, and foundations with 20 or more employees or $1 million or more in annual revenue must also adopt a Whistleblower Policy. In regards to investments, those responsible for managing foundation funds must manage and invest the funds in good faith and with care an ordinarily prudent person would exercise under similar circumstances.

2. **New York foundations should observe corporate formalities.** The Complaint seeks to dissolve the Trump Foundation, in part based on the Trump Foundation's failure to observe any corporate formalities. New York foundations should have regular board meetings. All board actions should be documented in writing and reflected on the foundation's records. The board should also enact policies for its activities, and act as a group rather than by the unilateral direction of an individual.

3. **Foundation funds must be segregated from the donor's personal funds or funds of his or her business, and cannot be used to benefit the donor or any of the donor's businesses.** The AG's complaint also alleges that the Trump Foundation's board failed to exercise control over the Trump Foundation's funds by giving up day-to-day management of the funds to the untrained staff of the Trump Organization. Additionally, the Complaint claims that the Trump Foundation used assets to benefit its donor, including paying debts on behalf of the donor.

   To avoid similar claims, foundations must have separate accounts from the donor and from the donor's businesses. Foundations also must not pay or receive money that is owed or owing to the donor or any of the donor's businesses. Moreover, if a family office is providing services to a foundation, the foundation's board must create procedures to ensure that assets are not co-mingled and to prevent family office employees from having signature authority over foundation assets if they are not directors or officers of the foundation.

   Additionally, foundations cannot use foundation assets to benefit the donor, including using foundation assets to satisfy the donor's debts or to purchase items to be used in the donor's home or office. All foundations are also prohibited, with limited exceptions, from entering into transactions with the donor or his or her businesses, and should be very cautious when considering any such transaction. In particular, foundations should take precaution when entering into any contracts with a donor's family office for services, as such contracts could be considered self-dealing.

4. **The foundation must make all required filings and disclose all activities and transactions therein.** The Complaint alleges that the Trump Foundation failed to disclose all of its activities on required tax returns. Foundations must disclose in a return all transfers (particularly grants).

5. **Foundations must not use funds for political purposes or engage in political activity.** According to the Complaint, the Trump Foundation was heavily involved in prohibited political activity. All foundations must refrain from donating to campaigns, promoting candidates, collecting money on behalf of a candidate

and conducting activities (such as grant award ceremonies) at political events. Moreover, foundations must not be controlled by or involved in sustained cooperation with any political campaign or entity.

If you have any questions or concerns, or would like to discuss your foundation with us, please do not hesitate to call.

Should You Create Your Own Private Foundation?

If you are a substantial charitable benefactor, you may consider establishing a private foundation to manage your charitable giving. With a private foundation, you and your family can carry out your charitable goals directly, without anyone else's participation. The IRS permits the contributors to a private foundation (often a single individual or family) a high level of control over the foundation's investments and grant-making. Contributors also receive a present tax deduction for all donations. In exchange for these benefits, a private foundation must strictly comply with the IRS's rigid anti-abuse rules.

I. What is a private foundation?

A private foundation is a charitable organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code. By definition, a private foundation receives most of its funding from nonpublic sources, such as a single individual or family, and such foundations are typically used as grant-making vehicles to support other charitable causes. In this model, the donors contribute money to the private foundation for a present charitable deduction, and the private foundation invests those funds to grow tax-free. By law, the private foundation must distribute some of its assets as charitable donations each year (roughly 5% of the value of its assets). The founders of a private foundation are permitted to manage its operations directly, even though they receive charitable deductions for their donations to the private foundation.

No particular form of organization is required to qualify your foundation for tax-exempt status. It can be organized as a nonprofit corporation or as a charitable trust. Organizing as a corporation (for example, under New York's Not-For-Profit Corporation Law) provides structured rules for the foundation's governance (e.g., election of directors and officers and schedule of meetings). Many states offer limited liability to foundation managers such as officers and directors.

By contrast, a charitable trust can be formed quickly and easily, without approval from state authorities. A trust's activities are often less subject to public scrutiny than are those of a corporation, but trustees may be subject to a more demanding standard of fiduciary liability than the directors or officers of a corporation. Because a trust is more loosely structured, the terms governing its affairs must be specifically set forth in the trust agreement. The trust agreement itself is often more difficult to amend than a corporation's governing documents, providing some protection from mission creep and decentralization of control.

II. Control and deductibility

A gift to your private foundation is complete (and thus deductible) upon transfer, despite the fact that (a) you and your fellow foundation managers have, by running the foundation, effectively reserved the power to control those funds, and (b) most of the donation will not be distributed to its ultimate charitable recipients for a long time. Through your private foundation, you can "save up" for a substantial philanthropic project, such as endowing a hospital wing or an academic chair, without actually transferring (or even committing) the endowment funds until such funds have been accumulated.

III. Succession planning and "philanthropic immortality"

Your foundation can also serve as the vehicle for involving future generations in charitable giving without unduly restricting the programs that your successors (for example, your children) may want to support in the future. The ongoing funding of your foundation will come primarily from gifts by you and your family and from the income derived from the foundation's own investments, while others may also contribute to it. Donations may be made at any time, including transfers by will and other dispositions taking effect at death. In this way, your donations can continue being used for charitable purposes (and continue being distributed in your name) for years after your initial contribution or even your death.

IV. Requirements and Regulations

The trade-off for the freedom and flexibility of maintaining your private foundation is that it will be regulated far more stringently than a publicly supported charity. Extensive recordkeeping is necessary to avoid the various penalty taxes which could result if your foundation engages in a host of "prohibited transactions."

These restrictions are set forth in special provisions of the Internal Revenue Code which were enacted by Congress to end the abuses of family controlled foundations. The Code provisions are designed to prohibit particular types of foundation conduct, which include those described in the following paragraphs.

A. Self-dealing is prohibited

   Strict rules apply to limit transactions between a private foundation and closely related persons, regardless of whether these transactions occur at arm's length. In general, transactions between a private foundation and a "disqualified person" are subject to a "self-dealing" penalty tax. For your private foundation, "disqualified persons" would include you, your family and certain business entities you own, as well as all substantial donors and all the managers (including directors, officers and/or trustees). As an example, leasing office space to your private foundation, even though at a fair market rental, is an act of self-dealing. There are, however, limited exceptions to these rules. For example, the managers of a private foundation can be paid reasonable compensation for their services.

B. Minimum distributions are required

   Each year, your private foundation will be required to disburse a minimum amount of its funds to one or more public charities or formally set such funds aside for a specific charitable project. The minimum amount required to be distributed is generally an amount equal to 5 percent of the aggregate fair market value of all of your foundation's assets (subject to certain adjustments) other than those funds employed directly in carrying out the charitable purposes of your foundation, such as office equipment.

C. "Excess Business Holdings" Are Limited

   Your private foundation generally may own no more than 20 percent of a business, less the percentage of the business owned by you and your family members; any excess holding is subject to tax. A foundation has five years in which to divest any such excess holding acquired by gift or bequest before the excess business holdings tax is assessed.

Any investment that will financially jeopardize the carrying out of the private foundation's exempt purpose is also subject to a penalty tax. Particularly risky investments, such as options and certain derivatives, may expose your foundation to this tax. However, your private foundation may properly retain such investments if they are donated to it in kind by you (or anyone else). This investment limitation does not relieve you as foundation manager from complying with any state law requiring diversification.

4. Certain expenditures are prohibited

   Another requirement is designed to ensure that your foundation's assets are used exclusively for charitable purposes. Payments made to influence legislation, promote political activities, benefit foundation insiders or provide grants for other non-charitable purposes will subject your foundation to a penalty tax. Because of this requirement, under most circumstances, your foundation will not be permitted to make grants directly to individuals, except for scholarships, fellowships and similar programs, which must be awarded based on a method approved by the IRS.

5. Additional taxes and reporting obligations

   Although "tax-exempt", your private foundation will generally have to pay a 2 percent tax (and estimated tax payments) on its net investment income. The rate of tax is reduced to 1 percent for any year in which certain accelerated charitable payout requirements are met.

   Federal law requires that an extensive annual information return be filed with the IRS and that each private foundation make its application for tax exemption, as well as its annual tax returns, widely available for public inspection. The preparation of these annual returns is familiar to most tax accountants, and computer programs are available to assist in producing them. In addition, under the laws of many states, including New York, your private foundation must also furnish an annual report to the Attorney General.

V. Planning and funding opportunities

1. Income tax planning

   You can receive present charitable deductions for donating to your private foundation, despite the fact that you retain control over the use of the donated assets. This is an opportunity to take large deductions in years you have high income while continuing to direct the management of your funds and charitable program. For a cash donation to a private foundation, you are entitled to a deduction in the full donated amount (subject to a cap equal to 30% of your adjusted gross income). By contrast, when you give appreciated assets to a foundation, your deduction is generally limited to your tax basis in those assets (up to 20% of your adjusted gross income). Consult an attorney or tax planner before making in-kind donations to your private foundation.

Note that, for donations to a private foundation, deductions are limited relative to those available for donating to a publicly supported charity. Deductions for cash donations to a public charity are capped at 50% of adjusted gross income, while deductions for appreciated assets are taken at the fair market value of the donated asset, not your tax basis (up to 30% of adjusted gross income). To get these deduction benefits, consider a donor advised fund or a private operating foundation.

A private operating foundation is a type of private foundation that is treated as a public charity for deduction purposes because it devotes a sufficient amount of its resources to direct charitable activity (for example, running a soup kitchen) as opposed to grant-making. In addition, a private operating foundation is not subject to a penalty tax imposed on its undistributed income, like an ordinary private foundation. Note, however, that private operating foundations are nevertheless subject to many of the same restrictions as are ordinary private foundations, including excise taxes on net investment income and prohibitions on self-dealing, excess business holdings, high-risk investments and impermissible expenditures.

2. Foundation as a beneficiary of your estate and family trusts

You can also fund your foundation (either initially, or in addition) by bequest under your will or as part of the remainder of a trust taking effect at your death. Your estate may then claim an estate tax charitable deduction based on the fair market value of the property passing to your foundation, regardless of the type of property or its original tax cost. You can also name your foundation as a beneficiary of various charitable trusts, including a charitable lead trust or charitable annuity trust.

A Donor Advised Fund Is an Easy Alternative to a Private Foundation

If you have philanthropic goals but wish to avoid the time and expense of creating and maintaining a private foundation, you may consider establishing a donor advised fund. A donor advised fund functions like a charitable investment account—you can make a donation that is presently tax deductible, and the donated funds can be invested to grow tax-free. At any time, you can recommend that the donor advised fund make particular charitable donations to causes or organizations you would like to support.

I. How does a donor advised fund work?

A donor advised fund is a fund or account maintained by a an organization that is tax-exempt under Section 501(c)(3) of the Internal Revenue Code and that qualifies as a public charity. The fund custodian may operate many such accounts, each segregated from the others and named for the primary donor or donor family (e.g., the Smith Family Charitable Fund). As a public charity, your donations to such organization are eligible for the maximum level of deductions available for a charitable donation.

When you donate to a donor advised fund, you relinquish all legal control over the investment of the funds and the legal right to determine how your funds are distributed to charity. However, you retain the right to "recommend" or "advise" that the fund make particular donations from time to time, and to designate the "recommenders" or "advisors" who will succeed you in this role. Such recommendations, while not legally binding, are almost always honored, and each time a grant is made, the fund custodian will (with your permission) identify the donation as coming from your fund.

Donor advised funds are offered by most major banking institutions such as Vanguard and Fidelity. Your donations can be large or small, regular or sporadic. Each year, the fund custodian will take a small portion of your fund to help defray the custodian's operating expenses.

II. Benefits

1. Simplicity and administrative ease

   When you donate to a donor advised fund, you have no recordkeeping or reporting responsibilities other than to keep track of your own gifts. The donor advised fund can be set up quickly, without state or other regulatory approval. Because the fund custodian is responsible for managing the fund, it lays no administrative burden on the donor. At the same time, you retain the right to recommend donations from the fund. Many substantial givers to charity maintain philanthropic funds and find them to be satisfactory alternatives to private foundations.

2. Deductibility is enhanced

   Since the fund custodian is a public charity and your fund has no separate legal existence, the more favorable percentage limitations applicable to contributions to public charities apply to donations to your fund. You are entitled to deductions for the full value of cash donations (up to 50% of your adjusted gross income), and the full fair market value of appreciated property (up to 30% of your adjusted gross income).

3. Succession planning

   The custodian of your donor advised fund will permit you to designate the people who succeed you in holding the recommendation/advice power with respect to the fund's charitable donations. You can use this designation to involve your family in your charitable giving, either before or after your death.

III. Requirements and regulations

A donor advised fund is not subject to the rigid self-dealing rules applicable to private foundations, nor is it subject to prohibitions on certain business holdings. However, donor advised funds may only make distributions for charitable purposes and may not be used to benefit the donor or the donor's family. For example, your donor advised fund should not be used to pay charitable pledges for which you are personally liable—such pledges are your personal legal obligations and the use of your donor advised fund to pay them would constitute a distribution from the fund to you.

In addition, a donor advised fund is only suitable as a charitable savings and grant-making vehicle—the fund will not allow you to engage directly in charitable activity. Donors who wish to make grants while also operating a scholarship program or other charitable activity should consider a private foundation (including a private operating foundation) as an alternative.

IV. Planning and funding opportunities

1. Income tax planning

   Donations to your donor advised fund are deductible at the maximum limits—the full value of cash donations (up to 50% of your adjusted gross income), and the full fair market value of appreciated property (up to 30% of your adjusted gross income). This is true despite the fact that you retain some de facto control over the disposition of the fund's assets. This is an opportunity to take large deductions in years you have high income while continuing your involvement in the management of your charitable gifts, and without needing to decide the ultimate charitable recipients at the time of your donation.

2. Donor advised fund as a beneficiary of your estate and family trusts

   You can also contribute to your donor advised fund (either initially, or in addition) by bequest under your will or as part of the remainder of a trust taking effect at your death. Your estate may then claim an estate tax charitable deduction based on the fair market value of the property passing to your fund. You can also name your fund as a beneficiary of various charitable trusts, including a charitable lead trust or charitable annuity trust. This will ensure the continued existence of your donor advised fund after your death.

New Florida Decanting Statute Expands Ability to Amend Irrevocable Trusts

When a trust is established to receive a gift, the trust must be irrevocable if the gift is to be considered complete for tax, creditor protection and other general purposes. This means that the trust creator cannot later amend or revoke the trust. Similarly, when a trust is revocable or if it is created under a will, the trust will become irrevocable when the creator dies.

Notwithstanding due diligence in planning, unforeseeable events may cause the terms of an irrevocable trust to no longer be efficient or effective at accomplishing the creator's goals or serving a beneficiary's best interests. For example, a trust may be designed to terminate at a certain time and distribute all principal to the beneficiary. However, if creditor considerations (business, medical, marital or otherwise) have arisen that did not exist at the time of creating the trust, it may not be in the best interests of the beneficiary to receive an outright distribution of the principal.

Many states, including Florida, Delaware and New York, have enacted "decanting statutes" to provide options for trustees to resolve many unforeseen issues by allowing the trustee to transfer or "decant" the principal of the existing irrevocable trust to a new irrevocable trust with more optimal dispositive or administrative provisions.

Until recently, Florida's decanting statute (Florida Statutes Section 736.04117) only permitted a trust to be decanted if the trustees of such trust had an absolute power to invade principal of the trust in favor of one or more beneficiaries that was not limited to an "ascertainable standard." An ascertainable standard generally allows distributions for health, education, maintenance and/or support, but does not give the trustees the power to make additional distributions in their absolute discretion. Effective earlier this year, the Florida decanting statute was updated to now allow trustees to decant pursuant to a power to distribute that is not an absolute power to invade principal of the trust (i.e., limited to an ascertainable standard).

Under the new statute, a trustee's power to decant an irrevocable trust is subject to several limitations. For decants involving an absolute power to invade principal, the beneficiaries of the second trust may only include beneficiaries of the first trust and may not reduce any vested interests. Powers of appointment may be retained, eliminated, or created. If a power of appointment is created, the class of permissible appointees may be different from any class identified in the first trust. The ability to decant into a new trust that contains a power of appointment exercisable in favor of one or more individuals who were not beneficiaries of the decanted trust is significant, as it effectively allows for the addition of new beneficiaries via a decant.

For decants involving powers to invade principal that are not absolute (i.e., limited to an ascertainable standard), the interests of each beneficiary of the first trust must be substantially similar to such beneficiary's interests in the second trust. Any powers of appointment must be retained from the first trust to the second trust, and the class of permissible appointees must be the same. New powers of appointment may not be granted. Notwithstanding the foregoing limitations, to the extent that the second trust extends the term of the trust beyond the term of the first trust, the second trust may grant absolute powers to invade principal and may create or expand powers of appointment.

In addition, a trustee can now decant principal of a trust to a supplemental needs trust if the beneficiary has a disability, without regard to whether the trustee has an absolute power to invade principal. Other than the changes to the interests of the disabled beneficiary, the interests of the beneficiaries in the second trust must be substantially similar to their interests in the first trust.

Like the prior version, the new decanting statute does not require court approval of the trustee's exercise of this decanting power to transfer the trust assets to a new trust. Instead, it requires that notice be given to the grantor (in certain cases), the other trustees, the "qualified beneficiaries" of the initial trust (essentially all current and presumptive remainder beneficiaries) and any person who holds the power to remove the trustee that is exercising the decanting power. Thus, the new decanting statute expands the class of persons to whom notice of the decant must be provided.

If your trust is not governed by the law of a state with a decanting statute, it may, nonetheless, include provisions that "mirror" the decanting powers and enable the trustee to reach the same result. However, in exercising the trustee's authority to, in effect, amend an irrevocable trust, care must be taken to ensure that any proposed trust-to-trust transfer does not trigger adverse generation-skipping transfer tax, estate tax, gift tax or income tax consequences.

If you would like to learn more about how these expansive and flexible trustee powers might be used, a member of the Private Client Services Department will be happy to assist you.

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