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GOT GOOD GOVERNANCE?

The Inside Track on
Reorganizing the Family Philanthropy

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I. Introduction of Topic

A. The thesis of our presentation is that just as family businesses must reinvent themselves as they pass from one generation to the next, so must family philanthropy.

B. Several studies of charitable giving behaviors, most particularly the Bank of America Study of High Net Worth Philanthropy, demonstrate that entrepreneurs, as a group, donate more money to charity than any other source of wealth.

C. This outline and presentation focus on existing family philanthropy, and existing private foundations in particular, and not on the topic of charitable planning.

II. The Role of Private Foundations in Philanthropy

A. Charitable Giving in the United States

"These Americans are the most peculiar people in the world…In a local community, in their country a citizen may conceive of some need, which is not being met. What does he do? He goes across the street and discusses it with his neighbor. Then what happens? A committee comes into existence and then the committee begins functioning on behalf of that need…All of this is done by private citizens of their own initiative."

Alexis de Tocqueville, *Democracy In America* (1835)

1. Giving USA, the most widely cited study on charitable giving in the United States, has been issued annually since 1956, and shows (among other findings):

a. Growth in giving in every year except 1987, 2008 and 2009.

b. Total giving of $298.42 Billion in 2011 (the latest year for which data is available).

B. Charitable Giving by Private Foundations

1. According to Giving USA, giving to Private Foundations in 2011 was $25.83 Billion, or 9% of all charitable giving.

2. According to Giving USA, giving from Private Foundations in 2011 was $41.7 Billion, representing 14% of total giving in 2011.

3. Almost sixty percent (60%) of private foundation giving was made by Family Foundations (as opposed to institutional or corporate foundations).

C. Growth of Private Foundations

1. Private philanthropy has always been with us

a. Plato's will left his farm to a nephew with instructions the proceeds be used to support students and faculty at the academy he founded. That was 347 B.C.

b. Pliny the Younger offers to contribute 1/3 the sum needed to build a new school to help educate children in Rome rather than sending them abroad. He challenges the other fathers to make up the difference (the first matching gift challenge grant). That was 113 B.C. No word on Pliny the Elder's charitable activities.

c. See "History of Giving," Timeline, on National Philanthropic Trust's website, www.nptrust.org.

2. Private foundations as we know them today

a. With the accumulation of the unprecedented fortunes of the late 19th century, there came the establishment of the first large private foundations. Among these were the Russell Sage Foundation in 1907; the Carnegie Corporation of New York in 1911; and the Rockefeller Foundation in 1913. McCoy at 1-4 to 1-5.

b. Over the next half-century, there were sporadic waves of Congressional suspicion and inquiry. Significant among these were the Walsh Commission, which investigated the role of foundations in the economy (1916); the Ways and Means Committee hearings on the business activities of foundations (1947); the Cox and Reece Committees, which focused on foundations and subversive activities (1952-1954); and the

Patman Committee (1961-1969), which recommended many of the provisions found in the Tax Reform Act of 1969. Fremont-Smith, 67-77.

c. Prior to enactment of the Tax Reform Act of 1969, certain restrictions on self-dealing, jeopardizing investments, and unreasonable accumulation of income were already part of the Internal Revenue Code. These applied only to the type of charitable organization that would later be categorized as a "private foundation" in the 1969 Act. Fremont-Smith at 60-61; Internal Revenue Code of 1954, Sections 503 and 504.

d. Given the considerable economic benefits resulting from tax-exempt status, it is not surprising that the Internal Revenue Service, as the ultimate arbiter of tax exemption, has become the de facto regulator of all tax-exempts, including private foundations. The Division of the IRS specifically tasked with oversight is the Tax Exempt and Government Entities Operating Division.

e. According to the Foundation Center, at the end of 2010, there were 68,211 private non-operating foundations, and 4,947 private operating foundations. The number of private non-operating foundations has almost tripled in the last 25 years; the growth of private operating foundations has been even greater. Growth rates were highest in the late 1980's and throughout the 1990's. That growth has slowed appreciably since 2001, likely because of two periods of economic instability, and the availability and rapid growth of Donor Advised Funds.

3. The growth of private foundations has been accompanied by:

a. The aging of the founders of those foundations.

b. The greater availability of alternative charitable planning options, particularly donor advised funds.

III. Introduction of the Case Studies

A. Facts Common to all Case Studies

1. Generation 1, Husband and Wife, both late-70's.

2. Husband started in the real estate business right out of high school, married his high school sweetheart, and they have now been married for almost 60 years!

3. Husband and Wife have worked, elbow to elbow, from the inception of the business, though she eventually spent more time with family and community activities.

4. Business has grown exponentially over the years, and is now worth close to $1 Billion.

5. About 20 years ago, Husband and Wife formed a private foundation to bring some discipline and organization to their varied philanthropic activities. Prior to that time, they gave money to many different causes, just about any time one of their friends came calling for money to support this or that pet cause.

6. Husband and Wife have always run the foundation themselves, making all grant decisions, though they have always employed their family attorney and accountant to handle legal, accounting and tax matters.

7. Husband and Wife are interesting in learning their options of carrying on their philanthropy, both because the day to day job of grantmaking has gotten to be too much for them, and because they realize that they will not be here forever to manage the foundation.

B. Facts Which Vary by Case Study

1. Case Study #1

a. The foundation is shrinking rapidly because of grantmaking well over the 5% minimum required distribution, and because of some bad investments made several years ago. Administration has become burdensome and expensive.

b. The children (if there are any) are not interested in perpetuating the family philanthropy.

2. Case Study #2

a. The growth of the foundation's assets is keeping pace with, or exceeding, the annual distributions.

b. The children live in different parts of the country and, although charitably inclined, are busy with their own families and careers.

3. Case Study #3

   a. The growth of the foundation's assets is keeping pace with, or exceeding, annual distributions.

   b. There is likely to be a large testamentary addition to the foundation at the death of either or both of Generation 1.

   c. The children are successful in their own right, and are also philanthropically inclined.

   d. Although the children are interested in charity, they each have their own "causes" and there is little, if any, overlap in their philanthropic interests.

4. Case Study #4

   a. Generation #1 has already transferred a significant amount of the ownership of the family business to one or more members of Generation #2.

   b. If fewer than all members of the next generation are to be involved in the business, the other members have had their inheritances "equalized" with other assets and/or life insurance.

   c. Generation #1 wants to leave the balance of the business that they still own to the foundation, not to the children or grandchildren, as they feel adequate provision has already been made for them.

5. Case Study #5

   a. Rather than forming a private foundation, the family instead opted to use a Type III Supporting Organization, with the Supported Charity being the Main Street USA Community Foundation. This allowed the family to take a more favorable income tax deduction upon the formation of the Supporting Organization, and flexibility in grant-making through a donor directed option with the Community Foundation. They were also advised that they would have for all practical purposes the same level of control as with a private foundation, and would not be subject to the private foundation excise taxes.

   b. The family funded the Supporting Organization with Family Limited Partnership interests, allowing them further control over investments, and actual distributions to the Supporting Organization, then to the donor directed fund at the Community Foundation.

IV. Private Foundation Basics/Primer

A. Federal Income Tax Rules

1. The exemption from income taxes/reporting requirements

a. Tax-exemption. A private foundation is tax exempt only if it receives a favorable determination letter from the Internal Revenue Service in response to a timely filed Form 1023. IRC Section 508 and Treasury Regulations Section 1.508-1 through 1.508-4.

b. Form 990-PF. A private foundation must annually file Form 990-PF with the IRS. This information return includes financial statements, a summary of grant-making activity, lists of contributors and managers, and a calculation of the excise tax on net investment income. IRC Section 6033 and Treasury Regulations Sections 1.6033-2(a) and 1.6033-3(a). Returns must be made available for public inspection during a three-year period beginning on the last day prescribed for filing the return. IRC Section 6104(d).

c. Form 4720. Any initial private foundation penalty excise tax is self-assessed on Form 4720. Treasury Regulation Section 1.6033-2(j).

d. Form 990-T. Unrelated business income tax is calculated and paid with Form 990-T. IRC Section 6012 and Treasury Regulations Sections 1.6012-2(e) and 1.6012-3(a)(5). Returns must be made available for public inspection during a three-year period beginning on the last day prescribed for filing the return. IRC Section 6104(d).

2. The 6 excise taxes ("baseline governance")

a. Enacted as part of the Tax Reform Act of 1969, the penalty excise taxes reinforce the role of basic fiduciary principles in the private foundation arena. Private foundations that willfully and repeatedly (or willfully and flagrantly!) incur a liability for the penalty excise taxes risk having their status as a private foundation terminated involuntarily - and becoming subject to an onerous termination tax that recaptures the benefits of tax-exempt status. IRC Section 507(a) and (c); Treasury Regulations Sections 1.507-1; 1.507-4 through 1.507-9.

b. Self-dealing and the duty of loyalty. The penalty excise tax on self-dealing punishes those individuals (and certain related parties) who breach the fiduciary duty of loyalty by entering into transactions with the foundation, including sales, loans, leases, and the furnishing of goods, services and facilities. The rule, which has many important exceptions, applies only to "disqualified persons" and "foundation managers." Both these terms are broadly defined in IRC Section 4946 and Treasury Regulation Section 53.4946-1.

i. The initial tax on "disqualified persons" is equal to 10 percent of the "amount involved with respect to the self-dealing"; the initial tax on "foundation managers" is 5 percent, with a $20,000 maximum per act of self-dealing. A confiscatory second tier tax is imposed if the parties fail to correct the self-dealing within the time provided by the statute. IRC Section 4941 and Treasury Regulations Sections 53.4941(a)-1through 53.4941(e)-1.

ii. Compensation (and loans) are the most reported act of self-dealing. Compensation, including reimbursement of expenses, to a disqualified person is specifically prohibited, except for personal services which are reasonable and necessary to carrying out the exempt purposes of the private foundation. IRC Section 4941(d)(2)(E).

a) Reasonable and necessary. The amount that may be paid to a disqualified person must not be "excessive," and must bear a reasonable relation to that person's job aptitude, the duties performed, and perhaps most important, what would be paid to an unrelated person to perform the same duties.

b) Personal services. Compensation may be paid to disqualified persons only for personal services that are necessary for the foundation to carry out its charitable purposes. The IRS has taken a strict view as to the types of services permitted, and views legal, investment management and banking services as the only permitted personal services for which reasonable compensation may be paid to a disqualified person.

iii. Other self-dealing

a) Shared resources. Private foundations often share resources with their disqualified persons. A family foundation may share space and staff with a family office. Companies regularly provide space and staff to the company foundation. When this is the case, the foundation must carefully observe the limits imposed by the prohibition on self dealing.

The foundation <u>may not</u> pay rent to the disqualified person, even if the rent is substantially below market. The prohibition on self-dealing prohibits a disqualified person's leasing of property to the foundation unless the lease is without charge. IRC Section 4941(d)(1)(A). If the disqualified person is unwilling to provide space for free, the foundation must rent space on the market from someone who is not a disqualified person.

The foundation <u>may not</u> reimburse the disqualified person for its use of computers, photocopiers, telephones and other office equipment and supplies. The self-dealing rule prohibits the furnishing of goods, services, or facilities between a private foundation and a disqualified person, IRC Section 4941(d)(1)(C), unless the disqualified person provides the goods or services free, IRC Section 4941(d)(2)(C). The foundation may purchase its own equipment and office supplies from persons who are not disqualified and, where this is feasible, may contract directly with utility companies for telephone and similar services.

The foundation <u>may</u> reimburse the disqualified person for personal services provided to the foundation by an employee of the disqualified person. This falls within the exception to self-dealing, noted above, that permits a private foundation to pay compensation to a disqualified person who provides services to it.

b) <u>Pledges and tickets</u>.

i) <u>Pledges.</u> A private foundation may not pay a pledge made by one of its disqualified persons if the pledge was legally binding on the person that made it. Because the payment would relieve a disqualified person of a legal obligation, it is considered a transfer of the foundation's assets to the disqualified person. Treas. Reg. § 53.4941(d)-2(f)(1). Whether a pledge is enforceable by the charity that received it is a question of state law.

ii) Tickets. Can a private foundation purchase tickets to a charity event and allow a disqualified person to use them? In general, this is an act of self-dealing unless either: i) the tickets are considered as compensation to the disqualified person and the total value, taking into account other compensation paid, if any, does not cause the person's compensation to be unreasonable; or (ii) attending the event is reasonable and necessary to the disqualified person's performance of his job with the foundation. IRS guidance is sparse and consists mainly of a few PLRs. This leaves unanswered a number of important questions including whether, if the disqualified person's attendance is necessary for her position at the foundation, can her spouse also attend? What about her children? Is showing the foundation's support for a grantee a sufficient reason to allow use of a foundation- paid ticket? If the foundation has made a grant to support a series of concerts, can a disqualified person attend every performance in the series in order to evaluate the success of the grant?

iv. Exceptions to Self-Dealing

a) In addition to the exception to self-dealing for reasonable compensation, there are several other statutory exceptions:

i) Money loaned and goods, services, and facilities furnished to the private foundation by a disqualified person is permitted, provided that no interest is paid and the proceeds are used for the foundation's purpose, and the goods, services or facilities are used for charitable purposes. IRC Section 4941(d)(2)(B) and (C). Regulations Section 53.4941(d)-2(d)(3).

ii) Goods, services and facilities may be furnished to the disqualified person by the foundation, provided that this is done on a basis that is no more favorable than that which is available to the general public. IRC Section 4941(d)(2)(C) and Regulations Section 53.4941(d)-3(b)(1) and (2).

iii) Transactions between a private foundation and a corporation that is a disqualified person pursuant to a liquidation, merger, redemption, recapitalization, or other similar corporate transaction upon specified conditions. IRC Section 4941(d)(2)(F).

iv) Certain business transactions between private foundations and disqualified persons that result from a business relationship that existed before such transaction would constitute an act of self-dealing. See Regulations Sections 53.4941(d)-1(b)(1) and 53.4941(d)-1(b)(8), ex. 2.

v) Transactions during the administration of an estate or revocable trust ("Estate Administration Exception"), provided that a 5-part test is met. Regulation Section 53.4941(d)-1(b)(3). This important exception will be specifically addressed in one of the case studies below.

c. <u>Failure to distribute</u>. Private foundations are subject to a 30 percent excise tax if they fail to make "qualifying distributions" in an amount equal to five percent of the average monthly net fair market value of their investment assets. (The amount is commonly referred to as 5% of investment assets, though the actual amount is subject to a more complicated formula that is calculated each year on the foundation's Form 990PF). The distribution for any given tax year must be made before the end of the following tax year.

With some important exceptions, the term "qualifying distributions" generally includes all amounts paid (including program-related investments) to accomplish a charitable purpose; certain assets used directly to carry out a charitable purpose (*note: this does not include investment assets*); and certain amounts set-aside for a specific project that has a charitable purpose. Distributions are most commonly made to domestic charitable organizations recognized as such by the IRS. This includes public charities, certain governmental entities so long as for charitable purposes, supporting organizations (excluding non-functionally related type III supporting organization unless expenditure responsibility is performed), private operating foundations, other non-operating private foundations under specified circumstances and, under specified circumstances, individuals for charitable purposes.

As noted above, the initial excise tax is 30 percent of the undistributed amount. If the under-distribution is not corrected, the second tier tax is 100 percent.

Both the amount, and the recipients, of the foundation's grants must be reported each year to the IRS, which is done as part of the Form 990PF.

IRC Section 4942 and Treasury Regulations Sections 53.4942(a)-1 through 53.4942(b)-2.

d. Excess business holdings. The penalty excise tax on excess business holdings punishes those private foundations that own too great an interest in an operating business. "Excess holdings" is generally defined in relation to "permitted holdings" of 20 percent of an entity's total voting stock or total profits interest. The initial tax (imposed if the securities are not divested within any available safe harbor period) is 10 percent of the value of the excess holdings. The second tier tax for failure to divest within the permitted time is 200 percent of the value of the excess holdings. IRC Section 4943 and Treasury Regulations Sections 53.4943-1 through 53.4943-11.

e. Jeopardizing investments and the duty of care. This penalty excise tax targets investments that jeopardize the carrying out any of a foundation's exempt purposes. It is intended to punish both the foundation that makes the investments and the "foundation managers" who approve them. The implementing regulations focus on the adequacy of the investment process: an investment is jeopardizing if the foundation managers have "failed to exercise ordinary business care and prudence." The initial excise tax (imposed on both the foundation and the negligent foundation managers) is 10 percent of the value of the jeopardizing investment; the initial penalty on investment managers is limited to $20,000 per investment. If the foundation fails to dispose of the jeopardizing investment, there are second tier taxes as well. IRC Section 4944 and Treasury Regulations Sections 53.4944-1 through 53.4944-6.

f. Taxable expenditures. IRC Section 4945 attempts to ensure that private foundation monies are spent for exclusively charitable purposes by taxing certain suspect expenditures. "Taxable expenditures" is defined in the statute to include expenditures for lobbying or electioneering (including voter registration); certain grants to private individuals (unless grant-making procedures are approved by the IRS); and certain grants to private foundations and supporting organizations (unless there is special oversight). The initial tax on the foundation is 20 percent of the amount of the expenditure; the initial tax on the foundation managers who approve such expenditures is 10 percent, with a ceiling of $20,000 per expenditure. A second tier tax applies unless an amount equal to the taxable expenditure is restored to the private foundation. IRC Section 4945 and Treasury Regulations Sections 53.4945-1 through 53.4945-6.

g. <u>Private foundation excise tax on net investment income</u>. Separate and apart from the private foundation penalty excise taxes is a two percent excise tax imposed on the net investment income of every private foundation, defined to include capital gains. Under certain circumstances, the two percent tax may be reduced to one percent. IRC Section 4940 and Treasury Regulations Section 53.4940-1.

3. Unrelated business income tax (UBIT). The first UBIT provisions were enacted in 1950 to discourage tax-exempt entities, including private foundations, from unfairly competing with for-profit businesses. Today, the amount of income subject to tax ("unrelated business taxable income" or "UBTI") is computed under the special rules of IRC Sections 511 through 515, while the tax itself is computed under IRC Section 11 (for corporations) or IRC Section 1(e) (for trusts). IRC Section 511(a) and (b). A specific $1,000 deduction prevents imposition of the tax on very small amounts. IRC Section 512(b)(12).

a. <u>Unrelated trade or business income</u>. Business income received by a private foundation is wholly taxable as unrelated business taxable income if it arises from activities unrelated to the foundation's charitable purpose. IRC Sections 512 and 513. A special rule treats all income or gain from S corporation stock as income from an unrelated trade or business. IRC Section 512(e). Garden-variety interest, royalties, and rents are expressly excluded from the definition of unrelated business taxable income. IRC Section 512(b).

b. <u>Unrelated debt-financed income</u>. Unrelated debt-financed income is included in the computation of unrelated business taxable income. IRC Section 514(a). As originally enacted in 1950, the unrelated debt-financed income provisions focused narrowly on rental income from debt-financed, sale-leaseback real estate transactions. IRC Section 514, prior to amendment by the Tax Reform Act of 1969. The concern was that charities were using their profits tax-free to purchase large amounts of commercial real estate, i.e. the tax-exempt rental income received by the charity was being used to pay off the installment purchase price. Senate Report No. 2375, Revenue Act of 1950. Under the Tax Reform Act of 1969, the unrelated debt-financed income provisions were substantially broadened to apply to gross income from any type of debt-financed property, including gain on disposition of that property. IRC Section 514. IRC Sections 511-514 and Treasury Regulations Sections 1.511-1 through 1.514-(d)-1.

B. State Fiduciary, Corporate and Trust Law

1. Structure and governing law. A foundation may be formed as either a non-profit corporation or as a trust. There are at least five differences to consider.

a. State law. Corporations are subject to state corporate law requirements for formation and annual corporate reporting to the secretary of state; trusts typically are not. Conversely, standards of conduct may be higher for trustees than for directors and officers.

b. Flexibility. Though arguably more difficult to establish, corporations are more flexible in their operation, especially if a change in purpose or mission is called for. All state laws provide a mechanism for amending corporate Articles and Bylaws; changes to irrevocable trusts usually require court action.

c. Operating foundations. The corporate form is preferred if the foundation will be operating any sort of program.

d. Foreign operations or grants. If the foundation contemplates foreign operations or grants, and expects to receive contributions from a corporate donor, then the foundation should be in corporate form, not trust form. IRC Section 170(c)(2) disallows a deduction to a corporate donor for contributions to a non-corporate entity that uses such funds outside the United States.

e. UBTI. If the foundation incurs unrelated business taxable income ("UBTI"), it will be subject to income tax at either the corporate or trust rate depending on its structure. Because trust income tax brackets are so compressed, tax on comparable amounts of UBTI will generally be higher for trusts than for corporations.

2. Fiduciary law

   a. The role of the board. The directors (or trustees if the foundation is established in trust form) are charged with overall management responsibility, including assuring that the foundation abides by its governing documents, mission statement and other policies and procedures.

      i. Fiduciary considerations. Directors, officers, and trustees, as well as key employees, are all fiduciaries of the foundation, though the required standards may differ.

         a) Conduct. State law standards of conduct for trustees may be higher than for corporate directors and officers.

         b) Liability. Conversely, state law limitations on liability may be higher for directors and officers than for trustees.

   b. Independence. Use of outside board members, or independent trustees, should be considered.

   c. Policies. Directors (or trustees) should consider adopting the various policy statements (investment policy, spending policy, conflict of interest policy, etc.) addressed elsewhere herein.

   d. Governing document. The governing document(s) should set out the general powers of the board, their number, tenure and qualifications, their manner of selection, and their succession.

   e. Sub-committees. Larger foundations may have sub-committees with oversight over specific functions, such as audit and compensation.

   f. Employees. Larger foundations may also use officers (or other employees) to carry out day-to-day functions.

3. Investment Considerations

   a. Uniform Prudent Investor Act. The UPIA applies to those private foundations that are trusts. Section 2(c) lists representative factors for the trustee to consider in investing and managing trust assets: general economic conditions; inflation or deflation; tax consequences; the role of the investment within the overall trust portfolio; expected total return; other resources of the beneficiaries; needs for liquidity, income and preservation or appreciation of capital; and the asset's special relationship, if any, to the purposes of the trust. Section 3 of the UPIA requires a trustee to diversify, with a limited exception for a trustee who "reasonably determines that because of special circumstances, the purposes of the trust are better served without diversifying."

b. Uniform Prudent Management of Institutional Funds Act. A private foundation organized as a corporation is an "institution" within the scope of UPMIFA, i.e. it is a person, other than an individual, organized exclusively for charitable purposes and it is not a trust. UPMIFA, Section 1(4).

i. Investment provisions. UPMIFA includes investment provisions that are expressly intended to conform to those of the UPIA. UPMIFA, Prefatory Note. In particular, the factors to be considered by the institution when managing its investments mirror the list set forth in the UPIA. UPMIFA, Section 3; UPIA, Section 2. In addition, UPMIFA includes a diversification requirement, with the same limited exception set forth in the UPIA. UPMIFA, Section 3; UPIA, Section 3.

ii. Endowment provisions. To the extent that the foundation's governing document restricts the annual expenditure of part or all of its funds, those funds constitute an endowment to which the UPMIFA endowment expenditure rules apply. Under UPMIFA, private foundations must consider seven enumerated factors before making an expenditure from a restricted fund: (1) duration and preservation of the fund; (2) the purposes of the foundation and the fund; (3) general economic conditions; (4) effect of deflation and inflation: (5) the expected total return from income and the appreciation of investments; (6) other resources of the private foundation; and (7) the foundation's investment policy. UPMIFA, Section 4.

C. Best Practices

1. Mission Statement. A mission statement can be a useful tool for preserving the founder's intentions for the foundation. Mission statements can also express the goals of the foundation's board. Care should be taken to distinguish between purpose restrictions imposed by the donor and binding on successor directors or trustees and non-binding expressions of preferences.

2. Spending Policy. A spending policy can set forth the founder's and the continuing board's policy with respect to the amount of grants to be distributed by the foundation, whether that is the minimum required by law, or a higher amount. The spending policy is also a key component of the Investment Policy.

3. Investment Policy. In an investment context, prudence requires a comprehensive, principled and timely consideration of a number of complex factors, including the individual asset itself, the relationships among assets within the portfolio and general economic conditions—as well as the purposes and terms of the private foundation. Those charged with investment responsibility must have the necessary skill as well as sufficient time to devote to the task at hand. Implementation and review of a written investment policy that clearly states investment objectives, including risk and return parameters, is strongly recommended.

4. Other Governance Policies

   a. Composition of the Board. Foundations should consider the use of outside directors (or trustees), unrelated to the donor or donor's family.

   b. Committees of the Board. Similar to Board composition, foundations should consider forming and utilizing committees which are tasked with specific functions. This may allow for the development of more expertise and independence within the governance structure.

   c. Delegation. Similar to the formation and use of committees, delegation of authority over specific functions may increase independence of the Board from the donor or donor's family. This is perhaps particularly true with respect to audit and other risk management functions.

   d. Conflicts of interest. Boards should consider the adoption of a conflicts of interest policy, which will reduce the risk of violating self-dealing prohibitions for both state law purposes and federal excise tax purposes. If adopted, such a policy should be reviewed at least annually, and acknowledged by each board member and key employee. Particular attention should be placed on potential transaction between any such persons and the foundation, and the relationship that any such person has with any foundation grantees.

   e. Training and succession. Foundations, regardless of governance structure, should provide for board or trustee succession, and provide a mechanism for training new directors or trustees.

f. Whistleblower Policy. Boards should consider adopting a Whistleblower Policy, either as a separate policy or as part of the conflicts of interest policy, to handle complaints and establish procedures for directors or employees to report suspected internal issues without fear of reprisal.

V. Supporting Organizations Basics/Primer

A. Introduction

1. Although less commonly used than a private foundation (because of the lack of familiarity and lack of control), the supporting organization is more commonly used in close association with public charities for purposes of the support of the organization (or often created by the charitable organization which they are organized to support) and may be a useful if the donor desires to benefit a few specifically named charities and influence the actions of the organization without violating any rules against controlling the organization. Here, the donor may have a specific project envisioned at a particular charity or may be actively involved in a charity or charities so much that he or she desires to create an organization to support those charities in the future. It is important, therefore, to weigh the donor's desire for continuing control with his or her need to surrender to control of the supported organization. If he or she is comfortable with giving up actual control in exchange for having a limited or even significant voice in the organization, then the supporting organization may be a planning option for the donor and will result in avoiding the private foundation restrictions discussed above. The organizational documentation is no different from a private foundation (discussed above); however, the difference is in the organizational structure and its governance and is reflected by the tax status created and approved through the filing of Form 1023 (discussed below).

2. Defined:

a. A supporting organization is an organization exempt under I.R.C. Sections 501(c)(3) and 509(a)(3) which supports one or more public charities qualifying under I.R.C. Section 509(a)(1) or (2). It may also, under certain circumstances, support a social welfare league, civic league, labor or agricultural organization, real estate board, or business league that is exempt under I.R.C. Section 501(c)(4), (5) or (6) [(4) describing civic leagues, social welfare organizations and local associations of employees, (5) describing labor, agricultural or horticultural organizations and (6) describing business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues].

b. It is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the exempt purposes of one or more public charities.

c. Contributions to a supporting organization are treated as being made to a public charity and are entitled to the more favorable income tax treatment available for such contributions.

3. <u>"Support" Tests:</u>

a. Supporting organizations are not required to meet the public "support" tests that some I.R.C. Section 509(a)(1) and all I.R.C. Section 509(a)(2) organizations must satisfy to establish the public support necessary to exempt them from the private foundation rules. As long as a supporting organization is organized and operated exclusively to support one or more public charities it does not matter whether the organization's funding is from one or from multiple sources.

4. <u>Organizational Test</u>:

a. The supporting organization, like the private foundation, may be established as a trust or as a corporation. The governing instruments of the supporting organization must:

i. State that the purposes of the organization are limited to the purposes of one or more benefited public charities;

ii. Not expressly empower the supporting organization to engage in activities that do not further the charitable purposes of the benefited public charity or charities;

iii. Designate by class or purpose or by name, the public charities to be benefited; and,

iv. Not authorize the supporting organization to benefit any other public or private charity or charities.

5. <u>Operational Test</u>:

a. The supporting organization must be "operated exclusively" for the support of the supported organizations, including the making of payments to or for the use of, or providing services or facilities for individual members of the charitable class benefited by the specified publicly supported organizations (sometimes referred to as the "permissible beneficiary" requirement). Additionally, the supporting organization must either pay over its income to the supported organization or use its income to carry on an independent activity or program which supports or benefits the supported organization (sometimes referred to as the "permissible activities" requirement). All types of supporting organizations are prohibited from making any payments or loans (including reasonable compensation for services) to any individual who is a substantial contributor or is a family member of a substantial contributor or to any company in which a substantial contributor or family member owns 35 percent or more of the controlling interest.

6. <u>Must Not Be Controlled By Disqualified Persons:</u>

a. A supporting organization must not be controlled directly or indirectly by one or more Disqualified Persons (as defined in I.R.C. Section 4946) other than foundation managers and other than one or more organizations described in I.R.C. Section 509(a)(1) or (2).

b. An organization will be considered "controlled" if the Disqualified Person(s), by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This control is demonstrated if the voting power of such Disqualified Persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. (There is a narrow exception to this rule, in situations such as a religious organization operated in connection with a church, where the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization. If a representative of the church, such as a bishop or other official has control over the policies and decisions of the organization, the Disqualified Persons on the governing body will not disqualify the organization under Section 509(a)(3)(C). Treas. Reg. Section 1.509(a)-4(j)(2)).

c. However, all pertinent facts and circumstances including the nature, diversity and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a Disqualified Person does in fact indirectly control an organization. For example, if the governing body of the supporting organization is composed of seven (7) directors, none of whom has a veto power over the actions of the supporting organization and no more than three directors are at any time Disqualified Persons, such supporting organization will not be considered to be controlled directly or indirectly by one or more Disqualified Persons by reason of this fact alone. However, all of the facts and circumstances will be examined to determine if a Disqualified Person (or several) have indirect control over the supported organization. Where persons on the governing body have a relationship with a Disqualified Person such that the Disqualified Person could exert control over such persons (e.g. an employer-employee relationship), the Disqualified Person may be deemed to possess indirect control of the organization.

7. <u>Three Subclasses of Supporting Organizations:</u>

a. At least one of the following relationships must be present in order to qualify as a supporting organization:

i. *"Operated, supervised, or controlled by" one or more publicly supported organizations (parent-subsidiary relationship) [Type I organization]:*

a) Includes a substantial degree of direction by the publicly supported organization(s) over the conduct of the supporting organization.

b) Existence established by majority of officers, directors or trustees of the supporting organization being appointed or elected by the governing body, members of the governing body, officers or membership of one or more of the supported organizations. (If multiple charitable organizations are being supported, then it is not necessary that each supported organization has a voice in management of the supporting organization.)

c) Purposes Requirement: The purposes of the supporting organization as set forth in the governing instrument may be similar to, but no broader than, the purposes set forth in the governing instrument of the controlling publicly supported organizations.

d) Specified Organization Requirement: May specify the publicly supported organizations in one of three ways: 1) designate by name in the governing instruments; 2) designate by class or by purpose in governing instruments;

and 3) none in the governing instruments if two conditions met: i) there exists a historic and continuing relationship between the supporting organization and the supported organization; and ii) by virtue of such relationship, there has developed a substantial identity of interest between the organizations.

ii. *"Supervised or controlled in connection with" one or more publicly supported organizations (brother-sister relationship) [Type II organization]:*

a) Must have common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations, such that the supporting organization will be responsive to the needs and requirements of the supported organization. To meet this requirement, the control or management of the supporting organization must be vested in the same persons that manage the supported organization.

b) The mere making of payments to the publicly supported organizations, even if such payment is enforceable by state law, does not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervision or control in connection with such organization.

c) Other Requirements: The organizational test may be satisfied for a Type II organization in the same manner as Type I "operated, supervised or controlled by" supporting organization.

iii. *"Operated in connection with" one or more publicly supported organizations [Type III organization]:*

a) Type III supporting organizations are the most independent form of the supporting organizations, as they may have an independent Board, with specified beneficiary organizations. Because of this, a Type III supporting organization has two additional tests to meet: the responsiveness test and integral part test.

b) <u>Responsiveness Test:</u> A Type III supporting organization satisfies the Responsiveness Test if it is responsive to the needs and demands of the supported organization. The supported organization must have a "significant voice" in the Type III supporting organization's investment policies, operations and grant-making activities. Treas. Reg. § 1.509(a)-4(i)(3).

i) The supported organization can have the required significant voice in one of the three following ways:

(a) If one or more officers or directors of the supporting organization are appointed or elected by the supported organization's officers, directors, trustees or members;

(b) If one or more members of the supporting organization's governing body are also officers, directors or trustees of, or hold other important offices in, the supported organization; or,

(c) The supporting organization's officers, directors or trustees maintain a close and continuous working relationship with the supported organization's officers, directors or trustees.

ii) Whether a supported organization has this significant voice in directing the use of the supporting organization's income or assets, and whether it has a close and continuous relationship with the supporting organization, will be determined based on all relevant facts and circumstances.

(a) The IRS and Treasury Department have concluded that the term "significant voice" requires only that the officers, directors or trustees of the supported organization have the *ability to influence* the supporting organization's decisions on the use of its income or assets, not that they have complete control over those decisions.

iii) Prior to the Pension Protection Act of 2006, charitable trusts were able to meet this requirement pursuant to the so-called "charitable trust test;" however, this alternative test has been removed.

c) Integral Part Test: A Type III supporting organization must meet one of the two alternate prongs of the Integral Part Test, which further classifies the supporting organization as either "Functionally Integrated" or "Non-Functionally Integrated."

i) Functionally Integrated: A functionally integrated Type III supporting organization actually conducts direct programs, rather than merely holding investment assets to produce income to then fund operations conducted by the supported organization. To be a functionally integrated organization, it must meet one of the following criteria:

(a) Engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations.

1) This means the activities directly further the supported organization(s)'s exempt purposes, by either performing the functions or carrying out the purposes of such supported organization(s), and but for the involvement of the supporting organization, those activities would usually be done by the supported organization(s). Treas. Reg. § 1.509(a)-4(i)(4)(ii).

2) Fundraising, making grants and investing and managing non-exempt-use assets are not considered to be activities bringing the organization within this provision, but holding title to and managing exempt-use assets are considered to be such activities.

3) To be considered direct furtherance activities, a supporting organization's grants, scholarships or other payments to individual beneficiaries must satisfy three prongs: (1) the individual beneficiaries must be members of the

charitable class benefitted by a supported organization; (2) the officers, directors or trustees of that supported organization must have a significant voice in the timing of the payments, the manner of making them and the selection of recipients; and (3) the individual beneficiaries must be selected on an objective and non-discriminatory basis.

(b) The supporting organization is the parent of each of its supported organizations.

1) A supporting organization is considered the parent of its supported organization if it exercises a substantial degree of direction over the policies, programs and activities of the supported organization and a majority of the officers, directors or trustees of the supported organization is appointed or elected (directly or indirectly) by the governing body, members of the governing body or officers of the supporting organization. Treas. Reg. § 1.509(a)-4(i)(4)(iii).

2) The IRS and Treasury Department intend to issue proposed regulations to provide a new definition of "parent," to specifically address the power to remove and replace officers, directors or trustees of the supported organization.

(c) Supports a governmental supported organization.

1) The Treasury Department and IRS intend to issue proposed regulations which will provide further guidance on

how supporting organizations can qualify by supporting a governmental entity.

ii) Non-Functionally Integrated: The second way to meet the Integral Part Test is to meet the requirements of being a "non-functionally integrated" supporting organization ("NFI"), which requires satisfying a distribution requirement and an attentiveness requirement or pre-November 20, 1970 trust requirements.

(a) Distribution Requirement

1) Each taxable year, to qualify as an NFI, the organization must distribute to, or for the use of, one or more supported organizations substantially all of its income, deemed to be an amount equal to the greater of 85% of adjusted net income (based on the principles of § 4942) or the supporting organization's minimum asset amount for the prior taxable year (essentially, 3.5% of the fair market value of the organization's non-exempt use assets, described in further detail below).

2) Because this distributable amount is significantly different from that described in the 2009 proposed regulations, the Treasury Department and IRS have issued the provisions regarding the *distributable amount* (below) as temporary and proposed regulations, to provide an opportunity for comment.

3) The distributable amount for the first taxable year an organization is treated as an NFI is zero.

4) The minimum asset amount is the average of the fair market value of the organization's non-exempt use assets, less the average acquisition indebtedness related to those assets, multiplied by 3.5%.

A) This number is then added to the recoveries of any amounts taken in a prior year to meet the distribution requirement,

B) Plus amounts received from the sale or disposition of property (to the extent the acquisition of that property was taken into account to meet the distribution requirement),

C) Plus any set-aside that was not ultimately deemed necessary for that purpose for which it was set-aside, and was taken into account to meet the distribution requirement.

5) In valuing the organization's assets, the same rules for valuing assets of a private foundation apply (i.e. § 4942). "Exempt-use" assets include those assets used or held for use in carrying out the exempt purposes of either the supporting organization or its supported organization (if made available to the supported organization for no or nominal cost).

6) Distributions which count toward the distribution requirement include:

A) Amounts paid to a supported organization to accomplish its exempt purposes;

B) An amount paid to perform any activity that furthers the exempt purpose of the supported organization, but only to the extent it exceeds any income derived by the supporting organization from the activity;

C) Reasonable and necessary administrative expenses paid to accomplish the supported organization's exempt purposes (not including expenses incurred in producing investment income);

D) Amounts paid to acquire an exempt-use asset that would be excluded from the payout requirement calculations; and

E) Amounts set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive, following certain set-aside rules.

7) An NFI Type III supporting organization which fails to meet the distribution requirement will be treated as a private foundation for that taxable year, unless it can prove reasonable cause for the failure, and meets the distribution requirement

within 180 days of the time it discovers the deficiency or becomes able to distribute following unforeseen events. Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F). Reasonable cause is shown if the failure was due solely to unforeseen events or circumstances that were beyond the organization's control, a clerical error, or an incorrect valuation of assets, and not due to willful neglect.

(b) Attentiveness Test: The NFI's support must be sufficient to assure that the supported organization will be attentive to its operations. The NFI must distribute 1/3 or more of its distributable amount to one or more supported organizations that are "attentive" to the operations of the supporting organization and to which the supporting organization is "responsive" (as defined in the Responsiveness Test, above). Treas. Reg. § 1.509(a)-4(i)(5)(iii). In determining whether a supported organization will be considered attentive to the operations of a supporting organization, any amount received from the supporting organization that is held by the supported organization in a donor advised fund is disregarded.

A supported organization is considered attentive to the operations of the supporting organization during a taxable year if, in the taxable year, at least one of the following requirements is satisfied:

1) The supporting organization distributes to the supported organization an amount equal to at least 10% of the supported

organization's total support received during the last taxable year ending before the beginning of the supporting organization's taxable year; or

2) The amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular (substantial but not primary) function or activity of the supported organization. Support is considered "necessary" if the supporting organization or the supported organization earmarks the support for that particular program or activity of the supported organization; or

3) Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supporting organization and its supported organization(s) and the purpose to which the funds are used, the amount of support received from the supporting organization is a sufficient part of a supported organization's total support to ensure attentiveness. The more substantial the amount involved in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to ensure the attentiveness

of the supported organization to the operations of the supporting organization (including attentiveness to the nature and yield of the supporting organization's investments), evidence of actual attentiveness by the supported organization is of almost equal importance. A supported organization is not considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

(c) Alternate Test: An NFI Type III supporting organization formed as a trust on or before November 20, 1970 does not have to satisfy the integral part requirements described above (i.e. the Distribution Requirement and Attentiveness Test), if it satisfies the following:

1) For taxable years beginning October 16, 1972, the trustee of the trust makes annual written reports to all of the trust’s supported organizations, setting forth a description of the trust’s assets, including a detailed list of the assets and income derived therefrom;

2) All of the unexpired interests in the trust are devoted to charitable purposes and a deduction (under appropriate Code sections) was allowed regarding such interests;

3) The trust has not received any grants, contributions, bequests or other transfers since November 20, 1970;

4) The trust is required by its governing instrument to distribute all of its net income to a designated beneficiary supported organization. (If there is more than one beneficiary, all of the net income must be distributable in fixed amounts to each beneficiary);

5) The trustee does not have discretion to vary the beneficiary supported organizations or the amounts payable to them. The ability to cease making payments to a particular supported organization in the event of certain occurrences such as the supported organization's loss of exemption or failure to operate for charitable purposes is not treated as impermissible discretion; and

6) None of the trustees would be disqualified persons within the meaning of § 4946(a) with respect to the trust if it were a private foundation (not including foundation managers in the definition of disqualified persons).

d) Additional Requirements for Type III Supporting Organizations

i) Foreign Supported Organizations: Type III supporting organizations may not support a supported organization which is organized outside of the United States. Treas. Reg. § 1.509(a)-4(i)(10).

ii) Notification Requirement: All Type III supporting organizations must satisfy the notification requirement for taxable years including December 28, 2012 and following, based on the new final regulations. Treas. Reg. § 1.509(a)-4(i)(2). This requires the supporting organization to provide annual notice to each supported organization(s) including information to help ensure the supporting organization is responsive to the supported organization's needs. The information must meet the following requirements:

(a) Written notice addressed to a principal officer of the supported organization, with the amount and type of support it provided to the supported organization during the immediately preceding taxable year of the supporting organization, and during any other taxable year of the supporting organization ending after December 28, 2012, for which support information has not previously been provided;

(b) A copy of the supporting organization's Form 990 or other annual information return most recently filed as of the date the notification is given, and any other return for other taxable years ending after December 28, 2012 and which has not been previously provided to the supported organization; and

(c) A copy of the supporting organization's governing documents as in effect on the date the notification is provided, including its articles of organization and bylaws (if any) and any amendments to such documents, unless such documents have been previously provided and not subsequently amended.

The notification may be provided electronically, and must be postmarked or electronically transmitted by the last day of the fifth calendar month following the close of that taxable year.

e) Transition Rules: The December, 2012 regulations provide for special transition rules for meeting the notification requirements and the Integral Part Test for (both functionally integrated and non-functionally integrated) Type III supporting organizations. Type III supporting organizations will be treated as having satisfied the notification requirement or its taxable year that includes December 28, 2012, if the required notification is postmarked or electronically transmitted by the later of the last day of the fifth calendar month following the close of that taxable year or the due date (including extensions) of the supporting organization's annual information return (Form 990) for that taxable year. Treas. Reg. § 1.509(a)-4(i)(11). A Type III supporting organization qualifying as functionally integrated that has met and continues to meet the requirements in effect before December 28, 2012 will continue to be treated as meeting the Integral Part Test until the first day of its second taxable year following December 28, 2012. Both Type III functionally integrated and non-functionally integrated supporting organizations must meet the new regulation requirements effective the first day of its second taxable year beginning after December 28, 2012, if they wish to continue such classification.

B. Reporting Requirements

1. Form 990, Return of Organization Exempt from Income Tax. (Churches, integrated auxiliaries of churches and conventions or associations of churches are not required to file Form 990.)

2. Form SS-4, Application for Employer Identification Number.

3. Form 990-T, Exempt Organization Business Income Tax Return.

4. Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax Exempt Organizations, if applicable.

5. Form 2758, Application for Extension of Time to File Certain Excise, Income, Information and Other Returns.

6. Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code; and

7. Form 8282, Donee Information Return.

C. Termination of Supporting Organization

1. No particular requirements are to be met by a supporting organization which terminates its existence. It must, however, inform the Internal Revenue Service of its termination in accordance with I.R.C. Section 6043.

2. Distribution of the organization's assets must be in accordance with its organizational documents to a qualified charitable organization.

VI. The Options

A. Donors and /or drafters often assume that a private foundation will be perpetual. Although permitted to have perpetual life under state law, private foundations may also have a limited term or, to the same effect, mandate a measured spend-down of their assets. Limited duration is appropriate for donors who do not intend the foundation to continue beyond their lifetimes - or who want the foundation's assets to have an immediate impact.

B. Even for donors who intend that their foundations have a perpetual life, the next generation may have different desires and goals, which may not surface until the donor generation has passed away. (Implementation of well-developed governance policies may avoid this result.)

C. Options for Future Generations

1. Foundation becomes more institutional in nature

a. Outside directors/trustees retained

b. Professional staff is hired to run all aspects of the foundation including investments, administration and grantmaking

2. Foundation Stays "As Is"

a. Governance continues with family

b. Role(s) of family members needs to be discussed and defined

3. Termination, via transfer of assets to public charity, or by split-up

a. As governance of a perpetual family foundation moves from one generation to the next, family members may be unable to agree on mission, grants or investments. If the private foundation is substantial, one solution is to transfer its assets to two or more private foundations (either existing or newly created), each controlled by one of the warring family factions.

b. As noted above, involuntary termination of private foundation status under IRC Section 507(a)(2) can result in the imposition of the confiscatory termination tax described in IRC Section 507(c). However, the statute does provide alternatives to this draconian result.

The simplest tax-friendly exit strategy is described in IRC Section 507(b)(1)(A): a complete distribution to one or more public charities described in IRC Section 509(a)(1), all of which have been in existence (and so described) for a continuous period of at least 60 months before the distribution. IRC Section 507(b)(1)(A); Treasury Regulations Section 1.507-2; Rev. Rul. 2003-13, 2003-1 C.B. 305; Publication 4779.

c. <u>Private foundation split-up</u>. In a foundation split-up situation, the same person or persons "effectively control," directly or indirectly, the transferor foundation and the transferee foundations. If, at least one day after the liquidating transfers, the transferor foundation gives the appropriate notice of voluntary termination to the IRS, it will pay no termination tax because it will have no assets. (The termination tax is imposed on the lower of the foundation's net asset value or its aggregate tax benefits.) Under the relevant regulations, the successor foundations succeed to various tax attributes and tax obligations of the transferor foundation. IRC Section 507(a)(2), 507(c), 507 (b)(2); Treasury Regulations Section 1.507-3(a)(9); Rev. Rul. 2002-28, 2002-1 C.B. 941; Publication 4779.

d. <u>Termination to a donor advised fund</u>. A private foundation "converts" to a donor advised fund by transferring all of its assets to the sponsoring organization of the fund under the fund's implementing agreement. If the sponsoring organization is a public charity described in IRC Section 509(a)(1), and meets the relevant five-year requirement, the transaction will fall within the ambit of IRC Section 507(b)(1)(A). As a result, no termination tax will be imposed under IRC Section 507(c) and no notice to the IRS will be required.

VII. The Case Studies

A. Case Study #1 – Termination

1. The foundation is shrinking rapidly because of grantmaking well over the 5% minimum required distribution, and because of some bad investments made several years ago. Administration has become burdensome and expensive. Finally, the children (if there are any) are not interested in perpetuating the family philanthropy.

2. The obvious answer here is to terminate the foundation.

3. Termination is subject to a potential 100% tax, but an exception exists that allows a full distribution to one or more public charities that have been in existence for 60 months or more.

B. Case Study #2 – Terminate to DAF

1. The growth of the foundation's assets is keeping pace with, or exceeding, the annual distributions. The children live in different parts of the country and, although charitably inclined, are busy with their own families and careers.

2. Under the same exception, the foundation can be terminated into a donor advised fund. Most donor advised funds give instructions on how to accomplish this on their websites.

C. Case Study #3 – Split-up

1. The growth of the foundation's assets is keeping pace with, or exceeding, annual distributions. There is likely to be a large testamentary addition to the foundation at the death of either or both of Generation 1. The children are successful in their own right, are also philanthropically inclined though they each have their own "causes" and there is little, if any, overlap in their philanthropic interests.

2. The foundation could continue "as is," or it could be split into several foundations that each of the children could run on their own.

D. Case Study #4 – Estate Administration Exception to Self-Dealing

1. Generation #1 has already transferred a significant amount of the ownership of the family business to one or more members of Generation #2. If fewer than all

members of the next generation are to be involved in the business, the other members have had their inheritances "equalized" with other assets and/or life insurance. Generation #1 wants to leave the balance of the business that they still own to the foundation, not to the children or grandchildren, as they feel adequate provision has already been made for them.

2. This is a relatively frequent scenario. However, unless proper planning is undertaken, it is likely to violate at least two of the prohibitions, self-dealing and excess business holdings.

3. Excess business holdings will be violated if the foundation, combined with family members, owns more than 20% of the family business. The foundation has 5 years in which to divest itself of this excess. The problem arises when the remaining family members, or the business itself, are the preferred (or only) potentials buyers of the business interests from the foundation. That transaction would constitute an act of self-dealing.

4. The Estate Administration exception to self-dealing is custom made for this situation.

E. Supporting Organization Case Study

1. Rather than forming a private foundation, the family instead opted to use a Type III Supporting Organization, with the Supported Charity being the Main Street USA Community Foundation. This allowed the family to take a more favorable income tax deduction upon the formation of the Supporting Organization, and flexibility in grant-making through a donor directed option with the Community Foundation. They were also advised that they would have for all practical purposes the same level of control as with a private foundation, and would not be subject to the private foundation excise taxes.

2. The family funded the Supporting Organization with Family Limited Partnership interests, allowing them further control over investments, and actual distributions to the Supporting Organization, then to the donor directed fund at the Community Foundation.

3. Even before the Pension Protection Act, this was an aggressive planning strategy. Since the Pension Protection Act, it is unlikely that the Supporting Organization would remain classified as such.

Acknowledgements

Statistical Information

All statistical information regarding charitable giving and private foundations was obtained from:

- Giving USA, at www.givinginstitute.org or "www.givingusareports.org"
- The Foundation Center, at "www.foundationcenter.org"
- The National Philanthropic Trust, at "www.nptrust.org"

Outlines

The authors have relied heavily upon previously prepared outlines, including:

- "2010 Private Foundations in Transition," by Grace Allison, Janne Gallagher and Ramsay Slugg, as presented to the ABA RPTE Spring Symposium, April, 2010
- "Public Charities and Private Foundations," Reference Outline, by Darren B. Moore and Michael V. Bourland
- "Resolving Trustee Disputes: Foundation Split-Ups and Other Approaches," Reference Outline, by Megan A. Cunningham, Darren B. Moore, and Michael V. Bourland

Other Resources and Further Reading

The reader is encouraged to consult the following additional resources. Please note that this list is suggestive of several resources that the authors of this outline know to be particularly helpful, and not exhaustive of all available resources.

- Books

Fremont-Smith, Marion R., *Governing NonProfit Organizations* (Harvard University Press, 2004).

McCoy, Jerry J. and Miree, Kathryn W., *Family Foundation Handbook* (CCH Incorporated, 2006).

Setterberg, Fred and Wilbur, Colburn S., *The Complete Guide to Grantmaking Basics* (Council on Foundations 2008),

- Monographs

Godeke, Steven, with Bauer, Doug, *Mission-Related Investing* (Rockefeller Philanthropy Advisors, 2008), www.rockpa.org

Stetson, Anne and Kramer, Mark, *Risk, Return and Social Impact: Demystifying the Law of Mission Investing by U.S. Foundations* (FSG Social Impact Advisors, 2008), www.fsg-impact.org

- Websites

Association of Small Foundations, www.smallfoundations.org

Community Foundations National Standards Board, www/cfstandards.org

Council on Foundations, www.cof.org

Foundation Center, www.foundationcenter.org

GEO (Grantmakers for Effective Organizations), www.geofunders.org/home.aspx.

Grantcraft, a project of the Ford Foundation, www.grantcraft.org

Panel on the Nonprofit Sector, www.nonprofitpanel.org

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Got Good Governance?

Reorganizing the Family Philanthropy

Planned Giving Roundtable of Arizona

19th Annual Summer Forum

June 12, 2013

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Bank of America Private Wealth Management

Got Good Governance?

Reorganizing the Family Philanthropy

- **Today's Topic:**
- **Just as all family businesses need to prepare to transition to the next generation, so does the family philanthropy**
- **Charitable Giving Statistics, especially as they apply to private foundations**
  - Philanthropy in America
  - Philanthropy among Entrepreneurs
  - Growth of Private Foundations

2

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Got Good Governance?
Reorganizing the Family Philanthropy

- **Introduction of our Case Studies**

Facts Common to all Case Studies

Generation 1, Husband and Wife, both late-70's.

Husband started in the real estate business right out of high school, married his high school sweetheart, and they have now been married for almost 60 years! They have worked, elbow to elbow, from the inception of the business, though she eventually spent more time with family and community activities.

Business has grown over the years, is now worth $1 Billion.

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3

Got Good Governance?
Reorganizing the Family Philanthropy

About 20 years ago, Husband and Wife formed a private foundation to bring some discipline and organization to their varied philanthropic activities. Prior to that time, they gave money to many different causes, just about any time one of their friends came calling for money to support this or that pet cause.

They have always run the foundation themselves, making all grant decisions, though they have always employed their family attorney and accountant to handle legal, accounting and tax matters.

They are interesting in learning their options of carrying on their philanthropy, both because the day to day job of grantmaking has gotten to be too much for them, and because they realize that they will not be here forever to manage the foundation.

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4

Got Good Governance?
Reorganizing the Family Philanthropy

- Private Foundation Baseline Governance
- 6 Excise Taxes
- Unrelated Business Income
- State corporate and trust law, fiduciary law, and investment rules
- Best Practices

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5

Got Good Governance?
Reorganizing the Family Philanthropy

- Supporting Organizations
- Types I, II and III
- Functionally Integrated or Not
- The Regulatory Super Highway!

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6

Got Good Governance?
Reorganizing the Family Philanthropy

- The Options
- Go Institutional
- The Cleaver Family Foundation
- Terminate
- "Convert" to a Donor Advised Fund
- Split Up

7

Got Good Governance?
Reorganizing the Family Philanthropy

- Case Studies Revisited:
- CS#1

The foundation is shrinking rapidly because of grantmaking well over the 5% minimum required distribution, and because of some bad investments made several years ago, Tech stocks in 2000 and Financials in 2007. Administration has become burdensome and expensive. Finally, the children (if there are any) are not interested in perpetuating the family philanthropy.

8

Got Good Governance?
Reorganizing the Family Philanthropy

- **Case Studies Revisited:**

- **CS#1**

The obvious answer here is to terminate the foundation.

Termination is subject to a potential 100% tax, but an exception exists that allows a full distribution to one or more public charities that have been in existence for 60 months or more.

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Got Good Governance?
Reorganizing the Family Philanthropy

- **CS #2**

The growth of the foundation's assets is keeping pace with, or exceeding, the annual distributions.

The children live in different parts of the country and, although charitably inclined, are busy with their own families and careers.

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Got Good Governance?
Reorganizing the Family Philanthropy

- **CS #2**

Under the same exception, the foundation can be terminated into a donor advised fund.

Most donor advised funds give instructions on how to accomplish this on their websites.

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- **CS #3**

The growth of the foundation's assets is keeping pace with, or exceeding, annual distributions.

There is likely to be a large testamentary addition to the foundation at the death of either or both of Generation 1.

The children are successful in their own right, are also philanthropically inclined though they each have their own "causes" and there is little, if any, overlap in their philanthropic interests.

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- **CS #3**

The foundation could continue "as is," or it could be split into several foundations that each of the children could run on their own.

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- **CS #4**

Generation #1 has already transferred a significant amount of the ownership of the family business to one or more members of Generation #2. If fewer than all members of the next generation are to be involved in the business, the other members have had their inheritances "equalized" with other assets and/or life insurance.

Generation #1 wants to leave the balance of the business that they still own to the foundation, not to the children or grandchildren, as they feel adequate provision has already been made for them.

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- **CS #4**

Unless proper planning is undertaken, it is likely to violate at least two of the prohibitions, self-dealing and excess business holdings.

Excess business holdings will be violated if the foundation, combined with family members, owns more than 20% of the family business. The foundation has 5 years in which to divest itself of this excess.

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- **CS #4**

The problem arises when the remaining family members, or the business itself, are the preferred (or only) potentials buyers of the business interests from the foundation. That transaction would constitute an act of self-dealing.

The Estate Administration exception to self-dealing is custom made for this situation, and allows the company or other family members (disqualified persons) to purchase the business interest from the foundation, even for a note, without violating the self-dealing rules.

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- **CS #5**

Rather than forming a private foundation, the family instead opted to use a Type III Supporting Organization, with the Supported Charity being the Main Street USA Community Foundation. This allowed the family to take a more favorable income tax deduction upon the formation of the Supporting Organization, and flexibility in grant-making through a donor directed option with the Community Foundation. They were also advised that they would have for all practical purposes the same level of control as with a private foundation, and would not be subject to the private foundation excise taxes.

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- **CS #5**

The family funded the Supporting Organization with Family Limited Partnership interests, allowing them further control over investments, and actual distributions to the Supporting Organization, then to the donor directed fund at the Community Foundation.

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- **CS #5**

Even before the Pension Protection Act, this was an aggressive planning strategy.

Since the Pension Protection Act, it is unlikely that the Supporting Organization would remain classified as such.

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- **Solutions are available**
  - **Plan, Plan, Plan**