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Firming Up Your Foundations

Creation of Lifetime Foundations to Avoid Postmortem Problems

by Jason E. Havens, Esq.

Editor's Note: *A family foundation is often used in an estate planning context as a means of facilitating charitable transfers at death. In this context, should the creator set up a foundation before death, or might this be left to the creator's heirs and advisors to be done after death? This piece discusses some of the difficulties that can arise in dealing with this situation. The author's advice: To eliminate delay and avoid possible problems with the IRS, set the foundation up while the creator is still around.*

Introductory Scenario (or "This Could Be You!")

Picture yourself in your conference room with affluent married clients who have strong charitable intent. The clients like the idea of providing for their descendants but want to create a private or "family" foundation to benefit the various charitable sectors that they have supported during their lifetimes. The clients are open to creating their family foundation during their lifetime. Nevertheless, based on your assurances that a testamentary family foundation will accomplish the same objectives, the clients follow your advice to defer their family foundation until the death of the surviving spouse. At the conclusion of the matter, the clients are pleased with the plan that you have helped them to create and implement.

Fast-forward 30 years or so. You are now working with the clients' eldest child, who is impressed with you and looking forward to participating in the family foundation. The accountant and you have already received the estate tax closing letter from the Internal Revenue Service. You help this accomplished daughter, who is also a lawyer focusing on constitutional law, by describing the process of obtaining tax-exempt status for the family foundation. You tell her that submission of the "Application for Recognition of Exemption [u]nder Section 501(c)(3) of the Internal Revenue Code," IRS Form 1023, should result in a determination letter in 6 to 12 months. You continue by discussing the "rules of the road" regarding family foundations. The daughter leaves your office feeling confident and excited about her family's estate and charitable planning.

Then you receive it—a telephone call from an IRS staff person who is not located in the familiar Covington, Kentucky, office. This IRS agent asks about the estate plan and questions whether the family foundation is even valid based on the Form 1023. You respond honestly and completely, but it is clear that the IRS and you are not seeing "eye to eye" on the issues surrounding the family foundation. You also receive a written response from the same IRS contact that asks the same follow-up questions.

It is hoped that this is a rare scenario. Perhaps it only occurs where even more complex planning, such as a testamentary charitable lead trust coupled with the family foundation, is involved. Even if it only happens once in your career, though, this kind of situation can result in stress, strained client relationships, and even lawsuits—even if only to seek a declaratory judgment to finalize the creation of the family foundation.

To minimize the likelihood of a protracted application process, or even an adverse determination letter, this author suggests that you encourage clients who are truly interested in a family foundation to consider its formation and application for exemption during the clients' lifetimes. The balance of this article focuses on several important issues to consider in forming an "inter vivos" family foundation, either during the lifetime of an individual client or at some point during the lifetimes of a married couple. This article will not focus on other aspects of the family foundation, such as whether to use a trust- or a corporate-based foundation, which are covered in other resources. (See generally Kathryn W. Miree, "The Family Foundation: An Owner's Manual," in 35 U. Miami

See LIFETIME FOUNDATIONS, next page

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CULTURAL DIFFERENCES, from page 1

Heckerling Inst. on Est. Plan. ch. 16 (2001); Jerry J. Mccoy & Kathryn W. Miree, *The Family Foundation Handbook* (2009 ed.); Bruce R. Hopkins & Jody Blazek, *Private Foundations: Tax Law and Compliance* (3rd ed. 2008 & Supp. 2010).)

Factor #1: Knowing (the Family Foundation Is Exempt) Is Half the Battle

First, one of the most important factors in forming a family foundation during a client's lifetime is the strategic advantage of knowing that the foundation is exempt for tax purposes. All the resources cited above provide excellent information on what is involved in creating a family foundation. However, there is a dearth of commentary on the critical issue of timing and how that can affect the viability of a family foundation and indeed the entire estate plan of the family. (*See, e.g.,* Roger D. Silk et al., "Carpe Diem: Set Up a Foundation While You're Still Alive," in *Creating a Private Foundation: The Essential Guide for Donors and Their Advisers* ch. 5 (2003) (one of few commentaries on this subject).)

As most of you know, creating the trust or nonprofit corporation that legally "gives birth" to the family foundation is only the beginning. The key part of the process is submitting the Form 1023 to the IRS and obtaining exempt status. Both essential parts of the process are the same whether the family desires to create a private nonoperating (grant-making) foundation or a private operating foundation. (*See generally* Thomas J. Ray, Jr., "Donor Controls and Private Foundations," in *Charitable Gift Planning: A Practical Guide for the Estate Planner* ch. 2 (2nd ed. 2008) (first edition available online via Google books).) After both parts are completed, you might also need to file various forms with your particular jurisdiction, and those rules vary from state to state. (*See* Steven D. Simpson, *Multistate Guide to Regulation and Taxation of Nonprofits* (2008) (detailed analysis of state laws and regulations pertaining to charities with charts and links to Internet resources).)

Clients typically expect the entire process to conclude within one year. Regrettably, even the smoothest approval of exempt status by the IRS might consume six to nine months, particularly given the dramatic increase in charitable filings over the past decade. That problem will likely only increase in terms of the time frame involved.

To minimize the likelihood of a protracted application process, or even an adverse determination letter, encourage clients truly interested in a family foundation to consider its formation and application for exemption during their lifetimes.

If more complex planning is involved, the IRS might take even more time to approve a family foundation's exemption. For example, one of the author's clients recently waited almost a year to receive their family foundation's determination letter because the situation involved a so-called "zeroed out testamentary charitable lead annuity trust (T-CLAT)." (*See, e.g.,* Donald R. Tescher & Barry A. Nelson, "The Frozen T-CLAT," 143 Tr. & Est. 33, (July 2004) (available online: *http://www.estatetaxlawyers.com/Articles.html*); H. Allan Shore & Jeffrey A. Kern, "The Testamentary Charitable Lead Annuity Trust Revisited," 80 Fla. Bar. J. 70 (Oct. 2006) (available online: *http://www.floridabar.org/DIVCOM/JN/JNJourna101.nsf* (under "Archives" > "by issue" > "2006" > "October, 2006").) The client received the estate tax closing letter regarding his mother's nontaxable estate within nine months of the estate tax return's filing. In contrast, the Form 1023 for the recipient family foundation of the T-CLAT was bounced from Covington, Kentucky, to another IRS office. That other office questioned not simply the foundation's application for exemption but also the underlying techniques—namely, the decedent's revocable trust and the T-CLAT, which had of course been approved as a result of the estate tax closing letter. After several rounds of correspondence, the determination letter was finally issued.

In retrospect, the client's late mother might have created the family foundation during her lifetime. In fact, she could have funded it with a nominal amount if desired to avoid committing too much value of her assets in the event that she might need access to those resources in the future. In this author's experience, applications for exemption (Forms 1023) that accurately depict a nominal funding over the family foundation's initial three-year period of existence (required in Part IX of the current IRS Form 1023) usually result in positive determination letters. As a result, the decedent's son would not have dealt with the application for exemption and could have finished the trust administration and funding of the T-CLAT much more efficiently.

Therefore, in the author's estimate, more clients should consider creation of a lifetime family foundation due to the practical advantage of a smoother approval process, culminating in the IRS's determination letter. In many cases, clients might want to use a nominal funding approach in order to "test drive" the family foundation and also probably obtain exempt status even more easily. Most lawyers charge between $7,500 and $10,000 (and in some cases more) in professional fees in order to create the family foundation, with most of that time devoted to completion and submission of the Form 1023. The Instructions for Form 1023 estimate nearly 200 hours to learn about and complete Form 1023, but most tax professionals would require substantially less time to do so. Despite the significant cost to create a lifetime family foundation, the primary advantage of not having to do so after the clients have died might be worth thousands or even millions

See LIFETIME FOUNDATIONS, next page

LIFETIME FOUNDATIONS, from page 2

of dollars in estate taxes payable if the application for exemption is denied at that stage.

Factor #2: Utilizing the Lifetime Income Tax Benefits of the Family Foundation

The second factor revolves around the clients' ability to use the family foundation for tax purposes during lifetime. As you all know, clients receive reduced income tax benefits when they contribute cash or other assets to a family foundation. The so-called percentage limitations apply because family foundations arguably provide less public benefit and definitely allow one or more of the family members to control the foundation. Even so, lifetime charitable contributions to the family foundation still generate greater tax benefits as a general rule because those gifts qualify for both the gift and income tax deductions.

An example illustrates this concept more clearly. Assume that Hugh and Wilma Founders create their family foundation and contribute $100,000 of cash to it. The Founders' income is generally taxed at the maximum income tax rate of 35%. Assuming that the Founders itemize their deductions and qualify to do so, they would receive a $30,000 (i.e., 30%) deduction from their income tax payable, which saves approximately $10,000 in actual income taxes that the Founders would have paid (excluding employment tax and other factors). The Founders can then carry forward the excess charitable deduction of $70,000 and use it for up to five years. In addition, the entire $100,000 should qualify for the gift tax deduction, which saves 45% of the value of the gift (assuming full use of their lifetime gift tax exclusion amounts). The charitable gift also effectively reduces the Founders' taxable estate by the same amount as that value no longer comprises a part of the Founders' estate-taxable assets.

In contrast, the Founders could have waited to transfer their $100,000 to their family foundation after the death of the surviving spouse (statistically Wilma). That testamentary charitable gift would have qualified for the unlimited charitable deduction under the estate tax regime, which generally results in a savings of 45% of the value of the charitable gift (assuming a taxable estate and full use of their applicable exclusion (or "credit") amounts). Notwithstanding that valuable tax benefit, the Founders would have lost any income tax benefit of their charitable gift.

For those interested in more detailed case studies, Mr. Ray includes a valuable version based on "Grover and Frances Grantmaker" in the first few pages of the "Private Foundations" portion of chapter 2 of his treatise (*supra*).

Factor #3: Controlling the Client's Legacy via the Family Foundation

Third, as noted by Mr. Silk (*supra*) and others, creating a lifetime family foundation affords clients a superior opportunity to shape their family foundation than merely doing so on a testamentary basis via their wills or revocable trusts. It is true that a skilled lawyer can draft a testamentary family foundation that addresses a myriad of circumstances and even provides extensive guidance on the specific charitable intent and mission of the founders. The treatise written by Mr. McCoy and Ms. Miree includes several safeguards to consider when drafting the legal documents to create a family foundation, such as the potential use of a trust protector. (McCoy & Miree, "Avoiding Future Changes Which Take the Foundation 'Off Course'" *supra*, at §2.09.)

Not even the most skilled lawyer, however, can anticipate everything, including the actual consequences of choosing a corporate- or trust-based foundation, whether the board of directors or trustees will capably carry out the foundation's mission, how a client's children or grandchildren will develop and mature, and much more. Perhaps a certain child or grandchild should not have been involved in the family foundation (or the converse). Forming the family foundation during lifetime gives the founders—generally parents or grandparents—an opportunity to teach the younger generation(s) about the founders' charitable values and goals for the foundation.

The historical activities of the family foundation are valuable for many other purposes. The bylaws or trust agreement governing the family foundation might be amended two or more times during the lifetimes of the founders in order to accommodate changes in their charitable values or even in the tax laws. Grantee charities inevitably come and go, particularly in these tumultuous times and in the wake of tragic situations such as the "Ponzi" scheme of Bernard L. ("Bernie") Madoff, which literally closed the doors of a number of charities in the United States. Consequently, the founders might decide to support different grantee charities or even a different portion or "flavor" of the charitable sector. All of these things tend to favor the lifetime formation of family foundations.

Conclusion

There are numerous other factors beyond the strategic estate and charitable planning advantages, the income tax advantage, and the practical "legacy" advantages of a lifetime family foundation. The author would quickly defer to the resources cited above and numerous others that explore these factors in much more depth. It is the author's hope, though, that this article will cause advisors and their clients to consider carefully whether they want to put the family foundation "egg" in the testamentary-only "basket." The IRS has a daunting task of regulating the ever-expanding charitable sector, and thus occasionally they "scramble" a perfectly good charitable "egg" before it hatches. The author hopes that this article will lead to more charitable chickens—rather, foundations—that will accomplish the good purposes for which their families intended them! ■