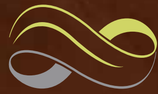

NATIONAL CENTER FOR
FAMILY PHILANTHROPY

SPLENDID LEGACY

CREATING AND RE-CREATING YOUR FAMILY FOUNDATION

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FUNDING YOUR FAMILY FOUNDATION

BY ANTONIA M. GRUMBACH, with a 2017 review and update by JOHN SARE and BRIAN SWEET

Founders face choices both in how to fund their family foundations and in which assets to use. The decisions of when to fund a foundation and how much to fund it with will depend not only on a founder's available assets, but also on how the founder plans to use the foundation. A founder can fund a foundation with one lump-sum contribution and make no further gift. Alternatively, the founder may decide to make periodic contributions to the foundation to build up its assets over a period of years. This approach makes sense for founders who are funding their foundations out of annual income; they contribute more in good years and less in lean years. Often, the founder's funding plan is tax-driven: the founder seeks to make contributions at times that will maximize the founder's income tax deductions, while the founder intends the foundation's operations and grantmaking activities to proceed on an independent schedule.

Some founders establish a foundation as an estate planning vehicle. They do not wish to use it for grantmaking immediately and so they create it, allow it to lie virtually dormant for years, and then fund it with a large bequest in their will or perhaps when they inherit significant sums. Still other founders establish a "pass-through" foundation to make gifts during their lifetimes. They make (or the family business makes) annual gifts to the foundation that support grantmaking and operations. The idea is to fund the foundation for annual operations, and not to commit large amounts of capital to fund it permanently. (For advantages and disadvantages of different methods of funding, see chart on page 98).

A founder must also decide which assets to use to fund the foundation. Federal tax law favors the contribution of cash or appreciated publicly-traded stock by allowing the founder the maximum deductibility: a deduction based on the fair market value of the property contributed. Tax treatment differs for other assets, such as interests in real estate or real estate trusts, stock in an S corporation, stock in a closely held family or other business, art and other valuable personal property, stock options, interests in protected intellectual property, and so on. Generally, contributions of those assets will be deductible only to the extent of their income tax basis, unless fair market value is lower than basis. Because most founders make their contributions from cash, publicly-traded stock, and closely-held stock, this discussion focuses on those types of assets. Whatever assets they use, founders should always review the matter with their lawyer or accountant. (For a discussion of tax deductibility of various classes of assets, *Facing Important Legal Issues, p. 59.*)

Constraints Limit **Business Holdings**

Families that establish private foundations often also own and operate successful business enterprises that can serve as convenient sources of income for the grantmaking activities of those foundations. Thus, family businesses are likely sources of lifetime gifts or bequests to family foundations. Enter the "excess business holdings" rule.

Congress adopted the 1969 Tax Reform Act to address concerns over the possible abuse of the control of charitable assets. One concern was that a donor or donor's family might receive a charitable deduction while still maintaining control of the donated family business through the foundation. Consequently, the 1969 legislation limits the extent to which a private foundation may own an interest in any business enterprise. This is an arcane and extremely complicated area of tax law.

Specifically, the excess business holdings rule limits the amount of voting interest a private foundation can hold in a business enterprise that is not related to its exempt purposes. If the limits are exceeded, an onerous excise tax is imposed. For this purpose, a business enterprise is broadly defined to include almost any trade or business, but excludes:

- **"Functionally related" businesses.** For instance, a foundation dedicated to grantmaking in the field of education that supports innovative teaching techniques in public schools could create, or acquire, a business that develops a web-based program for innovative educational curricula. Because this business is determined to be "functionally related" to the foundation's charitable purposes, no restrictions apply to the size of holdings in the business. The foundation could, in fact, hold a 100 percent ownership interest in a functionally related business.
- **Businesses that derive 95 percent of their gross income from passive sources, such as dividends, interest, or rent.** It may be possible for a foundation to hold a large interest in a family-owned real estate company if the company's income consists solely of rent from its properties.
- **"Program-related investments."** These are investments made by a foundation for a programmatic purpose that relates to its charitable purposes, not primarily for the production of income. An example is a foun-

dation that makes health-related grants and also invests in a startup company that is developing a promising drug to combat a particular disease.

Absent one of these exceptions, the size of the holdings a private foundation can have in a business enterprise — the "permitted holdings" — depends on the amount of voting stock of the business that is held by "disqualified persons." The *de minimis*, or safe harbor, rule establishes an upper limit on holdings, below which excess business holding provisions do not apply. Under this rule, if a foundation (and other related foundations) holds no more than 2 percent of the voting shares and no more than 2 percent of all classes of stock in a business enterprise, the foundation will not be treated as having excess business holdings, even if all remaining shares are held by a disqualified person. (For purposes of the 2 percent *de minimis* rule, the private foundation must include with its holdings stock held by private foundations that are effectively controlled by the same person or persons who control the private foundations in question; and private foundations to which substantially all contributions were made by the same person or persons, or their families, who made substantially all of the contributions to the private foundation in question. This rule prevents a donor from creating several private foundations, funding them with stock in a particular company and then using the foundations to control the company.)

Beyond the *de minimis* rule, voting stock in a business enterprise held by the foundation and its disqualified persons must be aggregated to determine whether a foundation's ownership position exceeds permitted holdings limitations. (Disqualified persons in this context include the founders of the foundation and their spouses, lineal ancestors, children, grandchildren, great grandchildren and spouses of children, grandchildren and great grandchildren.) In general, private foundations may not hold more than 20 percent of the voting stock of a corporation— including the voting stock owned by all disqualified persons. The foundation can, however, own any amount of nonvoting stock provided that the aggregate of all voting stock held by disqualified persons does not exceed 20 percent of the corporation's voting stock. (The permissible level of holdings increases to 35 percent if effective control of the enterprise rests with one or more persons who are not disqualified persons with respect to the private foundation, and the foundation and all disqualified persons together do not own more that 35 percent of the voting stock of the corporation.)

Moreover, direct ownership by a disqualified person is not necessary in computing the holdings of a private foundation or a disqualified person. In general, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust, is considered owned proportionately by or for its shareholders, partners, or beneficiaries. Thus, if any of those individuals is a disqualified person, the stock owned, for instance, by the estate or trust of which they are beneficiaries, must be aggregated as stock owned by the foundation when applying excess business holding rules. Thus, the sweep of inclusion and aggregation is broad.

Any foundation found to have exceeded its permitted holdings and, thereby, to have violated the excess business holdings rule, must dispose of its excess business holdings. Failure to do so subjects the foundation to a 10 percent initial tax on the value of its excess business holdings. In addition, if the foundation does not dispose of its excess business holdings after payment of the 10 percent tax, it will be subject to a 200 percent tax on its excess business holdings. This is clearly a confiscatory provision. Fortunately, foundations that have acquired interests in a business enterprise by gift or bequest have a grace period of 5 years after the receipt of stock in a business to dispose of excess business holdings before any tax is imposed. Moreover, the Internal Revenue Service may extend that five-year period for another five years if the foundation shows diligent efforts to dispose of the holdings and a plan to do so.

Because of the complexity of the rules regarding excess business, advice from expert legal counsel should be sought by any donor considering giving or bequeathing an interest in a closely held company to a private foundation.

Source: Adapted from Antonia M. Grumbach, "Funding a Foundation: What Assets to Use: Investment Issues for Family Funds: Managing and Maximizing Your Philanthropic Dollars." National Center for Family Philanthropy, 1999.

Strategies for **Timing Contributions**

STRATEGIES FOR TIMING CONTRIBUTIONS	ADVANTAGES	DISADVANTAGES AND OTHER CONSIDERATIONS
Fund the foundation with one lump-sum gift.	Clearly establishes the scope of grantmaking; simplifies transaction costs.	Grantmaking program may not yet be defined; personal circumstances (e.g., recent decline in wealth) may dictate lower amount or funding phased-in over time; deduction limitations based on donor's adjusted gross income may limit deductible amount of gift.
Fund the foundation through a series of periodic contributions.	Allows for unforeseen personal circumstances and the development of a grantmaking program.	Fewer funds may restrict grantmaking; operating costs are generally proportionately higher.
Establish the foundation at a low asset level, and fund it fully through a large bequest.	Allows for changes in personal circumstances; permits donor to have use of assets during his or her lifetime; provides donor with a window on how the foundation will be governed and managed.	Delays philanthropic impact; heirs may have other expectations that could disrupt family unity; after the foundation receives the bequest, the donor's original mission may not be carried out.
Establish a pass-through foundation, with the founder (or family business) making annual gifts that support grantmaking and operations.	Very flexible because specific timing, amount and scope of program are not set; allows foundation to be responsive to unforeseen needs such as funding to assist with needs resulting from the 9/11 tragedy.	Makes the establishment of a philanthropic program more difficult; does not foster partnerships with other foundations as readily; can limit ongoing strategic focus.
ALTERNATIVES/OPTIONS FOR ASSETS TO FUND THE FOUNDATION	**ADVANTAGES**	**DISADVANTAGES AND OTHER CONSIDERATIONS**
Cash or publicly held stock	Liquid and no valuation problems; cash gifts allow for deductions of up to 30% of adjusted gross income, stock gifts allow for deductions of value of the stock at the time of the gift of up to 20% of adjusted gross income.	Can be a problem if donor is left with non-income-producing, illiquid assets.
Real estate	May be good income producer; can diversify a portfolio of securities; allows for deduction of up to 20% of adjusted gross income.	Difficult to value and requires day- to-day management. Ability of charity to use property in its operation may be limited. Potential self-dealing issues may be raised for certain uses by a related entity.
Closely held stock, including an interest in a family enterprise, or stock in S corporations	Can enhance a family's wealth transfer plan; may produce good income if cash is distributed regularly.	Difficult to value; closely held stock deductible at cost basis only; can involve self-dealing issues and concentration problems.
Art and other valuable personal property	Generally do not affect donor's financial wellbeing directly; may be useful in the work of the foundation.	Difficult to value and possibly to sell; deduction generally limited to cost basis unless donor reasonably expects foundation to use property in a manner related to its exempt purpose..

Prepared by Kathryn McCarthy, Director of Client Advisory Services, Rockefeller & Co., and Jason Born, Program Director, National Center for Family Philanthropy.

Founders Choose **Different Routes to Funding**

- **Arthur and Abigail A.** started a business together, which was so successful that they took it public. The stock did well. In their mid-50s, they decided to establish a family foundation. They signed the papers of incorporation and the same day contributed $25 million of their stock in the publicly held company to fund the foundation. As trustees of the foundation, they kept grantmaking to the 5 percent minimum payout for 5 years to build assets in the portfolio. Now that the assets have reached $50 million, they have increased the annual payout.

- **Beatrice B.** is an entrepreneur whose income varies widely from year to year. She formed a family foundation with her husband and children as trustees. She contributes to the foundation as little as $10,000 a year and as much as $500,000. As the foundation's assets grow, the trustees adjust grantmaking to meet the 5 percent minimum payout rule. Given the rate of return on the foundation's portfolio, the foundation's assets continue to increase in value.

- **Lawrence L.** worked hard as a lawyer and accumulated a tidy net worth. After talking with his wife and children, he formed a family foundation with zero assets and he, his wife, and their children were trustees. Until his death, he contributed $50,000 a year from current income, which the foundation gave out as grants and used to cover operating costs. In his will, he provided for his surviving wife and his children and grandchildren, and he made bequests to a few close friends, favorite charities, and his law school. The residue of his estate, about $10 million, went to fund the foundation.

- **Patricia P.** received substantial assets when her highly successful husband died. She established a charitable trust to support certain named charities, one of which was a family foundation that she created. The foundation has no assets; it receives $2 million a year from the charitable trust, which it passes through as grants to nonprofit organizations and also uses for operating expenses.

- **Seth S.** took over a struggling family business and built it into a successful international company. He and his wife formed a family foundation and the same day gifted $10 million in closely held company stock to the foundation. The company immediately bought the stock back from the foundation (complying with the rules regarding purchases of stock from a family foundation), generating $10 million in cash for the foundation.

- **Wendy W.**, who lives alone, inherited $5 million on the death of her aunt, as did each of her four sisters and brothers. Wendy convinced her siblings to join her in forming a family foundation, with each contributing $1 million to fund the foundation. Wendy lived comfortably on her earned income, and continued to contribute 10 percent of her inheritance each year to the foundation in order to build its assets. The other siblings also made occasional contributions. ■