FOUNDATION**SOURCE**

What Private Foundations Should Consider in a Market Downturn

The following five ideas can help an **established private foundation** creatively meet its obligations in a difficult market environment.

1 Accelerate Your Minimum Distribution Requirement

If a foundation sees a downturn looming, or the downturn has just begun, a foundation that doesn't have enough cash on hand could consider accelerating its charitable disbursements to meet its minimum distribution requirement (MDR) before values decline further. If a foundation waits too long to liquidate sufficient assets to meet its MDR, it may be forced to do so after the stock price has fallen further, deepening the losses and creating a bigger shortfall. A private foundation's MDR is based on the prior year's asset average, which can be a challenge when there is a current year market crash or sustained volatility. When this occurs, a foundation may be required to satisfy its MDR with greatly diminished assets, representing far more than 5% of its assets in the downturn year.

2 Put Losses to Work

The majority of foundations are set up to exist in perpetuity. Unlike a direct gift that benefits one recipient on a single occasion, a foundation perpetuates your family's generosity and burnishes your name far beyond your lifetime. Today, Carnegie and Rockefeller are better remembered for their philanthropic legacies than for their accomplishments in the steel and oil industries. And because gifts are made from an endowment that generates investment revenue, the total gifts made by the foundation over time can far surpass the initial funding.

3 Help Your Grantees Fundraise with Suitability Set-Asides

If a foundation senses a downturn early in the year and wishes to incentivize its supported public charities to fundraise, it can consider a matching grants program and use the suitability "set-aside" strategy. For instance, a foundation might offer to match all donations made to a given charity over the course of a year up to a specified amount. While IRS approval would be needed for making such a set-aside, the foundation wouldn't be required to make a distribution that year to satisfy its MDR if the amount set aside is equal to or greater than its MDR. The foundation would then treat the amount set aside as a liability on its balance sheet and use it towards satisfying its MDR. By the time the foundation satisfies its set-aside obligation, its assets may have bounced back from the downturn. A foundation would need to apply for IRS approval for a "suitability" set-aside before the end of the set-aside year. In that case, it would be prudent to submit the set-aside approval request early enough in the year to be assured of an IRS response before year-end.

4 Donate Partial Interests in Illiquid Property

If a foundation wants to avoid selling depreciated assets, it may consider making a donation of a partial interest in illiquid assets, such as real estate, to a public charity. With a right of first refusal, the foundation could be given the opportunity to buy back that interest for the same price offered by a disinterested third party. A foundation pursuing this strategy would need to have a professional appraiser take into account any applicable discounts when determining the value of the interest to be given away.

5 Let Excess Grant Carryforwards Lighten the Burden

Excess grant carryforwards—grants made well in excess of the return year's MDR or "banked" excess grant carryforwards from prior years—are automatically taken into account when determining a foundation's MDR. Every dollar spent in a given year beyond the amount strictly required to meet that year's MDR will reduce next year's MDR by that amount, effectively prepaying next year's MDR. This can be beneficial if the next year is a downturn year because that year's MDR will have been partially or fully satisfied the year before. So, while there's no proactive strategy to apply in a downturn year, the existence of any prior years' excess grants can help decrease the burden of meeting an MDR in a downturn year and help in future years if the downturn and associated losses are sustained.

At the same time, **newly formed foundations** have several advantages that can help them weather a sustained market downturn and prepare for a future of inspired giving.

1 Enjoy a Reduced MDR in Early Years

New foundations have an advantage because under the IRS rules, they have no MDR for the foundation's formation year (e.g., the year the foundation is incorporated if it's a corporation or funded if it's a trust). Moreover, if the formation year is a short tax year, the following year's MDR won't be 5% of the value of the formation year's assets. Rather, the percentage will be prorated by applying a ratio of the number of days in the short tax year to a full year. For instance, a foundation on a calendar year that's formed on July 1, 2022, would have a short tax year running from that date through December 31, 2022. As a result, (1) the foundation would have no MDR for the balance of 2022; and (2) the 2023 MDR would be only 2.5% (instead of 5%) of the value of the prior year's assets because the prior year would have been only half as long as a full year. Accordingly, the foundation's MDR for its second year of existence could be far less than expected. Importantly, in this case, the Year 2 reduced MDR wouldn't need to be satisfied until December 31, 2023, providing a window for the foundation's investment portfolio to weather the markets.

2 Adopt a Fiscal Year

A new foundation can adopt a fiscal year strategy to manage its second year's MDR. For instance, suppose that the foundation is formed on July 1, 2022, as above, and adopts a June 30 year-end. In that case, it would have no MDR through June 30, 2023, and wouldn't have to satisfy its Year 2 MDR until June 30, 2024.

(It's worth noting that this strategy generally does not adapt well to existing foundations because the change of a taxable year-end would accelerate the MDR.)

3 Explore Cash Distribution Set-Asides

Another option for foundations in their early years could be the use of cash distribution set-asides, which do not require IRS approval. However, cash distribution set-aside rules are complex and such set asides should be done only in consultation with an experienced tax advisor.

For more information or to ask questions, please call 800.839.0054.

ABOUT FOUNDATION SOURCE

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For more than two decades, we've worked with individuals, families, boards and professional advisors to preserve legacies and make giving easier. Today we are proud to support **more than 2,000 unique foundations** and have facilitated over **$10 billion in charitable aid.** With a 98% retention rate, we are honored to have earned the trust and loyalty of our clients.

HAVE A QUESTION?

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