

WHAT ARE THE GENERAL STEPS IN STARTING A FOUNDATION?

PREFORMATION PLANNING

Before you begin the formation process, there are several questions you should consider that will help you decide which type of foundation would best suit the needs of the new organization.

- *Why are we forming this organization?*
- *Who will do what work?*
- *Who will donate the foundation start-up capital?*
- *How will the foundation sustain itself?*
- *Who will serve on the board of directors and who will be the officers?*
- *How much administration and management do you wish to take on yourself or do you want to delegate?*
- *What degree of control do you want over the funds?*
- *What are the tax consequences?*

Answering questions such as the ones listed above can help you and your advisers determine which type of charitable organization or giving vehicle is right for you.

SHOULD WE SET UP OUR FOUNDATION AS A TRUST OR A CORPORATION?

A trust is less formal in both its formation and operation. In most states, there are fewer requirements for trusts regarding regular meetings, minutes, state filings, officers, or other record keeping. However, amending the charitable trust instrument may be difficult, possibly requiring court approval or notice to the attorney general. On the other hand, a corporation can provide more flexibility and is usually adaptable to most foundation purposes. In addition, forming a nonprofit corporation often provides greater protection from personal liability for the directors. The corporate approach is more formal, requiring articles of incorporation, bylaws, regular meetings, minutes, state filings, and other reporting requirements. Corporate bylaws can be drafted to facilitate amendments for any necessary changes.

WHAT ARE THE COSTS OF STARTING A FOUNDATION?

Prospective donors often wonder if they have enough money to start a private foundation. While the amount of assets available to endow the foundation is important, it is by no means the sole, or even the most important, factor in your decision. For this reason it is not recommended to only use a monetary threshold for forming a private foundation.

Determining whether a private foundation is right for you involves a host of additional questions, such as:

- *What values do you plan to express through your giving?*
- *Do you wish to involve others (your family, your employees) and to what extent?*
- *What is the geographic scope of your philanthropy?*
- *How long do you want your philanthropy to operate? Years? Decades? Forever?*
- *Do you prefer supporting others' work or hands-on participation?*
- *To what degree are you comfortable delegating tasks (such as investment management or correspondence)?*
- *How much time do you have to devote to administering your philanthropy?*
- *What are the tax consequences?*

The decision is one you'll want to make only after doing some research and getting some sound advice from a trusted philanthropic advisor.

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WHAT ARE THE OPTIONS FOR ADMINISTERING A PRIVATE FOUNDATION?

You will know the assets you can afford to put into a private foundation when starting it, but what will the annual administrative expenses be? That will depend on how you choose to administer your private foundation. There are many options for managing private foundations. Some of them include management by:

- *volunteer board of directors*
- *paid staff*
- *consultant*
- *attorney*
- *bank trust department*
- *community foundation*
- *a combination of some of the above*

CAN YOU AFFORD TO HIRE STAFF?

The Council on Foundations has developed three basic examples to help you decide whether you can afford paid staff. The scenarios below roughly demonstrate the relationship between asset amounts, grant distribution, and staffing expenses.

- *You make grants and do not provide direct charitable services.*
- *You want a permanent endowment.*
- *Your charitable budget is going to be in the range of 5 to 20 percent of assets as a start up*
- *The IRS mandated minimum annual charitable expenditure is 5 percent of assets. This includes grants and administrative expenses, but does not include investment management expenses.*

In the formulas below, we use the median foundation expenditure percentage of 15 percent for your charitable budget as a start up scenario. The percentage of administration costs devoted to CEO and staff salaries vary greatly dependent on responsibilities and skill-sets. We will use 25% of admin costs for our scenarios.

- No more than 20 percent of your annual charitable budget should be used for administrative expenses.
- Research by the Council on Foundations shows that the median charitable administrative expense level in relation to the total charitable budget for all private foundations is 8.6 percent. However, smaller foundations don't have the same economies of scale as larger foundations. Therefore, for smaller foundations we suggest that you assume that administrative expenses will be no more than 20 percent of your annual charitable budget.
- Annual legal and accounting fees will total about \$5,000.

Example 1: \$1 Million Foundation (Part Time Staff)

Because of the small amount of money that should be devoted to administrative expenses (usually no more than 20 percent of your annual charitable budget), the option of hiring full-time staff is not financially prudent with a foundation of this size.

Total Annual Charitable Budget

$\$1,000,000 \times .15 = \$150,000$ Assets x 15 percent = total annual charitable budget (grants + expenses)

Administrative Costs

$\$150,000 \times .20 = \$37,500$ Total annual charitable budget x 25 percent = administrative budget. Hours per week for CEO and/or staff would vary depending on need and skill-set.

Volunteer Responsibilities

Because in this scenario the foundation cannot realistically afford full-time staff, it will be the responsibility of the donor and volunteer board to do a lot of the work; review all grant requests, go on site visits (as necessary), and handle most grantee correspondence, grantmaking investigations, and governance responsibilities of the foundation. If your grantmaking is focused and the grants are few in number, these responsibilities will be easier for you. These responsibilities can be extremely fulfilling when willingly undertaken.

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Example 2: \$5 Million Foundation (Half-time CEO)

Council on Foundations research shows the majority of private foundations with assets of \$5 million to \$9.9 million have part-time staff and half-time CEO only. Half time CEO would range between \$45,000 - \$110,000 depending on skillset. A half time CEO that also fund-raises would be at higher end of range.

Total Annual Charitable Budget

$\$5,000,000 \times .15 = \$750,000$ Assets x 15 percent = total annual charitable budget (grants + expenses)

Administrative Costs

$\$750,000 \times .25 = \$187,500$ Total annual charitable budget x 25 percent = administrative budget

In this case, because your total charitable budget is significantly larger than the previous example, you might consider the option of a half-time staff person and half-time CEO. You might also consider hiring a lower-compensated staff person such as a program officer or administrative assistant, with the board retaining many responsibilities, or hiring a CEO with legal or accounting skills so that the fee is reduced.

Example 3: \$10 Million Foundation (Full-Time CEO and staff) With these assets, admin costs should be estimated at 11 percent or less. We will use 8 percent for our estimates. In this case, your annual charitable budget is an amount that realistically allows you to consider the option of hiring a CEO and a staffing. A full time CEO range would be between \$85,000 - \$225,000 depending on skillset. A CEO that also fund-raises would be at higher end of range.

Total Annual Charitable Budget

$\$10,000,000 \times .09 = \$900,000$ Assets x 9 percent = total annual charitable budget (grants + expenses)

Administrative Costs

$\$900,000 \times .25 = \$225,000$ Total annual charitable budget x 25 percent = administrative budget

The costs related to starting a foundation on the state level will vary from one state to the next and depend on the type of structure (e.g., trust or corporation, public charity, or private foundation) chosen for the foundation. State fees are paid with submission of required documents to the state office that is responsible for regulating charities; usually this is the secretary of state or the attorney general's office. In addition, there are fees associated with seeking recognition of charity status with the IRS. Finally, there may be licensing or other fees required for operation of any business in a particular area.

WHAT ARE SOME ALTERNATIVES TO STARTING A PRIVATE FOUNDATION?

Donor Advised Funds

Donor advised funds make philanthropy administratively simpler if one of your goals is to lessen your day-to-day obligations. In a donor advised fund, donors make an irrevocable contribution to a fund, claim a charitable deduction on their income tax returns, and then recommend how the money in the fund should be distributed to charity. Public charities (e.g., community foundations) take the responsibility of managing such funds. Most accept gifts of cash, publicly traded stock, real estate, and other assets like closely held stock and life insurance. The donated funds are invested in the financial market, so they can keep growing. You can take the tax deduction—typically up to 50 percent of your adjusted gross income for cash gifts and 30 percent for appreciated properties such as stock—for the tax year in which the donation was made.

One advantage of creating a fund through a community foundation is that community foundation staff know and live in the community they serve and can work closely with you to fulfill your charitable goals.

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Supporting Organizations

A supporting organization (SO) is a tax-exempt entity that supports a public charity. SOs must meet one of three complex legal tests that assure, at a minimum, that the charity being supported has some influence over the actions of the SO. The use of this form is common in connection with community foundations. While SOs are distinguishable from donor advised funds because they are distinct legal entities, they share many of the same favorable deduction limitations.

Planned Gifts

Individual donors may explore various planned giving options, such as bequests, charitable remainder trusts, charitable lead trusts, pooled income funds, and charitable gift annuities. These usually involve a split income arrangement where the donor receives an income stream during his or her lifetime and the charity receives an outright gift after a term of years or upon the donor's death. You can make these planned gifts through community foundations and other charities.

Writing Checks

You also may decide to simply continue making direct donations. If you are contemplating increasing the size of your gifts, development (fundraising) professionals at your favorite nonprofits will be happy to work with you to honor any specific wishes you may have.

WHO REGULATES FOUNDATIONS?

Foundations are regulated by both federal and state entities. On the federal level, the IRS regulates the operations of both private foundations and public charities. In most states, the attorney general is empowered to supervise and regulate charities and foundations. The Council on Foundations does not regulate foundations. The Council is a membership organization that supports grantmakers in various aspects of foundation management.

HOW DOES AN ORGANIZATION APPLY TO BECOME A PUBLIC CHARITY OR PRIVATE FOUNDATION?

In order to be recognized by the IRS as a public charity, an organization must first be formed under state law, usually in the state where the organization is planning to do business. Once the organization is established under state law, it may seek to become a public charity by filing an IRS Form 1023 application. The IRS then will issue the applicant a determination letter that will state whether the IRS officially recognizes the organization as exempt under Section 501(c)(3) of the Internal Revenue Code. If a favorable determination has been made, the letter will indicate if the organization is considered a private foundation under 509(a), or a public charity under Section 509(a)(1), Section 509(a)(2), or Section 509(a)(3) of the Internal Revenue Code. For complete information on IRS requirements, visit the IRS's website at www.irs.gov, and review IRS Publication 526.

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