

## DEVELOPING

*a* SPENDING POLICY*By Ronald Litke*

*Although federal law dictates minimum annual spending requirements for private foundations, every family has preferences in how, and how much, it chooses to give each year. Should a foundation limit itself to the 5 percent-of-assets requirement? Should principle be invaded? Should spending policies be set through foundation bylaws? And, should succeeding generations have the option of changing spending policies? These and other issues related to spending policies are the subject of this chapter.*

**I**N 1993, AS HURRICANE INIKI HURTTLED TOWARD HAWAII, Alfred Castle sat at his kitchen table in Honolulu on a conference call, about to make a dramatic exception to the spending policy of his family's foundation. Just a few months before, Hurricane Andrew had devastated South Florida. Now, the main island of the Hawaiian chain appeared to be the next hurricane victim of the season. Castle wanted to provide immediate aid for the relief effort he presumed would follow Iniki.

Although the Castle Foundation family member trustees on the conference call were concerned, aiding victims of disasters was not an unusual move for the Samuel N. and Mary T. Castle Foundation. Established in 1894, the Castle Foundation is one of the oldest family foundations in the United States. When an earthquake devastated Tokyo in 1923, Mary Tenney Castle—Alfred's great-great-grandmother—was there with a check within a day. She was there as well when the Japanese attacked Pearl Harbor in 1941.

In his mind, by moving quickly and arranging for a \$500,000 distribution to help with what he surmised would be an enormous cleanup in the aftermath of Hurricane Iniki—even when that required dipping into principal—Alfred Castle showed fidelity to the philanthropic traditions of his family. “We had already finished our spending for the year,” says Castle. “We went into the principal, in a way replicating what our family had done nearly 100 years earlier and since during community emergencies.”

As it turned out, Iniki missed Oahu, striking the nearby island of Kauai mercilessly instead. Castle moved his funds to aid that island, going through the governor's office to cover costs where he could. Additional grants and donations were provided later in the rebuilding process.

Although family foundation spending policies are not often tested in such a dramatic fashion, Castle's quick action shows just how strong the desire of many family foundations is to be flexible and forceful in the face of an emergency or a need



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that must be addressed with alacrity. Depending on the family, spending policies can range from restrictive to almost nonexistent, or operate somewhere between. Surprisingly, the formal spending policies of few family foundations allow for such improvisations. Thus, when an issue such as providing immediate aid to an area devastated by a natural disaster arises, trustees are drawn into a debate of the original intent of the founders—even if they are still alive—much like legal scholars debate the intent of the U.S. Constitution.

Mary Tenney Castle, a devote Christian, abolitionist, and supporter of progressive education—with the help of her family—made a clear statement of the philanthropic intent of her foundation. When her husband, Samuel N. Castle, died in 1894, she established a benevolent trust in his name in the amount of \$500,000 (in Hawaiian dollars). The trust was funded from stock in Castle & Cooke, then one of the world's largest agribusiness corporations. In establishing the trust, Mary Castle's intent was to make less money available to her family and their descendants and more available for public causes. She was also specific about the direction of the family's philanthropy after her death: "Her children and their descendants would decide how the annual income from the trust would be used," Alfred Castle writes in *A Century of Philanthropy*, his comprehensive history of the Castle foundations. The trust gave her children wide latitude, but also indicated a strong preference for specific religious organizations; "intelligent assistance to help indigents live by their earnings, without depending on gratuitous charity;" and the creation of a major education memorial fund to her son Henry and her granddaughter, Dorothy Henry Castle. "The choice of that memorial," her great-great-grandson writes, "would serve to define Castle philanthropy for the next century."<sup>4</sup>

"Through her actions with the foundation," says Castle, "she was saying that our family legacy would be moral, not merely financial, as expressed through the foundation." The Castle Foundation (1999 assets: \$58 million) has been a bellwether of foundation trends for more than 100 years. Through its flexible spending policy generations of Castle family members have learned philanthropy and influenced others.

#### IDENTIFYING THE CORE ISSUE

The spending policy of a family foundation brings together the mission, philosophy, and daily operations of the organization. Internal Revenue Service regulations establish the baseline for the spending policies of all private foundations. As a matter of law, each year all private foundations must spend at least 5 percent of their net investment assets as "qualifying distributions." Qualifying distributions—also referred to as "payout"—of a foundation generally include:<sup>5</sup>

- Grants to public charities, nonprofit organizations, and individuals (in the form of scholarships or other academic or scholarly aid);



- Administrative and programmatic expenses associated with grantmaking; and
- Amounts paid to acquire assets used directly in carrying out the charitable purposes of the foundation.

Expenses incurred in managing the endowment of a family foundation do not count toward the 5 percent distribution. These expenses include:<sup>6</sup>

- Investment management fees;
- Brokerage fees;
- Custodial fees; and
- Salaries or board meeting expenses to oversee investments.

Families must address a number of important questions when setting—or evaluating—the spending policy of their foundation, including:<sup>7</sup>

- Is the foundation fully funded or will additional assets be received?
- Does the foundation board want to exceed annual, minimum payout requirements?
- Does the board want to grow the foundation's endowment or would it be satisfied simply to maintain the value of the endowment on an inflation-adjusted (“real”) basis?
- How would program objectives best be achieved: By spending more now? By constant and sustained effort over time? Or by growing the endowment so that more can be spent in the future?

A spending policy often includes guidelines and conditions for investment and portfolio growth. When establishing spending policy, families should determine whether the return requirement implied by such is realistic.

In many ways, a spending policy is the nexus where legal obligations meet family legacy issues, where philanthropic ambitions are expanded or mitigated by the investment market, and where philanthropic aspirations are reconciled with the reality of available resources. Examples of the primary goals for spending policies adopted by foundations include:<sup>8</sup>

- Meet the minimum distribution requirement.
- Distribute 5 percent of assets in grants, plus administrative expenses.
- Spend 5 percent to 6 percent of the average value of the endowment over the previous 12 quarters, making additional grants toward the end of the year as needed to fulfill the distribution requirement.
- Spend 5 percent to 5.5 percent with consideration given to qualifying for the reduced excise tax rate of 1 percent.
- Meet the 5 percent distribution requirement but consider paying out a bit more, depending on program objectives and current investment returns.



- Maintain or moderately increase the value of the endowment and distribute the remainder of the investment return.
- If the foundation is considering spending out, pay out 10 percent per year, with the expectation that all assets will be paid out within a predetermined horizon.

As these examples show, foundation spending policies usually begin with grants payout requirements, and then include other factors such as administrative expenses, past grantmaking by the foundation, grantee needs, and the status of current market returns. Whatever the criteria, the 5 percent minimum mandate set by the IRS must always be met.

Decisions concerning the allocation of assets and investments are often—and many advisors insist must be—tied directly to the grants element of a spending policy. Allocation relates to a foundation's tolerance for risk: Are the family member's willing to spend from principal to meet grant obligations, should that be necessary? Based on the Standard & Poor's 500 Index and the Ibbotson Immediate Treasuries, inflation-adjusted rates of return from 1950 through 1997 for stocks and bonds suggest that it takes a minimum allocation of 50 percent of assets to equities to maintain real asset value and meet the 5 percent payout.<sup>9</sup> In the early-to-mid-1990s, several prominent foundation investment advisors were calling the 1990s “the single-digit decade” of growth and predicting that returns would not keep pace with the 1980s.<sup>10</sup> Indeed, a study completed in 1995 made the case that a foundation established in 1950 with a \$1 million portfolio that paid out 5.5 percent annually over the 45-year period that concluded in 1994 would, with an adjusted asset value and percentage growth, have distributed \$755,000 more than if it had spent 6.5 percent annually during the same period, and almost \$1.5 million more than if it had spent at a 7.5 percent level.<sup>11</sup> This finding suggests that lower initial spending results in higher dollar spending over a long period of time.

An additional factor that can confuse foundation spending policies is the significant degree of fluctuations in the stock market over time. Although some foundations are recovering only now from the huge losses and volatile shifts of the early 1990s, many others have a wealth of assets—and possibilities—that exceeded what was previously planned or strategized.

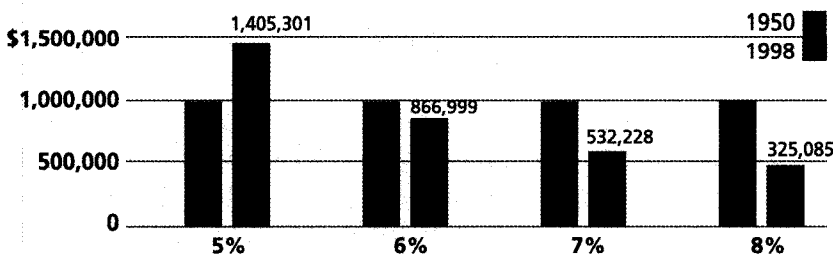
Finally, it is a well-established fact that the United States is in the midst of an unprecedented generational transfer of wealth. Comprehensive, coherent spending policies are critical for families who have, or are in the process of, raising their philanthropic aspirations as a result of this transfer of wealth. As one scion put it, “We could spend the foundation down with fantastic gifts to a few places, or we could go for perpetuity. We're in that debate now.” (See Chapter I, “Considering the Question of Perpetuity,” for a full discussion of these issues.)



**The Impact of Spending Policies Over Time**

A foundation’s spending level can have a significant impact on both its current and future potential payout. Figure 1 shows that if a foundation started in 1950 with \$1 million in assets, a spending policy of 5 percent per year would result in current (1998) assets of \$1,405,301 (adjusted for taxes and assuming that investment assets were split equally between equities and fixed income). If that same foundation had spent 8 percent per year over the same period, it would have just \$325,058 in current assets.

**FIGURE 1: ENDOWMENT SPENDING POLICY IMPACT**  
*50% Equity/50% Fixed Income\**



*\*50% S&P 500 and 50% Ibbotson Intermediate Treasury. Figures are adjusted for inflation annually and run from December 1950 – December 1998. Source: Trusts & Estates, June 1999: p.16.*

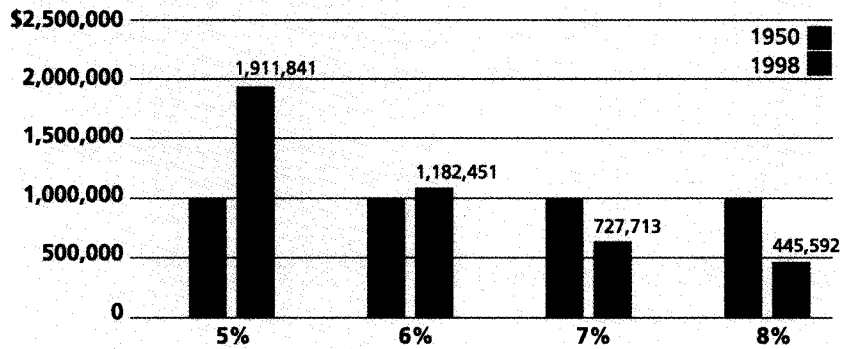
Figure 2 shows the potential impact of a high payout rate from 1950 to 1998. Although the foundation with the 8 percent payout rate would initially have a significantly larger grants budget—\$80,000 versus \$50,000 for the 5 percent payout rate—the impact of the higher spending rate would result in a lower level of investable assets over time. By 1998 the 8 percent payout foundation would have a grant payout level of \$26,005, whereas the 5 percent foundation would have a grant payout of \$70,265 (adjusted for inflation).

**FIGURE 2: 1950 AND 1998 GRANT PAYOUT LEVELS**

	5%	6%	7%	8%
<b>1950</b>	<b>\$50,000</b>	<b>\$60,000</b>	<b>\$70,000</b>	<b>\$80,000</b>
<b>1998</b>	<b>\$70,265</b>	<b>\$52,020</b>	<b>\$37,256</b>	<b>\$26,005</b>

Source: Trusts & Estates, June 1999: pp.16-17.

**FIGURE 3: ENDOWMENT SPENDING POLICY IMPACT**  
**60% Equity/40% Fixed Income\***



\*60% S&P 500 and 40% Ibbotson Intermediate Treasury. Figures are adjusted for inflation annually and run from December 1950 – December 1998. Source: Trusts & Estates, June 1999: p.18.

Other factors must be taken into consideration when reviewing the effect of any given spending policy. For instance, Figure 3 shows that over that same period, if the foundation or fund had invested an additional 10 percent of its assets in equities and 10 percent less in fixed income, while paying out 5 percent per year, its 1998 assets would have climbed to \$1,911,841 (versus \$1,405,301 at the 50/50 asset allocation). Perhaps an even more important factor is the specific time period looked at: an 8 percent payout level is much easier to maintain (without eroding principal of the foundation) in periods of sustained market growth, such as has been the case in the late 1990s.

The most important factor, of course, is the mission and goals of the donor and the foundation. The board must weigh their spending policy options against these goals, with the understanding that higher payout results in more dollars available for grantmaking in the short run, but is likely to result in fewer grant-making dollars in the long run.

#### CHARTING A COURSE FOR SPENDING

IRS regulations specify a minimum required annual payout only. Many family foundations regularly review their goals and the needs of their grantees to decide on the level of spending each year. “We have a unique opportunity—one that very few families are privileged to have—to make significant contributions to our communities and to make our world a better place,” says Robert N. Mayer, Ph.D., chair of the Nathan Cummings Foundation (1998 assets: \$400 million) in New York City and a third-generation family member. “With three family branches and three generations involved, we are all attempting to honor the donor who made this possible, to identify communities of interest, and to select key strategies which will maximize the impact of our grantmaking.”



Creating a formal and workable spending policy can sometimes, however, be a challenging matter. In its fourteenth year as a family foundation, the Cummings Foundation is only now “near” having policies that incorporate the family’s strategies and ambitions into coherent governance of the organization. “In the early years,” says Mayer, “we were just maintaining until we created our own organization. We spent the legally mandated minimum, following our grandfather’s lead. In those days, we felt a great deal of pressure to get the money out the door. Process was something to worry about later.”

“Donor intent,” he adds, “is a fundamental issue—in that context we had to answer questions such as: What were the values of our donor and trustees? What operating principles might we employ to fulfill our aspirations in philanthropy? Absent clear direction from the donor, are we bound by his pattern of giving?”

Nathan Cummings, who built the empire of Sara Lee Corp., liked capital projects or, as Mayer says, “He liked building buildings.” But Cummings left nothing to tell his family what to do with the foundation. No directing language existed on how the foundation should be run. When foundation management passed from the donor, the original board members—three family members of the second generation—were joined as trustees by Cummings’ long-time personal investment advisor, and his personal lawyer.

Children from the third generation saw the opportunity to move toward a different style of philanthropy. “Something more programmatic,” Mayer says. “We were much more interested in the soul of organizations, not the bricks and mortar, so we asked our parents for the chance to participate in this new venture.” An advisory committee of the third generation was created. “Our parents didn’t have to listen to us, and we had no vote, but we were successful in convincing them that we had something substantive to contribute,” he adds.

In 1986, the foundation began to craft an overall mission and organization for the foundation. Meetings were conducted with members of the Rockefeller family and community foundations, and a discussion was opened on how to realize Mr. Cummings’ personal ideals in the context of a foundation. “Although none of us knew where it would go, we recognized the opportunity of being a catalyst for change which would create a major foundation. Developing a spending policy was probably the last of the policy decisions—and I think rightly so. Mission and strategy and structure had to be determined first to accommodate both philanthropic interests and family dynamics,” says Mayer.

Interestingly, the Cummings Foundation board chose not to involve legal or financial counsel in these discussions. “Many families may rely on these advisors, but we felt the key questions of what kind of organization we would be and the direction our program would take was neither financial nor legal, but quite personal to our family,” Mayer says. “The legal and financial nuts and bolts were secondary issues, and we brought in our advisors when we reached these deliberations.”

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By 1987, the second- and third-generation families had devised a set of principles to guide their grantmaking. These principles are revised and continue to guide the foundation today. They call for the foundation to:

- Seek innovative, creative responses to needs;
- Take initiative and be proactive in grantmaking;
- Work cooperatively with grantees, funders, and other resources to maximize results;
- Seek impact and results;
- Fund based on merit and excellence;
- Monitor and evaluate project progress and results;
- Evaluate the foundation's performance in effectiveness, efficiency, and results;
- Engage in ongoing board and staff education and development;
- Treat applicants and grantees with respect, dignity, and sensitivity;
- Commit to the foundation's overall welfare, superceding individual interests; and
- Take pleasure in the spirit of giving.

“With these principles in place,” Mayer says, “we started to think about where to focus our grantmaking. To do that, however, we needed a staff that could do the research, understand issues in greater depth (than trustees had time for), and provide access for grantees.” In 1988, the trustees developed four core areas—arts, environment, Jewish life, and healthcare (a fifth was added later)—with a discretionary percentage for each family branch to go further and develop a personal approach to philanthropy within their communities and address peculiar types of projects that might not fall within the guidelines. Within each of these core areas, board and staff together identified separate objectives, strategies, and outcomes to further guide the work of the foundation. The board hired a CEO in 1989. Currently, the foundation has 19 paid staff members who interact with numerous committees, subcommittees, and ad hoc committees of family members and nonfamily trustees in a complicated organization that nonetheless runs smoothly. Members of the third and fourth generation are now active board and committee members.

Staff—even if it includes only one or two good people—can sometimes help clarify and implement spending policy. Morris Kaplan, chairman of the \$36 million Mayer & Morris Kaplan Family Foundation in Chicago, says that “for years our spending policy was unorganized; only over the past decade have we been getting to a formal process.” Founded in 1948 with father Mayer Kaplan, the foundation was intended by the father and son to be an expression of *tzedakah*—a Hebrew word for responsibility to help others. Initially, the foundation funded Jewish organizations and other social services in Chicago on an informal basis. In 1986, with the sale of

the family company, the foundation started giving more each year and rethinking what percent, over or at the 5 percent minimum, to give. Because of the recent performance of its assets—and an additional \$10 million left to the foundation by a family friend and only recently assimilated into the principal—the Kaplan family is deep into the process of creating a new spending policy. That policy includes a course toward a minimum 7 percent payout while the economy remains strong and the fund is in no danger of losing principal.

Most family foundations are administered by families, without staffs or advisors to guide their work. While the family makes all major decisions, both financial and program staff make recommendations with the help of the foundation's executive committee. Many family foundations, including the Kaplan Family Foundation, host retreats to give family members the extended time they need to discuss and reach decisions on governance and administrative issues—including the foundation's spending policy. "It is an amazing process," says one Kaplan trustee. "As a board, we've had two retreats over the past four years and are planning another for the year 2000. We learn so much about our family when members come in from different places, bringing new and different ideas with them. We have some strong discussions—sometimes significant disagreement—but we leave with a sense of unity of purpose."

At their annual retreat in 1998, Cummings Foundation trustees decided to set aside an additional \$7 million for grants above the mandated payout—"because we felt a strong sense of responsibility to the community and to our grantees," says Mayer. "That amount is a very small portion of the bump in our assets in this market. Even in our worst investment nightmare scenario, we couldn't imagine losing all of the substantial gains made. Therefore, we're very emboldened about our new spending experiment. It has also given us an opportunity to make some large and very important grants, which we would not have been able to make otherwise. The process of deciding how to allocate these additional funds was a very positive one that helped strengthen both our foundation and our family."

#### GROWING PHILANTHROPY THE AMERICAN WAY

The *fin de siècle* amplitude of U.S. philanthropy recalls in many ways the dynamics of the 1890s, when the modern American general-purpose charitable trust/foundation movement began—although the concept goes back to Benjamin Franklin.

At the close of the 19th century, rapid industrialization and the economic expansion of a growing nation created significant surplus wealth, some of which was channeled into charitable trusts. At that time, the dominant figure in philanthropy was John D. Rockefeller, Sr.—a man who remains one of the greatest philanthropists in American history. According to biographer Ron Chernow, "The most important

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concept Rockefeller bequeathed to philanthropy was that of wholesale giving, as opposed to small, scattershot giving. . . . Since for Rockefeller the imperative to make money and donate money emanated from a religious impulse—‘I am more and more satisfied no member of a church can afford not to contribute as the Lord prosper him,’ he told a friend—he approached his donations with extreme gravity.’<sup>12</sup>

In the early years of his philanthropic activities, Rockefeller had a simple spending policy: support education. Between 1856 and 1909, when he accumulated unprecedented wealth—and the IRS had yet to create charitable guidelines—Rockefeller donated \$157 million for charitable purposes (not adjusted for current value), including major grants for what became Spelman College in Atlanta, and virtually all the funds needed to create, build, and staff the University of Chicago, among other institutions. Rockefeller’s personal assets and charitable spending grew significantly in subsequent years. Included in his charitable gifts was the \$100 million he used to establish the Rockefeller Foundation in 1913. He had given an additional \$83 million to the foundation by 1919, and another \$180 million before he died in 1937.<sup>13</sup>

Although only a very few of today’s family foundations have enjoyed such explosive growth, the surging economy and escalating stock market have helped usher in a new era in family philanthropy. Some families are motivated to establish foundations at least in part for tax or other financial considerations, but just as often their motivation is that family foundations are a means of keeping their family together. Families establishing foundations these days have a decidedly different profile from that of their predecessors. Family members who participate in these foundations are often much younger and more geographically dispersed. Many also have diverse professional skills outside, or in addition to, their business acumen, and many carry an idealism influenced by the 1960s and the longest peacetime economic expansion in history. This profile is often reflected in the spending policies of their family foundations.

#### SPENDING POLICIES EVOLVE OVER TIME

Times have been good for the Sobrato family of Silicon Valley, California—so good that the family funded a new family foundation in 1996. The foundation consolidated and expanded on the charitable impulses begun by John A. Sobrato and his mother Ann Sobrato in the 1980s, supported by profits in commercial real estate development. Lisa Sobrato Sonsini, an attorney and the 32-year-old daughter of John Sobrato, left her law practice in 1996 to establish and run the foundation and begin a new career in professional philanthropy as president of the Sobrato Family Foundation.

She admits, “We created our spending policy backwards, formulating program areas after our first year of giving once we were able to analyze where our spending went, and we had time to research nonprofits in the Silicon Valley to really give a shape to our giving.” The groundwork, however, was considerable, from working with operating models provided by similar family foundations to close consultations with the local Silicon Valley Community Foundation (on whose advisory board Lisa Sonsini serves).

Still, during the first six months, the Sobrato family spent a total of \$500,000 without too much formal deliberation. “Our first concern was impact, not spending allotments,” Sonsini reports. “The \$500,000 figure was actually much greater than 5 percent of our assets—closer to 85 or 90 percent of the existing assets of the foundation. Since then, we have increased our annual spending, aiming to give \$1.5 million in 1999, also much higher than our required spending amount.”

For many older, more established foundations such as the Merck Family Fund of Boston (1998 assets: \$68 million), spending policies have evolved slowly and with little outside assistance. The original bylaws of the Merck Family Fund were created in 1954 and applied mostly to overall governance of the foundation. The bylaws have since been amended slightly to conform with tax laws and issues surrounding the new generation that has recently taken control. Changes occur, it seems, not so much by policy but by informal agreement. For the first 40 years, the foundation accepted no proposals. Grantmaking was based on the personal interests of the trustees, all of whom were family members, who met once each year to make decisions. “Looking back at the grant history, it is remarkably consistent,” says Whitney Hatch, current president of the foundation, “even if it was rather casual.”

In 1992, the trustees—nine grandchildren of George Merck, leader of the pharmaceutical firm that bears his name—saw a need for more strategic planning. A facilitator/consultant was hired to focus the varied interests of the new generation—Hatch calls it “a live autopsy”—and to create program categories and a framework for operations and successive generations.

Individual preferences were dropped in favor of a pragmatic approach. “Although each of us was individually empowered in the former system,” Hatch says, “we decided that having a staff member would create a more effective organization, bringing discipline to grantmaking and lessening squabbles among board members.” A slight change in investment allocation also occurred when 5 percent of the foundation’s assets were placed in a socially screened mutual fund. Still, 50 percent of the portfolio remains in Merck & Company stock.

Guided by a new executive director, the board honed its broad concerns for the environment and human services to a more focused grantmaking program. “It was difficult,” says Hatch, “but we arrived at a strategy and guidelines that focus on ecosystems, sustainable economics, and urban community issues. This allowed us to search for programs that we could support within a defined geography. It was a refinement of focus that permitted us to become more deliberate in our grantmaking.” The foundation now holds three trustee meetings each year, and Hatch reports that it “now has clear policies that allow for a smooth operation where people can work together and move the organization forward in unity—even if they have different interests, as our family does.”

A key change in foundation bylaws has given trustees the authority to consider proposals from out of the blue. “Staff is encouraged to bring up proposals they believe are important, even if the proposals fall outside funding guidelines,” he says. “Today, alternative proposals are considered at nearly every grant meeting.”



The year 1999 marked a significant affirmation of the foundation's concern for the environment, specifically in the northern woods of New England. The foundation's executive director has conducted research and is working with other foundations to support the purchase of various lands that Hatch says "until recently were rarely, if ever, available." This includes private parcels on the St. John's River in northwestern Maine, 750,000 acres of well-managed, private timberland in northern Maine, and a large parcel that straddles the Vermont-New Hampshire border. Together the parcels and development rights available for purchase are valued at more than \$130 million. The Merck Family Fund is offering \$1.5 million from principal—approximately 50 percent of what it spends in annual grants—to assist the nonprofit organizations attempting to protect these parcels and organize other foundations to participate. Why make this kind of investment? "Our portfolio has grown very well over the past five years," Hatch says, "and all the trustees jumped on what clearly is a unique and important opportunity. It's also a function of the market. Ordinarily we wouldn't have looked to dip into the principal. We have enough difficulty granting the 5 percent. Still, we'll be actively talking about changing spending policy because a similar opportunity may arise next year."

#### LAWS CHANGE THE LANDSCAPE

In the late nineteenth and early twentieth centuries, long before the tax laws on charitable trusts were enacted, the Castle Foundation had a spending policy that hovered between 5 percent and 25 percent. In what Alfred Castle calls "a dual sphere" of operations, whereby the men in the family managed the money and the women disbursed it, "Family members went into principal without much hesitation, especially for special projects such as Castle Memorial progressive kindergarten education projects (inspired by John Dewey's philosophy) and local, national, and international relief efforts for victims of war and natural disasters."

The modern version of the Castle Foundation came into being in 1925. For the next 33 years, the foundation was administered through the law offices of a succession of family members in Honolulu, which absorbed the costs. In 1958, it was moved to a trust office at the Bank of Hawaii, where its financial managers were, in effect, staff, and operated under the direction of the trustees. At that time, stock in Castle & Cook and Hawaiian banks accounted for nearly 80 percent of foundation assets.

The 1960s were a rocky decade for the Castle Foundation. The foundation came under scrutiny in a random investigative sampling of the nation's foundations by Rep. Wright Patman, who documented a series of abuses and portrayed several foundations as "tax dodges."<sup>14</sup> Although never accused, and eventually cleared of any impropriety in 1964, Castle Foundation trustees nonetheless entered into an agreement with the IRS to increase giving levels such that they would virtually equal net income from investments (excluding capital gains) until 1973. In addition, the foundation was forced to diversify its holdings so that it no longer appeared to con-



concentrate income. During this same period, Castle & Cook experienced severe growing pains as it moved to become a global conglomerate. As a result, its stock—and the foundation assets—suffered in the sell-off.

These changes prepared the foundation for the landmark Tax Reform Act of 1969. The act included such regulations as a 4 percent excise tax on net investment income, and required a payout equal to investment income in a given fiscal year. Enactment of the Revenue Act of 1978 reduced the excise tax to 2 percent, and the payout requirement has since been replaced by the 5 percent payout rule. The Revenue Act also included provisions under which the 2 percent excise tax can be reduced to 1 percent. In general, this is based on a formula that computes a ratio taking into account qualifying distributions for the current and five preceding years and the net value of the noncharitable use assets (securities and cash) for the same periods.

## RESPONDING TO CHANGING CONDITIONS

Although tax policy is the most obvious means by which the government affects foundation spending policies, foundations must also navigate a labyrinth of social policies, regulations, and political movements embodied in local, state, and federal legislation. For example, many family funds amended grantmaking and spending policies in the wake of the 1996 Welfare Reform Act, choosing to direct more grants toward social services and job creation to help soften the transition from welfare-to-work and patch a fraying social safety net.

Under its broad mission, the Kaplan Family Foundation has embraced the arts in Chicago, adjusting arts spending to try and meet the needs of small and mid-sized arts groups in Chicago without detracting from other spending areas like community organizing, housing, or employment. The trustees decided to “cap” arts spending at 20 percent of total grants. To most effectively use these funds, Executive Director Jobi Petersen engaged students at Northwestern University’s Kellogg School of Management to help identify organizations that needed them most in this time of reduced National Endowment for the Arts funding, competition for corporate dollars, and focus on arts education and outreach. Although state arts funding is at a record high, Petersen reports that “the small groups that receive these grants aren’t getting significant money, perhaps a small percent of their budget. Since more and more foundations focus their arts dollars on education and outreach, small arts groups are left with scarce funds to perform or administer their general program.”

Unlike some other foundations, Kaplan hopes to provide general operating support, especially to small or emerging arts groups. “We are the kind of funder that likes to give consistent support that fosters growth for organizations with clear, relevant missions,” Petersen says. “If the trustees are confident in a nonprofit, we’ll try to support it consistently. And, because we’re spending more money than ever, we hope to be able to help stabilize some of the mid-size organizations we’ve been funding at the same level for years and perhaps help them grow.”



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## MOVING POLICY INTO THE FUTURE

Much as legislators at all levels attempt to craft policy that can evolve into the future, family foundations try to balance past obligations and current grantmaking with upcoming philanthropic challenges. Succession, in particular, can be a difficult challenge. Few family foundations have grappled with succession issues in as focused a manner as the Nathan Cummings Foundation.

Cummings Foundation bylaws have been amended so that a simple—rather than two-thirds—majority of family members is all that is required for approval of spending policy decisions. In addition, the foundation has diversified its board, adding a former commissioner from the Securities and Exchange Commission, the president of the International Rescue Committee, the executive director of the Sundance Film Institute, a physician, and other nonfamily members. “We wanted values, experiences, and expertise beyond those of our family, considerable as it is,” says Robert Mayer. “We had to go beyond our own knowledge, in investment as well as specific program expertise.” The result is a series of committees and subcommittees integrated across the spectrum of foundation activities. Committees now include outside advisors as well as board and staff members.

The organizational flow extends into the idea of succession, particularly among family members. “It is a great challenge to grow succeeding generations into philanthropy from basic operations and grantmaking all the way to more complex issues such as investment and spending policy,” says Mayer. “We found that not all third generation family wanted to join the board. Therefore, we had to figure out how to make their participation in the foundation engaging and available in the broadest, most encompassing way. A simple board structure didn’t do it. An important part of our responsibility is to continue the education and development of succeeding (fourth and fifth) generations, to make it available to them on whatever terms they wish.”

The result is several classes of family membership and an ascending development structure: at the top is the board, followed by associate membership (attendance not required at all four board meetings, discretionary grantmaking budget), adjunct membership (usually college students who have small discretionary grants), a standing executive committee, as well as governance, finance, investment committees, and ad hoc committees as needed. This structure is in addition to the five program advisory committees to match each of the core giving areas. Family members are still invited to attend the annual retreat, even if they do not fit into established foundation membership categories. The foundation includes these family members to give them an opportunity to see the work of the foundation first hand and encourage them “to at least stay in touch with the foundation with the possibility of working with us in the future,” Mayer says.



“There’s more than enough work to go around,” Mayer adds. “We need family members to participate in order for our programs to move ahead. We want to be inclusive with family. If family doesn’t participate, over time we will become a non-family foundation, or certainly something much different than what we aspire to be. If that occurred, the direction of the foundation, which currently reflects the character of our family in all its dimensions, could change beyond recognition.”

The Cummings family has reached a philosophical and pragmatic definition of family philanthropy under which the foundation’s structure attempts to secure family participation in perpetuity: “The excitement—the passion—of a family foundation is being able to look for great ideas and programs and support them aggressively with our resources,” Mayer concludes. “Sometimes these ideas need to be created. As a family, we can support that process, but it requires a committed board and staff willing to put in the time. It takes work. It would be far simpler to sit in a room and simply disburse funds without a clear mission and a passion—simply reacting to whatever proposals happen by. As a family, we have elected to take the more challenging path because we believe the opportunities available and potential impact of our work is far greater than the alternatives.

“As a family the Cummings Foundation, or any family foundation, has the potential to do great things—but only if a passion to improve the world in which we live is coupled with the will to seek out and build solutions to society’s challenges. What could be a better legacy to leave for future generations than that?”

#### SUMMING UP

In many family foundations, spending policy drives investment strategy: the trustees decide on programs and grantmaking levels, and then fashion an investment strategy that will support that grantmaking. Spending policy brings together mission, philosophy, and daily processes of a family foundation. Although IRS regulations require foundations to pay out at least 5 percent of the value of their net investment assets, trustees of family foundations are typically influenced by many factors in setting spending policy. Those factors range from a desire to meet local emergencies to a determination to make long-term commitments to meritorious causes and nonprofit organizations. It is through its spending policies that a family foundation speaks and acts.

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