FAMILY FOUNDATIONS

Building the Family Vision
One of the most important aspects of a family’s legacy planning can be philanthropy. Family philanthropy can be thought of as the organized charitable giving by several members of a family to achieve a unified goal. It is more than the annual giving of one individual or married couple, though such giving is critically important in its own right. Perhaps the key distinguishing feature of family philanthropy is the presence of a larger collective vision. Whereas an individual might be moved to donate to a cause more or less spontaneously, for example, following a natural disaster, or following a change in life circumstance (recovery from a serious medical condition or a child attending private school, for instance), family philanthropy tends to be more structured, its distributions often made to further a particular purpose. Thus, family philanthropy typically has a “vision” that individual giving may not.

Claude Rosenberg, Jr., in his book Wealthy and Wise,1 notes some of the benefits associated with family philanthropy. These include its role as:

• A great teacher of sound values
• A cohesive element—a fine common interest—for a ladder of generations within a family, as it should be among those within each distinct generation
• A practical tool that helps young people learn about business
• A psychological boost for people of all ages and of all income levels, including those of inherited wealth, who sometimes suffer from low self-esteem related to, and even guilt stemming from, their receipt of money they haven’t “earned”2

Note that this list of benefits does not include income tax deductions. That’s because family philanthropy, unlike individual charitable giving, can play an important role in transmitting and maintaining a family’s values and vision. This emphasis on vision and values versus a simple focus on planning can be especially beneficial to families in the face of the inevitable generational and geographic drift that many families face over time.

At the same time, family philanthropy is not a panacea that, in itself, brings about family unity. Launching a philanthropic effort as a family requires practical and frank discussions and decisions that include topics such as the goals and proposed lifespan of the effort, the needed roles and selection process for these roles, and the proposed involvement of younger family members and spouses.

In this paper, we will discuss the potential benefits derived from a family foundation while being mindful that this is one of several vehicles available to families to further their philanthropic goals, including donor-advised funds, charitable trusts, or some combination of approaches.

What is a Family Foundation?

Charitable giving through foundations has grown by approximately 31% since 2000, with roughly 70% originating from independent foundations.3 This growth trend in charitable giving through foundations is even more remarkable when you consider that broad market returns over the same time period have been relatively flat.4 Why this growth in foundation giving? One could conclude that a primary factor is tax reduction; however, as mentioned previously, high-net-worth families often engage in family philanthropy for reasons beyond the tax benefits. To maintain the highest level of control over charitable giving activities, and for the other benefits that will be discussed later, many high-net-worth families are turning to family foundations as the preferred form.

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1. Claude Rosenberg, Jr., Wealthy and Wise
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3. Claude Rosenberg, Jr., Wealthy and Wise
4. Claude Rosenberg, Jr., Wealthy and Wise
A family foundation is a tax-exempt organization that is formed to coordinate a family’s charitable giving activities. Under tax law, charitable organizations are classified as private foundations unless a specific exception applies. Public charities are the most notable exception, but these organizations receive substantial support from the general public or government entities. Most family foundations receive their initial and ongoing support from a limited source (the family) and are treated as private foundations.

Typically family foundations do not participate directly in charitable activities but rather make contributions or grants to other organizations that do. To maintain their preferred tax-exempt nature, these grant-making foundations must distribute roughly 5% of the net fair market value of the foundation assets on an annual basis for qualified charitable purposes. Any distributions in excess of the minimum 5% amount can reduce required distributions going forward for up to five years.

**Establishing the Family Foundation**

Family foundations are established as either nonprofit corporations or trusts under state law. State laws usually contain more detailed governance and operational guidelines for nonprofit corporations than for trusts. The corporate structure may also be favored as the roles (Directors, President, Vice-President, and Treasurer) and responsibilities may be more familiar to family members. Once the entity is organized under state law, an application for recognition of the entity’s tax exemption (Form 1023) is filed with the Internal Revenue Service.

Funding of a family foundation depends on several factors, such as the nature of assets and legacy goals of the family. Families with ongoing business interests or substantial illiquid assets may have insufficient cash flow to substantially fund the foundation in the early years. Closely-held business interests or real estate transferred to the foundation may be difficult to redeem or sell to provide sufficient cash flow to meet the foundation’s expenses and grant-making obligations.

The foundation’s funding plan may also be influenced by the relationship between generations of the family. Parents may have clearly identified charitable goals that they want to share with their children or grandchildren. In some cases, these goals are so strong that they have some difficulty parting with control or entertaining differing views on charitable giving. Regardless of asset size, there is little likelihood for long-term success of a family foundation without effective collaboration among family members.

In his book, *Family Wealth—Keeping It in the Family*, James E. Hughes, Jr., discusses the roadblocks associated with long-term generational transfers of wealth. He reasons that families generally focus on financial capital but rarely address two other critical forms of capital—human and intellectual. Success is often measured on the accumulation of financial assets, but long-term success (defined as greater than 100 years) is extremely unlikely unless the family can positively answer certain qualitative questions including:

- Is each individual family member thriving?
- Are family members willing to listen to those they lead?
- Is the family’s collective capital (human, intellectual and financial) being managed to help family members achieve their individual pursuits of happiness?

Properly organized and managed, family foundations provide a unique structure that can improve the likelihood for successful transfer of a family’s legacy, especially its human and intellectual capital. Strong communication is the key.
What Are the Benefits to the Family?

A family foundation provides many unique opportunities to enhance communication and educational opportunities among family members. Perhaps the most important, and most often overlooked, are family financial education, family meetings and introducing broader family issues.

**First Benefit: Family Financial Education**

One of the greatest benefits that a family foundation can provide for a family is the opportunity for shared learning about financial and investment matters. Donor-advised funds and simple annual giving can, if used properly, bring the family together to discuss stewardship and social responsibility. But family foundations allow families to educate their members on how to handle money without giving that money directly to the family members. Under the right circumstances, a family foundation can be a valuable tool that provides the older generation the opportunity to mentor the younger generation on skills such as due diligence, analytic evaluation, problem solving, collaborative decision making and investment strategies.

An important point to remember about foundation investments is that, unlike individual investments, they are subject to state law restrictions. After all, there is no law saying that you can’t be as idiosyncratic as you like with your personal investments. There is, however, a law that governs foundation investments. This law is captured in two places: the Uniform Management of Institutional Funds Act and the Uniform Prudent Investor Act. The latter was drafted first and, for purposes of this discussion, can be seen as the appropriate standard for investments by all family foundations.

Although a detailed investment discussion is outside the scope of this paper, the laws governing foundation investments focus on a few simple principles. The most important of these principles is proper diversification. Although individuals are free to hold significant concentrations in a small number of securities, foundations generally are not (unless the governing documents specifically allow it).

Foundations are expected to diversify their holdings both within asset classes (for example, holding a mutual fund of many stocks, rather than stock in one company) and among asset classes (in other words, a foundation cannot have a simple bond-only portfolio). A foundation also must have a well-drafted investment policy statement and ongoing investment oversight, to ensure that the policy is consistently executed.

Because foundation investments are governed by law and subject to state government oversight, most foundations hire investment advisors who have extensive experience dealing with the challenges that foundation investing can pose. Hiring and working with such an advisor provides a great family education opportunity: it allows younger generations to be introduced to fundamental investment concepts and for them to start assuming at least some decision-making authority when they are ready to have it.

**Second Benefit: Family Meetings**

Given geographic dispersion, many families find it difficult to find opportunities to come together. Family foundations provide such opportunities: families can gather to make site visits, meet with charitable recipients, discuss their proposed annual distributions, as well as review administrative issues, investment updates and larger corporate guidance. Such family meetings may provide the only opportunity for families to discuss financial issues and individual goals and desires in a fairly neutral context (for example, the family may have a chance to talk more about the charities they are passionate about, and less about why the kids aren’t doing what the parents did when they were young).

To feel connected to the foundation, family members need a forum to share their individual passions and express their ideas. The family foundation is an enterprise that will not continue long-term without a deep commitment from all participants. Additionally, the most successful foundations recognize the unique talents of each member and seek out ways to tap into that strength. Egos must be set aside and replaced with respect and enhanced listening skills. The road to success is not easy, but the rewards to the family are beyond measure.
Third Benefit: Introducing Broader Family Topics

Charles Collier, in his book, *Wealth in Families*, lists the best practices of successful families, which include the following:

- A focus on the human, intellectual and social capital of their family
- Stress on the priority of each family member’s individual pursuit of happiness
- Work on enhancing intra-family communication
- Adoption of a long-term time frame for determining success
- The telling and retelling of the family’s most important stories
- Creation of mentor-like relationships when establishing family trusts
- Collaboratively defining a family vision statement (what Collier calls the “Shared Dream”)
- Teaching children and grandchildren the competencies and responsibilities that come with financial wealth
- Giving younger family members as much responsibility as soon as possible

Although Collier notes that no family engages in them all, the consequences of not taking at least some of these steps can be serious and far-reaching. Research suggests that up to 70% of family wealth may not pass effectively to the next generation. Note that the last four of these items can be addressed (at least in part) through the creation and administration of a family foundation.

Ideally, by getting the family together to talk about charitable and financial issues in a slightly more neutral context, the family foundation meeting may provide a setting for families to begin discussing more “hot button” issues such as estate planning, education, careers, and business succession planning.

Conclusion

In this paper we highlighted some benefits to family members that can be derived from establishing and managing a family foundation. We noted at the outset that this is not the only vehicle available to families who are charitably inclined. A philanthropic effort worth each family members’ time—and the IRS exemption—requires: clarity and focus surrounding the goals of the foundation; initial costs of establishing/funding the foundation; annual requirements for maintaining the foundation; skills for managing the foundation; a selection process for directors and managers; methods of defining and measuring success; and a consideration of the alternative ways for a family to give together.

For families with philanthropic intent and the desire to pursue this goal as a family, family foundations can contribute to several important goals: philanthropy, family financial education, and clarifying shared family values through regular meetings and discussions. Because foundations are complex, and can be expensive to create and maintain, families that want to achieve all of these goals, rather than just one or two of them, are the best candidates for family foundations. Viewed in this light, the family foundation can be a centerpiece for ongoing family communication and growth and not only a tax savings device.
Endnotes

1 Claude Rosenberg, Jr., Wealthy and Wise: How You and America Can Get the Most Out of Your Giving (1st Ed. 1994).
2 Id. at 39.
3 The Foundation Center, Foundation Giving and Growth Estimates (2011). Family foundations account for more than half of all independent foundations in terms of assets, giving and new gifts and bequests from donors. See The Foundation Center, Key Facts on Family Foundations (Jan. 2011).
4 For example, from January 3, 2000 through December 31, 2010, the compound annual growth rate for the S&P 500 was approximately -2.07%, after adjusting for inflation.
5 Tax exempt status for a family foundation is obtained under Internal Revenue Code §501(c).
6 See generally IRC §508(b).
8 For a more detailed explanation of the classification and compliance rules that apply to private foundations see IRS Pub. 4221-PF (Rev. 11-2010): Compliance Guide for 501(c)(3) Private Foundations. Whenever the term “family foundation” is used within this paper it is presumed that such entity is classified as a private foundation.
9 See IRC §4942.
10 IRC §4942(i).
12 Id. at 8.
13 Id. at 11-12.
14 Collier, Wealth in Families (Harvard Univ. 2002).
15 Id. at 7-8.
16 Williams & Preisser, Philanthropy, Heirs and Values (RDR 2005) at 19-22.