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PRIVATE FOUNDATION

CAUTION:

The purposes of this memorandum are to assist you, the directors of your private foundation, and your accountant in:

1. Creating your nonprofit corporation and transferring assets to the corporation;
2. Maintaining records for the corporation; and
3. Filing required tax returns.

This memorandum can only provide *general* information. If you, the directors, or your accountant have any questions, please contact us.

1. Definition of Private Foundation

a. A private foundation is a tax exempt charitable organization under Internal Revenue Code (“IRC”) §501(c)(3) that does not meet the definition of a public charity under IRC §509(a). Public charities include the following:

i. Organizations that conduct certain public activities: churches, schools, hospitals, government entities.

ii. Organizations supported by the general public’s contributions, by gross receipts from exempt activities (*e.g.*, museums) or by a government entity.

iii. Organizations that support one or more specific public charities (“supporting organizations”).

iv. Organizations that are operated exclusively for testing for public safety.

b. Public charities have a number of tax advantages over private foundations, such as:

i. Donors may deduct contributions to public charities generally up to 50% of their contribution base, while contributions to private foundations may be deducted only up to 30% of the contribution base.

ii. The excise taxes imposed on private foundations, discussed below, are not imposed on public charities.

iii. Public charities have less onerous reporting requirements than apply to private foundations on Form 990-PF.

c. An organization may qualify for exemption from federal income tax under IRC §501(c)(3) if it is organized and operated exclusively for one or more of the following purposes: charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition, or prevention of cruelty to children or animals. The organization cannot engage in political campaign activities and only public charities may engage in a limited amount of lobbying.

d. The organization must be a corporation, community chest, fund, or foundation. A trust is a fund or foundation and will qualify. An individual or partnership will not qualify. Generally either a nonprofit corporation or charitable trust is used as the vehicle for a private foundation. Your foundation is organized as a Colorado nonprofit corporation.

2. **Formation of Organization**

a. The basic requirements for the formation of a nonprofit corporation must be met: filing of articles of incorporation with the Secretary of State, adoption of by-laws, and organizational minutes. There are specific provisions which must be included in the articles of incorporation, in order to be granted tax exempt status. For example, the corporation’s purposes must be limited to charitable purposes, and the assets of the corporation must be dedicated to a charitable purpose upon dissolution.

b. The separate corporate existence must be maintained: creation of separate bank accounts, annual minutes must be prepared, officers’ actions should be duly authorized, and required corporate reports must be filed with the Secretary of State.

c. The exact requirements for maintenance of the corporation will depend on state law. Under Colorado's statutes, an annual report must be filed on-line.

3. Tax Exempt Status

a. IRC §508 provides that an organization will not be tax exempt until it notifies the IRS that it is seeking exempt status and the IRS recognizes the organization as tax exempt.

b. Notice is provided by filing an Application for Recognition of Exemption (Form 1023) with the Internal Revenue Service within 15 months after the organization is created (or 27 months if extension is authorized). If the application is filed late, exempt status will not apply to any taxable period prior to the filing. A filing fee is required. Currently, the filing fee for a new private foundation with gross receipts greater than \$10,000 annually is \$850. Copies of the organizational documents, financial statements, including a statement of revenue and expense for the current year and the last 4 years, or the current year and a proposed budget the next 3 years, and information about the creators of the organization, the principal officers, their donations, and purposes and activities of the organization must be provided to the IRS with the application.

c. Assuming the IRS grants tax exempt status, contributions to the organization will be tax deductible, up to the applicable limits, and the organization will only be taxed on its "unrelated trade or business income" under IRC §§511-515. Unrelated trade or business income is income from an activity which qualifies as a trade or business, is regularly carried on, and is not substantially related to the organization's exempt purpose.

d. Tax exempt status may be lost if the organization goes through a material change in its character or the primary purpose of its operations such that it is no longer organized or operated for charitable purposes. If an organization has substantial changes in character, purpose or method of operation, the IRS must be notified. Copies of new or amended by-laws or amended articles of incorporation must be filed with the Form 990-PF. However, if an organization decides to change from a corporate to a trust format, for example, a new application for exemption must be filed. A change in form can occur if the corporation fails to make required annual filings with the Secretary of State and the corporation is dissolved by operation of law. However, the IRS will generally allow reinstatement of the exemption and reincorporation of the organization if the failure to file reports was inadvertent.

4. Federal Tax Matters

a. The private foundation must obtain a taxpayer identification number (form SS-4), and it must file an annual information return on Form 990-PF, "Return of Private Foundation" by the 15th day of the fifth month following the close of the foundation's tax year. If a timely return is not filed, a penalty of ½ of 1% of the unpaid tax (not to exceed 25% of the tax due) will be assessed for each month or part of a month in which the tax is unpaid. Copies of the Form 990-PF must also be forwarded to the state attorney general if the foundation has assets of \$5,000 or more. The IRS publishes comprehensive instructions for completion of the Form 990-PF. For additional guidance on foundation activities, foundation administrators should obtain Publication 4221-PF, Compliance Guide for 501(c)(3) Private Foundations. This publication, and other forms and publications, can be obtained from the IRS website at www.irs.gov. We will be happy to print a copy of that publication for you; just let us know.

The foundation must publish a notice to the general public that Form 990-PF is available for inspection, with the name, address and phone number of the foundation and its principal manager. Because the Form 990-PF is considered a public document, the Foundation must make its application for exemption, and its last three annual returns (Form 990-PFs) with all attachments, available for

public inspection (without charge) at its principal, regional, and district offices. If the foundation has no permanent office, the documents may be made available at a location of the foundation's choice. The foundation must generally comply with requests for inspection of documents within a reasonable time (generally considered two weeks of the date of the request). Alternatively, the foundation may mail a copy of the requested information to the person requesting it. If a request is made for copies of foundation documents, and that request is made in person at the foundation office, the copies must generally be provided the day of the request. If the request for copies is made in writing (i.e., by letter, fax, or email), the foundation is generally required to mail the copies within 30 days of receiving the request. The foundation may charge for copies of the requested returns, but the charges may not exceed the per page fee charged by the IRS to provide copies. If the foundation makes copies of its documents widely available to the public, such as posting the information on the internet, or if the request for copies is part of a harassment campaign, the foundation is not required to respond to requests for copies or its organizational documents and returns.

b. If the foundation hires employees, it will also be subject to Social Security, unemployment taxes, and income tax withholding and will be required to file the appropriate forms with the IRS, including Form 941 (employer's quarterly federal tax return), Form 8109 Federal Tax Deposit Coupon for deposits of income taxes, Social Security and Medicare taxes paid and withheld), and Form W-2 (Wage and Tax Statement for employees).

c. Permanent books of account sufficient to establish the organization's items of gross income, receipts and disbursements, to substantiate the information disclosed on Form 990-PF, must be kept for at least four years. However, since a retroactive revocation of exempt status is possible, it is usually recommended that exempt organizations keep their records for their entire existence.

d. If an organization receives a donation of property, and disposes of the property within three years after the contribution, it must file Form 8282 to report the disposition.

e. Private Foundation Excise Taxes

i. Net Investment Income

A private foundation is subject to a tax of generally 2% of its net investment income each year. This includes interest, dividends, rents and royalties, and gain from sale of property used for the production of interest, dividends, rents or royalties. Estimated quarterly taxes must be paid if the tax will exceed \$500 per year. This tax can be reduced to 1% if certain distribution requirements are met.

ii. Minimum Distribution Requirement

A private foundation must distribute each year an amount equal to 5% of the fair market value of its net investment assets, to accomplish charitable purposes. The distributable amount for a tax year must be distributed before the close of the next tax year. Of course, grants in excess of the minimum amount may be made. If the foundation fails to distribute at least 5%, it may be subject to a 30% excise tax on the amount not distributed, and potentially an additional 100% tax on the amount not distributed. If the assets contributed to the foundation are difficult to value, this requirement could cause problems.

iii. Self-Dealing

(i) All private foundations are subject to the prohibition against self-dealing. This means that the foundation cannot enter into any business dealings, directly or indirectly, with disqualified persons. Disqualified persons include the foundation manager, creators of the

foundation, and principal donors, plus their family members, and any entities controlled by them. “Family” includes spouse, ancestors, children, grandchildren, great-grandchildren, and their spouses. Business dealings include leases, sales and any other dispositions of foundation property. For example, if stock in a closely held corporation or real estate is contributed to the foundation, neither family members nor their controlled entities would be able to purchase the property from the foundation. The only exception for leases between a foundation and disqualified person is where the foundation leases property from a disqualified person at no cost. The foundation may not reimburse the disqualified person for taxes, repairs, and other expenses associated with the property.

(ii) Compensation of family members for serving as officers, directors, or employees of the foundation is permissible under certain circumstances. Salary paid to family members as a member of the foundation’s staff is allowed if the salary is paid for personal services that are reasonable and necessary for the operation of the foundation, and the payment is not excessive. The foundation managers should analyze how much the foundation would pay a stranger to perform the same services, taking into account the complexity of the duties, the hours required, any special training that may be necessary, and similar factors. Salary surveys should also be used to determine reasonableness of compensation. Additionally, if certain requirements are met (including approval of the compensation, in writing, in advance of payment by independent persons, based on comparable salary data) the compensation may be deemed reasonable under the IRS safe harbor rules. Family members may also be compensated for their service as a director, trustee or officer of the foundation, so long as the tests for reasonableness and appropriateness are satisfied. Although service on a nonprofit board is generally a volunteer activity, and salaries for nonprofit directors are rare, each situation should be examined individually to determine the appropriateness of compensation to family members.

(iii) Generally, foundations and disqualified persons cannot provide goods, services or facilities to each other. Two very narrow exceptions exist: 1) the disqualified person may provide goods, services and facilities to the foundation if these items are used exclusively for charitable purposes and are provided without charge; and 2) the foundation may provide goods, services, and facilities to disqualified persons if the items are related to the foundation’s exempt purpose, and are provided to the general public on the same or better terms.

(iv) Foundation funds should not be used to purchase tickets to charity events for family members. The foundation may make a charitable contribution to the event, but the family member should pay the cost of his or her own ticket.

(v) If the self-dealing rules are violated, the tax penalties are substantial. The initial tax is 10% of the “amount involved” and is payable by the disqualified person. An additional tax of 5% of the amount involved may be imposed on the foundation manager or trustee, if he knew the act was self-dealing up to \$20,000. If the self-dealing is not corrected, the disqualified person is also subject to an excise tax equal to 200% of the amount involved. Any trustee or foundation manager who refuses to correct the act of self-dealing is subject to an excise tax equal to 50% of the amount involved up to \$20,000.

iv. Excess Business Holdings and Jeopardy Investments

A private foundation is prohibited from retaining certain excess business holdings (an interest in a corporation, partnership or other business entity which, when aggregated with interests of disqualified persons, exceeds 20% of the ownership interests in such entity). The penalty is a 10% tax on the value of the excess business holding, and 200% if not corrected. The foundation’s manager also cannot invest in assets that may jeopardize its exempt purpose. A 10% tax is imposed on the “jeopardizing” investments, and a 10% tax may be imposed on the trustee or manager who knowingly participated in the investment. A 25% tax may be imposed if the situation

is not corrected, and a 5% tax may be imposed on the trustee or manager who refused to correct the investment. The trustee or manager should be prudent in its investments.

v. Taxable Expenditures

These rules are very complex, and prohibit participation in political and legislative matters, grants to individuals without prior IRS approval of the grant procedure, grants to organization other than public charities without exercising “expenditure responsibility,” and grants for noncharitable purposes without exercising “expenditure responsibility.” To avoid these rules, many private foundations restrict their grants to public charities.

5. State Reporting Requirements

Tax returns or other filings will vary depending on the state of incorporation. For Colorado, no separate application for exemption need be filed; Colorado recognizes the tax exempt status of a private foundation to the same extent as the federal government. The IRS requires that a copy of the Form 990-PF must be filed each year with the Colorado Attorney General and the attorney general of any other state requiring reporting of assets or activities. IRC§6033(c)(2). If the foundation has unrelated business taxable income (UBTI) in any year, then it must file Form 112 with the Colorado Department of Revenue and pay the appropriate tax. This is a C Corporation return, but the starting point to determine Colorado taxable income is the federal UBTI figure.

6. Alternatives to Private “Grant-Making” Foundations

a. Supporting Organizations. The organization must enter into a formal association with one or more established public charities. Its activities are then limited to funding or “supporting” the same kinds of projects in which the parent charity is active. A supporting organization can qualify as a public charity.

b. Donor-advised Funds and Designated Funds. Most communities have a foundation (such as The Denver Foundation or Rose Community Foundation) that permit donors to contribute funds to a separate account in the donor’s name. In a donor-advised fund, the donor recommends which organizations are to receive grants from the fund. The community foundation is not required to follow the donor’s wishes, but generally it does. Community foundations also generally permit the creation of a fund in which the donor designates the charity in advance, and the income is paid to the designated charity each year. Community foundations are usually public charities, and the community foundation also takes care of all the administrative and reporting requirements.

The Denver Foundation and Rose Community Foundation also provide their donors with information about local charities, and can provide the donor with anonymity, if desired, or correspond with charities using the letterhead of the specific fund.

c. Private Operating Foundation (“POF”). This type of entity is a private foundation and not a public charity, so it is still subject to the same excise taxes on “prohibited transactions” mentioned above, but it is not required to distribute 5% of the fair market value of its investment assets each year to public charities. The requirements to qualify as an operating foundation are more onerous, which is why we suggested initially qualifying as a grant-making foundation, and then changing to an operating foundation when the facilities or programs are closer to being available for the public.

Private operating foundations have the advantages of (1) allowing a 50% deduction for cash contributions instead of 30% for grant-making private foundations, and (2) the minimum distribution requirement for a private operating foundation may be lower than that of a standard private

foundation. However, private operating foundations are, in fact, required to make certain minimum qualifying distributions to retain their status.

Private operating foundations must meet both an “income test” and one of the three following tests: asset test, endowment test or support test.

Income Test. The income test requires a POF to distribute 85% of the lesser of the POF’s “adjusted net income” or the “minimum investment return” (generally 4.25% of the POF’s noncharitable assets). The “adjusted net income” is determined by the following formula:

Gross income for the year - long term capital gains - gifts, grants and contributions received - ordinary and necessary expenses to produce gross income + modifications of qualified distributions from a prior year.

“Minimum investment return” is generally 5% of the average fair market value of the foundation’s noncharitable or investment assets (85% of that amount is 4.25%).

Asset Test. Substantially all (65% in this case) of the POF’s assets must be active-use assets which are (1) program assets devoted directly to the active conduct of the POF’s tax-exempt activities, to a functionally related business, or to a combination; (2) stock of a corporation controlled by the POF, in which 65% or more of the corporation’s assets are devoted as described in (1); or (3) partly assets in category (1) and partly assets in category (2).

Endowment Test. The POF must expend funds directly for the active conduct of its tax-exempt activities in an amount equal to at least 2/3 of its minimum investment return. The endowment test requires the POF to distribute 3 1/3% (2/3 of 5)% of the value of the investment or nonactive-use assets.

Support Test. The support test requires the POF to satisfy 3 concurrent tests which include:

1. Substantially all (85%) of its support (other than gross investment income) is normally received from the general public and from at least 5 tax-exempt organizations;
2. Not more than 25% of its support (not including gross investment income) is normally received from any one of these organizations; and
3. Not more than 1/2 of its support is normally received from gross investment income.



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