

# Weighing the options

Private foundation costs and alternatives

**Benjamin Franklin knew the value of money—and time. In 1791, he left \$5,000 to the citizens of Boston to invest for 100 years. In 1891, a portion of the appreciated assets established the Franklin Institute, with the remainder left to grow for another 100 years. In 1991, the balance of the Franklin money—by then \$5 million—was used to benefit the Boston community.**

Not everyone has the vision of Ben Franklin, but many philanthropists know that a wise decision today can make a world of difference tomorrow.

What does it take to start a private foundation today? First, it takes commitment. Forming a private foundation is like having a child... giving birth is just the first step. Running a successful, mission-driven foundation requires steadfast vision, strong leadership, and hard work. Second, it takes time. While the investment of time begins with the startup, it will continue for years to come.

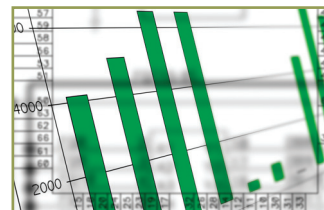
Third, of course, it takes money. Just how much money is a matter of debate. Theoretically, any amount is possible. But practically, many underestimate the amount needed to operate efficiently, both in terms of the charitable asset and ongoing operating costs.

Many private foundations are established without thorough assessment of all the costs involved and the alternatives available. Often prompted by year-end tax planning or the influence of peers, a quick decision can result in a costly and long-term responsibility.

In fact, after the first year or two of operations, some private foundation founders express mild regret, saying they didn't anticipate the magnitude of demands on their time, energy, and resources. They wish that someone had helped them consider the costs, the benefits, and the options... before they signed up for the responsibilities of a private foundation.

For people like these, practical alternatives are available.

Following is a review of perspectives on how much money it takes for a private foundation to operate efficiently, and an overview of the leading private foundation alternatives.



“A \$750,000 private foundation might have made sense to me when I was practicing law. But now that I'm managing investments, I understand both the administrative costs and how large a portfolio must be to have enough asset diversification to make it work.”

Stephanie Prem  
Principal, Lowry Hill



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**Money**

*Gift size.* How much is enough? Two hundred years ago, \$5,000 was an ample sum. More recently, \$1 million was considered a sufficient base.

But benchmarks change. Today, private foundations are subject to minimum payout rules... something Benjamin Franklin didn't have to contend with. Legally, a private foundation must pay out five percent of its total assets each year. Ideally, it distributes most of the money to deserving nonprofit organizations. But it can also spend hefty amounts on operations—investigating potential grants, measuring results of grantmaking, paying qualified staff, and just keeping the lights on at the office.

In most cases, these expenses contribute to the success of a foundation's grantmaking. But for a small foundation, the time and expenses invested may be out of sync with the dollars actually reaching charities. Unless much of the work is done by a volunteer founder, some experts say it takes a charitable gift of about \$5 million to establish and operate a private foundation efficiently. Still, the current trend runs counter to this advice. Each year, 1,000 new private foundations are established, and more than 60 percent of these have assets of less than \$1 million.

*Operating efficiency.* In the world of private foundations, bigger is usually more efficient. First, the most basic level of administrative support is essentially a fixed cost. Regardless of the asset size, few private foundations can operate without minimal administrative services. Sometimes this is provided pro bono by the founder, eliminating the expense from the foundation's balance sheet. In other circumstances, however, the foundation must pay for staff or professional services to handle administrative, financial, and legal work.

Second, the greater the asset, the greater the opportunity to actively manage a diversified portfolio of individual stocks. Given market performance in recent years, most investment experts continue touting the value and necessity of diversification across classes.

**Consider the potential expenses for a \$1 million foundation that wishes to preserve an endowment and pay out 5% of net assets:**

EXAMPLE ONE		
<b>Total payout</b>	<b>5%</b>	<b>\$50,000</b>
Operating expenses		\$15,000
Available for grantmaking <i>(up to 5% payout)</i>		\$35,000

**A larger foundation can operate more efficiently. Assuming incrementally higher administrative costs, consider the potential expenses for a \$10 million foundation:**

EXAMPLE TWO		
<b>Total payout</b>	<b>5%</b>	<b>\$500,000</b>
Operating expenses		\$100,000
Available for grantmaking <i>(up to 5% payout)</i>		\$400,000

Each year, 1,000 new private foundations are established, and more than 60 percent of these have assets of less than \$1 million.

In these examples, operating expenses for grantmaking consume a significant portion of the total payout. Increasing the payout for grantmaking is an option, but many private foundations are concerned with preserving principal and generating asset growth. A higher payout could jeopardize their permanence.

If, however, a founder plans to add assets at a later time, the \$1 million foundation may have merit. Future gifts or bequests may build the assets to several million, and the foundation could eventually be positioned to handle administrative costs, manage a diversified investment portfolio, and make meaningful grants.

### Alternatives

For those who want to give, but are not comfortable with the demands of a private foundation, two practical alternatives are available: supporting organizations and donor advised funds.

**Supporting organizations.** A supporting organization is the closest thing to a private foundation, with a fraction of the administrative requirements. Donors establish supporting organizations through community foundations or other public charities. The organization that's created is legally separate but affiliated with the parent charity.

Supporting organizations offer significant involvement. The founding donor appoints 49 percent of the board members—perhaps a spouse, an adult child, a professional advisor—and the rest are appointed by the charity. The organization's board makes decisions on grantmaking and investments. This arrangement also offers the prestige and involvement that make private foundations attractive to many philanthropists. A supporting organization has its own name and identity (chosen by the donor) and grants are made in this name. A donor can also elect to create public relations and marketing materials, differentiating her organization from its parent.

The community foundation or charitable partner handles startup and other time-consuming tasks essential to administration. Ongoing costs are minimized through the community foundation's pooled administration and investment fees. Plus, if part of a community foundation, the supporting organization can access information about local needs and opportunities.

Supporting organizations receive the favorable tax treatment given to public charities through their affiliation. A supporting organization is eligible for a deduction of up to 50 percent of adjusted gross income for gifts of cash, 30 percent for gifts of appreciated stock, and 30 percent for gifts of real estate and closely held stocks. The percentages for a private foundation are 30/20/20, respectively.

These tax advantages and services make a supporting organization easier and more efficient than the average private foundation. The considerable donor involvement in a supporting organization, however, makes it more expensive than other community foundation giving vehicles. For this reason, most community foundations recommend a minimum of \$1 million to \$2 million to establish this custom giving solution.

**Donor advised funds.** When a client has less interest in controlling certain aspects of charitable management—but still wants a hands-on giving experience—a donor advised fund might be the best option. This giving vehicle has grown in popularity over the past 15 years.

Donor advised funds are highly efficient because administration and investment are pooled with those of other funds at the public charity. The donor can make grant recommendations for approval by the organization's board of trustees.



### Recommended asset size of three major philanthropy options

#### **Private Foundation**

\$5 million or more

#### **Supporting Organization**

\$2 million or more

#### **Donor Advised Fund**

\$10,000 or more;  
\$50,000 or more to endow

“The economies of scale and resources that a community foundation can offer may be critical for smaller foundations.”

*David L. Kelly  
Attorney  
Estate Planning,  
Trust and Probate Law*

Grants are issued in the name the donor chooses for his fund (or anonymously if the donor wishes). As with a supporting organization, a community foundation donor adviser can take advantage of information about local needs and opportunities—and even include her family or business in recommending grants. It can be a simple, personal, highly effective way to give.

Today’s high net worth individuals share a lot in common with their predecessors. They want to give. They want to start a legacy. And they want a good value. Private foundations, supporting organizations, and donor advised funds are attractive giving options—but no one of these options is right for every donor.

As Benjamin Franklin famously advised, “A penny saved is a penny earned.” With his own legacy, Franklin demonstrated that by planning deliberately and investing wisely, he was able to create the giving solution best for him.