

# SHOULD I MAKE MY FOUNDATION GO AWAY, AND IF SO, WHERE SHOULD IT GO?

During the “go-go” days of the 90’s many of the newly wealthy decided to share their good fortune with their communities and established private foundations at a greater rate than ever before.<sup>1</sup> During the same period, California had the greatest increase in wealth creation and not surprisingly, it also had the greatest increase in the creation of family foundations and asset value.<sup>2</sup> There are currently over 55,000 private grantmaking foundations in the US today according to the latest estimates from The Foundation Center.<sup>3</sup>

But the 90’s have come and gone and with its passing, foundation asset values have in many cases plummeted over the past 2-3 years which is now having an impact on grantmaking. According to the same study:

*Three straight years of stock market declines, a year-long recession, a sluggish economy, and record giving levels, led to a nearly 4% decline in the value of U.S. foundation assets in 2001 and an estimated 1%-12% decline in 2002. This decrease in assets—especially among the largest endowed foundations—will undoubtedly result in a reduction in giving this year [2003].*

There is and has always been a certain cache in creating a foundation for charitable giving by a few individuals or a family. Individuals are drawn to establishing private family foundations for many reasons: (1) to be more focused in their giving; (2) to bring the family or others into the giving process; (3) to transmit family values inter-generationally; (4) to turn a family’s affluence into influence in the community; (5) to obtain a charitable income tax deduction on creation; (6) to avoid the imposition of capital gains taxes on the sale of appreciated assets by the foundation; and (7) to retain control of the “endowment” rather than giving such funds to a charity which manages the endowment. Just as there are many faces of philanthropy, there are diverse motives for entitizing family giving through a foundation.

However, many individuals are finding that the maintenance of these entities can rob them of much of the joy of grantmaking. The rules governing private foundations are numerous and complex. Founders must carefully wend their way through the private foundation minefield of rules— constant vigilance is key to crossing safely to the other side.

It is not unusual for philanthropy consultants to receive frantic phone calls around April 15th from clients and/or their advisors who have just become aware that a transaction that occurred in the prior tax year (which is now closed) may constitute an act of self-dealing.<sup>4</sup> For example, many foundations are approached by charitable organizations to buy tickets to gala events. Foundations are more than willing to purchase a table recognizing that the charity will receive a portion of the proceeds because the value of the tickets exceed the costs of the event itself. However, if the Foundation purchases the table and a Founder or other “disqualified person” actually attends the dinner, an act of self-dealing has occurred since a benefit has been received by such individual. Even if the disqualified person does not attend the event and gives the tickets to friends or colleagues, the fact that the disqualified person has the right to control the use of the tickets is still an impermissible benefit.

<sup>1</sup> Foundation Growth and Giving Estimates, The Foundation Center, 2003

<sup>2</sup> Family Foundations: A Profile of Funders and Trends, The Foundation Center 2000

<sup>3</sup> Foundation Growth and Giving Estimates, supra

<sup>4</sup> Section 4941 of the Internal Revenue Code of 1986, as amended (“IRC”)

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Another example is where a disqualified person wants to sell an asset to the foundation and will do so at a very reduced (or “bargain”) price. Even if the price is extremely favorable to the foundation, such a transaction constitutes self-dealing under the private foundation rules.

There are other rules that can only be mentioned because of space constraints, but which demand careful scrutiny by foundation managers: the excess business holding rules and jeopardy investments rules are traps for the unwary.<sup>5</sup>

In addition to avoiding the complex set of operational rules, there are other mandates: the foundation must file an annual return (Form 990PF) with the Internal Revenue Service and in some states—like California—an annual state return as well. Each state has its own requirements as to other filings that also must be followed.

And the foregoing is not all. Each year, the private grantmaking foundation must distribute a minimum of 5% of the value of its investment assets.<sup>6</sup> Failure to make the requisite distribution results in the imposition of penalties. Additionally, each year the foundation must pay an excise tax of 2% (or 1% in special circumstances) on the foundation’s income to the federal government.<sup>7</sup> The 2% excise tax is revenue the IRS then utilizes to police the operations of private foundations. Essentially, the foundation is paying the IRS to monitor its activities.

Finally, for some foundations, the foundation will pay other administrative, legal and accounting expenses that can further deplete the foundation assets leaving less available for making grants.

It must be stated that many foundations are operated very efficiently and properly and the family is well informed about the foregoing rules and is not intimidated by the compliance issues. But, many foundations are not operating within the parameters imposed by the various rules and founders and/or their families are surprised and chagrined to realize that their actions—even though innocent and even beneficial—can result in economic penalties and, in some cases, can jeopardize the exempt status of the foundation. Moreover, many individuals are finding they are not really cut out to be “charity operators” and are now looking for alternatives. When you add to the “charity operator frustration” the fact that many foundations have suffered substantial loss in asset value over the past 2-3 years, it is easy to see why individuals are considering ways to get out of the foundation “business.”

## **THE GOOD NEWS IS THAT THERE ARE ALTERNATIVES**

Foundations can certainly outsource much of the operational aspects of the foundation. Identifying qualified individuals or consultants to assist in managing the day-to-day tasks of the foundation is one way to avoid some of the challenges. Large family foundations have been “hiring it done” for years and there is now an entire industry that has emerged for just that purpose.

If, on the other hand, the family seeks to find a less time consuming and expensive alternative, the family could consider terminating the foundation and transferring the foundation assets to a charity that

<sup>5</sup> IRC Sections 4943 and 4944

<sup>6</sup> IRC Section 4942

<sup>7</sup> IRC Section 4940

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sponsors donor advised funds. Establishing a donor advised fund allows the family to participate in the grantmaking process (by recommending grants to the sponsoring charity) without the same level of costs associated with foundation management.<sup>8</sup>

Another feature not possible in the private foundation world is the ability to have grants from the donor advised fund made anonymously. There is nothing “private” about a private foundation— such description is clearly an oxymoron! All contributions (as well as contributor names) and all grants are listed on the foundation’s annual tax return filed with the IRS. However, grants can be made anonymously from donor advised fund accounts and many donors like having the ability to recommend that the grant be made anonymously in order to maintain their privacy.

Finally, many of the intangible benefits of family giving sought in operating a family foundation can still be achieved through donor advised fund giving. Family members can work together to determine which nonprofit organizations should be supported. Younger family members can be brought into the family philanthropy by allowing joint participation in the recommendation of grants to be made to various organizations selected by the family. Family members can still make site visits, review investment reports and analyze charitable proposals. The skills associated with grantmaking can, and many times does, translate into the skills needed for managing individual wealth. Such skills can also be developed by utilizing a donor advised fund for family philanthropy as opposed to utilizing a private foundation for such education.

What is lost is the absolute control over the funds. The family can recommend or advise the sponsoring charity as to the pre-selected investment pools the family would like to choose for investment of the family’s account assets. The family can recommend or advise the sponsoring charity as to the recipient charity for grants from the account. But, the final decision for investments and grantmaking is in the discretion of the sponsoring charity and not the donor. Generally, assuming the grant recommendation meets the parameters of the sponsoring charity’s policies and procedures, the advice is followed.

In summary, it is never too late to reassess the family’s philanthropy structure and determine if another vehicle is better suited to the family’s needs. Whether the family should continue as a charity operator or not depends on many factors—size of foundation, family involvement both now and in the future, desire to exercise absolute control over investments and grantmaking, cost of administering the foundation and tolerance for complexity. If the family decides to turn to a different model, then creating a donor advised fund is certainly an alternative worth exploring. In the final analysis, it is all about doing good and making a difference. How best to accomplish those objectives in the most meaningful and strategic manner is the task at hand for the family.

<sup>8</sup> Charities sponsoring donor advised funds do charge fees for the administration and investment of such assets, however, the costs are generally less than the costs associated with most private foundations. Moreover, donors reap the benefits of specialized knowledge in the area of administration and grantmaking.