By Mark E. Powell

Would They Do It Anyway?

How to make sure your client understands when a private foundation is right for him and his family—and when it is not

About six years ago, I started talking differently to prospective private foundation clients. I used to try to craft a cohesive answer to the most common question I got from financial advisors, accountants and attorneys: "How much should the client plan to contribute to a private foundation so that the idea makes sense?"

But after terminating three or four private foundations in a row, I decided that these advisors were asking the wrong question. Thereafter, I answered their question with one of my own: "If the client understood what it takes to run a private foundation, year in and year out, would he do it anyway?"

If the answer is "yes," then a private foundation may be a good option for that client—no matter how much he intends to contribute immediately.

So, what are the right reasons for starting a private foundation? From what I've seen, and I've seen a lot, the more a client can agree with the following statements, the more satisfied he will be having a private foundation:

(1) I have very specific philanthropic objectives that involve either my family or charities near to my heart.

(2) I want to retain substantial control over the governance of my organization so as to be sure to obtain my charitable objectives.

(3) I am willing either to live with the complexity of managing a highly regulated entity or to pay what it takes for advisors who are capable of doing so.

(4) I am more concerned with obtaining my charitable goals than maintaining my privacy. Indeed, gaining some recognition—or publicizing my cause through my efforts—is an important end in and of itself.

If a client cannot agree enthusiastically with more than one of these statements, he probably would be better served by some other charitable vehicle, such as a donor-advised fund (DAF). Spare him, his family and all his advisors the pain of setting up, trying to run and probably dismantling a private foundation that should not have been established in the first place.

Even if a client says he wholeheartedly agrees with a number of these statements, check that he truly understands the implications of his choice—as well as his other options. Walk him through it. Here's my guide.

What It Really Means

• **What it is**—We're talking about a private, grant-making foundation. "Private foundations" are the organizations to which a donor makes a contribution (generating for himself a current income tax deduction) and from which the board of directors makes annual grants to one or more public charities. A donor frequently seeds such a foundation during his lifetime with a relatively small contribution, then spends several years working out the grant-making procedures and governance issues, knowing that a more significant contribution will be made to the foundation upon his death through his estate plan (generating an estate tax deduction).

• **Charitable objectives**—Specific philanthropic objectives are the cornerstones of a good experience with a private foundation.

Mark E. Powell is a partner in Irvine, Calif.'s Albrecht & Barney

I've worked with many clients who formed private foundations primarily because of the associated income tax advantages—only to watch those clients become frustrated with the complexities of operating and maintaining these kinds of organizations.

As a result, I now encourage every client who expresses an interest in a private foundation to explore DAFs and all they have to offer—before committing to a private foundation.

• **Family involvement**—For many clients, developing a family legacy of philanthropy is the compelling objective behind a private foundation. Developing a plan to continue a long-term giving program, sharing a vision of community involvement, breaking a perceived cycle of entitlement attitude, and teaching younger generations about the value of social capital are all excellent motivators.

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Establishing a junior board remains one of the most fulfilling projects I've ever done. One year, this foundation's board, which consisted of the founders/grandparents and their children, empowered each of the grandchildren, who ranged in age from 10 to 25, to give away $1,000. We worked with each of the grandchildren to identify a charity that interested him or her.

The junior board helped the grandchildren learn how charities work and why they need private support. More importantly, it helped the grandchildren learn why donors should insist on accountability for their donations. The day that the grandchildren recommended grants to the family board was inspiring, but about six months later we saw the real value of this experience for this family.

One teenage grandson had not really bought into the idea that his involvement meant much. Then we visited his charity to find out what the organization had done with his donation—and his world changed. He walked into a gym in a community center and saw his name on a thank-you banner. That definitely had an impact. But as the basketball game got underway, the pride in having his name on the banner was replaced by something more enduring.

The executive director pointed out the various items the boy's donated money had helped purchase (from new basketballs to replacement computer parts for the scoreboard that was working for the first time in five years). The boy started to get it. His grandfather later said that the look of pride was replaced by a look of stewardship.

About a year later, the founders told me that this particular grandson was the one they had worried most about; they thought he was the grandchild most likely to wander away from the family. But after his experience on the junior board, the grandson became more involved with the foundation than any other grandchild. In fact, he encouraged other members of the family to increase their involvement. The founders concluded that the foundation had been more effective than any other estate planning they could do.

Yes, there is value in providing kids with social capital that they can spread around the community; it will surely open doors for them, and may provide more meaningful opportunities than a lifetime income stream. But the real value in creating a family legacy of philanthropy is immeasurable—because it's created in kids' hearts and between family members.

• **Support for specific charities or individuals**—Private foundations provide the most flexibility in distributing money for charitable purposes. Although I encourage potential private foundation clients to consider DAFs, such funds have one very significant limit: distributions from them must be made to public U.S. charities. Distributions cannot be made from DAFs to individuals or foreign organizations.

A private foundation, in contrast, can make grants

to individuals—so long as its selection procedures are pre-approved by the Internal Revenue Service. Grants to individuals include scholarships and fellowships. A donor who wants to establish a scholarship program has limited choices. He could make outright donations to or request distributions from his DAF to specific universities for scholarships, but only students at those particular universities will have a chance to benefit under this arrangement. Many donors shy away from this solution because ultimately the universities administer (that is to say, control) the programs. They could change the selection criteria at any time, leaving the donor dissatisfied with the experience–and out of pocket with little to show for it. If the donor wants, for example, to provide need-based scholarships for graduate study for high school teachers working with literacy theory, limiting his program to one or two particular universities may not be the most effective manner of promoting his interests, because most high school teachers tend to pursue graduate studies near the schools in which they teach. Alternatively, the donor could submit his scholarship selection procedures for IRS review and retain complete control over the scholarship endowment and the process once the Service has given its approval. The selection procedure guidelines are relatively straightforward, and it is not too difficult to construct a process that satisfies both the donor and the IRS.

Unlike DAFs, private foundations are able to make distributions to foreign organizations. A donor who wants to make contributions to a village medicine program in India may do so through his private foundation—so long as the medicine program in India is actually exempt under Indian law. If it isn't, the donor still can make the distribution by following one of several processes identified by the IRS in its regulations and various rulings. Working through a DAF instead of a private foundation, the donor would be able to make distributions only to a U.S. "friends of" the village medicine program. If there is no "friends of" the organization, the DAF will not allow any distribution toward the donor's objective. Even if there is such an organization, the donor may find that his charitable dollar is diluted through additional costs and administrative expenses of the friends of organization.

• **Control**—Private foundations excel above all other charitable vehicles in the level of control they afford their donors. Properly structured, a foundation's founder can guide nearly every aspect of the organization during his lifetime.

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The issue of control raises an important legal distinction between private foundations and DAFs. The assets of a private foundation belong to the foundation and are completely within the control of the board of directors, subject only to applicable state and federal regulation. In sharp contrast, the assets of a DAF belong to the nonprofit organization sponsoring the fund, and ultimate control of the assets rests with the board of directors of that organization. The donor and his chosen set of fellow advisors merely make recommendations about distributions of the assets. Although the nonprofit will honor those recommendations in most circumstances, there is no guarantee their instructions will be followed. The nonprofit may refuse to make a recommended distribution for any number of legitimate reasons—for example, community foundations are common DAF sponsors, but they often limit distributions to a particular geographic area, which means recommended distributions to organizations outside that area may not be honored

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The control issue highlights another difference between the two vehicles. A private foundation exists until its board decides to terminate it. A DAF usually exists so long as the donor and his successor advisors are around to make recommendations. Some sponsoring nonprofits limit the number of successor advisors who can serve. When neither the donor nor the successor advisor(s) can make recommendations, the assets are added to the general endowment of the nonprofit sponsoring the fund, to be administered by its board of directors. Absent other factors, a DAF would certainly be an inferior choice for a donor wanting to establish a philanthropic family legacy lasting several generations.

• **Complexity**— Private foundations excel on the control issue, but there's a price; they also are the most complex option. That's because:

They require additional tax returns. Private foundations must file annual informational returns with the IRS. The state in which the foundation organized also may require a similar return, as may any state in which the foundation conducts business. For example, a private foundation organized as a Delaware non-profit corporation conducting business in both California and Delaware will need to (1) prepare and file Treasury Form 990-PF with the IRS, (2) prepare and file California Franchise Tax Board Form 199, and (3) file a copy of its Form 990-PF with the Delaware attorney general.

These informational returns are complicated. At first glance, they appear simply to ask for information about what the foundation actually did in a particular period. But there is more going on than meets the eye. The federal returns ask for information about the current and the prior five tax years. Although the return does not spell this out, the provided information will be used by the IRS to determine whether the foundation has satisfied various operational tests and has therefore maintained its tax-exempt status.

It's misleading to think of these returns as merely informational; they are, in fact, vital to the continued existence of the foundation. They are also expensive to prepare. It might cost a few hundred dollars to prepare an individual's tax return, but it could easily cost several thousand dollars to have a qualified certified public accountant prepare a foundation's Form 990-PF. But these dollars are well spent. I once worked with a hands-on board of directors that decided a retired attorney sitting on the board could complete the foundation's returns. By the time they came to see me, the foundation had effectively lost its particular brand of tax-exempt status, violated several excise tax rules, and

found itself owing several tens of thousands of dollars in penalties.

Some states require more than just informational returns. California and New York, for example, require that audited financial statements be filed with the state attorney general's office in certain circumstances, usually depending on the foundation's type of fundraising and/or the amount of assets held or received by the foundation. If these are required, add another $10,000 to $15,000 a year for the preparation of those audited financial statements.

These costs can be paid by the foundation, which will divert money from the foundation's charitable purposes. For some clients, these administrative expenses are simply an operational cost. For others, they represent a significant disadvantage.

Tax-exempt does not mean tax free. Many clients are surprised to learn that private foundations must pay an annual federal excise tax equal to 2 percent of their net investment income. The rationale behind this tax is that tax-exempt organizations should contribute toward the costs of having the IRS around to administer and oversee tax-exempt organizations in general. Much is made of the fact that this is not an income tax. In fact, organizations can cut their tax liability in half in every year they effectively distribute the extra 1 percent for charitable purposes.

Distributing 5 percent isn't always easy. A private foundation must distribute 5 percent of the average of the fair market value (FMV) of its assets to maintain its tax-exempt status, and this can take considerable amounts of attention.

One foundation with which I worked had a fairly narrow mission (supporting children's cancer organizations and AIDS services organizations), but every year it received hundreds of requests for grants from organizations that did not fall within its mission. On the off chance that one of these organizations might be worthy of support, but just bad at filling out grant applications, the board reviewed every application and wrote letters to all the organizations that it denied. One of the board members had previously worked for a nonprofit and knew that even a rejection letter was better than waiting around wondering if some funding might turn up.

Writing a check isn't the end of the process. A foundation should have a follow-up process to ensure that its grants are being used for their intended purposes. This effort typically requires the grant to be made subject to an agreement under which the recipient will provide a written report regarding uses, about six months after receipt. If the process works properly, a recipient that fails to provide a follow-up report will never receive a grant again. This due diligence protects the foundation from potential claims of wasting charitable funds by giving it to organizations that use it for non-charitable purposes. Of course, it also adds to the overall administrative burden of running the organization.

For large foundations, 5 percent can be a substantial amount, and finding enough worthy recipients year after year can become burdensome on its own. I once worked with a foundation that made research grants to graduate students. When the donor died leaving a bequest that more than doubled the value of the foundation, the foundation struggled tremendously to find twice as many qualified graduate students within a relatively short period of time. For some private foundations, this kind of crunch can be alleviated by a timely distribution to a DAF, but it only delays the ultimate need for qualified recipients and subjects the funds to the other limitations mentioned regarding DAFs.

• **Costs**—Many financial consultants say you should not spend more than 5 percent of a fund if you want it to last in perpetuity. That figure coincides with the 5 percent annual distribution requirement for private foundations, but they also pay the 2 percent excise tax on investment income plus the ongoing administrative costs. Add in a financial consultant's fees, and a private foundation needs earnings or appreciation of nearly 9 percent just to break even.

Of course, costs are not the whole story, and breaking even is not the point. Private foundations serve other purposes. Still, there is a calculation that must be done. A foundation with $1 million in assets will distribute $50,000 to charities. It also will spend $3,000 to $5,000 a year on administrative costs and (to make things simple) $10,000 for financial advice. If it earns 9 percent (enough to break even), it also will pay $1,800 in excise taxes. In its first year, the start-up costs probably will be another $15,000. In this case, it will cost $29,800 to $ 31,800 in

Year 1 and $14,800 to $16,800 in succeeding years to distribute $50,000 to charities. Is that the best way to spend the client's charitable dollars? Using a DAF, the same $50,000 could make its way to charities and the only cost would be the 1 percent to 2 percent administrative cost assessed by the nonprofit for managing and investing the fund. (One of the additional advantages of establishing a DAF is that the fund assets are often invested as part of the nonprofit's general endowment, taking the investment management aspect off the donor's shoulders.)

Of course, if the private foundation has $10 million and $500,000 is going to charities each year, the costs might not seem so disproportionate.

• **Privacy**—Private foundations' annual returns disclose the names, addresses and compensation of all directors, trustees, officers and other managers of the foundation. The same information must be disclosed concerning employees and/or independent contractors who are paid more than $50,000 by the foundation. Every grant made by the foundation must be described, including the amount, and each recipient's contact information.

For clients who value anonymity, these disclosure requirements present almost insurmountable problems because foundations must comply with public inspection requirements regarding their annual returns. Generally, a foundation must provide copies of any or all of its last three annual returns to anyone who requests them. The rules regarding how requests can be made, how long a foundation has to comply with them and how much a foundation can charge for making the copies are tedious. So most foundations comply with the alternative provided in the IRS regulations: They make their returns available on the Internet.

I have worked with foundation founders who used creative names for their organizations and hired third parties to serve as the organization's face to the outside world, all for the sake of keeping their names private, who were stymied when their CPA explained these disclosure requirements. Ironically, for clients who crave privacy, a private foundation is probably not the best choice of philanthropic tools. DAFs or direct anonymous gifts to specific charities may be better choices for these clients.

In the End

Underneath most weighty questions, there is usually a fundamental issue that swings the vote. Despite all the pros and cons, experience tells me that a donor who believes that his grandchildren will—or should—be involved in the family's philanthropy is one who will opt for a private foundation seven times out of 10. If you combine charitable planning with a vehicle that makes the same board of directors responsible for using wealth to provide education and other opportunities for successive generations of the donor's family, such as a family bank or an opportunity fund, you can suggest a plan that might open the door to meaningful discussions about some of these fundamental issues.

And then, if the private foundation does not work out after all, it can be terminated. (See Kim Wright-Violich and Christopher W. Geison, "Breaking Up Is (Not So) Hard To Do," p. 52.) TE