

Rethinking Family Foundations: What's the Optimal Structure

By Claudia B. Sangster
Director, Philanthropy, Estate & Trust Services



For years, private family foundations have rewarded those who operate them in a variety of ways.

They help families focus their giving on issues that matter to them, so they can turn affluence into influence. They are a vehicle to educate new generations about the opportunities and responsibilities of wealth—and of the importance of managing it deliberately. Altruism aside, they also allow families to realize tax advantages and certain other non-financial benefits such as creating a platform for family communication and a training ground for teaching the skills the next generation of inheritors will need to manage their own wealth.

But when the economy faltered in 2008, so did the fortunes of many of the 75,000-plus grant making private foundations started by wealthy individuals and families to advance their charitable objectives. Flat or negative investment performance has driven down asset values and has caused many foundations to scale back their giving. At the same time, a GuideStar June 2010 survey reports that the volume of grant appeals that foundations receive has increased by 41 percent.¹

In the mean time, many families have also discovered that running a foundation is more than an exercise in check writing; foundations are businesses whose administration is more complicated and demanding than their founders anticipated. For example, foundations face a maze of complex compliance and operational rules and mandates that expose families to financial risks. Plus, missions, processes and procedures require periodic scrutiny to ensure that the foundation continues to operate effectively. As the future unfolds, founders must either adopt sunset provisions or develop the next generation of leaders.

As a result, many families are now reevaluating both their foundations and their capacity to give, and they're looking for more flexible, efficient and cost-effective ways to help others. The solutions they find can enable them to achieve their personal and family objectives through a vehicle that best serves the family's interests.

¹ "The Effect of the Economy On the Nonprofit Sector," a June 2010 Survey released by GuideStar USA, Inc. on August 16, 2010 [a survey of 6,434 public charities and 850 private foundations].

A COMPLEX ENVIRONMENT

Many established private family foundations operate effectively and efficiently because families understand, accept and adhere to both their own philosophic and operating parameters and the financial regulations that govern them. The most successful family foundations have invested the time to create a solid infrastructure that focuses activity and facilitates decision making.

For example, they have established a mission statement or have developed concise giving guidelines to identify potential grantees, solicit appeals and efficiently filter requests. They adhere to a disciplined process for performing due diligence on potential grantees, for measuring the outcomes of projects funded and for sharing knowledge and experience with the non-profit world. They also plan for the future. That means developing a clear succession plan, and for many family foundations, establishing junior boards to give next generation family members both exposure to administrative responsibilities and input into decision making.

These same internal and regulatory guidelines require constant vigilance. As new generations begin to make grant making decisions, conflicts may arise when individuals develop their own agendas that fall outside the parameters imposed by the founders. Some families also express concern that filing the required annual tax return compromises their privacy. And others discover that the administrative, legal and accounting expenses they incur deplete too much of the foundation's assets and leave less funding available for grant making.

For example, the IRS requires foundations to file an annual federal return, and many states require their own return. The IRS also mandates an annual minimum distribution of five percent of the value of the non-charitable use assets (typically the investment assets) and imposes significant penalties for non-compliance. What's more, additional penalties may arise if a family member unwittingly violates complex self-dealing rules. For example, by law, a "disqualified person" associated with the foundation cannot benefit from a foundation gift, nor can she sell an asset to the foundation—even at a reduced price.

"The most successful family foundations have invested time to create a solid infrastructure that focuses activity and facilitates decision making."

ATTRACTIVE ALTERNATIVES

What can families do if they become overwhelmed by the responsibilities of operating a private foundation? They have clear alternatives to consider. One option is to conclude that the family is not cut out to be a “charity operator,” close down the foundation and go back to check writing. A second alternative is to outsource all or some of the foundation’s operations to one of the many firms that specialize in foundation management. Some consultants offer menu-driven services that allow families to select and pay for only the features they require. For example, it is not unusual for foundations to outsource the day-to-day administrative and compliance functions so they can concentrate on grant making—typically their reason for being and their most satisfying activity.

Another practical alternative is to transfer the foundation’s assets to a charity that sponsors donor-advised funds. With this strategy, the family can still participate in the grant making process by researching and recommending grants.

Though they cannot make final decisions on specific awards (because only the sponsoring organization has the legal authority to do so), such sponsors will typically agree with the grant recommendation as long as the organization is a qualified public charity. As advisors to the donor-advised fund, there are also other privileges that a family or a family foundation can retain. For example, they can make investment recommendations for the assets in the donor-advised fund that align with both their interests and values and the projected time horizon for making grant recommendations. They can also name successor advisors so that the fund can last beyond the life of the original funders. Most importantly, families can leave the administration to others—a benefit that many in our fast-paced society are happy to give up.

What's more, donors can give other assets beyond cash and marketable securities and obtain higher tax benefits than they can when giving the same asset to a private foundation. For example, a gift of privately held stock to a private foundation limits the donor's deduction to the lesser of the donor's basis in the stock or fair market value, whereas the contribution of that same stock to fund a donor-advised fund allows the donor to use the fair market value of the stock as the measure of her charitable income tax deduction. Giving privately held stock to a donor-advised fund may also allow the donor to utilize the charitable income tax deduction more quickly. Assuming the donor has held the privately-held stock for more than a year (i.e., it is long-term capital gain stock), the donor can use the income tax deduction in the year of the gift up to 30 percent of adjusted gross income (AGI).

Conversely, that same gift to a private foundation only allows the deduction to be used up to 20 percent of the donor's AGI and (as mentioned above) only to the extent of basis. If a donor is looking to maximize the charitable income tax deduction at the time of the gift, and the asset is not marketable securities or cash, she should consider a donor-advised fund as the optimal vehicle for giving.

“What can families do if they become overwhelmed by the responsibilities of operating a private foundation?”

WEIGHING THE OPTIONS

To determine what structure best suits their individual circumstances and needs, families should consider the following questions:

- How much time are you able to devote to running a foundation business?
- Do you envision next-generation family members administering or otherwise contributing to the foundation?
- How much control do you want over the specific grants the foundation awards and the investment decisions?
- How much do you value privacy and anonymity?
- How important are the tax benefits that a foundation provides, and how comfortable are you with the tax provisions the government requires?

As a matter of course, families should reassess their existing philanthropy structures periodically, just as they review their investment strategies when market dynamics change. Their decision to continue as a “charity operator” depends on many factors—from administrative costs to the ability of future generations to provide leadership and support. If the family decides to turn to a different model, a donor-advised fund is an alternative well worth exploring. In the final analysis, family philanthropy is all about doing good and making a difference—and accomplishing these objectives in the most meaningful and strategic manner possible.

“In the final analysis, family philanthropy is all about doing good and making a difference...”

Claudia B. Sangster is Director of Philanthropy, Estate and Trust Services with Harris myCFO, Inc., a service within the Harris Private Bank. Ms. Sangster has more than 29 years of professional experience in delivering comprehensive family office solutions in estate, philanthropy and trust planning, and in counseling clients on sophisticated tax saving and wealth preservation strategies.

Harris myCFO is dedicated to managing the complex issues that face individuals and families of significant wealth by delivering the guidance and services of a comprehensive family office, along with the freedom to use your own trusted advisors and other best-in-class service providers.

Harris myCFO offers expertise in all areas of wealth services: Income Tax Planning & Compliance, Investment Advisory, Estate & Trust Planning, Risk Management & Insurance, Philanthropy, and Expense Management & Financial Reporting.

Harris myCFO™ is the brand used by Harris myCFO, Inc., providing family office services, Harris myCFO Investment Advisory Services LLC, an SEC-registered investment adviser, and certain divisions of Harris N.A. and its affiliates that are national banks with trust powers. Not all products and services are offered in every state and/or location.

Harris Private Bank is a trade name used by various financial service providers in Harris Financial Corp. Banking products and services are provided by Harris N.A., The Harris Bank N.A. and their bank affiliates. Member FDIC.

United States Department of Treasury Regulation Circular 230 requires that we notify you that, with respect to any statements regarding tax matters made herein, including any attachments, (1) nothing herein was intended or written to be used, and cannot be used by you, to avoid tax penalties; and (2) this document is written to support the promotion or marketing of the transaction(s) or matter(s) addressed herein. Further, to the extent any tax statement or tax advice is made herein, Harris N.A. does not and will not impose any limitation on disclosure of the tax treatment or tax structure of any transactions to which such tax statement or tax advice relates. Harris N.A. does not provide legal advice to clients. You should review your particular circumstances with your independent legal and tax advisors.

This presentation is for informational purposes only and is not sufficient to form any basis or financial planning decision. **Please consult with your advisor in regards to your own personal situation.**

Alternative investments, including derivative instruments, involve a high degree of risk, often engage in leveraging and other speculative investment practices that may increase the risk of investment loss and can be highly illiquid.

Please contact us for more information and/or for additional white paper titles or copies.

We look forward to the privilege of serving you.

For more information, visit us at harrismyCFO.com or call 1-877-692-3611.

