NATIONAL CENTER FOR FAMILY PHILANTHROPY

SPLENDID LEGACY 2

CREATING AND RE-CREATING YOUR FAMILY FOUNDATION

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FAMILY FOUNDATIONS AND **THE LAW**

BY JOHN SARE

When you decide to create a family foundation, you will confront a number of important legal issues. Specifically, you must make decisions about how to:

- Define your foundation's charitable purposes;
- Obtain tax-exempt status;
- Select the assets that will fund the foundation; and
- Ensure your foundation operates within the law.

Depending on the size and scope of your foundation, each of these decisions can be complicated. But you don't have to tackle these thorny decisions on your own. This chapter will provide you with advice and resources that can help you make the best decisions for your foundation.

Because of the complex nature of foundation law, many families choose to hire a professional counsel to help them with the process of setting up the foundation and creating its governance structure. In some cases, your own lawyer or accountant will have experience in foundation governance and will be an important resource. In other cases, he or she can refer you to a colleague who has experience in these issues. You can also find professional counsel by asking for referrals from friends who have created foundations — or through professional organizations such as the National Center for Family Philanthropy or the Council on Foundations.

What, Exactly, Is a **Family Foundation**?

Before we dive into how to create your foundation and set up the mechanisms that will help you follow the law, it's important to take some time to understand how family foundations are defined.

The term "family foundation" is actually a colloquial expression. The technical term for a family foundation under the Internal Revenue Code is "private foundation" — a concept that entered the tax laws in 1969 to refer to charitable trusts and nonprofit corporations that are endowed by an individual, a family, or a company for the purpose of making grants to other charitable organizations. The IRS doesn't differentiate between private foundations that are operated by families and those that are operated by other entities.

Private foundations (like all other charities) enjoy a variety of state and federal tax subsidies — namely, exemption from income tax and an ability to receive tax-deductible contributions.

But because private foundations receive these benefits, they have long been open to criticism. Critics contended in the late 1960s that private foundations abused their special status by (among other things):

1. amassing great wealth without making distributions in support of real charitable causes,

2. retaining unwise investments in family companies in order to prop up the stock price or preserve family control, and

3. paying over-generous compensation to friends and family or making discretionary travel and study grants.

Congress eventually concluded that these perceived and real abuses warranted special federal regulation. In 1969, the term "private foundation" took on its distinct legal meaning.

The law now draws a line between "private" and "public" charities and imposes more restrictive rules on those that are classified as "private." Furthermore, contributions to private foundations qualify for less favorable deductibility treatment than contributions to public charities.

Although some "private operating foundations" carry on active charitable or educational programs, most private foundations are grantmaking organizations, technically known as "private nonoperating foundations." Foundations of this type are the focus of this chapter.

Foundation or **Donor-Advised Fund?**

Before you create your family foundation, it is important to consider whether a private foundation is the best mechanism for achieving your philanthropic goals. In some cases, alternative approaches, such as a donor-advised fund or direct charitable giving, are more appropriate.

Donor-advised funds have become a popular choice for many donors. Donor-advised funds are irrevocable gifts to a public charity, such as a community foundation, federation, commercial gift fund, and some colleges and universities. Once the donor creates the fund, he or she (or someone he or she designates) retains the right to advise the charity concerning distributions from the fund.

Depending on your goals, donor-advised funds offer some advantages. But before you choose between creating a private foundation or a donor-advised fund, it's important to consider the following factors:

- **Control:** A foundation offers more ability to control grant-making and investment management decisions than a donor-advised fund. Donor-advised funds do allow donor advisors to recommend how charitable assets are granted and, in some cases, how they are invested within a pool of investment options. But donors never have true legal or financial control of a donor-advised fund.

- **Costs:** The start-up costs and ongoing administrative and management fees of a foundation are typically much greater than for a donor-advised fund. It is important to consider whether you have sufficient assets to sustain the ongoing costs associated with a foundation.

- **Required Grant Distribution:** Broadly speaking, a grant-making foundation is required to distribute 5% of its average annual asset value each year in support of its charitable purposes. Donor-advised funds do not have an annual distribution requirement.

- **Tax Deduction Limits:**
  - The tax deduction for gifts of cash to a foundation is limited to 30% of adjusted gross income, and the tax deduction for gifts of stock or real property to a foundation is limited to 20% of adjusted gross income. If the stock is not publicly traded, the deduction for giving it to a foundation is limited to the donor's basis. The tax deduction for gifts of cash to a donor-advised fund is 50% of adjusted gross income, and the tax deduction for gifts of stock or real property to a donor-advised fund is 30% of adjusted gross revenue. Even non-publicly traded stock given to a donor-advised fund is deductible at its fair market value, if the fund sponsor will accept stock of that nature.
  - Although unused deductions in one year may be carried forward for up to five additional years, a genuinely large charitable contribution may still not be fully deductible over that six-year period. The situation might or might not be improved by shifting the gift to a public charity (such as a donor-advised fund), where the annual deductibility limits are higher, and it may be that the best strategy is to spread the gift over multiple tax years — or simply to recognize that your philanthropy is going to exceed the amount you can deduct.

- **Confidentiality:** Foundations must file an annual report with the IRS listing assets, contributors, compensation, and grants. Donor-advised fund donors may remain anonymous.

- **Funding Outside the Box:** Foundations may make grants to individuals for scholarships or to alleviate hardship or distress. Foundations may also make program-related investments. Some donor-advised funds have operating rules that limit the type of grantees to which distributions may be made, including prohibitions on grants to foreign charities and to individuals.

The 5 Steps to Forming a New Family Foundation

Once you decide to create a family foundation, you and your lawyer will need to complete the following five steps to ensure that it is set up properly:

1. Draft and file the foundation's governing instrument, either an Agreement of Trust or a Certificate of Incorporation.
2. If the foundation is structured as a not-for-profit corporation, draft bylaws.
3. Hold an organizational Board meeting to adopt the bylaws, elect officers and transact initial business.
4. Draft and file the federal application for tax exemption (Form 1023).
5. Draft and file the appropriate state forms to hold charitable assets and exempt the foundation from certain taxes.

Defining Your Foundation's Charitable Purposes

Your foundation's "governing instrument" is a document that contains its statement of purposes. This statement of purposes is a crucial step in earning tax-exempt status.

The governing instrument also specifies whether or not a foundation must be perpetual and may spell out special restrictions on succession or control. If a foundation is structured as a charitable trust, the governing instrument is an Agreement of Trust, sometimes referred to as an "Instrument," "Declaration," or "Indenture" of Trust. If a foundation is structured as a not-for-profit corporation, the governing instrument is called the Articles of Incorporation or the Certificate of Incorporation.

To receive tax-exempt status, your foundation must be "organized" exclusively for tax-exempt purposes recognized by the Internal Revenue Code. In order to meet that threshold, the foundation's governing instrument must limit its activities to one or more of the following general purposes:

- educational
- literary
- scientific
- religious
- charitable.

These purposes (and a handful of others that are rarely relevant) are commonly lumped together in the governing instrument under the heading "charitable purposes" or "tax-exempt purposes." To receive IRS recognition, your foundation's purposes must fit within one of the recognized tax-exempt categories listed above. If you expect to make grants mainly to well-established charities — such as universities, relief organizations, nonprofit hospitals, arts organizations, religious institutions, and the like — you should have little difficulty specifying suitable purposes in the governing instrument and making grants that will readily qualify under one of the recognized tax-exempt categories.

However, you may have more novel objectives — such as the woman who wanted to create a foundation to perpetuate her mother's legacy of dressmaking and embroidery, or the man who wanted to provide economic assistance to family farmers to promote the tradition of family farming. If your specific objectives are innovative or even a bit idiosyncratic, your lawyer can help you figure out whether and how your objectives can be structured to fall within the legal definition of what is "charitable." Fortunately, the legal concept of "charity" is inherently flexible and is intended to evolve as the needs of society evolve.

If you wish, you can identify general purposes (educational, charitable, etc.) and then add specific limitations. An "educational" foundation, for example, might support only private colleges and universities in Texas or only museums of Asian art. A "scientific" foundation might support only medical research institutions studying prostate cancer. A "charitable" foundation might support only the relief of poverty and construction of charity hospitals in Peru. There are myriad possibilities.

When you define a foundation's charitable purposes, you face an important practical and legal issue: balancing your desire to achieve specific charitable purposes today, and the virtual certainty that you will need some degree of flexibility in the future.

You may wish to empower those who control the foundation after your death to amend the charitable purposes — or you may decide to prohibit changes of purpose after your death.

Philanthropists often find it appealing to create a foundation that will last in perpetuity. A foundation that pays out the minimum 5 percent a year of its average annual asset value and, net of operating expenses, earns more than that should indeed be able to last forever.

But bear in mind: Forever is a very long time, and the ideas that seem wise now may be inappropriate or unworkable a century, or even a decade, in the future.

Tips For Crafting Charitable Purposes

- **Be specific.** Vague charitable purposes and excessively limited ones routinely yield confusion, discord, and litigation — sometimes during the founder's lifetime; more often in a family foundation's second or third generation.
- **Take your time.** Invest ample time and thought in the development of a statement of charitable purposes and, if appropriate, a mission statement. Write down your ideas. Let your lawyer convert your concepts into suitable "legalese." Then read the lawyer's draft critically and work with your lawyer to improve it.
- **Be critical.** Encourage family, friends, and others whom you trust to ask hard questions about your philanthropic ideas and to participate actively in the process of identifying the right charitable purposes and deciding how they are expressed.

Five Key Questions on **Charitable Purposes**

Answer these five important questions to help ensure your charitable purposes will help your family achieve its philanthropic goals:

1. How likely are my charitable objectives to evolve during my lifetime?
2. To what extent are my objectives something that my children or other successors on the board of the foundation will want to pursue?
3. What are the chances that my particular purpose may one day become obsolete or unnecessary?
4. How well have I matched funding with purpose? Have I earnarked too little money? Too much?
5. How can I ensure that later generations won't quarrel over what I mean?

Questions **About Perpetuity**

Before setting up a perpetual foundation, it's important to answer the following questions to ensure you're making the best decision:

- Am I contributing enough money to my foundation to warrant the expense forever of the apparatus necessary to manage the assets prudently and give them away responsibly?
- Who is going to run a perpetual foundation? For how many generations can I expect volunteers to shoulder the burden of carrying out the philanthropic objectives I have in mind?
- Is my charitable objective broad enough that I can reasonably expect it to remain viable in perpetuity?
- Should I impose a time limit on my foundation — a fixed number of years after my death or for the lives of my children and grandchildren?
- Should I give the board the flexibility to distribute all of the assets so that future generations can decide when and if it makes sense for my foundation to go out of business?
- If the assets are large enough and the purpose broad enough to warrant a perpetual foundation, what kind of staffing and structure do I envision? Should I create that structure during my lifetime?

Crafting a **Mission Statement**

Many foundations create governing instruments with extremely broad charitable purposes —often as broad as the law will allow. Then, to provide a focus for grantmaking, those foundations adopt a mission statement, citing particular charitable causes that will be supported or particular styles of grantmaking that are to be favored (such as challenge grants or venture philanthropy).

A mission statement can help your foundation achieve disciplined grantmaking today while preserving flexibility over the longer term. Mission statements need not be legally binding and do not need approval from the IRS or state charities officials. As a result, a foundation's trustees can readily revise or replace a properly crafted mission statement, so that the focus of grantmaking can change without needing to revise or change the legally binding governing instrument. (See pages 41–49 for more on creating a mission statement.)

Below is a fictional example that illustrates how these two documents can work in tandem to provide family foundations with flexibility and clarity:

When Tom Fox, a 50-year-old investor, formed a foundation to support the preservation of Civil War battlefields and education about the Civil War, he approached his lawyer for guidance.

At the time, Tom's lawyer advised him to set up the foundation with a broad charitable purpose in its governing instrument. He also recommended that the foundation's mission statement — which is freely changeable at any time — to spell out its focus on Civil War history and education.

This proved to be a wise choice.

In his late 70s, Tom's health began to deteriorate. In his declining health, Tom decided that we wanted to shift the focus of his foundation's grantmaking away from Civil War-related issues and toward medical research. What's more, he wanted to leave the bulk of his remaining assets to the foundation and wanted those assets forever dedicated to research into cures and treatments for diabetes and arthritis, with a limitation favoring research by public universities.

At the same time, Tom was worried that his adult children would not take a serious interest in the foundation once he died and, even if they did, he was concerned that they would not be interested in having the foundation focus on diabetes, arthritis, or any other health-related issues.

With this in mind, Tom and his lawyer agreed to take the following actions:

- The statement of purposes in the foundation's governing instrument would remain broad and unchanged.
- The foundation would adopt a new mission statement to express the intention that the foundation support research at public universities into diabetes and arthritis and "in the event they are eradicated, other medical conditions affecting the elderly."
- Tom would sign a new Will, leaving the bulk of his assets to the foundation but on the condition that the assets passing at the time of his death be used exclusively in furtherance of the mission statement in effect at the time of his death.

As a result of this new structure, the foundation's assets would be used during Tom's lifetime to further its mission. At the same time, Tom maintained the flexibility to change his mind and make additional changes because of the broad nature of its governing instrument.

At his death, his bequest would be limited to the specific purposes set forth in a mission statement he approved during his lifetime. But it also included specific instructions on how to direct the foundation's assets if scientific advancements eradicated diabetes and arthritis.

Meanwhile, the new arrangement provided some flexibility to Tom's adult children and other descendants, too. Although the bequest in Tom's Will was limited to the purposes specified in a mission statement he approved during his lifetime, the mission statement can be changed vis à vis all other assets of the foundation. Therefore, assets Tom gave before his death and any assets his descendants contribute to the foundation in the future could be used in support of whatever charitable purposes future generations deem appropriate.

Establishing **Bylaws, Selecting Directors**, and **Appointing Officers**

As part of the process of applying for tax-exempt status, your foundation must also create the rules that will govern its day-to-day operations and elect the officers who will follow and enforce these rules.

To do this, you will create Bylaws, which outline the rules for routine matters of governance and say little or nothing about a foundation's purposes. Although the trustees of a charitable trust occasionally elect to adopt Bylaws, the directors of a not-for-profit corporation almost always do so, and in some states it may be required.

Your foundation will also need a board of directors or board of trustees. Who you choose for this role is critically important. Although initially it might be just you and your spouse or partner, plus perhaps an adult child or a trusted advisor, it is important to think about how you can ensure you have people with complementary skill sets in these roles. For example, you might choose to invite a board member with a background in legal issues if others on the board do not have this skill set. You should also think about the perspectives and values that each individual would bring to the board table. It is an ongoing task to make sure that a board has an appropriate balance of skills and temperaments and that the succession process attracts people with the know-how, commitment, and cohesiveness to move the foundation forward.

You also should think through issues such as the potential for conflicts of interest. For example, if the foundation is going to own a large position in a closely-held corporation, then it might not make sense to have executives of the corporation on the board.

And you should not forget about the potential for conflict itself. If two people do not get along now, there may not be much reason to suppose that sitting them at the same board table will change that.

Conflicts of interest and conflict itself can both be managed, of course. But it is always important to ask if there are ways to avoid such issues altogether, because they are likely to distract from the important work you want your foundation to do. And depending on the circumstances, a board riven with conflicts of interest or with sheer conflict may end up spending a lot of the foundation's resources on legal fees.

What is the difference between **directors** and **trustees?**

A not-for-profit corporation ordinarily has a "board of directors" or a "board of trustees," and the board appoints a president, a secretary, a treasurer, or other "officers." A charitable trust usually has "trustees" but no officers, although larger charitable trusts may appoint administrative and program "officers."

In this chapter, the term "trustee" is used generically — and can mean the trustee of a charitable trust or a member of the board of a not-for-profit corporation. The term "officer" refers to an officer of a not-for-profit corporation or a charitable trust.

At its initial meeting, your trustees will typically choose who will serve as officers, if it is a not-for-profit corporation. The trustees will also approve the foundation's bylaws and conduct any initial business.

Obtaining Recognition of **Federal Tax-Exempt Status**

After you form your foundation, either as a charitable trust or as a not-for-profit corporation, your next order of business is to obtain recognition of its tax-exempt status. This process begins with filing Form 1023 with the IRS. Form 1023 and related instructions may be found on the IRS website. This form asks many questions about the organization and, among other things, requires the following information:

- A copy of the governing documents;
- A description of the foundation's purposes and projected activities (for example, investing donated funds and making grants to other charities);
- A list of trustees and officers, their addresses, and the compensation they will receive for their service to the foundation;
- A balance sheet containing the most current information available; and
- A detailed multi-year budget.

Additional disclosures may be necessary if, for example, the foundation has entered into a lease. The form also includes several questions about compensation and how the foundation plans to carry out its grantmaking.

Once you file your Form 1023 and pay a filing fee, the IRS will typically respond with a letter acknowledging receipt and informing the foundation about the review process and timing. During the review, the IRS may contact you or your advisors for additional information. These IRS queries are ordinarily made in writing and offer only a brief period of time for foundations to respond, although the tax agency will routinely grant extensions, if they are needed.

The Form 1023 was once a much simpler document. Today, in almost all cases, the form is best filled out with seasoned professional guidance. Imprecise or mistaken answers can raise irrelevant or perplexing questions by the IRS and can result in months of delay while matters are straightened out.

Once the IRS approves your request, it will send your foundation a favorable determination letter. This letter should be kept in the foundation's minute book along with its governing instrument, its Bylaws, and a copy of Form 1023. Ordinarily, the determination letter is retroactive to the date the foundation was formed. That means that the foundation is retroactively tax-exempt and that contributions made prior to the issuance of the determination letter are eligible for the charitable deduction. However, you may decide it is prudent to delay any material amounts of charitable giving to the foundation until after the foundation receives its determination letter.

Filing With Your State

States and most local governments recognize the tax-exempt status of foundations that have received favorable IRS determination letters. Most states offer additional tax exemptions — for example, foundations usually can apply for exemption from sales and use tax on goods *purchased* by the foundation and for exemption from tax on real property owned by the foundation and used by it to fulfill its charitable purposes.

All states have one or more bureaus with authority to investigate and regulate charities. In most states, those bureaus are part of the Office of the Attorney General or the Office of the Secretary of State. Most states impose registration and annual reporting requirements on charities. Lawyers or accountants thoroughly familiar with local rules and practice may be able to guide you through the state law requirements. Alternatively, you may wish to speak directly with officials in your state. The staff of the state charities bureau should be thoroughly familiar with the requirements and can direct you to the necessary forms and instructions.

Funding the Foundation

As you get your foundation off the ground, you will also need to make a number of important decisions about how you will donate the assets that will fund the foundation's grantmaking and operations. It's important to be deliberate in how and when you direct those assets, since these decisions impact how the IRS allows you to calculate tax deductibility. As a result, your lawyer and/or accountant can be a valuable resource in helping you make these decisions and navigating the complex tax rules.

Below are a few scenarios that help illuminate some of the key questions and issues that face families that are making these important decisions:

SCENARIO 1: **Jumping the Gun**

Janet Ford creates a family foundation in early December — and hopes to be able to claim a tax deduction for her contribution to her newly formed foundation during the current tax year. With that goal in mind, she makes her first contribution the day after the family foundation is formed, even though the foundation does not yet have a favorable IRS determination letter. Recognizing this fact, she stipulates that the foundation must return her gift if it fails to obtain a favorable IRS determination letter.

However, this decision is a mistake.

Under IRS rules, gifts are considered nondeductible if they are made under the condition that the charity must receive tax-exempt status. Instead, Janet would be wise to hold off on making her gift to the foundation until a favorable IRS determination letter is safely in hand. If she does not want to wait until the IRS's determination and instead wants to claim her tax deduction during the current fiscal year, she could also choose to instead create a donor-advised fund at a community foundation and make the donation to the donor-advised fund rather than directly to the family foundation.

SCENARIO 2: Choosing Among Assets

Frank Bass, a filmmaker with a successful production company and a sizable stock portfolio, is trying to decide which assets he will contribute to a new foundation. He learns from his accountant that the factors that affect this decision are surprisingly intricate, especially when he must choose between gifting cash, securities, property, artwork, and mortgaged assets. Given these myriad options, his accountant offers the following advice:

- A gift of cash is the simplest gift. Valuation is not an issue, and in the year of the gift Frank can deduct an amount up to 30 percent of his adjusted gross income if his gift consists exclusively of cash and he makes no other gifts to charity.
- A gift of publicly traded securities with built-in capital gain may be the most economically beneficial gift for Frank. He should be able to deduct the fair market value of the contributed securities, and the foundation will be able to sell the securities without incurring the capital gains tax that Frank would have incurred if he had sold the securities himself. However, he can deduct only up to 20 percent of his adjusted gross income in the year of the gift if his gift consists exclusively of publicly traded securities.
- A donation of real property, artwork, or other tangible personal property, interests in a closely held business, and ordinary income property (such as a copyright or rights under a contract) would provide very little economic benefit for Frank, because his deduction would be limited to the lesser of fair market value or his cost. He also learns that a gift of interests in his closely held business could raise issues under the "excess business holdings" and "self-dealing" rules (discussed later in this chapter) — and because the interests are not "qualified appreciated stock" would be deductible only to the extent of his basis in the shares. Ultimately, Frank decides his real property, artwork, stock in his closely held production company, and the copyrights from his films should be retained or given to a public charity.
- Because a donation of mortgaged property may raise issues under the "self-dealing" rules and the unrelated-business income tax rules, Frank's accountant advises him not to contribute mortgaged assets.

SCENARIO 3: A Gift of Stock

Alice Brady wishes to fund a new foundation using publicly traded stock in a company founded by her father. The stock is worth about $8 million, but Alice quickly learns that she will be able to claim only a small portion of that value on her individual tax return. That's because the value of the stock vastly exceeds her annual income, which rarely tops $300,000.

Because of deductibility limitations — primarily, the fact that she cannot deduct more than 20 percent of her adjusted gross income in a given year for a donation of publicly traded stock to a foundation — she discovers that the most she can deduct in the year of her gift is $60,000. Her accountant advises her that she can "roll over" the deductions for an additional 5 tax years, meaning that her total deduction on an $8 million gift would be approximately $360,000 ($60,000 per year in each of 6 tax years, before taking into account limitations on itemized deductions). As a result of these limitations, Alice decides to contribute only $360,000 worth of stock up front, take deductions over a 6-year period, and defer the rest of her philanthropy.

Under this scenario, a "split-interest" charitable vehicle might be appealing, especially if Brady wants to make a gift to charity while getting something in return. An interest in property is "split" by dividing the property into two interests — present and future.

The most common "split-interest" vehicles are the **charitable remainder trust** and the **charitable lead trust**. Although these trusts can be structured in many ways, the basic concepts can be illustrated as follows:

Charitable Remainder Trust

Once Alice Brady decides to contribute only $360,000 of her stock to her foundation, her financial advisor points out that her remaining $7,640,000 of stock produces very little income for her. In addition, unless she diversifies, having all of that stock with one company means she has high exposure to market volatility. If the market experiences a downturn, her assets are at risk. She voices her concerns to her lawyer, who recommends that she use the stock assets to create a charitable remainder trust. Using this vehicle, she is entitled to a lifetime stream of payments and, upon her death, the trust remainder passes to the foundation. Because the trust is tax-exempt, it is able to sell appreciated assets that Alice contributes and to diversify its holdings without incurring any capital gains tax. Alice anticipates that her income will increase because of the distributions she will receive from the trust. Although the distributions will be taxable to her to the extent they consist of income or capital gains earned by the trust, the creation of the trust entitles Alice to a charitable deduction based on the value of the foundation's remainder interest — an amount determined actuarially based on Alice's age at the time of the gift and significantly smaller than the amount of the deduction she would have received if she had donated the assets to the foundation outright. She expects that this additional deduction will offset some of the income and capital gains she plans to receive from the trust.

Charitable Lead Trust

Phil Harmon has managed to shift a significant amount of his wealth into trusts for his adult children. Now, he wants to use some of his remaining assets to create a foundation and provide for his grandchildren.

To achieve these goals, Phil's lawyer recommends he create a charitable lead trust, which is the mirror image of a charitable remainder trust. In this arrangement, Phil creates a foundation, which is designated to receive a stream of payments from a trust for a specified period of years, and at the end of that period, the trust property passes in further trust for the benefit of his grandchildren and their families. The value of the family's remainder interest is discounted based on the value of the charity's intervening "lead" interest in the trust, so Phil is able to make a transfer to younger generations of his family at a reduced gift, estate, and generation-skipping transfer tax cost and, at the same time, to transfer assets to a foundation.

There is a trade-off: To avoid adverse estate-tax consequences, Phil must transfer legal control of the foundation to his adult children and grandchildren.

Charitable lead trusts are especially beneficial during times when interest rates are low, because of the IRS tables used to calculate the value of the family's remainder interest in a charitable lead trust. That is, if the actuarial assumptions about asset growth are conservative (as they are required to be when interest rates are low), the present value of the family's remainder interest in the trust will be conservatively calculated as well. If the trust's investments outperform the payout rate plus the assumed rate of interest, the actual value of the family remainder will exceed the actuarial value assigned to it for purposes of gift, estate and generation-skipping transfer taxes. (For more on this topic, see Funding Your Family Foundation.)

Operating **Within the Law**

In many ways, creating a foundation is similar to creating a new business in a regulated industry. You are committing hundreds of thousands, perhaps millions or tens of millions of dollars, to this activity. The IRS, state charities officials, journalists, and other watchdogs are looking over your shoulder to make sure you run the business legally and ethically. In the Internet age, these watchdogs have access to more information than ever before about foundations — meaning that the degree of public scrutiny is greater than ever. This higher degree of scrutiny can come with a high cost. If your foundation violates certain rules, the IRS can impose excise taxes (in effect, penalty taxes) at rates high enough that foundations and those associated with them cannot treat the taxes as an acceptable cost of doing business. Continued violations of the rules may cause a foundation to lose its tax exemption.

You owe it to yourself and your foundation to develop at least a basic understanding of the applicable rules. The following summary will help you gain a basic understanding of the key rules, but is by no means exhaustive. You should consult with qualified legal counsel if you wish to pursue these topics in greater detail.

Tips for Staying **Out of the Headlines**

As you set up your foundation, consider the following to help ensure that you're getting the right resources and advice regarding governance:

- Be prepared to commit a small but reasonable portion of the annual budget to good governance and compliance with applicable laws.
- Seek out lawyers, accountants, and financial advisors who are honest, experienced in the foundation area, and willing to commit the time and resources necessary to provide thorough and thoughtful advice to the foundation.
- Don't hesitate to ask prospective advisors how many foundations they have created and how many they advise on an ongoing basis. Ask for client references and try to find out if the clients believe they have been well served.
- Don't assume that the advisors who help you run your business, or the advisors who handle your estate planning or prepare your tax returns, are necessarily well versed in the intricate rules that govern private foundations. Ideally, the advisors who work with your foundation will have experience helping other foundations.
- Consider including your professional advisors at board meetings, so they can serve as ready resources to help the family solve legal, ethical, and practical issues.

Understanding **Your Risks**

The IRS has a number of strict penalties that it imposes on foundations that do not comply with the rules related to maintaining their tax-exempt status. Throughout this chapter, we'll explore how your foundation can ensure that it is operating in compliance with the law. However, it's important to understand the risks your foundation faces if it fails to adhere to the law.

The following table offers a summary of excise taxes the IRS can impose on private foundations:

Issue	Tax	Frequency	Tax on Knowing Foundation Manager	Second-Tier Tax (Other than on managers)
Act of Self-Dealing	10% of amount involved (on the individual self-dealer)	Each year until correction	1st tier: 5% up to \$20,000 maximum per act 2nd tier: 50% up to \$20,000 maximum per act	200%
Annual Distribution Requirement	30% of under distributed amount	Each year in which there is an under distribution	NA	100%
Excess Business Holdings	10% of value of excess business holdings	Each year in which the excess holdings continue	NA	200%
Jeopardizing Investments	10% on amount so invested for each year of taxable period	Each year until amount no longer in jeopardy	1st tier: 10% up to \$10,000 maximum per investment 2nd tier: 5% up to \$20,000 maximum per investment	25%

Technical compliance with the private foundation rules is a necessary condition of operating within the law, but it is not sufficient.

As a more general matter, a foundation must be operated prudently and for exclusively charitable purposes. A poorly run foundation risks not only imposition of the excise taxes outlined above, but also the loss of its tax-exempt status. The IRS has the power to revoke tax-exempt status if:

- A foundation engages in any political campaign activity;
- Any part of a foundation's net profits "inures" to the benefit of insiders;
- More than an "insubstantial part" of the activities of a foundation consists of legislative lobbying or confers a private, rather than public, benefit; or
- A foundation engages in repeated or flagrant violations of the private foundation tax rules.

In the final analysis, a foundation jeopardizes its tax-exempt status whenever the totality of its operations suggests that it no longer deserves the benefit of tax exemption. Furthermore, any amount of political campaign activity or lobbying activity may result in hefty excise taxes under the "taxable expenditure" rules described below — sometimes in tandem with the revocation of a foundation's tax-exempt status.

The **IRS Isn't the Only Cop** on the Beat

If state charities officials investigate a foundation and find abuses (for example, improper benefits flowing to insiders or a lack of sound financial management), the trustees and officers risk removal and may even be forced to pay monetary damages for any financial harm they do to the foundation.

Some states have specific laws about the role of family members in a foundation. For example, under section 5227 of California's Nonprofit Corporation Law, if even one family member is being paid by a California foundation that is structured as a corporation, California's corporate statute requires that at least 51 percent of the seats on the board be held by "disinterested" individuals — i.e., people who are not members of the family.

New York in 2014 enacted the Non-Profit Revitalization Act ("NPRA"), perhaps the most comprehensive set of recent state charities law reforms. Under NPRA, a family foundation may not enter into any transaction with a family member (not just compensation arrangements) unless the Board determines that the transaction is fair, reasonable and in the foundation's best interests. No family member with an interest in the transaction may participate in deliberations or vote on the transaction.

Even more stringent concepts of the "duty of loyalty" may apply if a foundation is created as a charitable trust, unless the governing instrument expressly says otherwise.

The bottom line: The transactions of a foundation can be readily subjected to public scrutiny. If you think a reporter could make a financial arrangement look bad on the front page of the local paper, consult with legal counsel before you do it.

Good Governance

The best way to stay out of trouble is to institute good governance practices right from the start. This includes holding Board meetings at least annually, taking minutes at all Board meetings and recording all Board decisions, following the procedures outlined in the bylaws for the election of directors and officers, and adopting and following policies and procedures so that:

1. the Board understands its fiduciary responsibilities,
2. assets are managed prudently, and
3. the foundation's charitable purposes are carried out.

Foundations typically have a conflict-of-interest policy, and many foundations have additional policies, such as an investment policy, whistleblower policy, compensation policy, or expense reimbursement policy. Breaches of fiduciary duties may result in financial and other liability for the Board.

Meeting Annual **Reporting Requirements**

A private foundation must file an annual Form 990-PF report with the IRS. This form is a highly detailed "information return" that includes details about your foundation's assets, investment income, donations, salaries and other expenses, and grants and other expenditures for charitable purposes. If a foundation has violated any of the so-called "private foundation rules" (discussed below), information about those violations must be disclosed in Form 990-PF and an accompanying IRS Form 4720. The Form 990-PF must be filed with the IRS by the 15th day of the 5th month after the close of the foundation's fiscal year, unless the foundation applies to the IRS and receives permission for an extension. The IRS may apply substantial penalties if the Form 990-PF is not filed by the deadline. Many states also require an annual report, the bulk of which is often a copy of Form 990-PF. Both the IRS and state charities officials typically make these documents available for public inspection, and much of this information is available online through organizations such as GuideStar and the Foundation Center.

A foundation is required to provide a copy of its three most recent Forms 990-PF as well as its Form 1023 (together with any documentation and correspondence submitted in support of the Form 1023) to any individual who requests a copy. If the request is made in person at a foundation office, the request must be honored immediately. If the request is written, the request must be honored within 30 days. A reasonable fee may be charged to cover photocopying and postage. In lieu of providing a copy, a foundation may post its three most recent Forms 990-PF and its Form 1023 online. The Form 990-PF and the Form 1023 also must be available for public inspection at the foundation's principal office. The IRS can penalize both the foundation and its responsible managers for failure to make these documents available upon request.

Form 1023 requires the names and addresses of trustees and officers, plus a phone number for a representative of the foundation — usually the lawyer filing the application. Form 990-PF requires a list of the names and addresses of substantial contributors, trustees and officers, but not telephone numbers. To insulate your home address from the disclosure requirements, you may prefer to use an address "in care of" your office or the office of a lawyer, accountant, or other advisor.

Avoiding **Self-Dealing**

With narrow exceptions, a foundation's transactions (direct and indirect) with "disqualified persons" will be treated as taxable "acts of self-dealing." That is true even if the transactions are on fair and reasonable terms and are approved by disinterested trustees or officers. Such transactions would include sales, loans, or leases between a foundation and a "disqualified person" and arrangements that result in the use of foundation assets by a "disqualified person."

What in the World is a **"Disqualified Person?"**

You become a "disqualified person" as soon as you create a family foundation. So do your spouse, your children, grandchildren, great-grandchildren, and their spouses. Your parents and other ancestors are "disqualified persons," too, but your brothers, sisters, and their descendants are not.

But that is only the beginning!

The trustees of a foundation are "disqualified persons," even if they have made no donations to it. For purposes of the "self-dealing" rules, government officials are "disqualified persons," regardless of their connection — or lack of a connection — to the family. And finally, family businesses, trusts, and estates also can be "disqualified persons," depending on the percentage owned or controlled by individuals who are "disqualified persons."

There are some useful exceptions to the self-dealing rules. For example, a foundation may pay compensation to a disqualified person for personal services rendered that are reasonable and necessary to carry out the exempt purpose of the foundation, provided the compensation is not excessive and provided state law does not prohibit the arrangement. The IRS has taken the position that the only personal services for which a disqualified person may receive compensation are services as a trustee, officer, or staff member and legal, investment, and banking services. Before a disqualified person is paid for services that fall outside those narrow categories, it is advisable to consult with legal counsel about the implications. Directors of private foundations generally serve without compensation. However, foundations often pay the premiums for directors' and officers' insurance and reimburse directors and officers for reasonable expenses incurred in connection with foundation activities.

The IRS imposes a penalty tax both on the "disqualified persons" who participate in an act of self-dealing and on those trustees and officers who knowingly participate in that act by approving it.

Examples of **Self Dealing**

- A foundation buys a table at a benefit dinner and distributes the benefit tickets to family members or other "disqualified persons."
- A foundation owns works of art and permits the founder or other "disqualified persons" to exhibit the works of art at home.
- A foundation pays an honorarium to a government official for giving a speech or participating in a seminar.
- A foundation and "disqualified persons" are investors in the same company, and the foundation holds onto an investment in order to "prop up" the stock price.
- A foundation buys an asset from a "disqualified person," even if the terms are economically advantageous to the foundation.
- A foundation invests in a partnership in which other "disqualified persons" own more than 35% of the profits interest.
- A foundation pays excessive compensation to a "disqualified person" for his or her services to the foundation.
- A foundation pays rent—even below-market rent—for office space in a building owned by a "disqualified person."
- A foundation makes a grant that satisfies a legal obligation of a "disqualified person."

A Cautionary Tale

Margery and Steve Wilks create a foundation and decide it needs office space. They speak with their son, Bob, and daughter-in-law, Susan, and decide to rent space in an office building owned by a corporation.

Although Susan is on the board of the corporation, she receives no compensation for that work, and she is not an officer. Susan owns no stock in the corporation, but she and her children are the sole life beneficiaries of a trust (created by Susan's father) that owns 36 percent of the voting stock of the corporation. The other 64 percent of the voting shares are owned by a group of unrelated investors. The sole trustee of the trust for Susan and her children is a large bank. Susan has no authority to decide whether the trust will retain or sell its stake in the corporation.

The Wilks conclude that the rental fee is fair and that the transaction should be fine because family members own no direct interest in the corporation and because the terms have been negotiated at "arm's length" with a corporation that no family member controls and from which no family member receives compensation.

The Wilks take the lease to their lawyer for review, and the lawyer informs them that there is a tax problem: The corporation that will be leasing space to the foundation is a "disqualified person," she says, and the lease would result in an "act of self-dealing" under the tax laws. She explains the analysis as follows:

1. The trust is a "disqualified person" because more than 35 percent of the beneficial interests in the trust are held for the benefit of individuals (Susan and her children) who are "disqualified persons" because of their family relationship to the Wilks.
2. The corporation is a "disqualified person" because more than 35 percent of the voting power is owned by a "disqualified person" — that is, by the trust described above.

The Wilks' lawyer explains that it is irrelevant for tax purposes whether Susan and her children control the trust or the corporation — and whether the rental fee is fair. The only acceptable solution, from a tax standpoint, is for the foundation to use the space for free. That solution is not financially acceptable to anyone. The Wilks then propose to lease office space from Steve's brother. Their lawyer advises them that siblings are not "disqualified persons," so the lease should be fine for federal law purposes. But the lawyer cautions that Steve's brother would become a "disqualified person" if he joined the foundation's board or became a substantial contributor. The lawyer also cites fiduciary considerations under state law, including a state statute that requires recusal of family members from the vote on a transaction such as this one. The Wilks decide they will look for space available from a completely unrelated party.

Protecting **Directors** and **Officers**

Good governance will help keep you foundation out of legal trouble. By remaining well-informed, attentive, and honest, foundation trustees should rarely, if ever, be subject to removal or financial sanctions. That is true even if the trustees occasionally, in good faith, make errors of judgment.

Even honest and hardworking foundation leaders can be sued or threatened with suit, however, or can inadvertently violate the private foundation tax rules. For that reason, every foundation should consider obtaining insurance coverage for its trustees and officers. This insurance — commonly known as "directors and officers" or "D&O" insurance — should cover defense costs as well as any damages, taxes, or fines that must be paid.

The component parts of this insurance should be reviewed carefully with counsel, to help the foundation assess whether the insurance is adequate to cover the relevant categories of potential liability.

Some types of insurance may be deemed "non-compensatory" and other types "compensatory," which will affect whether the premium payments must be treated as taxable income by those who are insured. Premiums for "compensatory" insurance — for example, insurance covering liability for the private foundation taxes — must be taken into account when evaluating the over-all reasonableness of the compensation a trustee or officer receives.

Those who receive insurance coverage from a foundation should consult with their own tax advisors about the income tax consequences of the premium payments.

For cases that insurance does not cover or situations in which an advance is needed to cover legal or other expenses, an indemnification from the assets of the foundation also may be appropriate, subject to applicable legal limits.

Holding On to the **Family Business**

A foundation and its "disqualified persons," in the aggregate, may not ordinarily hold more than 20 percent of the voting equity of a business enterprise. If they do, the foundation is subject to an excise tax.

To better understand how this plays out in practice, let's explore the following example.

Bill Reed plans to create a foundation by donating to it 80 percent of his family company — a figure that is well in excess of the 20 percent limit. He discusses the issue with his lawyer, who explains that there is a special "grace period" for gifts and bequests.

For donated assets, a foundation has 5 years from the date of the gift to divest itself of the excess and, if it fails in that effort but can demonstrate sufficiently diligent efforts to divest itself, it might qualify for a 5-year extension from the IRS. The lawyer points out, too, that the 5-year grace period can be extended if Bill delays his gift and makes a bequest instead. In that case, the 5-year grace period ordinarily would not start to run until the shares of the company are actually distributed to the foundation by Bill's estate. Bill's lawyer cautions that Bill probably should not give a large percentage of his company to the foundation unless he is certain that there will be a public market for it. If the only prospective buyers are members of Bill's family, or trusts for their benefit, their purchase of shares (from the foundation or from Bill's estate) could easily be "acts of self-dealing."

Other Exceptions to the Excess Business Holdings Rules

- The threshold of permitted ownership increases from 20 percent to 35 percent if a foundation can establish to the satisfaction of the IRS that the business enterprise is controlled by persons who are not "disqualified persons."
- If a foundation's holdings are 2 percent or less by vote and by value of a business enterprise, then the aggregate holdings of the foundation and "disqualified persons" may exceed 20 percent. If an enterprise receives at least 95 percent of its income from passive sources (such as interest and dividends earned on investments), or if the enterprise is properly classified as a "functionally-related business," then the foundation and "disqualified persons" may own any percentage, even 100 percent, of the enterprise.

Rules of the Road for **Grantmaking**

It is important to understand the legal considerations involved in making grants. Before sending out a grant check, the foundation should:

- Determine whether a prospective grantee would be an appropriate recipient of a foundation grant. If the grantee is a U.S. public charity, then a foundation grant may be made without requiring further reporting from the grantee. To determine whether a prospective grantee is a U.S. public charity, consult IRS Publication 78 or other resources available on the Internet. If the prospective grantee is not a U.S. public charity, the foundation's lawyer should be consulted to help determine the appropriate expenditure responsibility steps, or possibly develop the file necessary to establish that the foreign organization is equivalent to a U.S. public charity.
- Review the grant proposal carefully. Make sure making the grant will be in furtherance of the foundation's charitable purposes, and that there is not an expectation on the part of the prospective grantee that the funds will be used for political activities or lobbying.
- In general, ensure that the grant check is accompanied by an award letter or grant agreement. For a straightforward grant to a U.S. public charity, this can be a simple letter informing the grantee of the foundation's decision to award the grant, and providing that the foundation does not wish to receive any benefit in return for the grant. For a complicated grant or a grant with restrictions on the use of grant funds, a grant agreement that all parties sign, outlining the expectations of the foundation, can help to reduce future confusion and misuse of funds.

It is also important to understand what types of grants are not considered tax exempt under IRS rules.

Without exception, grants to political campaigns and other amounts spent on electioneering are "taxable expenditures" and as such can result in substantial excise taxes on the foundation and its managers. The same is true for expenditures to publicize a foundation's support of, or opposition to, a candidate for political office. Such expenditures should be avoided altogether. Advocacy activities should be undertaken with great care, and only in consultation with a lawyer familiar with the rules. There are many cases in which lobbying expenses also will be "taxable expenditures."

Grants to individuals, foreign charities, other private foundations, non-charities, and organizations whose tax status is unknown may be classified as "taxable expenditures" unless the grants are properly structured. Grants to organizations not classified as U.S. public charities (or determined to be the equivalent of a U.S. public charity) ordinarily will necessitate the exercise of "expenditure responsibility." The foundation's lawyer should be consulted in advance of making any such grant, to ensure that all appropriate steps are taken. Some of the requirements are:

- A diligent "pre-grant inquiry" about the grant recipient.
- A written agreement requiring, among other things, that the grant recipient:
  1. Provide written reports about its use of the grant money;
  2. Return funds not used for the purpose specified in the grant agreement; and
  3. Not use the funds to engage in political activity, legislative lobbying, or other prohibited activities.

Grants to individuals for travel, study, or other similar purposes (including scholarship grants) must be made pursuant to procedures pre-approved by the IRS. A foundation may make grants directly to individuals if the grants are not for travel or study and if the grants further charitable, educational, or other 501(c)(3) purposes, such as a grant to indigent individuals to enable them to purchase furniture.

FUNDING OUTSIDE THE BOX:

Expenditure **Responsibility and Scholarships**

Phyllis Landers is committed to disaster relief and education in Latin America. She decides she wants her foundation to make grants to organizations based in Latin America or, in some cases, directly to local governments in areas where hurricanes, floods, or earthquakes have occurred. She also wants to award scholarships to students in Latin America who want to study civil engineering and medicine and express an interest in applying their skills in Latin America.

When Phyllis brings up the idea at a foundation board meeting, her lawyer explains that the foundation should not just "write a check." He offers a daunting array of precautions:

- If the grant recipient is an organization not recognized by the IRS as a public charity, a grant agreement and other special steps are required under U.S. tax law unless there is an equivalency determination (i.e., that the foreign charity is equivalent to a U.S. public charity).
- Although the tax law does not mandate a grant agreement when the grantee is a foreign government (or a foreign government's agency or instrumentality), it would be prudent for the foundation to put the terms of the grant in writing anyway.
- A scholarship recipient does not have to sign an agreement, but the foundation must instead adopt an objective and nondiscriminatory procedure for the selection of scholarship recipients. This procedure, at a minimum, must:
    1. Require that scholarship winners be selected from a pool sufficiently large to constitute a charitable class;
    2. Enumerate suitable criteria for selecting scholarship winners (for example, academic performance, performance on tests designed to measure ability, aptitude, and motivation, recommendations from instructors, financial need, and conclusions drawn during an interview process concerning ability, character, etc.);
    3. Require that members of the selection committee not be in position to derive a personal benefit if one prospective scholarship winner is selected rather than another one;
    4. Require that the grant either be in the nature of a prize or an award, or for a scholarship for study at an academic institution, or a grant for the achievement of a specified educational objective (producing a report, enhancing an artistic or musical skill or talent, etc.); and
    5. Impose a reporting system, to allow the foundation to monitor the courses taken by the scholarship winner, grades received, degrees attained, articles written, research completed, music composed, etc.
- Before implementation, the scholarship procedure must be filed with the IRS for approval. The procedure is deemed approved if the IRS raises no objections within 45 days.
- Scholarships must be for study at a college or university and must be structured so that they would be excluded from the recipient's gross income — not under current tax law but under the law as in effect until 1986.
- Other rules apply if individuals receive grants that are not scholarships — for example, grants to enhance a scientific or similar skill, to recognize a specific achievement, or to relieve poverty or distress.

Phyllis and the other members of the board discuss these requirements at length and realize that they cannot, as volunteers, adequately handle the workload. The board votes to begin a program of Latin American grants and scholarships — but only after the foundation hires an administrative assistant who can dedicate 1 to 2 days a week to running the program.

FUNDING OUTSIDE THE BOX:

Program-Related Investments

On one of her frequent visits to Mexico, Phyllis Landers meets Juana Lopez, who is trying to revive the local silk-making industry in Oaxaca. During their meeting, Juana explains to Phyllis that there was an indigenous silk-making craft in southern Mexico prior to the Spanish Conquest. However, the industry was suppressed in the 16th Century when the Spanish, from their base in the Philippines, began to ship silk from the Far East to Mexico and Spain. Juana is cultivating silk worms on mulberry trees on her farm, but she says that too little silk is being produced for a viable industry to be established. Fifteen to 20 local women, most without jobs or any education, are being trained to cultivate the silk, harvest it, and make cloth. Juana sells the cloth in local shops, mainly to tourists. Juana says that she sees the potential to hire more people and perhaps eventually operate a profitable business.

At a foundation board meeting, Phyllis proposes that the foundation make a grant in support of Juana's silk-making activities. Several trustees express the view that a grant would not be appropriate, because Juana appears to be operating a business with a profit motive. Phyllis argues that Juana's business probably will never make a profit, or at least not a significant one, and that the real objective of the activity is to restore a craft tradition that died out nearly 500 years ago and to provide job training and jobs in an impoverished region.

One trustee asks whether the idea of a PRI might be appropriate. The trustee explains that "PRI is foundation lingo for program-related investment — an investment no one would ever make except to do good in the world."

After meeting with the foundation's counsel, the board learns that the PRI must be for a purpose that is genuinely charitable and consistent with the foundation's governing instrument. The production of income or gain cannot be a significant motive of a PRI. After a review of the relevant documents and the law, the lawyer concludes that the foundation may make the investment as a charitable undertaking.

After some debate about whether to lend money to the project, in exchange for a promissory note, or to invest in the project, in exchange for a share of the equity, the board selects the second option. The foundation will seek, in exchange, a seat on the board of directors of the new business. The trustees conclude that a seat on the board will enable the foundation to provide ongoing business advice intended to ensure the survival of the new company and will prevent the company from abandoning its initial mandate. Protecting the foundation's investment, the trustees conclude, is not a significant objective of taking a seat on the board.

Although the foundation will own more than 20 percent of the stock in the new business, counsel to the foundation advises the trustees that there should not be any problem with "excess business holdings" so long as the foundation can show that an investment in the business is substantially related to the foundation's performance of its charitable purposes.

Steering Clear of Jeopardy Investments

Investments by a foundation that "jeopardize" its ability to fulfill its charitable purposes may result in the imposition of an excise tax on the foundation and foundation managers who participate in the investment decision. This rule is analogous to the state-law requirement that a foundation's assets be managed "prudently."

According to IRS Regulations, some types of investments will be "closely scrutinized": margin investments, commodity futures, oil and gas wells, "puts," "calls," and "straddles," warrants, and short sales. There are exceptions for donated assets and for investments that are "program-related" — that is, investments made in furtherance of a foundation's charitable purposes.

Ensuring Minimum Distributions

A grantmaking foundation must annually distribute at least 5 percent of its average annual asset value in furtherance of its charitable purposes. The bulk of these "qualifying distributions" ordinarily consists of grants to appropriate grantees, although the reasonable expenses of administration of the foundation (other than investment-related expenses such as manager fees and the legal and accounting costs associated with investment activities) also can be counted toward the minimum-distribution requirement.

A foundation must meet its 5 percent distribution requirement either in the tax year the requirement arises or by the end of the following tax year. The excise tax for failure to meet the annual distribution requirement is imposed only on the foundation.

Paying Tax on Net Investment Income

A foundation's net investment income is taxed at a rate of 1 percent or 2 percent per year. Qualification for the 1 percent tax rate depends on a somewhat complicated calculation linked to the foundation's qualifying distributions in the current tax year, its average qualifying distributions in prior tax years, and its net investment income.

Broadly speaking, a foundation that exceeds its average historical levels for qualifying distributions by at least 1 percent of its net investment income can qualify for a 1 percent, rather than 2 percent, tax on its net investment income.

A foundation cannot qualify for the 1 percent tax rate in its first year of operation. Accordingly, it may be advisable to delay sales that will result in a significant capital gain until the foundation's second tax year — and to make grants in the first and second years sufficient to qualify for the 1 percent tax during the second year. This is the only private foundation excise tax that is not avoidable.

Succession and Changing the Legal Structure of the Foundation

Succession planning is a key aspect of governance. It should be discussed carefully with friends and family and, ultimately, with your legal and financial advisors.

As you consider succession, it's important to ask the following questions:

- Will the foundation remain in the hands of your family?
- Will it be placed in the hands of trusted advisors or employees and the people they select?
- Will it go on perpetually or will it go "out of business" in a generation or two?
- To what extent, if any, should the governing documents limit eligibility for the governing body or the intended "life" of the foundation?
- Are your goals for succession best accomplished using a charitable trust or a not-for-profit corporation?

- Should there be special arrangements if you develop dementia or are otherwise incapacitated for an extended period prior to death?

Many foundations change dramatically after the death or permanent incapacity of the founder. Some divide into multiple foundations, reflecting the geographic dispersion and differences of opinion of the founder's adult children and grandchildren. As a legal matter, the division of a foundation is relatively easy to accomplish, although family discord can complicate the process. The divided foundation enables each branch of the family to pursue its philanthropic goals (and its investment strategies) in the way it sees fit. Such a division should limit opportunities for internecine conflict. If you create a foundation and sense that its division is inevitable, or even desirable given the family relationships, you might wish to leave a letter of instructions outlining your intentions and hopes for the family's future and the future of the foundation. It may be easier for your heirs to endorse the idea of dividing the foundation if you have endorsed it in advance.

A foundation with close ties to a small group of public charities — a favorite university and a favorite museum, for example — might convert into a "supporting organization" of those charities, and in that way enjoy preferred tax treatment as a public charity. A foundation might even pay out all of its assets directly to favorite charities — on the theory that a "middle man" is no longer necessary or appropriate. A foundation lacking wealth of a magnitude that warrants a staff of investment experts and grants officers might conclude, after the founder's death or permanent incapacity, that it should transfer its assets to a community foundation. A community foundation can hold the foundation's assets in a "field-of-interest" or donor-advised fund that furthers the goals of the founder but relieves friends and family of administrative burdens — and should reduce administrative costs as well.

Termination

Should you wish to terminate the foundation, it is important to consult with the foundation's lawyer, as federal and state law require the foundation to follow specific termination procedures.

Summing Up

For the philanthropist who is in the process of creating and running a foundation, the legal issues outlined in this chapter can be distilled into a few basic questions that bear fundamentally on the long-term success of the foundation:

- Have I provided clear guidance about what I envision?
- Have I provided the flexibility that I will need if my charitable goals change with the passage of time?
- Have I defined a mission that is broad enough so that it will endure as long as there is money to fund it?
- Have I structured my philanthropy in a way that best achieves my family's tax and financial objectives?
- Do I understand the "ground rules" well enough to know that I can be comfortable operating within them?
- Have I created a system of checks and balances to ensure that the foundation fulfills its charitable mission and remains in compliance with applicable laws?

Affirmative answers to these questions should result in a solid legal framework for your foundation — an enduring structure that will enable you and your family to accomplish your philanthropic objectives. ■