CHAPTER 1

The Basics of Charitable Giving

You need no special knowledge to write a check to charity. But if you are a serious philanthropist, someone who wants to have an impact, to take advantage of tax breaks, and to exercise control, you need to know how the system works. Specifically, you need to know about the ways in which you can give to charity.

Charitable vehicles are legal structures that make effective charity possible. For people who are new to the world of philanthropy—and some who aren't so new—the range of charitable instruments can seem overwhelming. The first step in understanding them is to review all of the options with their advantages and disadvantages. In this chapter, we will look at four approaches to philanthropy: direct gifts, supporting organizations, donor-advised funds, and private foundations. We examine two other popular vehicles, charitable lead trusts and charitable remainder trusts, in greater detail in Chapter 4. Our aim is to provide a working overview of the available options so that donors and their advisers will be able to make choices appropriate for their specific situations.

Of course, we'll be focusing on the private foundation, the vehicle of choice for 75 percent of the country's wealthiest 400 families and truly the gold standard of charitable vehicles. However, to understand why private foundations work so well, it's important to know something about the other three approaches for a basis of comparison.

P1: OTA/XYZ P2: ABC
JWBT2091-c01 JWBT2091-Silk August 25, 2016 19:54 Printer Name: To Come

Direct Gifts

A direct gift of money is the simplest, easiest, and perhaps most familiar way to support a cause. Essentially, you write a check to the charity of your choice, and you're done. Large direct gifts are usually endowment gifts—money that will be held and invested by the charity or invested into bricks and mortar. Over time, the charity will spend the income generated by those assets. For example, anyone who's attended a class at any one of dozens of U.S. universities has probably seen the name "Kresge" on a hall or auditorium. "Kresge" is the "K" in "Kmart," and the Kresge family has given large amounts to numerous schools, where the family name is now carved in stone. Kresge obviously favors using direct gifts as a means of supporting select charities and organizations. And for having buildings named after you, there's probably no better way to go.

But direct gifts often are not the best strategy for an effective long-term program. Here's why. Once a donor makes an endowment grant, he or she may have an opportunity to advise the board of the charitable organization, but will no longer have control over how the funds are used. Charities with large endowments—classic examples being Harvard University, with an endowment approaching $30 billion at last count, and Yale, with over $15 billion—are often less than responsive to the donors who created those endowments. Yale famously returned a $20 million gift from Texas billionaire Lee Bass, saying that Bass wanted too much control over how his money was used.

Unresponsiveness is no problem for donors who don't want a lot of involvement and are willing or even happy to give control over the money they have donated to the organization they've chosen. Many donors, though, especially those whose gifts are large, want to use their donations to create and implement a specific vision or to encourage a specific project. It is important for these donors to have control.

In the best cases, donors make large endowment gifts because they conclude that doing so will put the money to the best possible use. In many cases, however, donors may be interested in the publicity, the kudos, and the goodwill that attend the announcement of such gifts. The reader may recall Ted Turner's $1 billion pledge to the United Nations in 1997. It's hard to know what really went on in Turner's mind, but it's not unreasonable to believe that favorable publicity may have factored into his decision.

It can be very frustrating to make a large endowment gift only to watch the charity change its mission or act contrary to the donors' wishes. Even having your name on the door does not guarantee that a charity will always do what you want. In 2000 in New York City, this was illustrated in an ugly and public battle between Marylou Whitney and the Whitney Museum over a work of art by Hans Haacke entitled *Sanitation.* Marylou Whitney, a daughter-in-law of Whitney Museum founder Gertrude Vanderbilt Whitney, was a director and member of the museum's national fund-raising committee. But when she and other family members raised objections to the planned exhibit because of the exhibit's appallingly insensitive use of Nazi iconography, the museum dismissed her concerns and proceeded to mount the show. Whitney resigned from the museum's fund-raising committee and removed the museum from her will. The Whitney was "free to associate itself with trash," she told the BBC, but she did not want people to think she approved of it. Marylou Whitney also cancelled a planned $1 million gift to the Whitney Gallery of Western Art.

Another problem with large endowments is that they can make it feasible for the people running the charity to focus more on their own positions or on raising still more funds than on the immediate needs of the charity's beneficiaries. In our view, the actions of many large, privately endowed universities in the United States are a case in point. Schools such as Harvard, Stanford, and Princeton continue to aggressively seek new funds for their endowments, and continue to raise the pay levels of senior faculty and administration, even as they continue to raise tuition at rates far exceeding the rate of inflation, without using the endowment to moderate these costs. Some universities pay their presidents what many would consider to be astronomical salaries. For example, Rensselaer Polytechnic Institute, in Troy, New York, paid its president, Shirley-Ann Jackson, $1,598,247 in fiscal 2008 according to the New York *Times*. But she has company. The *Times* reported that 23 presidents of private universities earned more than $1 million in 2008.

Jon Van Til, a professor at Rutgers University, told the *Chronicle of Philanthropy,* seen by many as the newspaper of record for the philanthropic community, that such salaries often allow the people running the organizations to lose touch with the people they're supposed to be serving. James Abruzzo, who heads nonprofit headhunting for the New Jersey–based firm DHR International, draws the link explicitly. Many of the largest nonprofits tie executive pay to fund-raising success, he says.

Some cases of a charity actually violating a donor's intent are particularly blatant and egregious. If you haven't heard such stories, it's because they rarely reach the courts or show up in the press. Donors are too embarrassed to go public with their complaints. And even if the donors seem to have a good legal argument, it's difficult and expensive to meet the legally required standards of evidence on something as subjective as intent.

One case that did go to court involved Manhattan's St. Luke's Roosevelt hospital and a donor named R. Brinkley Smithers. Smithers dramatically influenced the treatment of alcoholism in the second half of the twentieth century. During the 1970s and 1980s, he pledged $10 million to St. Luke's Roosevelt in order to establish the Smithers Alcoholism and Treatment Center. Smithers was a strong supporter of an approach that encourages alcoholics to give up drinking entirely and to rely on group support from other alcoholics, the same approach pioneered by Alcoholics Anonymous. Smithers spent millions of dollars funding research on this form of treatment. He naturally expected the Smithers Alcoholism and Treatment Center to support his views on abstinence.

Smithers' theories were generally supported during his lifetime. But a year after he died, in 1994, St. Luke's developed an intervention clinic that accepted and supported a "controlled drinking" treatment. In addition, the hospital, heavily in debt, decided to sell the town house on Manhattan's Upper East Side that had housed the program for years. Smithers' widow Adele sued St. Luke's, but she lost, and before she could get an appeals court ruling, St. Luke's sold the building for $15.9 million. Smithers and her son were so displeased with St. Luke's that they now publicly disavow the program that bears the family name. The trial court ruled that Mrs. Smithers lacked standing to sue. She appealed, and won. St. Luke's finally agreed to settle the case in 2003, by agreeing to give almost $6 million to another nonprofit, which is expected to carry out Brinkley Smithers' original intentions.

As foundation managers, we've seen a number of similar cases up close, involving donors who felt mistreated and saw their money used in ways they'd never wanted. To protect our clients, we have removed identifying detail from these stories. But they are worth hearing.

In one case, during the 1970s, a well-known university raised $20 million from a prominent donor to finance research in a then-arcane area of finance called "derivative contracts" by a distinguished professor. When the university accepted the funds, it seemed to be in complete agreement with the donor's wishes that the money be spent on this particular area; the funds were put in a separate endowment account. Time passed, and the endowment grew. For a number of years, the research went on as intended.

But when the university changed hands in the 1990s, so did its priorities. The administration eliminated the entire research program and even the department for which the funds had been raised. A primary motive was to get their hands on the endowment funds. The donor had already died, but the finance professor, now retired, decided to fight. Over a period of several years, he expressed concerns quietly, and then made formal protests. He tried his best to gather allies against the administration, but he still hadn't made any headway when he died from a stroke in 1997. The assets were commingled with the endowment of the university.

In a second case, which also involves a university, a donor agreed to endow a chair for an economics professor. Endowed chairs, which establish a named professorship in a given field, are a staple of university fund-raising. They are created by universities as a fund-raising tactic, or by a donor who wants his or her name associated with a chair in exchange for funding. Perhaps the most famous is the Lucasian chair in mathematics at Cambridge University, now held by Stephen Hawking and once held by Sir Isaac Newton. That chair was created in 1663 by a gift of land from a Member of Parliament named Henry Lucas. The land yielded £100 a year, which was a lot of money in those days. These days, it costs a lot more than £100 a year to endow a chair. The price varies from school to school and even department to department, but it generally runs into six or seven figures. (The price may be negotiable, although this is a fact that schools would prefer remained secret.)

In our case of the economics chair, which occurred in the late 1990s, a wealthy donor who was already a supporter of a well-known eastern school decided to give an additional $1 million to endow a chair in economics. It was up to the university to make the appointment, and it chose one of the university's well-known professors. The professor was chosen partly because of work he had done to establish an important academic organization within the university—an organization that was endowed by the same generous donor who now wanted to endow the chair.

Receipt of a chair (which is always tenured) is both an honor and a sinecure for any professor, who has a public platform and cannot be fired. In this instance, the professor started a very public attack on an academic organization supported and funded by the same donor who had endowed the professor's chair. As a result, the organization's ideology changed dramatically, and in opposition to the donor's beliefs.

The donor was furious and extremely disappointed that his intentions for the organization and for the endowed chair had gone awry. There was nothing he or the university could do. He had no choice but to live with his mistake. But it is certain that he doesn't plan to endow another chair anytime soon. In all his future giving, the donor has been careful to attach strings and fund programs only a year at a time.

Stories like these are not unusual. We urge donors to weigh decisions carefully before making endowment grants to charities, whether these charities are universities, arts organizations, hospitals, or any other large institution. If donors have no doubt that a charity will be responsive to their wishes, or accept the idea that a charity should be free to modify its use of the funds as it thinks best, an endowment grant may be appropriate.

If you like the idea of your name carved in stone or on a plaque, and you believe in the mission of the organization and have confidence in its leadership, go ahead and make an endowment. You will be in a lot of good company. But if you want more control over the use of your money, we believe that there are better alternatives.

To encourage one-time endowment gifts, charities often tell donors that they need such gifts to ensure funding for long-term programs. In certain cases, this logic may be justified. But there are ways that a donor can arrange to provide long-term funding and still retain control. As we shall see later in this chapter, a private foundation is an ideal way to get the immediate tax benefits that come from an endowment-level gift, but still exercise the control and judgment you want (and that you believe can benefit the charities over the long run).

As you've seen, we are particularly cautious about universities. Even under the best of circumstances, in our view, universities are no longer good places to make big donations. Despite the popularity of university endowment funds, we do not usually advise large endowments for universities if a donor wants to have significant control over how that money is spent.

Supporting Organizations

Another charitable vehicle that can be appropriate in certain situations is a supporting organization. A supporting organization has some characteristics of a private foundation and some of a public charity. Like a private foundation, a supporting organization is a separate, freestanding legal entity. But it is often associated with a charitable organization that supplies it with certain services, such as money management and administration. The founder can often be on the board of the associated charity. However, unlike with a private foundation, the founder cannot have control. Control must rest with one or more public charities.

Recently a number of fund-raising organizations such as community foundations, universities, and Jewish federations have been marketing supporting organizations as "family foundations." That creates some confusion, so it is worth examining these organizations in some depth.

For example, the Associated Jewish Charities in Baltimore, Maryland, in cooperation with Zanvyl Krieger, a very wealthy Baltimore businessman, created the Zanvyl Krieger Fund as a supporting organization in 1978. The Associated named Krieger and several of his family members, as well as a larger number of nonrelated people, to the board of the fund. For many years, until his death in the late 1990s, Krieger treated the fund much as he would have his private foundation. However, unlike with a foundation, Krieger had to take into account the desires of the Associated—the supporting organization—which at times conflicted with his own.

The rules describing supporting organizations are, not surprisingly, fairly complex. They are laid out in the Internal Revenue Code (IRC)'s Section 509(a)3. In essence, the rules state that a supporting organization must have a relationship with one or more public charities as follows. The supporting organization must be:

- Operated, supervised, or controlled by,
- Supervised or controlled in connection with, or
- Operated in connection with the principal organization.

In practice, "operated, supervised, or controlled by" means that the directors or officers of the supporting organization are selected by the associated group. Thus, a donor can be on the board of a supporting organization, but the donor and related people (generally the same people who would be disqualified persons under the private foundation rules, as discussed in Chapter 11) cannot constitute a majority of the board. The selection of these board members would be entirely in the hands of the associated organization.

"Supervised or controlled in connection with" generally means that the same people who control the associated organization also control the supporting organization. This requirement can be met, for example, by having the board members of the supporting organization be the same people who are on the board of the associated organization.

"Operated in connection with" is probably the most complicated of the three types of relationships, in that to qualify for this type of relationship, a supporting organization must meet both a so-called responsiveness test and an "integral part" test. Since these, in turn, have more tests, we will not go into full detail here. It is sufficient to note that this relationship will qualify only in cases where the supporting organization works very closely with, for the purposes of, and under the control of the primary group.

As the above makes clear, a charitable entity organized as a supporting organization is not a family foundation in the sense that most people use that term. That is, it is not an independent, private foundation. People charged with raising funds for the associated organization may reason that, since they will allow the donor's name to be attached to the fund and since the donor may be allowed to sit on the board, the organization is like a private foundation and can be called one. Since there is no legal definition of the term, this practice is legal. However, it may mislead some donors. Anyone considering a vehicle that purports to offer the benefits of a private foundation (without the restrictions) should fully investigate what he is getting. If it's a supporting organization, the donor must, by definition, give up control.

In practice, a supporting organization can be much like an outright endowment gift in that the donor may have an advisory role but is not allowed to maintain control. Our experience is that most donors do not use supporting organizations if their circumstances allow a private foundation. When donors choose on their own to form supporting organizations, it is most often a situation in which a private foundation simply won't work because of one or more regulatory or tax considerations.

Perhaps the most salient issues for a donor considering a supporting organization are the choice of the primary organization and the manner in which that group will exercise control. Note that the rules permit the control to be vested in more than one public charity. From the donor's point of view, a supporting organization controlled by several public charities can give the donor more flexibility and influence than is possible with just one charity in control. With several public charities, it may be easier to prevent any single organization from dictating terms on its own.

There are several circumstances that may cause a donor to select a supporting organization as the charitable structure of choice—usually in cases where something precludes the use of a private foundation. These include situations where a donor wishes to contribute closely held company stock, where a donor wants to contribute appreciated property that is not publicly traded stock and get an income tax deduction at fair market value, or where a donor expects to carry out transactions with the organization that would be deemed self-dealing (see Chapter 11) if done with a private foundation.

In such circumstances, a supporting organization can be the best alternative, allowing the donor to achieve a central goal and still maintain sufficient influence over how the funds are used. With an informed donor driving the process, a supporting organization can be a useful and satisfactory tool for all parties over the long run.

Donor-Advised Funds

Donor-advised funds are public charities or subsidiaries of public charities that give donors the ability to make a large gift to the charity and then "advise"—without the legal right to actually direct—the fund on how and when to make specific charitable gifts. Several donor-advised funds, such as the Fidelity Gift Fund and the Vanguard Charitable Endowment Program, have been very successful in raising money on a commercial basis. In addition, a growing number of community foundations, including most of the larger ones, such as the California Community Foundation and the Central New York Community Foundation, offer donor-advised funds.

The donor-advised fund area, once a sleepy backwater of charitable giving, has in recent years gained tremendous acceptance, driven in part by Fidelity's marketing machine. There are several reasons. First, a donor-advised fund, whether a commercial or a community foundation, offers the donor the ability to make a gift immediately for tax purposes and decide later when and where to make grants to the charities that will eventually spend the money.

Second, gifts to donor-advised funds qualify as gifts to a public charity for tax deduction purposes. Depending on the specifics of the donor's situation, this advantage may be worth anything between zero and a large number.

Third, it is simple. A donor simply writes a check or sends money, not unlike opening a mutual fund account, and may sign an agreement covering the way in which she will advise on grants to be made. There is no further paperwork for the donor, because the fund takes care of it all.

Because a donor-advised fund is treated as a public charity for purposes of income-tax deduction limitations, it can offer some benefits for donors who want to give more than 30 percent of their income to charity each year or to donate appreciated property other than publicly traded stock. If this is the only reason for considering a donor-advised fund, however, a donor may wish to consult an adviser about other possibilities that can allow him to give a higher percentage of income and maintain better control.

Donor-advised funds can offer some savings in certain situations. For example, they do not pay excise taxes, as private foundations do. However, because the excise tax rate for foundations is only 2 percent of earnings (not assets), this advantage is typically very small—a few hundred dollars a year on $500,000 of assets. A donor-advised fund may also save money on annual fees for donors who will never have more than $200,000 or so in a charitable entity.

Donor-advised funds spare donors some paperwork, because the funds handle the compliance work. But with professional foundation management, donors to private foundations are also spared paperwork. For charitable commitments of about $500,000 or greater, such a donor can have all the benefits of a private foundation and none of the headaches, for about the same costs.

In spite of, or perhaps because of, these benefits, some donors are confused about what a donor-advised fund actually is. Some donor-advised funds encourage the confusion by calling a donor's account a "foundation." A donor-advised fund is itself a charity. When you give money to a donor-advised fund, you are giving away your money—irrevocably. The charity that receives it—that is, the donor-advised fund—then owns the money. “Once a contribution is accepted, it’s an irrevocable charitable contribution to the Gift Fund, to be owned and held by our Trustees,” says the nation’s largest commercial donor-advised fund, Fidelity Gift Fund.

While usually there is no issue, occasionally the donor might end up out-of-luck. For example, the National Heritage Foundation for years offered donor-advised fund accounts that they called “Foundations.” As with all donor-advised funds, contributions to National Heritage Foundation’s donor-advised fund are considered legal contributions to the National Heritage Foundation. Donor-advised contributors learned the significance of this distinction the hard way in January 2009, when National Heritage filed for bankruptcy. The bankruptcy court in that case reaffirmed the fact that donor-advised fund donors have no legal claim to the assets, and have merely an “advisory” role. In other words, “sorry, fellas.”

National Heritage Foundation is the exception. A donor-advised fund will generally take the donor’s advice, but is not *required* to take such advice. In fact, the Internal Revenue Service (IRS) takes a negative view of any pledge by a donor-advised fund to follow donor advice. In the Tax Reform Act of 1969, which established the current laws dealing with private foundations, Congress made quite clear that it considered control over a foundation to be a privilege, and that in exchange for that privilege, foundations had to adhere to a complex set of requirements and limitations. The agency objects to attempts to offer the benefits and avoid the rules. In accordance with those rules, Fidelity makes it very plain that Fidelity, not the donor, controls the money. “As a donor, you may recommend grants,” states Fidelity’s marketing material. That recommendation is then reviewed by the fund trustees or staff. “If the recommendation is not approved, we will try to notify you and obtain a recommendation for a grant to an alternative charitable organization.” In other words, they’ll try to accommodate you, but your funds become their money, and they’ll ultimately do as they see fit.

A private foundation, in contrast, gives the donor full, legal control. And if a foundation is managed by a full-service professional management firm, administration is nearly as simple for the donor as it would be with a donor-advised fund. The difference is that the donor need not worry about whether his wishes will be followed.

While most donor-advised funds follow donors’ advice most of the time, this could change. The IRS, in its 2001 Exempt Organizations Instruction Program (EOIP), said that it “will look closely at” donor-advised funds that say they will “follow donor advice as to charitable distributions all the time.” They finally got around to issuing further clarification in 2006. We review those changes in some depth in Chapter 14.

Another concern about donor-advised funds is that they are susceptible to public pressure to avoid controversy. A popular "Mom-and-apple-pie" charity can quickly become highly controversial, as the Boy Scouts has. Once that happens, public and political pressure may be placed on donor-advised funds to stop directing funds to such charities—regardless of the donor's wishes. Private foundations, in contrast, can support any cause as long as it is a recognized charity.

A new potential problem for donor-advised funds has been created by the antiterrorism measures enacted since September 11, 2001, targeting charities that support—or are believed to support—terrorism. A donor-advised fund is legally a single charity. But it might agree to make a grant to any charity that a donor to the fund designated. What happens if one of those recipient charities turns out to be a supporter of terrorism? Will the government freeze the assets of the donor-advised fund? While this is probably not likely, it still applies and does raise the possibility that those who give money to a donor-advised fund are linking their fate to the actions of hundreds or thousands of other people whom they do not even know.

A number of people who have put money into donor-advised funds found that the sponsors made it difficult to distribute money to unpopular causes, or causes they didn't deem important. One of the largest disputes between a donor and a community foundation has dragged on for several years between the Chicago Community Trust and the Searle family, led now by Daniel Searle. He is the son of pharmaceutical magnate John G. Searle (most famous for his company's Nutra-Sweet products) who provided the funding in question. The Office of the Illinois Attorney General states, "The issue centers on whether and to what degree [John G.] Searle intended the Chicago Community Trust to defer to the Searle 'family consultants' in the granting of monies from the fund."

While the relationship between the Searles and the Trust is not exactly a donor-advised fund relationship, it shares the critical element of donor advice without legal control. Under the will of the elder Searle, the Chicago Community Trust was to administer certain funds, currently about $20 million a year, in conjunction with advice and input from the Searle family. In 2001, about $40 million was frozen in an account at the Harris Bank in Chicago, and the dispute resulted in a lawsuit. Ironically, the Searles argued that the Chicago Community Trust should behave *more* like donor-advised funds and the Trust countered that it was attempting to act in the best interests of everyone. "Really what this all comes down to … is a relationship that has deteriorated over time," Tina-Marie Adams, a spokeswoman for the Searle family, told the *Chicago Tribune.* That's as good as any comment for an implied warning to those considering entering into such long-term, nonbinding relationships.

P1: OTA/XYZ P2: ABC
JWBT2091-c01 JWBT2091-Silk August 25, 2016 19:54 Printer Name: To Come

Searle's lawsuit dragged on until 2004, when it was settled under terms that were kept quiet. The Searle Fund continued at the Chicago Community Trust, where it remains. However, whether by coincidence or not, shortly after the suit was settled, the President of the Chicago Community Trust, Donald Stewart, stepped down after only four years in the position.

While this case is notable for its magnitude, it is hard to know exactly how often donor-advised funds disregard a donor's wishes. Again, disputes are often embarrassing for both sides, so that neither has much desire to publicize them. And, usually, donors have no standing to complain. After all, they agreed to the terms specifying that they didn't have control, and to attempt to assert a legal claim would be tantamount to admitting that they obtained improper tax benefits.

There are other limitations to commercial donor-advised funds. One is that they offer few investment options. Financial services companies that run donor-advised funds generally require donors to put their money into their own mutual funds or other investment vehicles. A donor cannot hold stock in a donor-advised fund; if he donates stock, the fund will sell it and invest the proceeds in its own mutual funds. Furthermore, the choice of mutual funds is restricted not just to that company's funds, but to specified funds—which impose additional costs, beyond the administration fee charged by the donor-advised fund itself. Fidelity Gift Fund, the largest commercial donor-advised fund, offers only four investment choices, each consisting of a pool of its own mutual funds. Even among these four, Fidelity has the ultimate say as to where the money is invested. As we see in Chapters 9 and 10, limited investment flexibility can sometimes be quite costly.

Private Foundations

In essence, a private foundation is a tax-exempt charity that is funded and controlled by an individual or a family. A private foundation may be set up as a not-for-profit corporation or as a trust. Whichever arrangement you choose, a private foundation is treated the same for tax purposes. However, there are certain advantages that usually make the not-for-profit corporation more appealing than the trust.

The Not-for-Profit Corporation

Establishing a foundation as a not-for-profit corporation is a routine matter. As with a for-profit corporation, incorporation requires filing a certificate of incorporation with the state and adopting by-laws, which describe the internal workings of the organization. The primary difference is that a not-for-profit corporation usually has no shareholders. Instead, it may have members who elect a board of directors, which in turn appoints the officers. Alternatively, the board of directors can elect its own successors.

There are several advantages to the corporate form for a foundation: limited liability for officers and directors, greater flexibility (than a trust would have) to adapt the organization's structure as circumstances change, and the ability to have perpetual life (still not available for trusts in most states). Another feature of the corporate form is that it permits changes in the foundation's charitable goals. While some founders view this flexibility as a negative, we have found that you can have the best of both worlds by using a corporate form but maintaining control by having the donor make restricted grants to the foundation. Not-for-profit corporations, just like for-profits, are managed by their directors or officers. Certain management tasks, such as investment management and administration, may be delegated to professional advisers. Officers and directors, including family members, may be paid reasonable compensation for services actually performed.

Corporate form requires that the usual corporate formalities be observed, such as annual meetings and minutes. While these can be done simply, even perfunctorily, many families view them as a useful way to expose younger members to corporate workings.

The Trust

To establish a private foundation as a trust, the founder must sign a written document making a gift, in trust, to one or more trustees. The founder himself can be the trustee. A trust is generally located in the founder's home state. The registration rules vary from state to state.

Within limits, the terms of the trust can be broad or narrow, as desired. For example, a founder could write very narrow language into the trust document (see Chapter 7), or very broad language. For this reason, some founders believe that a trust gives them more control because it can be more difficult to change a trust, as compared to a corporation. However, structuring a trust very narrowly is not inherently better than making restricted gifts to the foundation, and may inadvertently (because of the difficulty of making changes) tie the hands of the trustee—even if the trustee is the founder—when unforeseen changes occur.

A trust has one or more trustees, just as a corporation has directors. Trustees generally select their successors. Trustees may receive reasonable compensation for services actually performed, although some states have more restrictive rules for trustee pay than for corporate director pay. Conversely, California imposes strict rules that often make the corporate form a bad choice for foundations in that state. Because investment management is traditionally seen as part of the trustee's duty, payments to professional investment managers may reduce the amount that can be paid to trustees under state law. These kinds of rules vary from state to state.

There are other drawbacks to creating a foundation as a trust. Perhaps the most important is that trustees have a fiduciary duty to the beneficiaries. This is a higher standard than the "business judgment" rule that applies to corporate directors, and can make it more difficult to attract outsiders as trustees. In addition, beneficiaries of a trust may have standing to sue that they would not have if the foundation were a corporation.

Because some foundations are trusts, and are therefore governed by trustees, and some are corporations and therefore governed by directors, the terms "trustee" and "director" are commonly used interchangeably in the nonprofit world. We generally use the term "director" in this book.

Private Foundations: Why the Gold Standard?

For a donor with substantial assets, no other charitable vehicle can match the unique combination of flexibility, control, and tax advantages offered by private foundations. A private foundation offers its founder the ability to make a difference in the world, build a permanent legacy, gain personal satisfaction and recognition, and keep control in the family forever. (It also offers an array of tax and financial benefits, which we cover in greater detail in the next chapter.)

- **Make a Difference.** A truly effective foundation is much more than a sum of money set aside for philanthropic use. It is the carefully cultivated, ever-evolving product of the founder's vision, drive, and ethical will. The ways in which foundations make a difference are as varied and interesting as their founders.

For example, the Arthur Schultz Foundation, headquartered in western Wyoming, is dedicated to promoting environmental conservation and providing access to recreation for the disabled. The Russell Sage Foundation, founded in 1907 by Margaret Olivia Sage in New York, funds research into the social sciences with the goal of improving social policies. The James S. McDonnell Foundation, founded in 1950 by the aviation pioneer and co-founder of the McDonnell Douglas Corporation, aggressively encourages the "improvement of mankind" through its 21st Century Science Initiative.

When Congress was debating restrictions on foundations in the 1960s, a supporter of foundations, noted philanthropist Irwin Miller, the former

CEO of Cummins Engine who built the company into a major player in its market, commented that "while foundations are the most peculiarly American manifestation of the philanthropic impulse, they do not operate as simply as traditional charity; taking the long view, and working with professional skills, they have grown more sophisticated and specialized in their approach to problems."

- **Create a Legacy.** Charitable foundations have a long and honorable history. When Plato died in 347 B.C., he left income from his estate for the perpetual support of his academy. Control passed through heirs who each designated their successor, and the academy thrived until 529 A.D., when Roman emperor Justinian terminated it for spreading pagan doctrines. While 856 years is not exactly forever, Plato's foundation surely ranks among the most long-lived individual institutions in the history of humankind.

When Benjamin Franklin died, he left 1,000 pounds sterling to the cities of Boston and Philadelphia with detailed instructions for use of the money. Franklin directed that some of the earnings be used initially for loans to young married couples, allowing principal and interest to grow, with the first use of the accumulated funds to be made 100 years later. The endowment helped finance the Franklin Institute of Philadelphia and the Franklin Institute of Boston, and the remainder continues to grow today.

Andrew Carnegie and John D. Rockefeller are often viewed as the pioneers of the modern charitable foundation. In 1899, Rockefeller told a group gathered to commemorate the tenth anniversary of the University of Chicago, "Let us erect a foundation, a trust, and engage directors who will make it a life work to manage, with our personal cooperation, this business of benevolence properly and effectively." The foundations established by Rockefeller and Carnegie are still active today, doing good work and carrying on their founders' names.

But a private foundation offers more than a long-lasting legacy. Because it is private, it can be and do exactly what the founders and directors want—even if what they want is considered unconventional by others. The John D. and Catherine D. MacArthur Foundation pursues an unconventional path. Founded in the late 1970s upon the death of industrialist John D. MacArthur (his wife died in 1981), it has become known for its "genius" grants—unrestricted grants, with no required reports or expected outcomes, given to "exceptionally creative individuals, regardless of field of endeavor." The MacArthurs' son, Roderick, a trustee of the foundation, revels in the foundation's freedom to pursue its own vision. "This [the private foundation] is the only institution in our society that does not have constituencies that it has to keep looking to. All the others have to worry about pleasing a lot of people, so they're bound to tend toward conventional wisdom, respectability, and the lowest common denominator.… Foundations should be striving to do the kinds of things that the government cannot do. I repeat, cannot do: things that are not politically popular, things that are too risky, things that are just too far ahead of what the public will put up with.… A private foundation, where the board of directors is answerable only to itself, is in a completely different situation, and if it doesn't take advantage of that uniqueness, it's just blowing its opportunity, and perhaps even its moral obligation."

- **Achieve Personal Satisfaction and Recognition.** In the late 1990s, Karen Maru File, an associate professor of marketing at the University of Connecticut, conducted a survey of philanthropists who had established their own private foundations. She found that 86 percent said their giving had become much more gratifying, and 79 percent said they felt less barraged by solicitations from charities.

Another important benefit is the recognition that comes from having a private foundation. Researcher Teresa Odendhal, author of several books on philanthropy and foundations, quotes one donor who created a private foundation: "If you are an individual making small contributions, you are magically transformed when you become a foundation making small grants. I feel that I am taken very seriously."

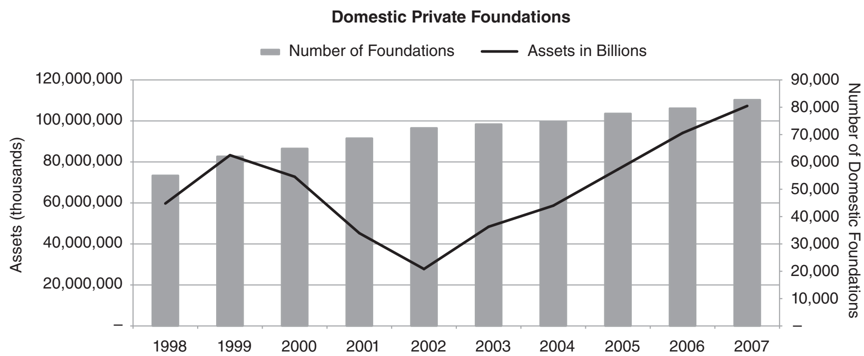
A 1999 article in *Scientist Magazine* predicted that in the coming millennium, the private foundation would become the status symbol of choice. And in the first decade of this millennium, the number of foundations has continued to grow, despite two of the worst stock market dives in the past century, as seen in Figure 1.1. In 2011, the *New York Times* reported that status is a major factor for some donors. "Of course," says the January 28 Wealth Matters column, "There are reasons that go well beyond charitable giving … Status is the obvious one …"

Donors who intend to have their children eventually run their foundations will also benefit—not merely by having a status symbol, but by being able to give more. As one adviser who also has his own foundation told the authors, "It's a great way to give my kids my influence, and it makes good financial sense, too."

- **Maintain Family Control.** As we saw in the discussion of other charitable vehicles above, control over how money is spent is often an issue. With private foundations, the donor retains full control. Indeed, the Searle family learned its lesson, and the current generation, led by Dan Searle, has an active private foundation, the D&D Foundation, which was created in 1983. A spokesperson for D&D speculated that the elder Searle made the now-troublesome arrangement with the Chicago Community Trust only because

P1: OTA/XYZ P2: ABC
JWBT2091-c01 JWBT2091-Silk August 25, 2016 19:54 Printer Name: To Come

FIGURE 1.1 Growth in Domestic Private Foundations



Domestic Private Foundations*

Asset Range	Number of Returns	% of Total
Zero or unreported	2,259	3%
$1 to under $100,000	20,630	24%
$100,000 to under $1,000,000	31,081	37%
$1,000,000 to under $10,000,000	24,083	28%
$10,000,000 to under $25,000,000	3,581	4%
$25,000,000 to under $50,000,000	1,421	2%
$50,000,000 to under $100,000,000	788	1%
$100,000,000 or more	769	1%
Total	**84,613**	

Source: http://www.irs.gov/taxstats/charitablestats/article/0,,id=96996,00.html
*Based on tax year 2007 data, the most recent year for which data is available as of 2011.

P1: OTA/XYZ P2: ABC
JWBT2091-c01 JWBT2091-Silk August 25, 2016 19:54 Printer Name: To Come

at the time, in the mid-1960s, his generation did not see control as such an important matter.

Control extends to all aspects of a foundation: the name; who is on the board; when, how, and to whom the money is donated; how the money is invested; and the choice of the bank or institution that will actually hold the funds.

Conclusion

The following table summarizes and compares the key features of the charitable vehicles discussed in this chapter.

Comparison of Charitable Vehicles

	Private Foundation	Direct Gift	Supporting Organization	Donor-Advised Fund
Immediate income tax deduction	Yes	Yes	Yes	Yes
Gift exempt from estate tax	Yes	Yes	Yes	Yes
Donor retains legal control	Yes	No	No	No
Legally controlled by donor's family in perpetuity	Yes	No	No	No
Builds charitable wealth free of income tax	Yes	No	Depends	Yes
IRS attitude	Supports	Supports	Supports	Supports
Investment options	Broad	Not applicable	Depends	Limited
When to use	When the amounts are large; When control is important	In special situations	In special situations	When amounts are small; When control doesn't matter

As this table shows, only the private foundation offers legal control along with its tax benefits. A private foundation also offers more flexibility—in how to invest and how to spend the money—than the alternatives. As for eventual disposition of assets, if a donor creates a private foundation but later changes her mind and wants to stop running it, she can still give some or all of the foundation assets to a donor-advised fund. The reverse is not true: A donor-advised fund may not contribute to a private foundation.

In addition, if its assets are large enough, a private foundation can be very cost-effective. While it is possible to spend upwards of $20,000 to set up a foundation, it does not necessarily cost that much. It may be $10,000 or less. Many full-service foundation companies—especially those providing financial management services, grants administration, and full foundation management—set fees based on a foundation's assets. For example, a foundation might pay an annual fee of 1 percent of total assets to a company that handles all the foundation's financial and administrative operations.

Most donor-advised funds do not impose a setup fee, but they tend to charge higher annual fees. Fees for donor-advised funds vary quite a bit, with the typical cost running about 1.5 percent of assets, which consists of an administrative fee of 1 percent of assets, plus investment management fees of approximately 0.5 percent.

Private foundations and donor-advised funds both play an important role in the charitable universe, and in general neither can be decisively preferred on the basis of cost alone. Donor-advised funds and private foundations each offer a unique combination of grant-making control, investment flexibility, and tax benefits. The next chapter looks at these tax benefits in greater depth and discusses several ways to take advantage of them.