



# Navigating the Family Philanthropy Lifecycle

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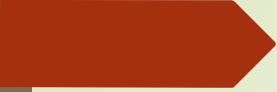
# What is a Family Office

- ▶ What is a Family Office?
  - ▶ A common definition goes something like this "Once you've seen one family office you have seen ONE family office"
  - ▶ The family office will work with as few as one generation while other well established offices can serve 5 or more
  - ▶ A Forbes article I found describes a Family Office in its simplest form as an organization that oversees the day to day affairs of a family
- ▶ What about structure?
  - ▶ A cost center in the Operating Company
  - ▶ An independent office only providing bookkeeping or investment oversight
  - ▶ A fully integrated organization with an independent or family board of directors serving all aspects of family wealth management and concierge services
  - ▶ Just about any structure you can imagine in between



# What Services Do Family Offices Perform

- ▶ The menu of services offered within in a family office are as varied as families can be:
    - ▶ Full Menu of Investment Management Services
    - ▶ Cash Management
    - ▶ Bill Pay
    - ▶ Tax Planning and Preparation
    - ▶ Estate / Gift and Transfer Tax Planning
    - ▶ Trust Company/ Trust Administration
    - ▶ Estate Administration
    - ▶ Funeral Planning
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# Even More Services Performed by Family Offices

- Family Education
- Collections Management
- Property Management
- Human Resources for Family Office, House Staff, Vacation or Ranch Property Staff
- Strategic Planning and Family Governance
- Philanthropy Planning and Administration
- Travel
- Security
- Family Meeting and Retreat Planning and Management
- The list could go on for a few more slides, but we probably have more to cover.



# Mom and Dad have decided to create a Family Office now what?

- First steps are to determine what services the family office will provide?
  - Are we purely an investment office?
  - Full Service – What does that mean to our family
  - What does the family want this family office to be?
    - Just taking care of business
    - The interface between the family and an operating business
    - That facilitator of the link that holds our family together.
- Now that we have our menu of services do what do we do in-house and what is outsourced with in-house oversight?
  - This decision will drive staffing
  - Skill Sets Typically Found in a Family Office Staff - Legal(T&E), Tax, Investment Management, Accounting



# Who Pays for All of This

- ▶ Most family offices will have some sort of client fee structure much like any other service provider.
- ▶ In most cases the family office is not intended to make a profit but to cover the costs of the office.
- ▶ Be careful of the most senior generation absorbing the full cost of the family office. The practice can lead to unintended gifts if not done appropriately.
- ▶ Common practice for family office billing structures are
  - ▶ AUM Fees
  - ▶ Direct Billing for things such as concierge services, airplane and vacation home usage.
  - ▶ Time billing(think law or public accounting firms)



# Final Point on the Family Office


- A much harder to quantify role of the family office is carrying on and maintaining the values and principles of the family.
  - Who was the wealth creator and what did they stand for?
  - What are the important values of our family?
- Some families will have very formal family value statements and governance policies.





# Philanthropy at the Early Stages: Direct Giving

- Direct Giving:
  - Direct giving can take many forms.
    - Individual family members may make gifts to specific organizations or purchase gala tables. This type of giving is standard individual tax compliance around charitable contributions and deductibility. It is the role of the family office or the tax preparer to advise on charitable giving when you know in advance.
    - If the family still has an operating business, depending on form and structure, charitable giving can be done by the operating business. This can be in the form of monetary gifts, corporate sponsorships, gifts of services (e.g. Junior Achievement, Habitat for Humanity). Again this is standard tax compliance for charitable giving. Make sure your tax advisor is aware of gifts and involved prior to the gift if deductibility is important.
  - Direct giving is a great way to start prior to the formation of a private foundation. The family/family office can help organize philanthropy meetings either as a way to test the family's desire to work together in a private foundation setting or for next generation training.



# Philanthropy at the Early Stages: Pledges

- Pledges: Many charitably-inclined individuals will sign charitable pledges, some of which will remain outstanding at the time of death.
- Review pledges carefully, specifically around whether they are claiming to be enforceable.
- Confirm that the maker of the pledge matches the payor (if DAF or PF will be payor, it needs to make the pledge).
- At death, Executor will have to determine:
  - (1) whether the pledge is enforceable (perhaps under doctrine of promissory estoppel);
  - (2) whether a charitable pledge paid during the estate administration is deductible (two prong test); and
  - (3) if it would be appropriate for the private foundation to satisfy any outstanding pledges at the decedent's death (not if it was enforceable; PF could choose to make a grant of a similar amount from its own assets).
- Practical Suggestions: If donor wants it satisfied, fashion as a bequest. If Executor satisfies it, secure release and consider collecting evidence of enforceability.



# Philanthropy at the Early Stages: Gift Agreements

- Generally will contain amount of gift, timing, restrictions on use, naming rights, enforceability, reporting requirements and administrative provisions.
- Reporting on results- shared understanding before signing
- Be careful in just signing the form the charity creates!
  - Moral turpitude clauses
  - Standing for enforceability
  - Term during which use of funds is restricted
  - Duration of naming rights (Avery Fisher Hall example)
  - Display and storage restrictions (art)
  - If matching is required, what counts? Pledges or \$ in the door?



# Donor Advised Fund

- ▶ In recent years, Donor Advised Funds have proliferated and are a common alternative to the creation of a private foundation.
- ▶ The rules around donor advised funds were significantly clarified in the Pension Protection Act of 2006.
- ▶ What is a Donor Advised Fund?
  - ▶ Not a separate charitable entity for federal tax purposes
  - ▶ Typically a program offered by an existing public charity to facilitate charitable gifts by individual donors
  - ▶ The public charity that offers the program is referred to as the “sponsoring organization”. A sponsoring organization can be a public charity, a community foundation or a commercial donor advised fund.
- ▶ Generally structured as a fund or account held by the sponsoring organization that:
  - ▶ Is separately identified by reference to the contributions by the donor
  - ▶ Is owned and controlled by the sponsoring organization
  - ▶ Is one that donor (or donor’s designee) has, or reasonably expects to have, advisory privileges with respect to investments and distributions.
    - ▶ Note: advisory privileges are not enforceable rights under a gift agreement.



# Donor Advised Fund

- When a DAF is a logical choice before creating a private foundation?
- How to use a DAF for generational planning and training
- Using a DAF to compliment other charitable activities
- Using a DAF to address a private foundation in need of winding down or splitting
- Caution areas:
  - Taxes on Prohibited Benefits: there is an excise tax if the advised distribution results in the donor, donor advisor or a related person receiving, directly or indirectly, more than an “incidental benefit”
  - Tickets and tables: until IRS clarifies, proceed with caution



# Private Foundations



- ▶ Many families find the formation of a Private Foundation key to achieving the family's philanthropic goals and important to carry on the legacy of the Founding Generation.
  - ▶ Private Foundations can be formed at any time, but in many cases are funded at estate settlement.
  - ▶ Private Foundations are a great tool for education for the next generation.
- ▶ Foundations can be and generally are served by the Family Office
  - ▶ Many families chose to not burden the Foundation with overhead from the family office, and there is no requirement to do so.
  - ▶ If a family does chose to charge administrative costs to the Private Foundation, be very careful of Self-Dealing rules. Review any cost sharing with tax counsel.



# Philanthropy in the Private Foundation


- ▶ **Philanthropy can take on many different forms inside a private foundation.**
  - ▶ **Direct Giving** - the check writing philanthropist - Many private foundations are generally simply the givers of funds. They will review grantees for appropriate use of funds but will not take an active role in the application of program or management of the grantee.
  - ▶ **Program Partner** - in this instance the private foundation will work with already established organizations in their field of interest but will provide more than just dollars becoming actively involved in the program and/or management of the organization. This can sometimes take on the incubator role with new charities with the private foundation providing management and organizational guidance to assist the charity in becoming a better organization and provider.
  - ▶ **Program Developer** - many private foundations have a very strong sense of purpose or have a very specific issue to be addressed. In this case the private foundation will fund studies and create programs and organizations to fill a need the private foundation feels is not being addressed effectively elsewhere.
  - ▶ **Collaborative Philanthropy** - becoming much more common where several private foundations or private foundations along with a community or community foundation will partner together to meet a specific need. In Houston there is a very large collaborative on Human Trafficking which includes private foundations, Greater Houston Community Foundation, the City of Houston and several service providers in the field.



# Private Foundations: Choice of Form

- Private foundations are a state law entity (most commonly a nonprofit corporation or a trust)
- Trust form: irrevocable trust agreement for sole benefit of charity. Generally court order required for amendment.
- Nonprofit corporation: governed by articles of incorporation and bylaws; can be amended as provided therein or as allowed under state law.
- Entity then applies for recognition of exemption from federal tax on a Form 1023.
- An exemption letter issued by the IRS actually contains two separate determinations: first that the organization qualifies for the basic federal income tax exemption found in section 501(c)(3); and second that the organization is classified for tax purposes as either a private foundation or a public charity.





# How a Corporate Fiduciary or Bank Can Support Private Foundation Formation

- ▶ Integrating wealth planning and giving
  - ▶ Investment management
  - ▶ Administrative and operations support
  - ▶ Strategic advice and grant making
  - ▶ Education and support
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# Private Foundation is Created: Now What?

- **Services provided by the Family Office to the Private Foundation**
  - In many cases the private foundation is purely an extension of the family office with no dedicated private foundation staff.
  - **The Family Office can provide**
    - Accounting
    - Legal
    - Compliance
    - Treasury
    - Grants Management
    - Tax
    - Planning
    - This list can be endless as well
  - **It is important for a new private foundation for proper training of the family office staff and in many cases the family as well. This is not really your money anymore! There are very specific compliance and tax rules that can be more burdensome than the in the family office.**
- The family office will often be involved with the interaction between the private foundations, family members and related entities.
- It is critically important for the family office to understand all of the "private foundation rules", including Self-dealing, Excess Business Holdings, Jeopardizing Investments and the Excise Tax on Investment Income.



# Disqualified Persons

- ▶ Substantial contributors (persons, including corporations, who contribute an aggregate amount of more than \$5,000, if such amount is more than 2% of the total contributions received by the foundation during such year),
- ▶ A foundation manager (officer or director),
- ▶ An owner of more than 20% of a corporation or other entity which is a substantial contributor,
- ▶ A member of the family of any of the foregoing (spouse, ancestors, and children, grandchildren, great grandchildren and their spouses -- but not brothers or sisters),
- ▶ Any entity in which any of the foregoing persons own more than 35%,
- ▶ And a trust in which the foregoing persons own more than 35% of the beneficial interest.
- ▶ An estate will not automatically be a disqualified person just because the decedent was a disqualified person – it has to separately qualify under one of the disqualified person tests (usually 35% of the estate beneficiaries being disqualified persons).
- ▶ SO: PRETTY MUCH EVERYONE IS A DISQUALIFIED PERSON IN THE FAMILY OFFICE CONTEXT



# Self-Dealing




- Self-dealing is any direct or indirect transaction which is listed in section 4941 and which occurs between a private foundation and a disqualified person with respect to such foundation.
- Specifically, section 4941 prohibits the following transactions between a private foundation and its disqualified persons:
  - (a) Sale or exchange of property;
  - (b) Leasing of property;
  - (c) Transfers of income or assets by the foundation for the benefit of a disqualified person;
  - (d) Lending of any money or other extension of credit; and
  - (e) The furnishing of any goods, services, or facilities.



# Self-Dealing



- ▶ Good Rule of Thumb: all transactions between a private foundation and its disqualified persons are prohibited, except for
  - ▶ (a) Wholly gratuitous transfers from disqualified persons to the foundation (e.g., gifts of cash or property, rent-free occupancy of disqualified persons' space, etc.)
  - ▶ (b) Payments by the foundation of reasonable compensation or reimbursement of expenses to disqualified persons for ordinary and necessary services rendered to the foundation.
  - ▶ Of course, there are a number of other specific exceptions, but all exceptions seem to fall within the general framework of these two areas.
- ▶ Some examples of where self-dealing comes up:
  - ▶ Co-ownership of assets among DPs and PF
  - ▶ Compensation of Officers and Directors of PF
  - ▶ Lease Agreements
  - ▶ Joint (or similar) Investments
  - ▶ Charitable Planning with Family Entities
  - ▶ Tickets and Tables in the Private Foundation Context



# What are the penalties for self-dealing?

- ▶ Penalty for Self-Dealing:
  - ▶ 10% of the amount involved to be paid by the disqualified person
  - ▶ Any Foundation Manager who knowingly and willfully participates will be subject to a tax of 5% of the amount involved
  - ▶ If not corrected within certain time frames, a tax of 200% will be imposed on the disqualified person and a tax of 50% will be imposed on the Foundation manager.
- ▶ Keep in mind: it doesn't matter if it is a "good deal" for the PF. Self-dealing, even if resulting in a bargain transaction for the PF, is subject to penalties unless an exception applies.



# Other Chapter 42 Restrictions

- ▶ PF Excise Tax: 2% excise tax imposed on the "net investment income" of a private foundation. Can be reduced to 1% under certain circumstances.
- ▶ Excess Business Holdings: an excise tax is imposed equal to 10% of the total value of all excess business holdings of a private foundation.
  - ▶ If such holdings are not reduced to "permitted holdings" within the specified periods, a second-tier tax equal to 200% of the value of the excess business holdings will be assessed.
  - ▶ In general, a private foundation may own 20% of a business enterprise, **reduced by the percentage of ownership in such enterprise by all disqualified persons.**
- ▶ Jeopardizing Investments: If a private foundation invests its corpus in a manner which will jeopardize the carrying out of its exempt purposes, the foundation, and possibly its managers, will be subject to the excise taxes set forth in section 4944.
  - ▶ An investment jeopardizes the carrying out of a foundation's exempt purposes if the foundation's managers, at the time of making the investment, fail to exercise ordinary business care and prudence in providing for the long and short term financial needs of the foundation. No category of investment is, per se, treated as a violation of section 4944.



# Planning for Future Funding

- ▶ Strategic planning
  - ▶ Governance
  - ▶ Investments
  - ▶ Administration
  - ▶ Grant making
  - ▶ Tax and legal
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# Succession Planning for the Private Foundation

- Structural Considerations:
  - Check your bylaws and trust agreements – this is where the procedure for filling vacancies (or removal) would be located. State law may also contain default provisions to apply where documents are silent.
  - How many directors or trustees should the foundation have?
  - Who can serve?
    - Specifying qualifications
    - Issues for small families
    - Issues for large families
- Ideological Matters: How do you transfer the founding generation's ideas and beliefs about charitable giving to succeeding generations?




# Death of Founding Generation and the Family Office

- ▶ The death of a family member, but specifically the Founding Generation can have a significant impact on the office.
- ▶ In many cases the death of the Founding Generation is the trigger for a more formal philanthropic program with the formation of a Private Foundation.
- ▶ When possible planning is key
  - ▶ Pre – Planning
    - ▶ Copies and Flow Charts of the Wills
    - ▶ Life Insurance Policies
    - ▶ Complete list of Assets and Liabilities including bank accounts and safe deposit boxes
    - ▶ Service and Interment Planning
      - ▶ Outsource Firms
      - ▶ Managed Completely In House
    - ▶ Wishes for Care of Minor Children if Applicable
    - ▶ Media Plan if Applicable



# Death of Founding Generation and the Family Office

- Longer Term Considerations
    - Executing on the Estate Plan
    - Tax Deadlines
    - Business Continuity and Transition
      - Operating Business
      - Family Office
      - Household and Personal Staff
  - Most Important – This is an emotional time for the family and the staff. Key Staff will need to be aware of the emotional toll on not only the family, but staff as well.
    - Grief
    - Concerns about loss of job
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# Death of Founding Generation

- Keep in mind this will be a fundamental shift for many family offices: historically, G1 has made the decisions (often unilaterally) with no accountability to anyone.
- Now you have a large group of people (Executors and Trustees) with fiduciary duties to all estate beneficiaries, which may include public or private charities.
- A fiduciary cannot do certain things that a person could do while living, such as paying unenforceable charitable pledges or continuing to make gifts/distributions to persons who are not beneficiaries of the estate.
- It is critically important to follow the terms of the governing documents, have good counsel and keep excellent records during the estate administration process.



## Death of Founding Generation: Estate Tax Inclusion Possibility for PF Assets

- Rev. Rul. 72-552, 1972 C.B. 525 holds that inter-vivos transfers to a charitable corporation are to be included in the estate of the donor under 2036 since the decedent, as an officer of the corporation, had the power to direct the disposition of his funds for charitable purposes.
  - Often not a bad result: step up in basis (effectively reducing excise tax)
  - 2055 Estate Tax Charitable Deduction causes no FET liability associated with inclusion of PF assets
  - But consider valuation issues
- Caution with 501(c)(4) social welfare organizations – gift tax was clarified, estate tax remains nondeductible



## Death of Founding Generation: Testamentary Gifts to Public Charities

- Public Charities are very well-informed beneficiaries. Their job is to make sure the public charity receives all that it is entitled to receive.
- Specific bequests of cash or assets can be easy to distribute.
- Assets requiring a sale can be more difficult (charity may not agree to sales price).
- Percentage decisions can require significant disclosure of estate assets, valuations and liabilities.



# Death of Founding Generation: Testamentary Gifts to Private Foundations

- Gifts can be a specific dollar amount, a specific asset or a portion of the estate assets
- Section 4941 defines self-dealing to include virtually every economic transaction between a disqualified person and a private foundation.
- If assets pass under the Will to a private foundation, then generally the private foundation has an interest or expectancy in the estate (or the assets, depending on the structure of the gift).
- The self-dealing prohibitions of Section 4941 continue to apply during a reasonable period of settlement of an estate, unless a regulatory exception applies.
- The most common indirect self-dealing issues that can arise in the estate administration are:
  - Sales of estate assets (in which the private foundation has an interest or expectancy) to a disqualified person
  - An allocation of assets of the residuary estate by the executor between a private foundation and other heirs (generally disqualified persons).



# Death of Founding Generation: Testamentary Gifts to Private Foundations

- Reallocation of assets/sales of estate assets where the PF is a remainder beneficiary often involves self-dealing transactions.
- Fortunately, the regulations provide an exception to the self-dealing rules if the following conditions are met.
- The Executor or Trustee EITHER:
  - a. Possesses a power of sale with respect to the property; has the power to reallocate the property to another beneficiary; or c. is required to sell the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);
  - (ii) Such transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate (or trust) or over the private foundation);
  - (iii) Such transaction occurs before the estate is considered terminated for federal income tax purposes pursuant to paragraph (a) of §1.641(b)-3 (or in the case of a revocable trust, before it is considered subject to section 4947);
  - (iv) The estate (or trust) receives an amount which equal or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate or trust; AND
  - (v) The transaction EITHER:
    - a. Results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up;
    - b. Results in the foundation receiving an asset related to the active carrying out of its exempt purposes; or
    - c. Is required under the terms of any option which is binding on the estate or trust.<sup>112</sup>





## Role of State Attorney General in Charitable Oversight

- ▶ The Attorney General of the State of Texas is charged with the duty of protecting the public interest in charity.
- ▶ Structurally, there is a Charitable Trusts Section within the Financial and Tax Litigation of the Texas Attorney General's office.
- ▶ In Texas, the Attorney General's office is required to be notified of a judicial proceeding involving the estate exception, and may object to the transaction.



# Conclusion

- At the end of the day, the role of the Family Office is to deal with/plan for these issues.
- The family office can take many forms and provide many different roles both in the running of the family, as well as their family philanthropy.
- As stated earlier in the presentation "If you have seen one family office you have seen ONE family office"
- Questions?