

THE EFFECTIVE DONOR

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STARTING  
A PRIVATE  
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FOUNDATION

CARRYING OUT

THE DONOR'S

INTENT

PAUL K. RHOADS  
STEPHANIE H. DENBY

## THE EFFECTIVE DONOR

The Effective Donor, a series of monographs and studies in philanthropy published by the Philanthropy Roundtable, focuses on the “how to” of effective grantmaking and foundation formation. These publications offer timely advice and perspectives on the practical challenges of grantmaking. This series emphasizes the importance of donor intent, as well as effective giving strategies that promote well being through individual liberty, personal responsibility, and self-reliance. *Starting A Private Foundation* is the first monograph in the Effective Donor series.

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# STARTING A PRIVATE FOUNDATION

CARRYING OUT THE DONOR'S INTENT  
PAUL K. RHOADS • STEPHANIE H. DENBY

You are involved in the great American tradition of giving. Perhaps you are generally philanthropically-minded and help worthy causes where and when you can. Or you may have a particular charitable interest or cause of great importance to you. In either case, giving of your financial resources is an important way to express your principles. Among the alternatives available to accomplish your objective is the establishment of a private foundation.

Indeed, the much-discussed coming boom in philanthropy may result in a tremendous outpouring of charitable giving. The economic success of recent decades has generated a great deal of new wealth, particularly among members of the baby boom generation, who now are entering their prime giving years. It is expected that there will be a huge intergenerational transfer of wealth — estimates have ranged as high as \$8 trillion — as parents of baby boomers pass their wealth along. These forces are converging and are expected to result in the establishment of numerous new trusts and foundations.

If you want to be more involved in charitable giving, you are undoubtedly aware that effective philanthropy is a major undertaking. True, it should be enjoyed, but careful thought must be given to your objectives and how best to attain them, and to the options, possibilities, responsibilities, and implications of your decisions. If establishing a private foundation is one option you want to consider, this publication is for you. It is designed to be informative, to provide you with some general insights into the world of philanthropy and specific observations about private foundations.

Although there are suggestions with respect to private foundation structure and operations, this should not be considered an exhaustive source. You are urged to use it merely as a point of departure and to consult with competent tax and financial advisors and legal counsel to help you plan and then implement your formal entry into the field of private foundations.

“Donor intent” is the core concept around which this work is written. At the heart of all philanthropic endeavors lies the donor’s vision. Donor intent involves the presentation, execution, and interpretation of that vision. The next generation of philanthropists will be successful only to the extent that their giving plans are imbued with clear intent. The ultimate responsibility rests with the donor, who must express a clear mission and develop an enduring structure that will protect and carry out that vision.

Because donor intent cannot be “boilerplated,” the aims of this publication must be modest. It provides a framework for thinking about establishing a private foundation, beginning with a general discussion of charitable giving and giving alternatives in Section I. Next, some of the benefits and potential drawbacks of private foundations are discussed in Section II. Some of the many issues relating to donor intent and the structure of a private foundation are discussed in Sections III and IV. Finally, in Section V, there is a brief discussion of some of the issues relating to getting started and beginning operations.

This publication is intended to help you not only to understand the role and workings of a private foundation, but also to define your charitable philosophy and intent, and to perpetuate this vision through your successors.

P.K.R.  
S.H.D.

# I. CHARITABLE GIVING IN GENERAL

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## THE IMPORTANCE OF PRIVATE PHILANTHROPY

Charities contribute immeasurably to communities and individuals throughout America by assisting a broad variety of causes, such as medical and scientific research, education, religion, the arts, the elderly, the needy, and the community in general. Although in our recent history government has increasingly participated in a number of these activities, private funding is again becoming important. Due in large measure to federal government budgetary constraints, federal funds available for “essential” programs have been significantly reduced, and funds for many “nonessential” programs are disappearing. Charities largely dependent on federal funds have entered “no growth” phases and have been forced to cut back programs or, in some instances, to cease all operations.

Talk of budget cuts is typically driven by concern for the national debt and a desire to reduce marginal tax rates. In the case of philanthropy, however, a different dynamic applies. While individuals may resent paying higher taxes in order to fund charitable programs indirectly via government programs, many are willing personally to finance programs that interest them and that provide an opportunity to focus on specific objectives. In addition, there is the widely held perception that government bureaucracy is not nearly as effective as private philanthropy in financing programs, identifying worthy endeavors, or monitoring the use of funds. Many individuals want to keep government out of the charitable process. Others want to be involved in the needs and causes around them. The fulfillment of both of these sentiments requires individuals to commit more funds to charity.

Charitable giving is one of the most satisfying of human endeavors. Aside from providing an excellent and usually more efficient alternative to government involvement in many of society's important areas of need or interest, it is simply "the right thing to do." Private funding of many important causes has proven to be of immeasurable benefit to the American way of life. Past examples of successful private philanthropy and the innovation it produces in many charitable institutions are too numerous to recount. Formally joining this vitally important field by establishing a private foundation can be a source of lifelong joy and satisfaction for you, and possibly for your descendants for generations to come.

## YOUR GIVING ALTERNATIVES

There are a variety of ways to make charitable gifts and you should consider all your options. In particular, your charitable giving should be coordinated with your financial position, your tax situation, and your estate planning. The principal ways to make charitable gifts and bequests, and also the variety of organizations to which such transfers can be made, are summarized below. The objectives, tax implications of each type of gift, and organization are discussed.

### *TYPES OF CHARITABLE GIFTS*

**DIRECT GIFT.** A direct gift is the most common type of charitable gift, consisting of the transfer of cash, securities, or other property to existing public charities, including schools, churches, medical facilities, or to any of several types of foundations. An outright lifetime gift provides the donor with a current federal income tax deduction, is exempt from federal gift tax, and has the effect of reducing the donor's estate for federal estate tax purposes. (All references to federal income tax deductions are subject to the limitations described beginning on Page 14.) A direct testamentary charitable bequest is exempt from federal estate tax, but does not generate an income tax deduction.

**GIFT ANNUITY.** A gift annuity is somewhat more complicated than a direct gift. Here, the donor gives cash, securities, or other property to a charitable organization subject to an agreement under which the charity retains the property for its own charitable purposes, but will pay an annuity to the

donor or another individual, either alone or in combination, for life or for a specified term. The annuity payment may begin promptly after the gift or may have a deferred starting date, such as the annuitant's retirement. The donor receives a current income tax deduction in an amount equal to the value of the charitable interest, which is the total value of the gift less the computed present value of the annuity, determined under Internal Revenue Service tables.

**CHARITABLE SPLIT INTEREST TRUST.** Another technique by which the donor may reserve an interest in a charitable gift is a split interest trust. Here, the donor establishes an irrevocable trust. The trustee can be a trust company or individual, or even the charity benefitting from the trust, where permissible. A non-charitable beneficiary, such as the donor or other individual selected by the donor, receives an interest in the trust. That interest may be a current interest, where the non-charitable beneficiary receives a payment for a specified term (which cannot exceed 20 years) or for life, with the remainder going to charity. This type of split interest trust is called a "charitable remainder trust." Alternatively, the non-charitable beneficiary's interest may be a future interest, where the charity receives payments for a period of time, with the remainder being distributable to identified individuals. This type is called a "charitable lead trust."

Under fairly rigid rules, a charitable *remainder* trust can be established either during one's lifetime or at death, pursuant to one's will. The payments must be in the form of either an "annuity trust" or a "unitrust." With the *annuity* trust, the donor or others will be paid an annuity equal to a fixed dollar amount, which may not be less than 5 percent of the initial fair market value of the trust. With the unitrust, the donor or others will receive payments equal to a fixed percentage (which must be 5 percent or more) of the fair market value of the trust assets, computed each year. Payments thus will vary from year to year. If created during life, either form of remainder trust will generate for the donor a current income tax deduction equal to the actuarial value of the remainder interest, computed under IRS tables. If the current beneficiary is someone other than the donor, there also is a reportable gift for federal gift tax purposes of an amount equal to the actuarial present value of the anticipated stream of income payments.

A charitable *lead* trust essentially is the reverse of a charitable remainder trust. Income payments (there is no 5 percent floor, as with the remainder trust) are made from the trust to a charity for a term of years (no limit on the duration of the term). The remainder at the end of the term then is distributable to the donor's descendants or other identified non-charitable beneficiaries. Payments to the charity must be in the form of annuity or unitrust payments, as described above. (It is recommended that you not name a private foundation that you control as a lead trust beneficiary. You might lose the gift tax benefits of establishing the trust.) Generally there is no income tax deduction on the establishment of a lead trust; but a similar benefit is obtained because the income generated each year in the trust is excluded from the donor's income tax return. Also, the ultimate transfer of the remainder interest to beneficiaries is made at a significantly reduced gift tax cost, because that remainder interest is computed as a discounted present value.

#### *TYPES OF CHARITABLE ORGANIZATIONS*

The tax laws create several categories of charitable organizations to which you may make gifts.

**PUBLIC CHARITIES.** A great number of organizations commonly thought of as "charitable" typically are a form of public charity. An organization's status as a public charity is determined either by its *activities* (serving a variety of permissible purposes set forth in the Internal Revenue Code), or by the type of *support* it receives (generally more than one-third of such support comes from the general public, and not more than one-third from investment income). These public charities, in turn, take several different forms:

***Traditional Charitable Organizations.*** These basic "end-use" type of organizations include entities such as colleges or universities, tax-exempt hospitals, medical research or other health organizations, churches or other religious organizations, libraries, museums, and welfare or community organizations. Giving to a charity of this type offers you the benefit of directly supporting the specific purposes or objectives of that organization.

***Community Foundations.*** Community Foundations are typically organizations established to benefit a community or other local geographic area. They are funded by the local citizenry and, in turn, make grants to traditional public charities located typically in the defined geographic area. A community foundation provides broad-based support for a wide variety of local organizations, and can be a convenient vehicle for discharging a large percentage of your local charitable giving.

As a potential donor, before deciding whether to make a grant to a community foundation, you should familiarize yourself with the foundation's priorities. Get to know the types of organizations supported by the foundation and the level of that support. It also is possible to express your own donor intent through a community foundation. For instance, one convenient way to target charities that meet your personal objectives is to establish your own "donor advised" fund to be administered by a community foundation. This may take one of a variety of forms, but generally consists of a grant to the community foundation based on a non-binding agreement with the foundation to keep your funds segregated for a specified period of time, during which it will make grants to qualified public charities that you specify. Depending on the size of your gift and the proposed restrictions you wish to place on it, community foundations often are willing to agree to such an arrangement. Also, it affords you a vehicle whereby the foundation handles the investment of your funds and the required federal and state reporting, while allowing you to determine, within reasonable limits, how those funds are to be disbursed. And if anonymity is an objective, it can also be achieved through this vehicle.

***Professionally Managed Donor Advised Funds.*** In recent years new donor advised fund accounts have been established by professional investment and trust companies, such as the Fidelity Charitable Gift Fund, Trust, Boston, MA, Donors Trust, Alexandria, VA, and others. These organizations are recognized by the IRS as public charities, and contributions to separate funds over which the donors have advisory privileges are treated as grants to public charities.

**Support or Supporting Organizations.** A support or supporting organization is established specifically to support a public charity and is operated under the auspices of or in conjunction with the supported organization. As with a donor-advised fund in a community foundation, you may establish a fund named for yourself.

**Pooled Income Funds.** A pooled income fund is similar to a charitable remainder trust, discussed above. It is different in that it is managed by the charitable organization itself, rather than by a separate trustee. You give cash or marketable securities and receive units in a commingled investment fund that is established for multiple donors, the number of units being based on the value of your gift as a percentage of the total fund value at the time of the gift. You, or possibly another individual whom you designate, will receive regular income payments from the fund. At your death, or that of the designated income beneficiary, fund assets equal to the value of those units are severed from the fund and distributed to the charity for its unrestricted use.

**PRIVATE OPERATING FOUNDATIONS.** Private operating foundations are organizations established to conduct their own programs, consisting of tax-exempt activities such as operating libraries or museums, or conducting seminars and research. They do not usually make grants to other organizations, although they can. Typically they receive most of their support from one individual or a small group of contributors. A private operating foundation is subject to somewhat different restrictive rules than those applicable to nonoperating foundations, described below. Moreover, like a public charity, contributions to it are deductible at the higher public charity percentage limitations discussed beginning on page 14. It must use substantially all of its income for its exempt purposes and must meet one of certain other tests relating to its assets, endowment, or support. Its status is determined on an annual basis; it may become a nonoperating foundation at any time.

**CORPORATE FOUNDATIONS.** A corporate foundation usually takes the form of a private foundation having a very close affiliation with a business corporation that funds it. This organization often is designed to benefit the community in which the corporation is located, but it can have much broader purposes that may advance causes of special interest to the corporation. Typically, the foundation is managed by officers of the corporation.

**PRIVATE NONOPERATING FOUNDATIONS.** Private nonoperating foundations are the primary focus of this book. (Unless otherwise noted, references in these pages to “private foundation” or “foundation” will refer to nonoperating foundations.) Sometimes referred to as independent or family foundations, they are tax-exempt, not-for-profit entities established either as corporations or trusts for the purpose of supporting other qualified charitable organizations. A private foundation may choose to provide broad-based support to a wide variety of charitable organizations or purposes, or it may adhere to a special focus, such as limiting itself to the support of narrowly defined causes or organizations, or to specific geographic areas. It typically is established and funded by a single source, consisting of an individual or family, and is operated by a board of directors or trustees for stated purposes that are spelled out by the donor in the governing instrument.

Although the private foundation usually has a substantial endowment consisting of investment securities and disburses its income annually for charitable purposes, there are some other varieties of these foundations. One is known as a “flow-through” foundation (sometimes called a “conduit” or “pass-through” foundation). This entity distributes to qualifying public charities or private operating foundations all gifts and investment income it receives during a given year. The distribution must be made no later than two and one-half months after the end of that year. Its status is determined on an annual basis, and thus it can become a regular private nonoperating foundation in any year. The donor to a flow-through foundation receives the full federal income tax deduction to which he or she would have been entitled had the gift been to a public charity (see below). This type of arrangement may be useful when you first establish a foundation but are not ready to begin substantially funding it.

#### *TAX CONSIDERATIONS*

There are many personal benefits to be gained by helping charitable causes. Although your primary motivation for charitable giving may be philanthropic, tax considerations obviously are important and will play a key role in the planning process. Gifts to private foundations generate income and transfer tax benefits to the donor. When establishing a private foundation, you must weigh the projected consequences from the stand-

point of both deductions from taxable income and reductions in transfer taxes (estate, gift, and generation-skipping transfer taxes). You also should be aware of the tax rules that apply to the foundation.

**INCOME TAX CONSEQUENCES TO THE DONOR.** There is a federal statutory bias in favor of public charities and private operating foundations over private nonoperating foundations. Thus, depending on the level of your income and the amount of your giving, income tax benefits for gifts to such public organizations can be more generous than for gifts to private nonoperating foundations.

This bias is easily illustrated. Cash contributions to private foundations are deductible in an amount up to 30 percent of the donor's adjusted gross income for the year, whereas such gifts to public charities are deductible up to 50 percent of such income. In like manner, contributions of long-term capital gain property to private foundations are deductible up to 20 percent of the donor's adjusted gross income, while such gifts to public charities are deductible up to 30 percent. In each case, current-year deductions can be maximized by giving the allowable percentage value in the form of capital gain property, plus an additional amount of cash to result in total gifts up to the highest allowable percentage level (e.g., a gift of appreciated stock to a private foundation in an amount equal to 20 percent of adjusted gross income and an additional cash gift equal to 10 percent of adjusted gross income). And, indeed, if maximization of tax deductions is a goal, one certainly can go further by giving cash of up to 30 percent of adjusted gross income to a private foundation and an additional 20 percent to public charity.

The "value" of a contribution to a private foundation, for purposes of determining the amount of the income tax deduction, depends on the kind of gift it is. A gift of cash is deductible in the amount of the gift. Subject to certain limitations, a gift of "qualified appreciated stock" (generally publicly traded securities) is deductible at its full value on the date of transfer. A gift of other long-term capital gain property, including real estate and closely held stock, is deductible only in an amount equal to the donor's adjusted cost basis for such asset. This creates problems for owners of family businesses because much of their asset value often resides in highly appreciated, closely held stock.

A possible solution to the limited deductibility of highly appreciated real property or closely held stock is to establish a private *operating* foundation to receive such property, and to manage the foundation as a private operating foundation for a period of time. This option permits valuation of the property at its current value, as opposed to the donor's cost. In addition, there are reduced and more liberal payout requirements for a private operating foundation, and thus one needs to commit only a manageable level of the foundation's resources to direct charitable activities, while obtaining valuable personal tax benefits.

A private foundation may own S Corporation stock. When that occurs, items of S Corporation income, loss, credit or deduction, and any gain or loss on the sale of S Corporation stock, must be taken into account in calculating unrelated business taxable income for the foundation.

Regardless of whether gifts are to public charities or private foundations, or are in the form of cash or other property, a deduction for any amount given in excess of the applicable percentage limitations discussed above is not necessarily lost. The amount that you are not entitled to deduct in a given year may be "carried over" and utilized in up to five subsequent federal income tax returns, subject to the same limitations.

Because of the applicable percentage limitations, significant gifts to public charities may provide you with better, or at least earlier, income tax benefits than will gifts to a private foundation. It all depends on your circumstances. However, the *intangible* benefits that accrue to private foundation donors—including future control over, and ongoing involvement in, your charitable giving—may considerably outweigh these measurable differences in income tax consequences.

Actually, one way of analyzing the potential beneficial after-tax consequences of gifts to private foundations is to consider briefly "pre-funding gifts." You can pre-fund future payments to charities at a lower after-tax cost by making a lump sum payment to your private foundation rather than by making a series of annual gifts directly to public charity. This is because the lump sum contribution to the private foundation becomes a fund from which the foundation will earn future income that will be taxed only at the 2 percent level, to be used to make the charitable payments. Since that



income is eliminated from your individual income tax return, you in effect receive an income tax deduction for the present value of that future income stream.

**TRANSFER TAX CONSEQUENCES TO THE DONOR.** Gifts to either public charities or private foundations are deductible for estate and gift tax purposes. The amount of the deduction is equal to the full value of the bequest or gift. Thus, the favoritism of the federal tax law shown toward public charities in the area of income taxes is not present with respect to transfer taxes. You may make a lifetime or testamentary gift to a private foundation without limitation or taxability.

**TAX CONSEQUENCES TO THE FOUNDATION.** There is a 2 percent excise tax on a private foundation's net investment income, which can be reduced to 1 percent in certain circumstances. See the more detailed discussion of tax consequences to the private foundation beginning on Page 20.

## II. THE PRIVATE FOUNDATION ALTERNATIVE

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### BENEFITS OF THE PRIVATE FOUNDATION

For many, establishing a private foundation is a major step in organizing an effective gift-giving program. It is a significant undertaking that will require an investment of your time and personal resources. Remember: you will not be simply utilizing a new means to discharge your charitable giving. You will be embarking upon a new venture, much like founding a new business, that may be expected to grow and have a long-lasting impact on your community and your family's relationship to the community. Thus, you should not consider establishing a private foundation without a careful examination of (a) your overall estate planning objectives, (b) the extent to which a charitable giving program fits within those objectives, and (c) the anticipated consequences that a private foundation will have on your immediate family and descendants. With care, the advantages of starting a private foundation easily can outweigh any potential drawbacks.

A private foundation will help you define your charitable priorities and target worthwhile charities. The process can transform you from a passive supporter of a wide variety of charities to an important force in a particular charitable field. The creation of a foundation, by itself, informs the community of the seriousness of your endeavor as well as your long-term commitment. This can increase the extent of your influence because charities interpret the establishment of a private foundation as a long-term investment in the charitable community, while it may take an individual a number of years and considerable donations to earn the same reputation.

Based on this perception, charities are more likely to submit sophisticated and in-depth grant proposals to a foundation. Receiving such proposals permits your foundation to better target its funds and more substantively interact with the charities. The process of establishing a foundation, with the virtually instant respect that it will command, can quickly catapult you into a leadership role and expand your impact.

In addition, a foundation is an excellent vehicle for encouraging family involvement in charitable endeavors. It can spur the commitment of other family members to your personal causes or encourage them to become involved in their own causes. On a more personal level, it can strengthen family relationships by providing a forum for regular meetings, and can create a personal legacy that will keep your memory alive in both your family and the community. Finally, as the foundation establishes prominence in the community, you will foster new ties among other prominent individuals and corporate leaders, facilitating the flow of ideas and leading to new opportunities.

## DRAWBACKS TO THE PRIVATE FOUNDATION

As with many institutional endeavors, establishing a foundation also adds a new and ongoing level of complexity to your life.

While a foundation can strengthen family relationships as well as a family's involvement in charitable endeavors, there may be attendant risks along the same lines. It is possible that a foundation can become the site for playing out family tensions emanating from sibling rivalries, generational conflicts, and even possible divorces. Issues of control over the use of funds, board membership, and succession are potential problems in any kind of organization. Family relationships can ease, or significantly complicate, such matters. It is imperative, therefore, to candidly assess the nature and strength of family ties when considering starting a foundation. Don't consider a foundation a solution to existing family stresses. As discussed in greater detail below, try to anticipate potential problems and to provide for appropriate solutions in your structuring of the foundation.

In order to determine whether a foundation is the appropriate vehicle for you, you should fully understand the additional burdens it will entail. Many individuals will find that the restrictions on a private founda-

tion are not overly burdensome and do not interfere with their goals. They realize that a foundation can avoid difficulties by being managed and invested in a businesslike manner. However, a private foundation may not be the best alternative for those individuals whose particular goals may conflict with these restrictions or require excessive reporting in order to implement.

### *COMPLIANCE WITH REPORTING REQUIREMENTS*

A private foundation must comply with federal, and often state, reporting requirements that can be time consuming and will entail some administrative expenses. Therefore, an understanding of these requirements is critical when deciding whether to establish a foundation.

**INITIAL TAX EXEMPTION.** First, the private foundation must apply to the IRS to obtain tax exempt status. In addition to other information, the application requires a statement of the foundation's purposes and its anticipated budget. Completing the application actually can be a useful process, helping you to define your mission and develop a grantmaking and operating budget.

**ANNUAL INFORMATIONAL RETURN.** The IRS requires that a private foundation file a Form 990-PF annually, not later than four months and fifteen days after the end of the foundation's fiscal year. This is a detailed form that tracks the foundation's activities by examining its income, expenses, contributions received, and charitable distributions made.

**PUBLIC INSPECTION.** The federal government requires that the Form 990-PF be made available for public inspection.

**STATE REQUIREMENTS.** Many states also require the foundation to file an application for state tax exemption and an annual report with the state's attorney general. Often this involves little more than copies of the relevant federal forms, but it may require the preparation of additional state forms. In addition, many states require that a private foundation that is organized as a not-for-profit corporation must file a corporate annual report. Frequently, however, these corporate reports are short, simple forms.

*REGULATION OF PRIVATE FOUNDATIONS VIA TAXES*

In response to perceived abuses in the charitable sector, Congress in 1969 implemented significant changes to the tax laws governing private foundations. These laws, as subsequently amended, regulate many foundation activities, including their distributions and investments. Not surprisingly, the government uses a series of taxes to require foundations to comply with these regulations. Basically there are two categories of taxes at the foundation level: the excise tax and a series of penalty taxes.

**EXCISE TAX ON NET INVESTMENT INCOME.** Although a foundation often is described as being “tax exempt,” the Internal Revenue Code actually requires it to pay annually an excise tax equal to 2 percent of its “net investment income,” which consists of its gross investment income (including dividends, interest, and capital gains) minus expenses attributable to the production of that income. A foundation can qualify for a reduced rate of 1 percent if certain distribution requirements are met over a five-year span. The foundation is required to pay estimated taxes on a quarterly basis, the final tax payment being due when the Form 990-PF is filed.

**PENALTY TAXES.** A private foundation may be subject to penalties in the form of additional taxes for violations that constitute a failure to comply with certain requirements. These taxes can be severe and in some cases can be assessed against the foundation managers and board members personally. Moreover, the penalties often apply whether the violation is intentional or not. If a foundation fails to take corrective action after being alerted to a violation, it can be subject to additional penalties including confiscation of its property. These penalty taxes are easily avoidable, however, if the foundation implements sound procedures with respect to its investments, distributions, and general business practices.

**Prohibition Against Self-Dealing.** In order to prohibit the use of a private foundation for personal gain, the Internal Revenue Code prohibits a variety of financial transactions between a foundation and a “disqualified person.” For these purposes disqualified persons include (a) all officers and directors of the foundation, (b) substantial individual or corporate contributors to the foundation, and (c) family members or entities related to substantial contributors, officers, or directors. Penalties for engaging in acts of self-dealing can be assessed against the foundation as well as against the dis-

qualified persons individually. Transactions directly or indirectly between a disqualified person and the foundation can constitute acts of self-dealing. For example, sales, exchanges, or leases of property between the foundation and a disqualified person are prohibited in all events, no matter how reasonable or competitive the terms. Loans from a foundation to a disqualified person are prohibited; in many instances a loan from a disqualified person to a foundation also is prohibited. A disqualified person cannot charge for goods, services, or facilities furnished to the foundation. However, a foundation can pay reasonable compensation to a disqualified person for personal services that are reasonable and necessary to the foundation. Many acts of self-dealing are easily identifiable simply because they have the appearance of impropriety. Since a violation of the rules against self-dealing will expose the foundation and perhaps a board member or foundation manager personally to large tax penalties, it is wise to avoid any financial transactions that conceivably may fall within this area.

**Minimum Distribution Requirement.** A foundation must distribute at minimum an amount equal to its “distributable amount,” which is its “minimum investment return” reduced by taxes payable for the year. With some leeway given to a startup foundation, the minimum investment return is equal to 5 percent of the value of the foundation’s assets, subject to certain adjustments. The required distribution must be made before completion of the following year. So in 2002, for example, a foundation’s minimum distribution would be based on the valuation of its investments held in 2001. A variety of valuation rules apply for determining the average value of each asset during the year. A foundation that fails to meet the minimum distribution requirement will be subject to a penalty tax.

**Excess Business Holdings.** A private foundation and all disqualified persons, in the aggregate, generally may not own over 20 percent of the business interests in a for-profit enterprise. (There is a *de minimis* exception if the foundation owns less than a 2 percent interest in the enterprise.) The 20 percent amount is increased to 35 percent if the foundation and the disqualified persons do not control the enterprise. For these purposes, an enterprise can be a corporation, partnership, or other business venture. A foundation is subject to a penalty tax when it has excess business holdings. However, if it receives property, such as by gift or bequest, that constitutes

an excess business holding, it has five years after the receipt of the property to divest those holdings to a point at which they are below the 20 percent (or 35 percent) permissible ownership.

**Jeopardizing Investments.** A private foundation may not invest in property that might “jeopardize” its ability to carry out its exempt function. Although the definition of a jeopardizing investment may vary from situation to situation, the IRS may scrutinize transactions such as margin trading, futures, short sales, option trading, and working interests in oil and gas.

**Taxable Expenditures.** A private foundation will be subject to a penalty tax for making a “taxable expenditure,” which includes distributions:

- To carry out propaganda or otherwise attempt to influence legislation;
- To influence the outcome of any specific public election, including, under certain circumstances, carrying out a voter registration drive;
- As a grant to an individual for travel, study, or similar purposes, unless an objective and nondiscriminatory selection process is adopted and approved in advance by the IRS;
- As a grant to any organization other than a domestic public charity (such as another private foundation, foreign charity, or government body) unless the granting foundation exercises “expenditure responsibility” (which requires it to implement procedures to assure that the grant is spent solely for exempt purposes, to obtain reports from the grantee to that effect, and to make a detailed report with respect to such expenditures to the IRS); and
- As a grant for any purposes not described under Section 170(c)(2)(B) of the Internal Revenue Code (relating to religious, charitable, scientific, literary, or educational purposes, or to fostering with certain restrictions amateur sports competition, or preventing cruelty to children or animals).

The penalty tax on taxable expenditures significantly increases the administrative burden of providing scholarships or other grants to individuals, or grants to other private foundations and foreign charities. Many foundations find that the extensive reporting requirements make such grants

impractical. If you wish to confirm that an organization is a public charity, the IRS publishes a bulletin that lists many public charities. In addition, even if an organization may not be in the bulletin, it may be able to provide you with a copy of its tax-exemption letter from the IRS to confirm its exempt status.

## HOW MUCH TO GIVE?

There are no legal requirements regarding the amount of cash or other property one must give to establish a private foundation. There are, however, administrative costs in establishing a foundation and filing the required annual reports. As the value of the foundation’s assets increases, those expenses become increasingly negligible in proportion to asset values. Accordingly, there is no clear minimum amount that makes forming and operating a private foundation “worthwhile.” For most individuals, the question turns on personal goals, such as family involvement, furthering a charitable cause, or establishing a legacy. The additional burdens of operating a foundation should not be undertaken unless the foundation will advance such goals. You will want to fund the foundation at a level that is consistent with your long-term giving strategy. If you wish to build up an endowment that will generate income sufficient to fund your anticipated giving program out of income alone, you will need to build up a large enough principal reserve to meet that goal. This emphasizes the need to establish goals and a clear plan of implementation. For example, if your goal is to give \$50,000 per year and you anticipate an investment return of 6 percent, then you might wish to start funding the foundation with \$100,000 per year, with the plan that over a period of nine years you will have built up a sufficient endowment so that the assets in the foundation can generate a little over \$50,000 each year for your gift program.

Of course, the giving program that you develop will need to be coordinated with the foundation’s minimum distribution requirements, excise taxes, and other administrative costs. Therefore, the foundation cannot concentrate exclusively on building a reserve during the initial years.

Some individuals or families like the idea of having a foundation in place that might not become active, beyond the minimum requirements, for a number of years. This gives the family an opportunity to become

familiar and comfortable with the workings of the foundation before committing significant funds. For example, it is not uncommon for an individual to establish a private foundation that ultimately will receive a substantial bequest at his or her death. Such an individual may fund the foundation with only minimal amounts during life, but can establish a record for how the foundation is to be run, fine tune the administrative provisions, and develop confidence in board members. The donor thus can feel comfortable that when the foundation receives a significant distribution at his or her death, it will run smoothly and according to plan.

### III. DONOR INTENT: DEFINING AND CARRYING OUT YOUR MISSION

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#### GENERAL

Much has been written about the technical requirements involved in establishing foundations, precious little about how to express, and then carry out, the intent of the donor. The focus of this section is precisely on the crucial issue of donor intent. Although many points are highlighted and questions raised herein, no definitive blueprint for incorporating donor intent can be provided. That is up to you, the donor. Each situation is different and your wishes are unique and individual to you. But remember: when you establish a foundation you are embarking upon a very important and possibly long-term venture. It is worth your effort to make sure it gets off to a good start by taking the time to consider all the issues surrounding your charitable goals and how you can best accomplish them.

The first step in establishing a private foundation is to formulate your goals. A number of questions must be asked: How will you determine and describe the intended mission for your foundation? How do you identify the types of charitable needs your foundation will address? Do you want to assist only certain defined causes, or do you wish to be very flexible and permit grants to the broadest range of organizations, by giving future board members authority to change your foundation's focus from time to time? If you do wish to be specific in setting your goals, how can you ensure that these goals will be honored and carried out in the future?

The second step in establishing a private foundation is designing a strong organization that is capable of successfully achieving your charitable goals. The clarity of your goals and a strong structure to promote them will become even more important if you intend for the foundation to continue indefinitely. When you are no longer active in the organization, it may become sluggish or even change into something you would not recognize or support. This can be true whether your goal is to develop your family's spirit of giving or to promote certain charitable causes. For example, if you are concerned with maintaining family involvement, it is important to design an organization in which the family will retain control of the decision-making. If you want to develop in family members a sense of commitment to a broad array of philanthropic purposes, then it may be important that the organization permit them to pursue their own interests. If you are interested in advancing particular causes, distributions should be restricted to causes you designate so that future board members cannot use the foundation to pursue their own possibly contrary interests.

Let's now focus on how you can define and perpetuate your wishes.

## THE PROBLEM

Even with a carefully drawn governing instrument, it can be difficult to express the intended mission of your foundation and assure continued adherence to that mission by future generations of board members. Why? Frankly, many donors and their counsel pay insufficient attention to these important details. A variety of situations may develop. Many foundation organizational documents are prepared using only "generic" language, targeted primarily to obtaining the necessary tax exemption and dealing with basic state law charitable requirements. They don't address the compelling personal reasons for starting a private foundation. They don't deal with administrative direction or bother about perpetuation of the mission. The governing instrument may express the donor's intent only vaguely, or possibly not at all. Disputes may then easily arise among the board members over the governing document's proper interpretation. In other cases,

time or events may be the culprits. The intent may be spelled out clearly, but circumstances may change. The question becomes whether it is possible to carry out that intent.

In still other cases, whether intent is vague or clear, the board members may realize that their contemplated programs place them on questionable ground in terms of the donor's wishes, and they may decide to seek the court's confirmation that their programs are consistent with the donor's intent, or they may ask the court to amend the trust to accommodate their objectives. And, of course, there are the widely discussed cases where board members seemingly—or openly—ignore the donor's intent and support programs the donor would not have endorsed. Their views may be radically different from those of the donor, and they may make grants for causes that carry forward their own personal agendas, but which would be completely at odds with the donor's known or presumed desires or objectives. They don't seek court authorization for their programs, they just distribute grant funds as they deem fit.

Examples of court actions by trustees have occurred recently in some famous cases. In the *Buck Trust* case in California in the 1980's, the trustees of the community foundation that received and administered the trust petitioned the court for judicial change of the donor's trust provision that specified very precise limitations on the geographic area where the Buck Trust funds could be expended. The trustees filed the court action notwithstanding the fact that they previously had specifically *agreed* to abide by the provisions of the trust when they received its assets—at a time when they already were *planning* the court action.

Among their justifications for asking the court to authorize expenditures in a broader geographic area was their claim that Mrs. Buck could not have realized that her foundation would become as large as it did (the implication being that she presumably would have wanted to spend the funds differently). It was also claimed that a judicial change would "redress the inequities" of spending such vast sums in a small geographic area. Fortunately for the cause of donor intent, the court largely rejected the trustees' request.

Another case involves the Barnes Foundation art education collection in Philadelphia. Here again, the trustees went to court to ask for judicial amendment of a number of significant facets of a trust instrument that could not have been more clearly spelled out by the donor. The court authorized a modification of one major feature of the instrument (permitting 80 paintings to be shipped to Paris and Japan in direct opposition to what the donor had instructed). It did so by enumerating a number of findings as to the purported *need* to make the requested change, despite the fact that there was a substantial fund available from a separate source established for precisely that purpose.

Finally, of course, there are the famous Pew Charitable Trusts, also in Philadelphia. Many believe that enormous sums are being expended for causes that are inconsistent with, and often in opposition to, the donors' expressed intent.

## CY PRES

If you have an appreciation for the way courts typically resolve problems that can arise regarding donor intent, you will be better equipped to plan carefully to avoid certain problems at the outset. When the question put before the court is whether it is *possible* to carry out the donor's intent, something called the *cy pres* doctrine often comes into play. The term *cy pres* comes from the Norman French *cypres comme possible*, which means "as near as possible." Although there are occasional minor differences among the courts of different states, the doctrine generally is applied where the expressed purpose of a trust has become illegal, impossible, or impracticable to implement. Where a trust fund is clearly intended to be applied to a general charitable purpose, but the specific purpose spelled out in the instrument is not possible, the court may direct that the property be used for a charitable purpose that is "as near as possible" to the one described by the donor. For instance, the trustees may be administering a gift for the cure of a disease that has already been cured, or for the construction of a library where one has been constructed. In such cases, if it appears that the donor had a general charitable intent, the court will attempt to find a similar use, one that the court believes the donor would have approved.

You should keep this doctrine in mind when expressing your specific intent. You may want to include in your wishes both broad philosophical principles and narrowly defined specific examples. Include, as well, possible alternative uses in the event that it becomes no longer possible to carry out your original design.

## DESCRIPTION OF DONOR'S INTENT

What can be done to minimize the possibility of disputes? How *should* your intent be described? Depending on the subject and your personal goals, the precise description of your objectives may be very difficult. But whatever your personal intentions, you must spend sufficient time on this task. You must focus on clearly describing your intent, leaving no doubt as to your views.

Even the location of your intent provisions in the governing instrument is important. If your organization is a trust, set forth your intent as the opening statement, possibly as a preamble. Get the reader's attention and demonstrate that you believe it is the most important element of the instrument. If you use a corporation, describe your intent in the corporate charter as well as in its bylaws. In either case, consider establishing criteria that the board must confirm before making any grant. Also consider setting forth an irrevocable requirement that the foundation's board provide all potential grantees with pre-established guidelines that include the basic description of your intent. This will put them on notice as to the manner in which you intend that your foundation's funds be utilized and may discourage organizations that don't meet your criteria from applying for grants.

As for content, give a complete expression of your relevant philosophies and objectives. State *what* you want your foundation to support by reference to areas of interest or types of organization. If appropriate, state what you do *not* want supported by describing any prohibited areas of grants. In both cases, do not hesitate to be expansive in describing your views. It is extremely important to try to anticipate possible future changes in circumstances. If you are interested in public policy issues, try to describe your philosophy in a way that will distinguish it from contrary current views (even those that may adopt your labels), but also, if possible, in a way that will try to anticipate future changes in terminology. You may want to identify partic-

ular organizations as permissible or desirable grantees, but you must realize that they may not exist in the future or they may change *their* mission. Do you want minimum percentages of the foundation's annual giving to be allocated to certain causes? Make provision for that. Also, try to anticipate change by providing your own *cy pres* alternatives. Identify acceptable alternate uses for your foundation's funds, should your primary purposes not be possible or practicable to achieve at a future date. Consider providing for distributions pursuant to some strict general standard and then spell it out.

### PERPETUATION OF THE MISSION

What about the duration of your foundation's existence?

Do you want the foundation terminated at the expiration of a specific number of years, or do you want to authorize its perpetual existence? Is there some ideal time to accomplish your goals? There are numerous considerations, including (a) your family members, descendants, and their potential interest in perpetuating the organization; (b) other likely participants; (c) the size of the foundation, and the likelihood of additional grants to it; and (d) the intended purposes and whether there might be a reasonable time period to carry them out.

### AMENDMENT OR REVOCATION

Regardless of the duration of your foundation's existence, how can you make its structure, or at least the provisions expressing your intent, irrevocable and unamendable? That's easy to do with a trust, simply by making it irrevocable, forcing the trustees to go to court if they want to change the provisions. It's a little more difficult with a corporation, which itself is subject to easier change because it can be amended under state corporation laws.

Whatever your duration and revocability provisions, you should consider specifying that there may be no amendments of the intent provisions. If you use the corporate form, consider having the charter and bylaws provide that certain bylaw sections (such as the name of the foundation and corporate purposes and intent, and possibly the provisions regarding manner of selection of future directors) may not be amended. Whether such provisions are binding upon future boards of directors depends upon state

law. With a trust, you might provide that, during your lifetime, you are authorized to amend the trust in areas that won't adversely affect the federal tax exemption. Care should be taken to avoid potential estate tax pitfalls as well. Following your death or during any period of your disability, changes in the trust can be prohibited.

### DISTRIBUTION ON TERMINATION

What about providing for distribution of the foundation's assets on its termination, whether by expiration of some specified term or for any other cause? The legal requirements under the Internal Revenue Code are that (a) the assets must be transferred to public charities that have been in existence over five years (the board may specify the purpose and even name the gift); or (b) the foundation itself may qualify as a public charity at that time (there are technical requirements that must be met); or (c) the foundation may be consolidated with other private foundations (again, there are certain technical requirements). You should, however, be clear as to what you want done with these assets. Make a specific provision. State that if your program ever fails or the foundation otherwise terminates for any reason, you want the assets distributed to some specific organization or group, or according to a specific set of guidelines. Make the rules very clear so that the board members will be less likely to attempt to change them. Possibly list several organizations, providing for distribution equally to those then in existence, or allow specific organizations to be selected by the trustees from among classes of organizations described by type.

### THE BOARD

The mechanism in the governing instrument that provides for the selection and replacement of board members is one of the most important features of any foundation. Again, too little thought often is given to it, even though proper board selection is vital to any effort to ensure that the organization remains true to the donor's intent. The longer the anticipated life of the organization, the more important the need for the donor to articulate at the outset the qualifications and the process for selection of future board



members. It is also important to think about ways to educate board members to better understand your intent. Several considerations should be addressed.

#### *QUALIFICATIONS*

When establishing your foundation you have the ability to make a careful choice of your initial board members, based on your own awareness of the views and loyalties of the individuals you select. The more difficult task is providing for the future. How do you provide for board succession? What methods should be used to select future board members? Whatever mechanism is chosen, it certainly is impossible to ensure that all future members will share your views. For that reason, you should at least attempt to describe the type of individuals you want by prescribing certain qualifications. You might require that they be members of identified external organizations, or possibly establish educational, professional, occupational, or other litmus tests. Even with family members or descendants, the enumeration of additional qualifications may be appropriate. An unrestricted requirement of the inclusion of descendants can lead to future control by grandchildren who may have interests diametrically opposed to yours.

#### *MANNER OF SELECTION*

Aside from qualifications, what about the *manner* in which board members are to be selected in the future? When a vacancy occurs, how should successors be chosen? There are many different possibilities. Carefully consider this issue in light of your situation and needs, and with a view to preserving your charitable intent.

Should you provide for selection of a new member by the others then in office? Or should individuals or organizations unconnected with the foundation make the decision? For instance, selection could be by the presidents, from time to time, of A, B, and C, described as organizations intended as beneficiaries of the foundation, adding alternatives in case any of those organizations may cease to exist. Another possibility would be to have a committee of all your living descendants choose board members at an annual family council.

There are private foundations in existence that have devoted considerable effort to the perpetuation of their donor's intent and to establishing mechanisms to accomplish that end. As part of the planning process, careful attention has been given to establishing a system of regular and repeated reviews of and discussions about the founder's philosophies. For instance, board meetings or meetings of family members where family involvement is the prime focus can be held on a periodic basis and used for that purpose. An annual family council can provide an opportunity to reiterate and discuss the donor's original intent and to think about the mission of the foundation. Some organizations have even utilized video tapes of the founder's personal statement of his or her objectives.

In addition to repeated reference to the foundation's mission, there is a variety of ways to try to ensure that future board members will adhere to the donor's intent. You might stipulate that potential board members must serve apprenticeships of two to three years before being permitted actually to serve on the board. One example is the Samuel Roberts Noble Foundation in Ardmore, Oklahoma, which has "advisory" trustees in addition to its regular trustees. The advisor-trustees attend regular trustee meetings, receive trustee compensation, and are aware of all foundation activities. They simply do not have a vote on foundation matters. It is a form of apprenticeship, with each advisor-trustee serving a one-year period and then "rotating" off the advisory board for a period of two or three years before they rejoin (although being kept fully advised during the interim). There is no guarantee that an advisor-trustee, even a family member, will ever be elected to the full board of trustees.

#### *SIZE OF BOARD*

What should be the size of your foundation's board? Try to limit it to the number of members you believe will be necessary to get the job done effectively and efficiently. If you decide to use a corporate form, your bylaws might contain provisions limiting any changes in board size; in some states you can designate a range of permissible directors. If you establish a trust, consider specific limitations on the number of trustees.

*CONTINUITY*

It also is important to consider whether a continuously changing board is desirable. While there are potential adverse consequences if board members remain in office for a long period of time, a rapid turnover of members could result in a lack of continuity. Then again, if there is provision for a regular turnover of board members, it is possible that more attention will be paid to the details of running the foundation than to empire building. A solution to this dilemma might be to require that each member be “re-elected” to the board. The desire to be re-elected can force board members to examine individual performances periodically and motivate them to be more attentive to operating the foundation in a manner consistent with your wishes. A member who does not face re-election might feel no such accountability. If the members are elected, moreover, you might stagger each member’s term so the board is not comprised of all new members at any one time. Consider various options, such as a provision for (a) terms in office of a specific duration (assuming you’re satisfied that it won’t lead to inefficiency in operations) as opposed to service until death or incapacity; (b) a maximum number of terms one may serve or a minimum hiatus between nonconsecutive terms; and (c) staggered turnover of board members to ensure continuity.

You also should consider including provisions to remove a board member. You can place this power in a family member, an independent individual, or a family adviser. Or you might permit the board to monitor itself by allowing a majority of the board to remove a member. Finally, you might grant removal power to an existing entity, such as a public charity with which you wish the foundation to have a close relationship. Recall, however, that although an independent “watchdog” may seem comforting, there always is the possibility that such an individual or entity, itself, may change direction or establish a board that has no independence.

It also is useful to consider indemnification of fiduciaries from liability for various acts. You need good fiduciaries, so you may need to induce them to serve. Indemnification may be automatic under some state laws. Determine whether any statutory indemnification is broad enough. Some

states permit indemnification, but it is not automatic. You might then think about specifically providing for indemnification in your governing instrument, whether you opt for a trust or a corporation.

## PROVISION FOR ENFORCEMENT OF YOUR INTENT

Is it possible to ensure that someone will assume responsibility to enforce future compliance with your wishes? Will someone litigate, even sue the board members then serving if necessary, to accomplish that end? In order to become involved as a party to a donor intent case, one must have legal *standing*, which is difficult to acquire. The attorney general of the appropriate state normally has a statutory duty to oversee charitable entities. The issue then becomes: will the attorney general discharge that duty when a charity’s governing board is not honoring the organization’s charter? There have been cases where an attorney general has become involved, but where the donor’s intent seemingly has not been promoted vigorously. In other instances, the attorney general has not acted. Whether or act, not the attorney general takes action where appropriate, can your governing instrument specifically designate someone with authority to enforce your intent?

It is not possible to state categorically that one may grant legal standing to external individuals or organizations. Private trusts have identifiable beneficiaries, who by definition have standing to sue trustees. Charitable trusts and not-for-profit corporations rarely have identifiable beneficiaries and, accordingly, there is a question whether their governing instruments may delegate to someone the authority to go to court to attempt to enforce intent. An example of a state court granting standing to someone other than (actually, in addition to) the attorney general was the Pennsylvania court in the *Barnes* case mentioned above. The court did so, but recited the Pennsylvania rule that requires as a prerequisite to having standing that an individual or organization have “relevant” origin, a substantive and legitimate relationship to the foundation, a record of significant contributions to the foundation, and a “real interest” in the issues in litigation. Since there seems to be no sure method of granting standing, any recommendation is precarious at best.

One suggestion of a way to attempt to accomplish this objective is for the donor to provide that the foundation will grant a certain percentage or some meaningful amount of its regular giving to one organization, coupling that requirement with a specific authorization for that organization to have standing. Or possibly the organizations whose presidents may be involved in the selection of trustees, as mentioned earlier, can be granted standing. In summary, there are no guarantees of success in identifying an “enforcement” individual or organization. However, it may well be worth the effort to try.

The ultimate issue is: who should decide what to do with your charitable contributions? You, or someone else? As with any other legally binding document that is or will become irrevocable and thus beyond your control, you should take great care to envision the broadest variety of possible future circumstances. You’ve got to plan and to anticipate future policy revisionists. Prepare for that contingency by carefully drafting the instrument establishing your foundation or amending your existing instrument, if you can. Think about the areas of structure, fiduciary succession, amenability, and, of course, the precise expression of your *intent*.

## IV. DETERMINING THE STRUCTURE OF YOUR FOUNDATION

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Implementing a structure that complements your mission and intent will be crucial if your foundation is to achieve its goals. You cannot adopt a “standardized” form and expect it to do so. That is why the issues discussed thus far deserve careful thought. Similarly, while the structure of a foundation does not affect its tax exempt status so long as the foundation is properly organized, it will have substantial impact on the foundation’s operations, including such issues as who makes decisions, how these people are selected, the causes that are supported, and the size of the grants.

### ORGANIZATIONAL STRUCTURE: TRUST OR CORPORATION

The two basic forms available for establishing a foundation are a trust and a not-for-profit corporation. There are advantages and disadvantages associated with both of these options. Each state has its own laws that apply to trusts and not-for-profit corporations. It is important, therefore, to survey the particular legal impact of establishing one structure over another in the state in which you form your entity.

The following discussion highlights some of the key differences between these two forms.

#### *FLEXIBILITY*

One of the considerations in establishing a private foundation is to assure that the structure selected is workable given the donor’s goals. In establishing an organization that is expected to continue for a long period, it may be important to provide a considerable degree of flexibility so that the organization can respond to changes. Obviously, a structure that is so rigid that it may become unworkable over time is undesirable. A trust tends

to be a more restrictive structure than a corporation. Traditionally, a trustee is limited to the activities specifically set forth in the trust instrument, and the trustee's powers also are restricted to those enumerated in the instrument or otherwise granted by law. Although a trust instrument can be drafted to grant the trustee a broad measure of flexibility, a trustee may be unable to respond to circumstances that were not originally contemplated. To the extent a trust instrument eventually is unamendable, so often there is not a second chance to expand or clarify it. In order to resolve any ambiguity in the trust instrument, the trustee may need court instruction. Having to go to court is both expensive and time consuming.

A corporation provides much more flexibility. Typically, directors have broad powers and authority, defined by state statute, unless the organizing document imposes specific restrictions. Therefore, a director has inherent statutory authority to address unforeseen circumstances. In addition, the governing instruments (articles of incorporation and bylaws) are easily amendable, so the structure can be reworked if necessary. It often is possible to have a second chance to expand or clarify the governing instruments. However, flexibility can be a double-edged sword. If you have specific goals in mind and do not want the board members to be able to deviate unless absolutely necessary, you may not want the board to have the flexibility of the corporation form to change the course of the foundation. Commonly, directors can change bylaws and even the articles of incorporation. This permits them in essence to redefine the primary goals of the foundation. You must determine whether you feel comfortable with the directors having such flexibility in the future, after you are no longer controlling the foundation.

#### *LIABILITY*

The issue of personal liability has become an increasingly important one for private foundations as well as public charities. Many individuals are unwilling to serve on a board because of potential personal liability. A foundation's ability to attract qualified board members may depend on its ability to indemnify those members. The level and effectiveness of indemnification of a trustee may vary significantly from indemnification of a director.

Trustees historically have had the highest level of responsibility and are held to the highest standard of care. Under common law, a trustee can be liable for simple negligence. Even having acted in good faith will not be sufficient to protect the trustee from claims and possible personal liability. Specific provisions in a trust instrument may reduce the standard of care that a trustee must exercise or may provide broad indemnification of the trustee. However, there is a strong body of case law that requires a trustee always to act in good faith. Based on public policy concerns, some courts will not sanction a trust instrument's attempt to indemnify a trustee who has not acted in good faith. In addition, courts tend to construe indemnification provisions very narrowly. A court may find that certain actions are not within the scope of the indemnification. Therefore, it is uncertain how effectively a trust instrument can indemnify a trustee.

Directors of not-for-profit corporations usually are not held to as high a standard of care and often are held liable only for gross negligence or willful and wanton disregard of that duty. Many states have enacted laws that specifically provide for indemnification of directors of not-for-profit corporations, without having done so for trustees of charitable trusts. In Illinois, for example, a non-compensated director of a not-for-profit corporation may receive significant indemnification so long as the director has not acted willfully and wantonly.

#### COMBINED ORGANIZATION

It is useful at this point to note that you are not necessarily confined to the use of only a trust or corporation. You might consider establishing a combined or hybrid type of organization that provides some advantages of both of those forms of organization. Such an organization has flexibility in the area of business powers, but not with respect to changes in the foundation's goals. This is possible in jurisdictions, such as Illinois, that make statutory provisions for "members" of not-for-profit corporations. The approach, using this Illinois statutory vehicle, is to establish the foundation as a not-for-profit corporation, with a board of directors, and also to provide that the corporation will have "members." These members are given certain important powers over key corporate decision-making, such as election of new directors, amendment of bylaws, and the like. At the same time,

the donor establishes a trust that identifies with specificity the carefully drafted intent provisions. The trust becomes the sole member of the corporation. The result is a corporation with a public record, entitled to the benefits of state law providing for indemnification of directors, but which is effectively controlled by the trustee of a trust that has fairly rigid guidelines governing its administration. This may offer the greatest possible protection against unwanted substantial change while permitting administrative flexibility. It allows for the desirable elements of a corporation, with its benefits of flexibility in relatively minor matters, and of a trust, which affords a structure that promotes steadfastness and fidelity in pursuing the long-term goals and values of the donor. Management should be flexible; leadership must be steadfast.

## BASIC PROVISIONS

Whether you choose a trust or a corporation, or possibly the combined approach mentioned above, certain provisions must be included in the governing instrument for the organization to qualify as an exempt private foundation. And there are additional provisions that probably should be included for the foundation to operate smoothly.

### *REQUIRED TAX PROVISIONS*

To qualify for tax-exempt status, it is imperative that the foundation be required to devote its funds solely to charitable purposes. In order to assure this, the governing instrument should include statements: (a) not only delineating the types of charitable purposes for which distributions may be made, but also restricting distributions to those made solely for charitable purposes; (b) that no part of the earnings shall inure to the benefit of any shareholder or individual (this does not prohibit reasonable compensation for services rendered or reimbursement of reasonable expenses); (c) that no substantial part of the foundation's activities will consist of attempts to influence legislation or participation in political campaigns; (d) identifying charities which will receive the funds upon termination of the foundation and also restricting a terminating distribution exclu-

sively to charitable entities; and (e) that the foundation will comply with the requirements of Sections 4941 through 4945 of the Internal Revenue Code.

### *CONVERSION TO NOT-FOR-PROFIT CORPORATION*

Many charitable trusts provide that the trustees may elect at any time to convert the trust into a not-for-profit corporation without seeking court approval. This grants the trustees considerable flexibility in administering the foundation. This power may be desirable because of the increasing benefits associated with not-for-profit corporations in many states, as previously discussed. So long as such flexibility does not conflict with your goals, this can be a desirable option.

### *CHOICE OF JURISDICTION*

Because laws regulating trusts and not-for-profit corporations vary from state to state, you should determine which state law you would like to govern your foundation. One of the primary state law questions that concerns many donors is the scope of indemnification available. You also might consider the filing requirements of operating a foundation in a given state. The inclusion of provisions permitting the board to transfer the foundation into a new jurisdiction may be desirable. This flexibility will permit the foundation to take advantage of a different state's laws. Again you must determine whether such flexibility will be desirable.

# V. GETTING STARTED: HOW TO BEGIN THE FOUNDATION

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Having covered the important considerations of how to define and attempt to ensure perpetuation of your objectives, you now are in a position to implement your plans and make decisions necessary to a successful foundation start-up.

An exhaustive description of the important details involved in getting started is beyond the scope of this work; thankfully, information on these matters is available elsewhere. However, the following brief listing of matters to consider in implementing your plans should be of assistance in getting you started.

## PRE-ESTABLISHMENT PLANNING

### *CHOOSE INITIAL BOARD MEMBERS*

As discussed earlier, the selection of your board members is an extremely important element in carrying out your intent. Make your decision as to your initial directors or trustees, depending on your form of organization. Secure their agreement to become involved in the venture and to carry out your intended mission.

### *RETAIN QUALIFIED COUNSEL*

There are a considerable number of individuals and organizations experienced in starting foundations that may be of assistance to you. You may want to obtain the advice of a consultant or advisor on philanthropy and foundations.

By all means retain qualified legal counsel. This should be an attorney experienced in the establishment and representation of private foundations. This is particularly important because of the complex federal

regulatory rules governing private foundations and the potential penalties that may be assessed for not observing those rules. Ideally, he or she also will possess a sophisticated level of estate planning expertise, and will be able to consult with you on the important estate planning considerations that will be involved. Financial advisors and accountants also should be brought into the equation early on.

#### *DETERMINE YOUR FOUNDATION'S SITUS*

Your foundation's situs will be the state of incorporation, if you decide to use the corporate form, or the law of your chosen state, if you use a trust.

#### *BEGIN LONG-RANGE PLANNING*

Involve your initial board members in this process.

#### *CONSIDER STAFFING*

Whether you retain paid staff will depend in large part on the size and expected activities of your foundation. You may consider an outside advisor to handle many administrative details.

## ESTABLISH THE ORGANIZATION

#### *GOVERNING INSTRUMENTS*

Prepare and execute the governing instruments (if a corporation, the articles of incorporation or charter and bylaws; if a trust, your trust instrument). These obviously must be prepared with careful attention to all of the details described above.

#### *FUND THE ENTITY*

Of course, the timing, amount, and asset makeup of your initial grant or grants will have been carefully planned well in advance, after careful consultation with estate planning counsel, your tax advisor, and your investment counselor.

#### *APPLY FOR TAX EXEMPT STATUS*

You must apply to the IRS for its determination that your organization qualifies as tax exempt. This should be done promptly after the organization is established and funded, although the rules allow you 15 months, and even an extension beyond that, to make your application. The application is made on a "Form 1023," which requires information about the purposes of the foundation, the individuals funding it, and copies of its governing instruments. This form should be completed by qualified legal counsel.

#### *COMPLETE STATE FILINGS*

If necessary, file any documents that may be required for a new charitable entity with the state attorney general or other supervisory authority.

## BEGIN OPERATIONS

#### *INITIAL MEETING*

If your foundation is structured as a corporation, at its first meeting the incorporators or board of directors will formally elect the directors and officers and will adopt the bylaws. Whether you choose a corporation or a trust, depending on the number of board members and the size of the foundation, consider providing for the establishment of committees, such as an executive committee, investment committee, grants committee, and audit committee. Often these details will be addressed over a period of time, as the individual board members become accustomed to operations.

#### *RECORD KEEPING*

Retain experienced, qualified accountants, and establish professional accounting and record-keeping systems. This is very important because of the federal and state reporting requirements.

#### *INVESTMENTS*

Retain qualified investment counsel, and establish and adopt investment policies, with particular reference to the prevailing prudent investor rules and private foundation jeopardizing investment rules.

*BUSINESS PLAN*

Establish and adopt a preliminary strategic business plan consisting of a mission statement, rationale, goals, and objectives. Determine your initial annual budget of foundation grants.

*GRANTMAKING POLICIES*

Establish and adopt grantmaking policies. Pay particular attention to your organization's intended purposes, and adopt policies that will be consistent with, and will assist the foundation managers in carrying out, those purposes.

Some factors to consider:

- Determine whether to support specific project grants, general support grants, or both.
- Decide whether any minimum or approximate percentages of annual grants are to be made for certain causes or to identified organizations.
- Determine whether to adopt any policy on matching grants.
- Set up a system for evaluation of grants. Determine internal guides relating to grantmaking decisions: Who will review grant requests or proposals? Should there be any required benchmarks to measure the financial condition of grant seekers, their administrative expenses, their total grants received, etc.? Establish procedures to analyze a grant seeking organization's endowment, to determine the extent of its need.
- If any grants to other private foundations or individual scholarships are contemplated (in most cases not worth the effort), determine a policy regarding the monitoring of such grants to ensure the careful exercise of "expenditure responsibility."
- Determine whether to establish calendar deadlines for applications by reference to scheduled board meetings.
- Determine whether to create a form of application to be used by grant-seeking organizations.
- Consider whether your foundation will play an active, as opposed to a passive, role. Decide whether to search for grant-seeking organizations or simply to await applications from any and all organizations that may apply within your grantmaking areas.

*GUIDELINES*

Prepare formal written guidelines for distribution to all grant-seeking organizations. This will enable the foundation to avoid extensive dealings with fund seekers in areas falling outside of the foundation's published areas of interest. This can be accomplished effectively only after determining your foundation's parameters; it may take some time and experience to become as specific as you may want to be. Preparing guidelines will help you translate your vision into specific programs and to incorporate decisions reached when developing your business plan and grantmaking policies. The guidelines should clearly spell out the foundation's intended purposes. As soon as guidelines have been published and distributed, it is important to be consistent in the handling of all applications and all grant-seeking organizations.

*OTHER DETAILS*

- The board should consider appointing officers to implement the foundation's policies. Also, if staff is retained, consider establishing employment policies for them. In addition, provide that all grant seeking proposals that are submitted to the board by staff be demonstrably consistent with the intent of the organization.
- Determine director compensation, if any. Consider state law schedules of fees for charitable trusts based on assets or income.
- Consider other benefits to directors or staff, including medical and group life insurance, retirement benefits, and vacation policies.
- And finally, consider involvement in organizations dedicated to responsible philanthropy.



## VI. CONCLUSION

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This publication has been prepared to provide guidance to individuals in establishing private foundations. In addition, it may help individuals in a position to re-evaluate and amend the instruments that govern their existing foundations.

We conclude by re-emphasizing that you should make sure your goals and vision are reflected throughout your foundation's governing instruments and that you should include a clear statement of your intent. Carefully work out mechanisms to select, appoint, and remove board members; an indemnification provision; and possibly a provision granting standing to outsiders. No significant final decisions should be made without consultation with competent and experienced legal counsel and tax and investment advisors.

The United States has entered a period that is expected to be unprecedented in the magnitude of resources devoted to philanthropy. Should you decide to participate in that development through the formation of a private foundation, do so with a clear vision as to its intended mission, and with a carefully designed vehicle to accomplish that end. Not only will this be a rewarding task in and of itself for you and your family, it will also be your contribution to a great American philanthropic tradition. You will be adding your vision to America's humanity, liberty, and creativity.

# ABOUT THE AUTHORS

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**Paul K. Rhoads** is a past board member of the Philanthropy Roundtable. He is past partner in charge of the Estate Planning and Administration Division of Schiff Hardin & Waite, a law firm headquartered in Chicago with offices in several cities in the United States and Ireland. He now maintains his law offices in Western Springs, Illinois. He received his bachelor's degree from Washington & Lee University, Lexington, Virginia, and his J.D. degree from Loyola University of Chicago. His experience extends to all phases and complexities of estate planning and charitable giving, with particular emphasis on private foundations. He has lectured on estate planning and administration and charitable giving, including private foundations, has co-authored chapters for Illinois Institute for Continuing Legal Education publications on estate and trust administration, and has written articles on various charitable giving topics. He is a director and president of The Grover Hermann Foundation. He is a past trustee of the Illinois Institute of Technology, of Chicago, Illinois; past member of the Board of Overseers of IIT Chicago-Kent College of Law; and also past director of Cyrus Tang Scholarship Foundation of Chicago, and of the Loyola University of Chicago Advisory Committee on Estate, Tax and Financial Planning. He has served as a director of several public and private corporations, and of various community organizations.

**Stephanie H. Denby** is a shareholder in Burke, Warren, MacKay, and Serritella, P.C. in Chicago, Illinois. She received her B.A. from the University of Chicago, Chicago, Illinois, and her J.D. from the University of Michigan, Ann Arbor, Michigan. She concentrates her practice in the fields of estate planning, charitable giving, and federal and estate gift taxes. She has lectured and written articles on various estate planning topics. She is an adjunct professor at John Marshall Law School and is a past member of the Editorial Board and the Charitable Giving Mini-Board of *Trusts & Estates* magazine. She also serves as a director and acts as counsel for several Chicago charities.

# THE PHILANTHROPY ROUNDTABLE

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The Philanthropy Roundtable is a national association of donors. It was founded in 1987 as a vehicle for grantmakers to exchange ideas and information about what works—and what doesn't—in philanthropy. Its programs are devoted to the exploration of effective giving strategies that promote well-being through individual liberty, personal responsibility, and self-reliance.

The Roundtable seeks to enhance private philanthropy by encouraging appreciation of the voluntary market system that makes philanthropy possible and by stressing the importance of the donor's vision and intent. Its work is motivated by the tremendous potential for private initiative to address society's most pressing needs.

Individual donors, corporate giving representatives, foundation staff and trustees, and trust and estate officers may become Roundtable Associates. In particular, the Roundtable welcomes members of small foundations, family foundations, and individual donors for whom philanthropy is a serious avocation.

Suggested annual contributions for Roundtable Associates begin as low as \$250 for individual donors and \$500 for corporations and foundations. The Philanthropy Roundtable also solicits grants for general operating purposes and for special projects.

## PROGRAMS, PUBLICATIONS, AND SERVICES AVAILABLE TO ROUNDTABLE ASSOCIATES

**Philanthropy:** Associates receive a subscription to the Roundtable’s six-times-a-year magazine, which explores the issues of greatest concern to grantmakers and welcomes articles by donors and others about new ideas and developments in philanthropy.

**The Annual National Meeting:** Associates are eligible for discounted registration fees for the Roundtable’s annual meeting, which focuses each year on a theme of central importance to philanthropy. Donors gather from around the country for this three-day conference, which also includes sessions on practical matters of concern to donors.

**Regional Meetings:** Associates receive invitations to attend all regional meetings of the Roundtable, bringing donors together in cities around the country to discuss issues of common concern and to develop strategies to address them.

**Publications:** Associates receive free or discounted copies of guidebooks, studies, and other special publications of the Roundtable.

**Consulting and Referral Services:** Consulting and referral services are available for Associates seeking advice on establishing, restructuring, or managing giving programs, as well as those seeking guidance on tax, legal, and other matters.

## OTHER ROUNDTABLE PUBLICATIONS

**Managing a Private Foundation** (by Paul K. Rhoads). The latest release in the Effective Donor series, this thoroughly researched guidebook covers practical issues confronting foundation trustees and staff. Mr. Rhoads provides guidance on foundation planning, trustee organization, staff, trustee meetings, oversight of investment management, grants management, and trustees’ legal responsibilities and liabilities.

**Questions to Ask Before You Write the Check** (introduction by Dr. Marvin Olasky). It can be as difficult to give away money effectively as it is to earn it in the first place. In this much-needed guidebook, five experts pose the questions to ask *before* you give. Essays are organized by the type of giving: social services, higher education, the arts, and health care.

**Death, Taxes, and the Independent Sector** (by Hudson Institute Director of Economic Research Alan Reynolds). Reynolds explores the true nature of the so-called “independent sector”—its size, scope, and the forces that influence its growth. Reynolds challenges the conventional thinking in philanthropy by asserting that traditional measures of the “independent sector” have overstated both its size and its charitable function. Reynolds also maintains that higher taxes do not spur greater giving, but in fact hurt charitable giving by reducing family incomes and discouraging asset accumulation.

**Should Foundations Exist in Perpetuity?** (by Heather Higgins and Michael Joyce, of the Randolph Foundation and the Lynde and Harry Bradley Foundation, respectively). Higgins argues for foundation sunset laws. Joyce counters that under the right conditions, foundations can be trusted to carry out the wishes of their founders.

**Discovering Charity** (by Gaylord Swim, of the ALS Foundation). Swim articulates his understanding of charity and explains how that understanding has both shaped and been shaped by his grantmaking.

**Donor Intent** (by Robert H. Bork and Waldemar Nielsen). Two essays variously discuss the parallels between constitutional interpretation and the interpretation of donors’ intentions, and the question of how best to enforce donor intent.

**The Market Foundations of Philanthropy** (by Richard B. McKenzie). This essay demonstrates the critical role that an entrepreneurial economy plays in creating the conditions necessary for effective philanthropy.

**The Promise of Community: Strengthening Civil Society** (by Paul Heyne). This monograph makes the case for placing responsibility for social problems with local communities.

**The Promise of Community: Local Voluntary Organizations as Problem-Solvers** (by James L. Payne). This Roundtable publication articulates voluntary organizations’ unique role at the local level and how foundations can help them.