FOUNDATIONSOURCE

KEY TAKEAWAYS

Pivotal Philanthropic Stages:

A Look at the Lifecycle of a Foundation

The decision to establish a private foundation is without a doubt a transformative milestone. But it's just the beginning of the journey. There are so many crucial decisions that founders must make in those early days, all of which will guide a foundation throughout its lifecycle and enable it to carry out its philanthropic mission.

Whether it's determining the ideal legal structure, establishing the necessary operational frameworks or ensuring tax compliance, these choices lay the groundwork for a foundation's enduring success. Thankfully, foundations can lean on experts, such as those from Foundation Source, to guide them throughout the process.

In a recent Foundation Source webinar, **Jeffrey Haskell, our chief legal officer,** detailed the many considerations that funders must navigate at different junctures. These are **five** crucial decisions that foundations should undertake throughout their lifecycles. The discussion was moderated by **Susan Lipp, editor-in-chief of Trusts & Estates magazine.**

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DECISION 1 What will the foundation's legal structure and purpose be?

The key decision for any new foundation revolves around its legal structure. Foundations face the all-important choice between adopting a trust or a corporate structure and each one comes with its own set of pluses and minuses.

Trusts, which adhere to stringent fiduciary standards, operate under complex rules and regulations. Corporations, on the other hand, enjoy a high level of flexibility. Additionally, each legal form is subject to different tax rates regarding unrelated business taxable income (UBTI). All these considerations could sway the decision-making process around which legal form to adopt.

In addition, foundations must also define their mission and purpose, whether that's broad or narrow. However, depending on the legal structure, it may be possible for future boards to revise that. For instance, corporate foundations can't lock in their philanthropic purpose, while trusts can. A trust's governing instrument can only be changed with a court's approval, unless the trust's terms expressly permit its revision.

DECISION 2 How will the foundation be funded?

Board members are responsible for making sure that investments are prudent. They must carefully review prospective investments beforehand and regularly review the foundation's investment portfolio to see if adjustments must be made.

Because foundations have a 5% minimum payout requirement, board members should be on the lookout for investments that will produce enough return to meet that minimum. Relying solely on investments might not cover these operational expenses if the bulk of investments are in non- or low-income producing illiquid investments.

To have an accurate accounting of how much the 5% annual payout requirement is, foundations will need to obtain detailed annual valuations if they hold assets beyond cash and publicly traded securities.

DECISION 3

How will the foundation avoid self-dealing and other violations?

Foundations are subject to strict self-dealing regulations, which generally prohibit transactions between a foundation and its insiders. Any self-dealing penalties must be paid by the self-dealer, not the foundation.

When it comes to corporate foundations, there must be clear distinctions between corporate employees' roles and foundation activities. These lines can be blurred because corporate employees sometimes wear two hats when foundations are run by existing employees of the corporate parent. Therefore, it's important to be clear about which capacity they're active in and when.

Self-dealing rules can be complicated. Even seemingly beneficial transactions can still be considered self-dealing if they are between insiders and the foundation. For example, a foundation paying rent to a corporate parent, even if it's below market value, would still be considered self-dealing.

DECISION 4

How will the foundation navigate legal complexities?

To ensure that a foundation is operating according to all its legal requirements and in a way that fulfills its purpose, it's important to have clearly written policies. These can guide both day-to-day operations as well as provide an operational framework.

Furthermore, it's important to understand the differences between non-operating and operating foundations and how to meet the specific tests for operating foundation status, if applicable. The main difference between operating and non-operating foundations is that non-operating foundations typically fund programs run by other organizations (although they can conduct their own direct charitable activities). Operating foundations, meanwhile, run their own charitable projects or programs. The benefit of being an operating foundation is that you can offer donors more favorable charitable deductions.

Private foundations that don't have the specialized staff, or legal and financial expertise within their own ranks, should consider bringing in external professionals. Work with accountants who are well-versed in form 990-PF, the annual tax return form filed by private foundations. For example, it takes specialized knowledge to understand how to calculate the 5% annual payout requirement, and it may not be something that foundation staff or officers will be able to do on their own.

DECISION 5

What will guide board governance and responsibilities?

While officers, employees and managers of a foundation oversee the day-to-day operations, board members focus on high-level strategy, oversight and compliance. Board members bear three types of fiduciary duties: the duty of care, the duty of loyalty and the duty of obedience.

Beyond fiduciary duties, board members must also navigate complex governance dynamics. They are entrusted with decisions about board size, member selection and succession planning. While some states set parameters around board composition, many do not. As a result, the task of organizing their foundation's board falls directly on individual boards themselves.

One pivotal decision concerns the compensation of board members. Opting to compensate board members necessitates a transparent and fair process. To avoid conflicts of interest or the perception of a conflict, be sure to establish clear criteria and guidelines that adhere to industry standards. Additionally, because excess compensation paid to any insider, including board members, can result in a self-dealing violation and/or a taxable expenditure violation, it's important that the foundation determine the appropriate level of compensation in accordance with applicable IRS regulations.

To learn more about these key decision points, listen to the full conversation here.

HAVE A QUESTION?

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