

# PRIVATE FOUNDATIONS

Prepared by

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*Your Foundation's primary purpose is to provide funding for charitable activities that interest you and your selected other family members (Trust Managers).*

*Your Foundation's secondary purpose will be to create for you and your family members an organized giving structure.*

*The private foundation form can provide a formal structure that allows your children and grandchildren to participate and can be used to teach them about issues such as finance, policy setting, and the social contract. Your Foundation will provide an ongoing legacy to your favorite charities by making annual distributions to those charities on your behalf, even after you are gone.*

*Ultimately, your foundation will evolve into something that reflects you and your values. The foundation may have a formal structure or may conduct its activities in an informal manner.*

*A short purposes or mission statement can be considered and placed into the Foundation document. This will help future Trust Managers know the types of activities that you are most interested in supporting.*

*A family foundation, like any business, is a formal structure that is governed by federal and state laws and regulations. Most family foundations make gifts (or grants) to charitable organizations that carry out a charitable activity. For example, a family foundation interested in helping the homeless would probably provide money for a charity working with the homeless, rather than directly provide services to homeless persons.*

*The rest of this memorandum explains some of the basic features of a private foundation.*

## **When is the use of a Foundation indicated?**

Many clients have accumulated significant wealth and realize that their assets are subject to a heavy estate tax burden at their deaths. Retirement accounts, in particular, bear a tremendous tax burden with *both* estate taxes and income taxes being levied on the account(s). Once a client has implemented estate tax minimization techniques, an analysis can be done of the methods available to eliminate estate taxes that are still projected to be incurred at the clients death. Many clients prefer to have these funds pass to the charity of their selection, rather than be paid in taxes to the federal government to be spent at the discretion of our elected officials in Washington D.C. These clients have established private foundations to receive the client's lifetime gifts and/or gifts from their estates or trusts upon their death.

The foundation can also help if you want to give a significant gift to a smaller charity. This charity may not have a professional investment team in place. By making the gift to your private foundation, you can select the team that will manage the investments. The small charity is guaranteed an annual donation from your Foundation.

Foundations are also used by affluent families as a way to involve children and grandchildren in their effort to benefit the less fortunate and support favorite charitable causes. The thought process that accompanies a charitable gift can serve to help ground children and grandchildren, who might otherwise not be aware of needs outside of their own social circle.

## **What type of property can I put into a Foundation?**

Stocks and cash are often used to fund a Foundation. Real estate can also be used to fund a Foundation. One type of property that is not suitable for a Foundation is mortgaged real estate. Also, it is preferable if you have owned the appreciated property for more than one year.

Note, that there are certain rules that apply to Foundations that govern your ability to take an income tax deduction. One rule involves the gift and subsequent sale of appreciated property. The sale of the property to be gifted to your Foundation cannot be legally binding *before* the property is placed into the Foundation. For this reason, if you are thinking of using a Foundation to avoid the payment of capital gains tax upon the sale of your appreciated real estate, contact us sooner, rather than later.

## **Who can create the Foundation?**

The person who contributes the property to the Foundation is the Donor. This can be a single person or a husband and wife or an entire family.

## **What is the legal structure of my Foundation?**

The Foundation is formed under Ohio law as a Trust.

## **Who controls the Foundation?**

The technical administration of the Foundation will be controlled by its Trustee. While the Trustee can be you or a family member, we usually recommend that you name a corporate institution as the initial Trustee in order to familiarize you with the requirements of running the Foundation. The corporate Trustee's fees are not an additional personal expense to you, but are instead charged to the Foundation.

There are many things that the Trustee of the Foundation needs to make sure are done on a timely basis. If you are interested in being your own Trustee, please ask us for a list of these items.

If you choose to be your own Trustee, then we are available to act as legal counsel for the Foundation and help you meet these requirements. Like with the corporate Trustee's fees, our fees for this work would be charged to the Foundation, in the same manner as our original legal fee for establishing the charitable trust and obtaining the tax-exempt status from the IRS.

Since the Foundation has a separate legal existence, the Foundation will maintain separate bank and investment accounts, such as checking or brokerage accounts.

## **Who makes the charitable distributions from the Foundation?**

The distributions will be controlled by the Manager(s) that you name. If you make a lifetime gift to the Foundation, you may be the Manager. After your death, if a contribution is made to the Foundation through your estate or a trust, you can specify individual Manager(s). Usually our clients name trusted family members, advisors and friends as the Trust Managers. If there is no Trust Manager named, the Trustee will also serve as the Manager.

The distributions by the Managers will be dictated by the precise instructions that you have asked us to include in the Trust document. Your instructions may be very detailed and leave little discretion to the Managers, or they may be very broad. We counsel you on these important decisions while we are preparing the Trust document.

## **What makes the Foundation income tax exempt?**

The IRS requires the Foundation to file an application for recognition of its exemption from federal income taxes (Form 1023) within 15 months of its organization. We will prepare the necessary forms to request the exempt status. This is included as part of our original fee to set up the Foundation. If your Foundation will only be funded through your estate or a trust upon your death and will not be funded with lifetime gifts, then this application will be filed after your death.

When the application is submitted, the IRS reviews the trust agreement to make sure that the Foundation's funds may only be used for charitable purposes, including scientific, educational, and literary purposes or the prevention of cruelty to animals. Once the IRS approves the application, it issues a determination letter indicating that gifts to the Foundation qualify as gifts to a qualified charitable organization for tax purposes.

The approval by the IRS is retroactive to the date of formation of the Foundation.

## **When I make a gift to my Foundation, what is my income tax deduction based upon?**

Lifetime gifts to your private non-operating foundation generate the following income tax deductions. The deduction may be taken the year the gift is made and, if it is not entirely consumed in that year, carried forward for up to 5 additional years. This information should be conveyed to your tax accountant so that he or she can make the necessary adjustments to your estimated tax payments and prepare any schedules necessary to report the gift.

*Real Estate, Tangible Personal Property:* The amount of your deduction is lower of the cost basis or the fair market value of the contributed property. Barring unusual circumstances, the cost basis (essentially, what you paid for the property) will be lower than the fair market value.

*Stock.* The donor may deduct the fair market value for long-term appreciated publicly traded securities. Generally, this is the type of property that is placed into the Foundation.

## **How much can I deduct each year against my income?**

*30% deduction.* For ordinary income property and cash, you may deduct up to 30% of your Adjusted Gross Income (AGI) in each year that the deduction may be taken.

*20% deduction.* For gifts of appreciated capital gain property, which would include most gifts of stock, your deduction is limited to 20% of your AGI in each year that the deduction may be taken.

### **What is my estate tax deduction based upon?**

If the gift to your Foundation occurs at your death, through your Will or under your revocable trust, your estate receives an estate tax deduction equal to the date of death value of the gift.

### **What kind of appraisal do I need to satisfy the IRS for my income tax deduction?**

Publicly traded stocks use the fair market value on the date of the contribution (the average of the high and low values on that date). A professional appraisal should be obtained before real estate is given to a Foundation.

### **Who else can make gifts to my Foundation?**

Anyone can make a gift to the Foundation, as long as it is permitted in the trust agreement. Each gift generates an additional income tax deduction. This permits children to make gifts to a family Foundation.

### **What tax forms need to be filed for the Foundation?**

An annual information return on Form 990-PF, "Return of Private Foundation" is filed with the IRS, and a copy of the signed Form 990-PF is sent to Ohio's Attorney General. Form 990-PF is due on or before May 15<sup>th</sup>. This filing will be handled by the Trustee. This form is only required after the Foundation is funded. If the Foundation is only funded upon your death, these forms are only required thereafter.

The Trustee will also place an advertisement in the county newspaper that Form 990-PF is available for inspection by any citizen who requests it within 180 days after the ad is published.

It is not anticipated that your Foundation will be hiring active employees to act on behalf of the Foundation. If the Foundation ever does hire an employee, the Foundation will also be subject to the requirements for paying Social Security and unemployment taxes and income tax withholding. These forms are usually completed by a tax service or accountant retained by the Foundation.

### **Must the Foundation pay income taxes on its investments?**

There is a 2% tax (1% under certain circumstances) on net investment income. The net investment income of the Foundation includes interest, dividends, rents,

and the gains and losses from the sale or other disposition of property, such as stocks or bonds, used for the production of interest, dividends, and rents. There may be other items of income, such as royalties, in unusual circumstances.

If this 2% tax will exceed \$500 for a tax year, the Foundation makes quarterly estimated tax payments. It will take a substantial amount of net investment income to require estimated tax payments. For example, if the Foundation earns \$10,000 of net interest income on \$200,000 of investment assets (a 5% net return), the 2% tax on the \$10,000 would be \$200. This \$200 tax is below the \$500 threshold tax amount that triggers the requirement of estimated tax payments.

### **What amount must the Foundation distribute each year to charities?**

The Foundation must distribute 5% of the fair market value of its noncharitable assets to charities on an annual basis. This 5% is calculated at the end of each year by averaging the Foundation accounts on a monthly basis. Then the amount is distributed over the succeeding year. This gives the Foundation plenty of time to make sure that the 5% distribution is made on a timely basis.

Special guidelines will be created for your Foundation to indicate which charities you select to receive these distributions. You can always give your Foundation the authority to distribute more than this minimum amount. For instance, you may want your Foundation to be able to consider approving grant requests from a public charity.

If your Foundation distributes to charities an amount in excess of 5%, the excess will be credited against the distributable amount for subsequent years, so the Foundation does not need to distribute as much.

The distributable amount will change each year. When the Foundation prepares the Form 990-PF each May for the prior calendar tax year, the accountant or tax preparer will notify the Foundation of the amount that must be distributed by that December 31<sup>st</sup>. This will be the job of the Trustee.

### **What if the Foundation fails to make this distribution in time?**

It is important to make sure that the 5% is distributed. If the Foundation fails to timely make the 5% distributions, it may be subject to a 15% excise tax on the amount not distributed and, potentially, a 100% tax on the amount not distributed. Of course, we always want your Foundation to avoid these taxes.

**How can the Foundation make sure that the charity that it wants to give money to is a qualified public charity?**

The Foundation can assure itself of the public charity status of the donee by: (i) asking the organization for proof of its tax classification by the IRS; and (ii) checking IRS Publication 78, "Cumulative List of Organizations Described in Sec. 170 of the Code" (the "Cumulative List"). This Cumulative List is updated annually and supplemented quarterly.

**What happens to amounts in excess of the 5% that are not distributed by the Foundation?**

To the extent that the Foundation's earnings are not required to be distributed, they may be accumulated as part of the principal of the Foundation's assets.

**Are there any restrictions in my dealings with the Foundation?**

Any Trustee or significant Donor to the Foundation (i.e. you) and all persons and entities related to the Trustee or significant Donor are prohibited from entering business dealings with the Foundation. For example, the Foundation may not lease property from you, your family, or any entity, such as a corporation or partnership controlled by you or your family, unless such lease is without charge. If you have any questions regarding a proposed transaction that you or a family member would like to enter with the Foundation, please call us and we will be able to advise you if there are any limitations.

**If my children are involved in the grant-making process, can they receive compensation from the Foundation?**

Yes, both you and members of your family may receive reasonable compensation for services rendered to the Foundation. This permits your children to be actively involved in the grant-making process of the Foundation, by selecting eligible recipients, overseeing the use of the grants, interviewing grant applicants, etc. and to be compensated for this work. We believe that this work helps children of affluent individuals gain or maintain a sense of perspective on the needs of the community.

**What kind of investments will be made by the Trustee?**

The Trustee will make prudent investments that will serve to overall increase the portfolio of the Foundation. The Trustee cannot make any "jeopardizing investments" with Foundation funds. Investing in, for example, federally issued certificates of deposit, AAA-rated bonds, and "blue chip" stocks will ordinarily satisfy the prudent trustee standards. Also, investments should be reasonably diversified. In contrast, trading commodity futures or writing naked stock option

puts or calls -- activities which could result in immediate and substantial portfolio losses -- will be subject to “close scrutiny” and may be found to constitute a jeopardizing investment. No investment is, however, specifically designated as a jeopardy investment. Again, please call us if you have a specific question or if the Foundation plans to invest in any item other than cash and publicly traded securities.

### **Is there anything else the Foundation *can't* do?**

Your Foundation is prohibited from engaging in the following types of activities. If your Foundation does any of these activities, the IRS can levy an excise tax on these distributions.

- Participation in political and legislative matters;
- Grants to individuals without prior IRS approval of the grant procedures— we will make sure these procedures are in place if necessary;
- Grants to organizations other than public charities; and
- Grants for non-charitable purposes.

The rules governing taxable expenditures are technical and complex. Your private foundation will forbid all taxable expenditures, unless you expressly apply for approval of a grant-making procedure. We will know that you plan to do this when we set up the Foundation and make sure that the rules are followed.

### **Are there any Ohio state requirements?**

At the beginning, the Foundation will fill out a one-page form to register as a charitable trust. We will complete this for you. After that, the filing of a copy of the 990-PF form is the only reporting or return imposed by Ohio.

### **When does the Foundation end?**

The Foundation continues forever, always making gifts as you have set forth in the Trust Agreement. This is the ongoing legacy of your charitable gift. The Trustee is given the authority to end the Foundation if there is a good reason to do so, such as the value of the Foundation property has drastically diminished.

### **What happens when the Foundation ends?**

The property will be distributed to the charities you have selected.

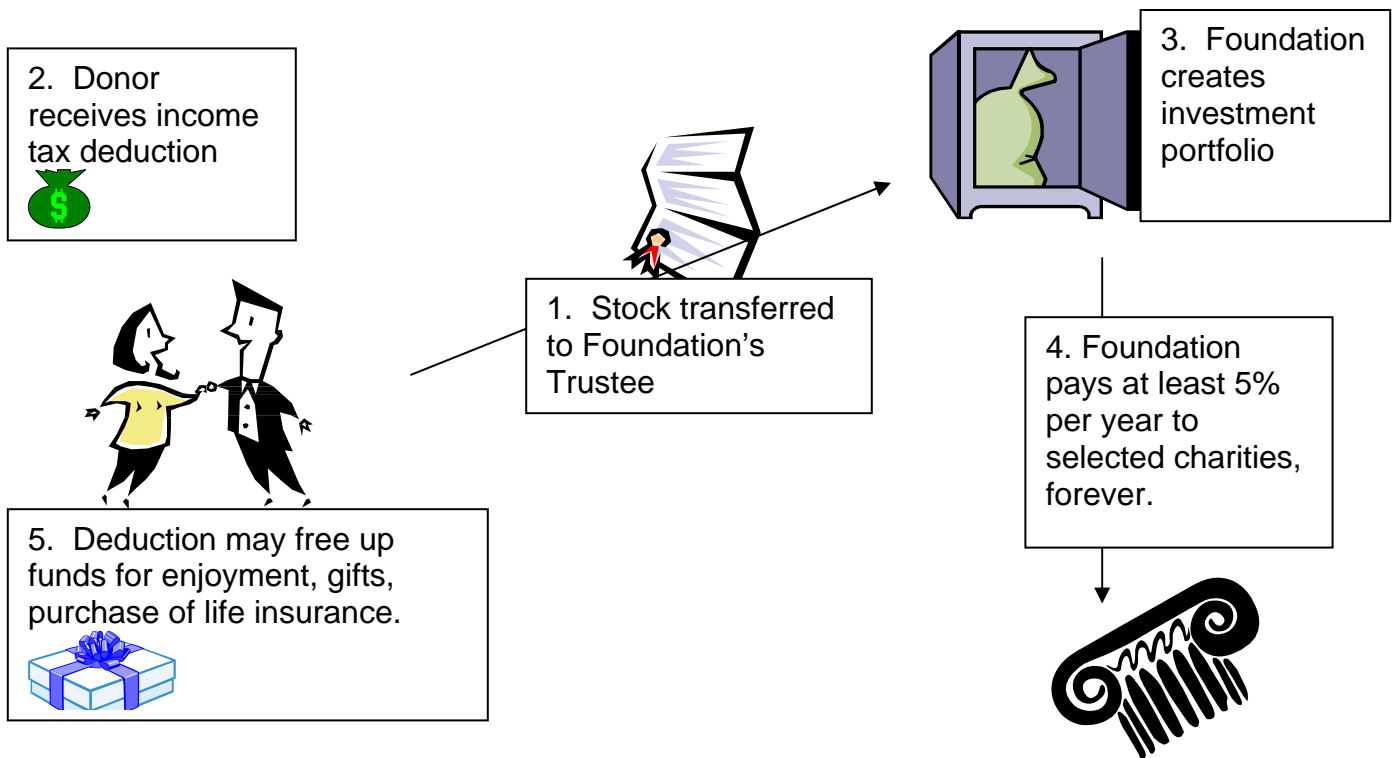
### **Can I make future contributions to the Foundation?**

You can definitely make additional gifts to your Foundation. Each time you make a contribution, you are entitled to another income tax deduction.

## Can I withdraw all of the funds if I change my mind?

No, the Foundation is irrevocable. Therefore, we make it as flexible as we can. Remember, you have already received an income tax deduction based on your gift to the Foundation. If you could pull the gift out, the IRS would have to negate your income tax deduction. Only the Trustee is given the ability to amend the Foundation and only for the purpose of keeping the Foundation in compliance with all tax regulations.

Can you give me a flowchart for a Private Foundation? Of course.



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