CHARITABLE FOUNDATIONS FOR THE FAMILY

Family foundations have a strong appeal for generous individuals who wish to have an impact through charitable giving to an array of organizations over an extended period of time and for those who wish to provide family members and others with an opportunity to influence charitable giving now and in the future. Historically, private non-operating foundations have been the vehicles of choice used to establish a family foundation; however there are other alternative methods to establishing a family foundation. A donor advised fund or a supporting organization can effectively function as a family foundation while offering much of the flexibility and appeal of a private family foundation, without many of the regulations, requirements and overhead expenses.

A. Types of Family Foundations

1. Donor Advised Fund

Donor advised funds are among the fastest growing techniques in personal philanthropy. Donor advised funds are most often created through community foundations. A community foundation's mission is to receive donations from individuals, businesses, private foundations, or other charities, and make grants to charities in their community. Many community foundations define their community very broadly, and some will even make overseas grants. They are public charities, not subject to the operating restrictions or donation limitations of private foundations.

Through a written agreement with a charity, a donor creates a fund bearing the donor's name to which contributions are made. The fund can be a permanent endowment from which the principal is not distributed, or a provisional fund that may distribute principal. The terms of the agreement provide the donor (or the donor's children or other designees) the privilege of making non-binding recommendations regarding charitable distributions the charity makes from the fund. Although each foundation will have it own procedures in place for a review of grant requests, usually the recommendations of the original donor are followed.

Since the donor makes contributions directly to the charitable organization maintaining the fund, they are treated as charitable contributions to a public charity rather than gifts to a private foundation. Because the fund is an account of the charity, it is not required to file separate tax returns or accountings, and is not subject to private foundation rules. The key factor for the donor is that the continuing relationship to the fund is advisory only.

2. Private Foundation

The best known entity for deferred giving is the private foundation. In general, a private foundation is a charitable organization established so that the donor can control, to the fullest extent possible, the use of donor's charitable dollars. It may be formed as a corporation, or less commonly, as a trust.

A private foundation is a charity that does not receive contributions from numerous unrelated individuals but, instead, receives most of its financial support from one family or business. There are two types of private foundations:

a. Private non-operating foundations. A private non-operating foundation's charitable activity consists of making grants to other charitable organizations.

b. Private operating foundations. A private operating foundation actively engages in a physical activity (e.g., the Getty Art Museum).

Most private foundations are non-operating foundations. This outline will limit its discussion on private foundations to non-operating foundations.

3. Supporting Organizations
A supporting organization is a foundation organized as a corporation or trust whose organizing documents require it to support one or more public charities. A supporting organization is classified as a public charity rather than a private foundation because it "supports" one or more publicly supported charities. It is one of the few organizations that receive the benefits of public charity status for tax deductibility and operation without having to satisfy the public support test. A supporting organization can be classified as a public charity, even if there is only one donor, or one family of donors. The feeling is that the scrutiny that is provided by the public charity on the supporting organization is enough public scrutiny to exempt it from the private foundation rules and regulations.

To qualify as a supporting organization, a foundation must meet an organization test, an operational test, and a relationship test.

a. Organizational and Operational Test. Organizational documents must specifically state that the supporting organization is organized exclusively for the benefit of one or more public charities that are specified in the organizational documents.

b. Control Test. The donor (or the donor's family) cannot control the foundation (i.e., 50% or more of the voting power of the governing body must be in the hands of non-family members).

c. Relationship Test. A supporting organization must stand in a defined relationship with one or more public charities. Due to the available variations, this is the most complex of the three tests for qualification as a supporting organization. The test may be met with one of three types of relationships.

(1) "Parent-Sub" Relationship. A majority of the governing body of the foundation must be appointed by the supported charity or charities.

(2) "Brother-Sister" Relationship. There is common supervision or control of the foundation and the supported charity or charities.

(3) "Operated in Connection With". The "operated in connection with" test requires that through its operations, the foundation does either one of the following:

(a) Engages in activities that the publicly-supported charity would otherwise do itself but for the supporting organization, or

(b) Distributes 85% or more of its income to or for the use of the publicly-supported charity in such a way that the publicly-supported charity is "attentive" to the supporting organization.

B. When Should a Donor Advised Fund Be Considered?

1. Desire to Establish an Endowment
The donors would like to establish a fund or endowment for the purpose of making future donations to charities.

2. Desire to Pass on Philanthropic Values to Family Members
The donors want to expose their children or grandchildren to the joys and responsibilities of philanthropy. Within limits, donors can involve their families as advisers to their funds - donor advised funds can be advised by someone other than the donor, such as a spouse or descendant. Depending on the rules of the foundation, the fund can exist for more than one generation to pay out income.

3. Easy to Establish and Maintain
Donors do not want to incur the time and expense of establishing and administering a private foundation or supporting organization. There are no legal fees to establish a trust or corporation or to apply to the IRS for tax-exempt status. A donor advised fund can be set up in less than half an hour. Annual administrative costs are usually lower than those of private foundations or supporting organizations because of economies of scale and the absence of a separate annual tax return.

4. Desire to Benefit a Charity Over a Period of Time
The donors want to make a large donation to a specific charity, but do not want to make the donation unrestricted, or want to limit the use of the income to specific programs. Perhaps the charity is not in a position to manage a large endowment. The community foundation will be around in perpetuity to manage the funds and pay out the income.

5. Use of Community Foundation's Staff
Donors want to take advantage of the staff of the community foundation who can give advice regarding programs and needs within their community.

6. Desire to Remain Anonymous
The donor wishes to remain anonymous. The foundation must know who the donor is, but the ultimate charitable recipient need not know.

7. No Management Responsibility
Donors do not want to be burdened with the responsibility of managing endowment investments. Funds are under consolidated investment management, which can provide a better return with lower costs through economies of scale.

8. Annual Cost
Costs are minimal, usually set by the community foundation on a breakeven basis, although the

community foundation may require that a small percentage of contributions be set aside in the community foundation's unrestricted fund.

9. Practical Minimum Size
It depends upon the community foundation's policy, but the minimum donation is often between $10,000 and $25,000.

C. Disadvantages of Donor Advised Funds

1. Advisory Role Only
The community foundation or other public charity has legal control over the fund. The donor only has an advisory role, although the community foundation usually follows the donor's advice substantially all of the time.

2. Limited Control Over Investments
The funds are owned by the community foundation and therefore the community foundation has control over fund investments. However, some community foundations allow the donor to select among asset allocation models for their donor advised fund.

3. Ability to Continue for Future Generations
Depending on the community foundation, the donor's family may not be able to continue to advise in perpetuity (i.e. some funds may revert to the general fund of the foundation after a number of years or generations.)

4. Certain Assets May Not Be Accepted
Certain types of assets may not be acceptable to proprietary funds, e.g., any closely-held stock that will not be redeemed promptly, real estate, or timber property.

D. When Should a Private Foundation Be Considered?

1. Control
The donors retain complete control over charitable dollars. The governing board of the foundation can be completely comprised of the donors and/or their family. Therefore, all decisions regarding grants and investments of foundation assets can be in the hands of the donor and/or the donor's family.

2. Increased Ability to Involve Family Members
Private foundations (as with supporting organizations) can provide an organized structure for a family's charitable activities. No matter which family member funds the foundation, any family member can be on the board and/or grant committee. Grant committee meetings can be a way of renewing family ties as well as passing on the family's sense of social responsibility to the next generation. Especially after a family business is sold, a family foundation may be the best reason for a family to continue to meet for a common purpose. Even if the family's business is ongoing, a family foundation can involve family members who do not participate in the business.

3. Perpetuating Donors or Donors' Family Name
If the donors have a strong desire to perpetuate the family name (or name of the family business)

through successive generations, private foundations (as well as supporting organization) are preferred charitable vehicles.

4. Avoids Direct Solicitations
The donors of private foundations (like those of supporting organizations) may avoid direct charitable solicitations by referring requests "to the Foundation Board."

5. Practical Minimum Size
Although there is no required minimum amount necessary to set up a private foundation, due to the cost of establishing and administering the foundation, a private foundation is usually not considered unless the donors expect to fund the foundation with at least $100,000 to $200,000 over the first few years.

E. Disadvantages of Private Foundations

In addition to the factors listed below, if the donor is not interested in being involved in running a family foundation, a donor advised fund at a community foundation is a better choice. This is also true if the donor has no heirs that will be interested in continuing the organization after they are gone.

1. Cost to Establish and Administer
A private foundation requires formation of a corporation or trust and establishing tax-exempt status as a private foundation. On-going administration includes substantial record keeping, filing of annual tax returns and implementing grant approval procedures.

2. Limitations on Charitable Income Tax Deduction
Income tax charitable deduction limitations are much more favorable to donor advised funds and supporting organizations, which receive the same tax benefits as public charities.

a. Deduction May Be Limited to Tax Basis Contributions to a private foundation of assets other than cash and publicly traded stock are limited to the tax basis of the assets (not the fair market value of such assets).

b. Adjusted Gross Income (AGI) Limitation. The charitable deductions for contributions to a private foundation for any given year are limited to 30% of adjusted gross income (AGI) for cash contributions and 20% of AGI for non-cash contributions. Contributions to donor advised funds and supporting organizations can be deducted up to 50% of AGI for cash contributions and 30% of AGI for non-cash donations. Any contributions in excess of the limits for private foundations (and donor advised funds and supporting organizations) can be carried forward for five years.

3. Annual Distribution Requirements
Private foundations are required annually to make grants equal to 5% of the average monthly balance of the foundation's assets regardless of annual income. Meeting this requirement may be difficult for a foundation that is funded with illiquid assets.

4. Excise Tax
A private foundation is required to pay an annual excise tax equal to 2% of the foundation's investment

income, including capital gains. If grants from the private foundation increase each year, it is possible to reduce the excise tax to 1% of the foundation's income.

5. Prohibition Against Holding Stock of Closely-Held Business
A Private foundation cannot hold (beyond a five-year period) stock of a closely-held business which is owned by the donor.

6. Prohibition Against "Jeopardy" (i.e. Risky) Investments
A private foundation may not invest in so called "jeopardy" investments. Such investments typically include general partnership interests (due to the unlimited liability risk), options, puts and calls, etc.

7. Prohibition Against "Self-Dealing" Transactions
A private foundation is prohibited from engaging in certain transactions with the donor such as selling or leasing assets or making loans to or from the donor even if the transaction is at fair market value. Compensation can be paid to the donor or the donor's family for services rendered to the foundation if the compensation is reasonable; however, under California law, such compensation can only be paid if a majority of the members comprising the foundation's governing body are not family members.

8. Privacy
Private foundations are required to file tax returns which disclose grants, investment fees, and staff salaries. The tax returns are public records. Information from tax returns are compiled in grant seeker directories.

F. When Should a Supporting Organization Be Considered?

Donors who desire to operate a separate independent philanthropic entity but do not want to incur the tax and other limitations associated with private foundations (discussed above) should consider establishing a supporting organization. However, supporting organizations are subject to the following two requirements not associated with private foundations:

1. Only Listed Charities May Be Supported
Private foundations may make grants to any public charities. Supporting organizations may only make grants to the charities listed in the organization's governing documents; however, the governing documents of a supporting organization may list numerous charities, including a community foundation, as potential beneficiaries, which allows the donor, at least indirectly, to gift to any number of public charities.

2. Voting Control Must Be Vested In Non-Family Members
Family members may comprise a majority of the private foundation's board. With supporting organizations, at least 51% of the voting power of the board must be vested in non-family members. However, it is possible to structure a supporting organization so that the family members have "practical" control of the board.

G. Advantages of Supporting Organizations Over Private Foundations

1. "Public Charity" Status for Charitable Deduction Purposes
The charitable income tax deduction for contributions to a supporting organization are only subject to the "public charity" income tax limitations (i.e., (1) deductions are based on "fair market value" not "tax basis"; (2) deductions can be taken for up to 50% of adjusted gross income). This benefit can be particularly important if the client, in the future, wishes to donate assets other than cash or publicly traded stock to the foundation.

2. No 5% Distribution Requirement
The requirement that private foundations annually distribute an amount equal to 5% of trust assets to charities is not applicable to supporting organizations. However, certain types of supporting organizations are required to pay out 85% of the organization's income.

3. No Excise Tax
Supporting organizations are not subject to the private foundation excise tax (i.e., 1% to 2% of investment income).

4. Can Contribute Stock of Closely-Held Company
Unlike private foundations, there are no limitations on contributing stock of a closely-held business to a private foundation.

5. More Flexibility On Types of Investments Allowed
Supporting organizations are not subject to the prohibition against "jeopardy investments" (e.g. general partnership interest, etc.).

6. Not Subject to "Prohibited Transaction" Rules
Supporting organizations are not subject to the "prohibited transaction" rules that are applicable to family foundations organized as private foundations. Supporting organizations can engage in economic activity with their donors. (Of course, like any other charity, they cannot provide any private benefit).

7. Record Keeping
Private foundations typically require more extensive record keeping than supporting organizations in order to keep track of such things as (i) the average value of "non-charitable use" assets and (ii) "net investment income." Such record keeping is in addition to the normal requirements of keeping track of all receipts and disbursements.

H. Disadvantages of Supporting Organizations

As mentioned above, supporting organizations have the following disadvantages:

1. Supporting organizations may only make grants to charities listed in their governing documents; and

2. At least 51% of the voting power of the supporting organization's board must be vested in non-family members.