



# HAWAI'I COMMUNITY FOUNDATION

## Conversion of a Private Foundation into a Philanthropic Fund

### **Background**

An organization classified as a private foundation is able to offer tax benefits to its founders and donors in the form of tax-deductible charitable contributions. It is also exempt from federal income tax so long as it serves the charitable purpose for which it was formed. Private foundations are, however, subject to numerous special provisions and reporting requirements under the Internal Revenue Code, including:

- 1) a 2% excise tax on investment income under Section 4940
- 2) required distributions pursuant to Section 4942
- 3) a limitation on excess business holdings under Section 4943
- 4) prohibition on self dealing under Section 4941

Directors and Officers of private foundations must also comply with state registration and business filing requirements as well as state and federal information tax returns. Many private foundation principals conclude that a private foundation is no longer optimal for carrying out their desired objectives because of these administrative and compliance requirements. This is most often the case for smaller foundations and foundations where the original founders are no longer able to actively participate.

### **Termination of Private Foundation Status**

Private foundations that decide to terminate their corporate existence face a potential tax penalty if the termination is not handled in a manner exempt from the private termination tax under Section 507 of the Internal Revenue Code. The termination tax can be severe as it is equal to the lesser of: 1) all the tax benefits received by contributors and the foundation or 2) the net value of the foundation's assets.

### **Conversion to a Component Fund**

Conversion to a component fund of Hawai'i Community Foundation can enable a private foundation to avoid the administrative and compliance burdens of the private foundation form, avoid the termination tax under Section 507 and still fulfill its charitable purpose. The conversion can be accomplished quite easily - the private foundation converts to a component fund by transferring all its assets to Hawai'i Community Foundation and filing an election with the IRS.

### **Component Fund Features**

Private foundations most often choose to convert to a donor advised fund so that the principals can participate in grant recommendations. Other options include a field of interest fund scholarship fund or an unrestricted fund of the Foundation. All component fund types allow the maximum tax benefits for fund contributors and are not subject to the private foundation rules discussed above. Furthermore, Hawai'i Community Foundation handles all required tax filings as part of its combined reporting procedures.

If you are interested in discussing whether conversion is appropriate for your private foundation, please call our Vice President of Operations, Kate Lloyd at (808) 566-5521.