FOUNDATIONSOURCE

WEBINAR

Pivotal Philanthropic Stages:

A Look at the Lifecycle of a Foundation

Q&A

Establishing a private foundation is the beginning of a journey full of crucial decisions. Every step requires careful consideration to set the foundation up for success throughout its lifecycle.

Initially, selecting the appropriate legal structure is the top concern. Later, crafting the optimal operational frameworks to realize the funders' philanthropic intent becomes paramount. Throughout, foundations must navigate tax and legal requirements so they ensure compliance and longevity. And if funders choose to terminate their foundations, there is a complex set of regulations to do so in a tax-efficient way.

These choices not only allow foundations to operate in compliance with state and federal requirements, but they also define a foundation's purpose and mission, allowing funders to have the philanthropic impact they envision.

In a recent Foundation Source webinar, **Jeffrey Haskell, our chief legal officer,** detailed the many considerations that founders must navigate throughout their foundations' lifecycles. **Susan Lipp, editor-in-chief of Trusts & Estates magazine**, moderated the discussion.

JEFFREY D. HASKELL
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What is the first decision foundations must make early on in their lifecycle?

Haskell: One of the very first decisions you'll need to make is which legal form your foundation should take. There are several differences between a foundation formed as a trust and one that's formed as a corporation. For instance, trustees are held to a higher fiduciary standard than the directors of a corporation.

Another consideration is taxes, specifically if a private foundation has investments that generate significant unrelated business taxable income or UBTI. Trusts generally have higher tax rates for ordinary UBTI, but they have a lower tax rate on capital gain UBTI. Further, foundations set up as a corporation can offset up to 10% of UBTI with grants to U.S. charities, although trusts can offset up to 50% of the UBTI.

After you've decided on your legal structure, what must you do next?

Haskell: You need to define your foundation's purpose. You have the option of defining the purpose very broadly or you can define it very narrowly, for example, choosing to support cancer research.

For foundations formed as a corporation, it's important to understand that their governing instruments can be amended by future boards. Therefore, locking in the foundation's purpose can't really be accomplished by specifying that purpose in the certificate of incorporation. On the other hand, a trust's governing instrument can't be revised without a court's—sometimes even an attorney general's—approval, unless the trust's terms expressly permit its revision.

While a corporation's certificate of incorporation can be subject to future revision, a restricted gift to the foundation is generally binding. For example, if there's a restricted gift that can only be used for a specific purpose like cancer research, that is binding, even if a corporation's governing instrument otherwise permits the foundation to engage in a very broad range of charitable activities.

In addition, you need to decide whether the foundation should exist in perpetuity or only for a specified span of years.

What are the compliance considerations foundations should be thinking about as they begin their journey?

Haskell: First, the foundation should be tracking its substantial contributors and other individuals and entities who are considered disqualified persons. That will help the foundation avoid running afoul of the IRS's self-dealing rules, which generally prohibit transactions between a foundation and its insiders. That also helps avoid violations of the excess business holding rules, which limit the combined holdings that a foundation and its insiders, also called disqualified persons, can have in an active business.

There might be compliance issues around cash flow. For example, these issues can arise if the bulk of a foundation's investment portfolio consists of non- and low-income producing illiquid holdings. The portfolio may not provide enough cash flow to cover the foundation's ongoing operating expenses, like its annual minimum 5% payout requirements and tax bills.

Finally, keep in mind that any assets other than cash and publicly traded securities require ongoing annual valuations to prepare the foundation's annual return, but a qualified appraisal of real estate can last up to five years.

What are the specific considerations for corporate foundations around self-dealing?

Haskell: Self-dealing rules prohibit transactions between the foundation and its insiders, with some exceptions. When a for-profit company starts a corporate foundation, it's often run by existing employees of the corporate parent. Because these individuals serve in dual roles, it's important to be clear which capacity they're acting in.

For example, someone who is wearing both the foundation's and the company's hats buys a table at a charity fundraiser and gives those tickets to the company's top clients. Suppose that the charity mistakenly invoices those tickets to the foundation. If the foundation were to pay that invoice, a self-dealing violation would result.

Another major violation is using the corporate foundation's assets to drive business opportunities to the parent company.

One understandable misconception is thinking that the company can charge the foundation rent. Unfortunately, self-dealing will result from the foundation's payment of rent to the corporate parent, even at a discounted rate. That said, a foundation may be able to pay third-party vendors for the foundation's share of expenses that are attributable to its use of the rent-free space that is owned by the corporate parent.

In all these cases, if self-dealing penalties are due, they must be paid by the self-dealer (here, the corporate parent), not the private foundation.

What should family foundations be keeping in mind?

Haskell: Most private foundations are family foundations, where they're funded by one or more members of the family. Some family foundations even make family membership an eligibility criterion for board service. But foundations need to decide whether spouses and stepchildren are considered family for these purposes. This could be a particular concern in the event of a divorce.

Another thing to keep in mind is that there may be more than one generation of the family involved. While this could be considered a wonderful opportunity to get both the younger and older members of the family together, differing opinions and perspectives among the generations can sometimes lead to conflict.

Also, unlike corporate foundations, family foundations are less likely to have an accountant or investment advisor. They may need to bring in outside professionals for these important tasks.

What are the differences between operating and non-operating foundations?

Haskell: The main difference between operating and non-operating foundations is that non-operating foundations generally fund projects and programs run by other organizations (although they can conduct their own direct charitable activities), and operating foundations run their own charitable projects or programs.

The benefit of being an operating foundation is that you can offer donors more favorable charitable deductions. That can make the difference between a fair market value charitable deduction versus a deduction that's limited to basis.

To meet the requirements for operating foundation status, the foundation must meet certain tests, specifically an income test as well as one of three other tests: assets test, endowment test and support test. The foundation must satisfy these tests for any three years during a moving four-year window.

What should foundation leaders know about setting up their boards?

Haskell: The job of board members is to focus on high-level strategy, oversight and accountability. That contrasts with the officers, employees or managers who oversee the day-to-day operations. Three types of fiduciary duties board members have include:

- ensuring prudent use of all assets
- the duty of loyalty
- placing the foundation's interests ahead of their own

When it comes to board size, states have varying minimums. For example, Delaware requires only a single director, while California requires at least three.

As for selection, consider which skills and personality traits are necessary to run the foundation well. Some foundations formed as corporations impose term limits for officers so that family members can rotate through different positions on the foundation.

For family foundations with young children, the creation of a junior board can be a great idea. Although not directors, junior board members can assist in identifying charities or researching grant requests, so they feel like they're making a meaningful contribution to the foundation's work.

Finally, consider the issue of succession. Succession protocols can be set up in the foundation's governing instrument. For a trust, one or more individuals may be designated as successor trustees, whereas with corporations, successor directors may be designated in a board resolution.

What are some administrative issues that foundations need to tackle?

Haskell: An important aspect of private foundation operations is ensuring that the foundation has clearly articulated written policies, which guide the day-to-day operations. Without written policies, things can go off the rails quickly.

Also, foundations should work with accountants who are very well versed in form 990-PF, which is the annual information return filed by private foundations. For example, knowing how to calculate the 5% payout requirement takes specialized knowledge.

In addition, foundations need a game plan for ongoing compliance monitoring because the rules aren't always intuitive. Foundations must be mindful of the IRS's excess business holding rules, which limit the percentage of ownership in a business enterprise that foundation insiders may have. That's tricky because insiders aren't necessarily only those serving in the foundation. They may be family members who are not serving, too.

Additionally, the foundation will need to conduct basic charity research to determine the tax status of potential grantees before disbursing grant funds. Bear in mind that certain grants to individuals and organizations can result in violations known as taxable expenditures if they are made without following certain procedures, even if the purpose is charitable. Of course, any expenditure for a non-charitable purpose can also result in such a violation.

Once grants are approved, you should consider monitoring or having some sort of impact measurement, such as requiring reports.

What do foundations need to keep in mind about investments?

Haskell: The board must oversee the foundation's assets and ensure that they're being invested prudently. Prospective investments must be carefully reviewed beforehand and the portfolio should be reviewed regularly.

In a similar vein, the foundation will want to ensure that its accounts are reconciled regularly, ideally monthly, to ensure accurate records. This will be important for tax return preparation.

What happens if the board wants to change the foundation's structure?

Haskell: At some point, the board may want to convert the foundation to a public charity. To do that, the foundation has to notify the IRS, and then prove after 60 months that the organization met the public support test that public charities need to satisfy on an ongoing basis. If the foundation fails the public support test at the end of that 60-month period, the foundation has to pay the foundation excise taxes for any year in which it failed the test.

Unlike converting from a private foundation to a public charity, converting from a non-operating foundation to an operating foundation is pretty straightforward. There is no need to notify the IRS in advance. The foundation can simply fill out the applicable sections of the 990-PF and meet the required operating tests. If an operating foundation fails the applicable test, it defaults to non-operation foundation status.

Lastly, if the foundation is looking to terminate its foundation status, it's important to be aware that it may be subject to a termination tax. The foundation won't owe a termination tax if there are no assets left, if it distributes all of its assets or if it successfully converts to public charity status.

Should foundations compensate officers, directors and trustees?

Haskell: It can be done compliantly if approached carefully. If the board decides that board members should be compensated, the foundation should craft compensation and reimbursement policies. These policies should cover the rationale for paying compensation, job descriptions and which expenses will be reimbursed.

Of course, there's an inherent conflict of interest when the board wants to determine compensation for themselves or for family members serving on the foundation. If there's no independent unpaid board member, the foundation should consult with counsel.

If a foundation is found to pay unreasonable compensation, it could be subject to a 20% taxable expenditure penalty on that portion of the compensation found to be unreasonably excessive. And the manager could be personally liable for a 5% penalty on that unreasonable portion. Additionally, because officers, directors, and trustees are considered insiders, or disqualified persons, with respect to the foundation, self-dealing penalties would result as well and those penalties will be owed by the insider personally, not by the foundation.

What are the financial considerations of establishing a private foundation versus a donor-advised fund (DAF)?

Haskell: If you have less than $1 million to devote to your philanthropic activities, a donor-advised fund might be the best way to do that. A donor-advised fund can be a placeholder if you are expecting a bequest, or some sort of liquidity event, at a later date.

Can a private foundation donate funds to a donor-advised fund?

Haskell: A foundation can contribute to a donor-advised fund. After all, a DAF is an account at a public charity. One alternative to board compensation could be to set up discretionary granting for board members or officers. Maybe a board member or officer wants to fund something that doesn't align with the foundation's charitable mission. It can be appropriate to fund a donor-advised fund and let them make grants out of that account.

Can 501(c)(3) nonprofits donate funds to 501(c)(6) nonprofits?

Haskell: This would be a donation from a private foundation to a 501(c)(6) entity, which could be something like a business league such as a Rotary Club. While these may be exempt organizations, they aren't dedicated exclusively to charitable purposes.

If it wishes to support a particular charitable project of the 501(c)(6), a foundation can make a grant to the organization for that specific purpose, provided that it exercises expenditure responsibility, which is due diligence and oversight over the grant funds to make sure they are spent as intended.

To hear more of Jeffrey's insights, listen to the full webinar.

ABOUT FOUNDATION SOURCE

Foundation Source **empowers people and companies to create a better world** through philanthropy. As the nation's largest provider of foundation management services, we're a trusted source for philanthropic expertise. We invest in industry-leading technology for private foundations and offer a configurable suite of administrative, compliance, tax and advisory solutions that meet you where you are in your philanthropic journey.

For more than two decades, we've worked with individuals, families, boards and professional advisors to preserve legacies and make giving easier. Today we are proud to support **more than 2,000 unique foundations** and have facilitated over **$10 billion in charitable aid.** With a 98% retention rate, we are honored to have earned the trust and loyalty of our clients.

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