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Level Five Philanthropy: Designing a Plan for Strategic, Effective, Efficient Giving

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LEVEL FIVE PHILANTHROPY: DESIGNING A PLAN FOR STRATEGIC, EFFECTIVE, EFFICIENT GIVING

*James Edward Harris**

INTRODUCTION

Maclellan Foundation president Hugh Maclellan contends that half of all charitable giving is ineffective: "Most people . . . give in response to emotional or persistent appeals. Very few of us take the time to check out an organization to see whether the need is justified or whether the group can produce results."[1] If that assessment is accurate, America has the potential to double the value of its charity (or at least significantly enhance it). Attorneys can play a vital role in that endeavor by helping clients develop a strategic approach to philanthropy.

The impact of strategic giving is exponential. Burt Nanus and Stephen Dobbs offer a powerful analogy to a famous equation: $E = mc^2$, where E = social energy, m = the strength of the mandate, and c = the organizational capital invested in addressing the mandate.[2] Social energy is defined as the energy generated when a nonprofit marshals common action for the common good.[3] Capital includes the physical assets and financial and human resources that enable an organization to produce social goods. Organizational capital is the exponential multiplier in the equation, and much of that capital is created by the wise investment of charitable contributions.[4]

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1. RON BLUE, GENEROUS LIVING: FINDING CONTENTMENT THROUGH GIVING 135–36 (1997). Hugh O. Maclellan, Jr. is President of the Maclellan Foundation based in Chattanooga, Tennessee.

2. BURT NANUS & STEPHEN M. DOBBS, LEADERS WHO MAKE A DIFFERENCE: ESSENTIAL STRATEGIES FOR MEETING THE NONPROFIT CHALLENGE 43 (1999).

3. John Lawrence Hargrove, *Force, A Culture of Law, and American Interests*, 36 COLUM. J. TRANSNAT'L L. 433, 439 (1997).

4. Expenses reported annually to the IRS provide a measure of the magnitude of organizational capital. Total expenditures of reporting public charities in Arkansas were nearly $5 billion in 2000 (excluding many religious organizations not required to file returns). *Nonprofit Sector Makes a Big Impact on the Arkansas Economy*, POL'Y POINTS (Good Faith Fund, Little Rock, AR), Jan. 2002, at 2. By comparison the general revenue for the State of Arkansas for fiscal year 2003 is only $3.4 billion. Richard A. Weiss, *Arkansas State Budget Facts*, Ark. Dep't of Fin. & Admin., *at* http://www.accessarkansas.org/dfa/budget/facts_brochure.html (last visited August 3, 2003).

Therefore, coaching clients to give effectively can have large-scale social impact.

Wealthy individuals want to be more strategic in their giving, according to a report of The Philanthropic Initiative, Inc.[5] They want more comprehensive planning approaches that include philanthropy, and they want their advisors to be more knowledgeable about such matters.[6] Donors and advisors who participated in the survey agreed on that point.[7] Yet donors complain that counselors usually do not inquire about philanthropic interests unless clients raise the subject.[8]

Advisor reticence in this area stems from concerns that bringing up philanthropy may be too presumptuous, may imply value judgments, or may be too personal and, therefore, too risky.[9] To the contrary, donor groups say that offering this kind of advice is good business and a valuable service.[10] This is number one on the list of the *Top Ten Reasons Why You Should Discuss Philanthropy with Your Clients*: "It's good for society, it's good for your clients, it's good for your business, and it's good for you."[11]

These are strong motivations to include philanthropy in the planning dialogue as a matter of course. Yet, counselors must do more than simply raise the issue if they are to serve their clients' highest interests. Counselors must integrate charitable planning with comprehensive estate planning, and they must show clients how to achieve the greatest results and the greatest rewards with the dollars dedicated to charity. This requires a strategic planning process which enables clients to achieve the following: (1) define core values and establish priorities for financial security, family and charity; (2) bring into clear focus the philanthropic areas of interest; (3) measure the effectiveness of charities at work in those areas; (4) leverage gifts for greatest impact; and (5) build the infrastructure for philanthropy by identifying the most efficient assets to allocate to each objective, determining the role of family and providing for management succession, and designing the legal structures and tax techniques to accomplish clients' goals.[12]

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5. THE PHILANTHROPIC INITIATIVE, INC., DOING WELL BY DOING GOOD, IMPROVING CLIENT SERVICE INCREASES PHILANTHROPIC CAPITAL: THE LEGAL AND FINANCIAL ADVISOR'S ROLE 9 (2000).

6. *See generally id.*

7. *Id.* at 5.

8. *Id.*

9. *Id.* at 7.

10. *Id.*

11. Forum of Reg'l Ass'ns of Grantmakers, *Top Ten Reasons Why You Should Discuss Philanthropy With Your Clients*, *at* http://www.rag.org/giving/top10.html (last visited August 3, 2003).

12. *See, e.g.*, CAROLYN C. CLARK & JOHN SARE, STRATEGIC PHILANTHROPIC PLANNING: THE CHANGING FACE OF CHARITABLE GIVING, 2001 ACTEC ANNUAL MEETING SYMPOSIUM S-4-CCC (2001); CHARLES H. HAMILTON, NAT'L CTR. FOR FAMILY PHILANTHROPY,

By working through the foundational first level, clients can determine whether philanthropy has a significant role in their planning. If it does, the remaining steps pave the way to make the most of the clients' gifts. This five level analysis constitutes a process to develop an optimal plan for giving, a LEVEL FIVE GIVING PLAN.™[13] Instead of starting with tax techniques, the process integrates that planning element in a broader framework for highly effective philanthropy. Sharpening the focus, measuring effectiveness, and looking for leverage together yield maximum results from resources invested in charity. Choosing tax efficient assets, determining the role of family, and then designing the planning vehicles build the platform for conducting those good works.

Every subsequent stage of the process must be informed by and aligned with the client's mission, values and priorities. Thus, the place to begin is the point at which clients discern and define their own highest values and sense of purpose.

I. BUILD THE FOUNDATION ON PRINCIPLES

A. Defining What Matters Most

The success of many great companies is founded upon an enduring set of core values from which mission and vision are derived and around which all plans and strategies are aligned.[14] While clients affirm this premise for business, few are so inclined when it comes to their personal planning. Yet the maxim, "[t]he most important thing in life is to decide what's most important," [15] applies to how they spend their money as well as how they spend their lives.[16]

A growing body of literature encourages people to identify their basic values and to write a personal mission statement: a clear, concise declaration of their purpose in life and what they hope to accomplish with it. Two best sellers that advocate this are *The Seven Habits of Highly Effective Peo-*

SPLENDID LEGACY: THE GUIDE TO CREATING YOUR FAMILY FOUNDATION 154–55 (Charles H. Hamilton ed., 2002); *see also* Heather Larkin Eason, *Philanthropic Options*, ARK. FORTY-FIRST FED. TAX INST., Dec. 12, 2002.

13. Naming a process makes it more accessible and memorable. "Level Five" identifies the five stages of the process, and it evokes the highest measure of readiness, performance and impact. It also alludes to the parable of the good (and most effective) steward who promptly doubled the five talents.

14. *See generally* JAMES C. COLLINS & JERRY I. PORRAS, BUILT TO LAST: SUCCESSFUL HABITS OF VISIONARY COMPANIES 71 (1994). *See generally* KENNETH BLANCHARD & MICHAEL O'CONNOR, MANAGING BY VALUES (1997).

15. BLANCHARD & O'CONNOR, *supra* note 14, at 26.

16. *See generally* RUSS CROSSON, A LIFE WELL SPENT: INVESTING YOURSELF AND YOUR MONEY IN YOUR FAMILY (1994).

ple, by Stephen Covey, and *What Color is Your Parachute*, by Richard Bolles.[17] Covey develops a personal planning system that applies values and mission to the various roles in life and develops goals for each role.[18] Bolles combines those ideas with the concept of discovering one's unique skills and interests to land the job of one's dreams.[19]

The practice of creating a lasting expression of one's most deeply held values is not new. Examples of the ancient custom of "ethical wills," statements intended to pass along values and beliefs to succeeding generations, can be found among the Old Testament patriarchs.[20] First handed down in oral tradition and later reduced to writing, ethical wills at one point became as common as attachments to legal wills.[21] Dr. Barry Baines, the leading advocate for ethical wills today, uses this comparison: "[L]egal wills bequeath *valuables*, while ethical wills bequeath *values*."[22]

B. Establishing the "Hierarchy of Planning Objectives"

The synthesis of the two in estate planning, the application of one's values to guide the use of one's wealth, has been championed by Scott Fithian.[23] In his book, *Values-Based Estate Planning*, Fithian outlines a system for helping clients determine their values and attitudes about wealth and how to dispose of it consistently with those principles.[24] The foundation of the system is what Fithian calls a Family Financial Philosophy,™ a financial mission statement that defines the clients' core values and draws from them a blueprint for the allocation of wealth to accomplish the desired goals for personal financial security, family inheritance, and philanthropy.[25]

Mr. Fithian calls those three planning objectives (1) financial independence, (2) family legacy, and (3) social capital legacy, and their treatment in that order establishes their priority.[26]

First, the paramount objective is to determine the assets and income required to assure the clients' financial independence and lifestyle mainte-

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17. STEPHEN R. COVEY, THE SEVEN HABITS OF HIGHLY SUCCESSFUL PEOPLE (1989); RICHARD N. BOLLES, WHAT COLOR IS YOUR PARACHUTE: A PRACTICAL MANUAL FOR JOB-HUNTERS & CAREER-CHANGERS (2002).

18. COVEY, *supra* note 17, at 95.

19. BOLLES, *supra* note 17, at 125, 307.

20. *See, e.g.*, *Deuteronomy* 33: 1–29 (stating Moses' final blessing of Israel).

21. BARRY K. BAINES, M.D., ETHICAL WILLS: PUTTING YOUR VALUES ON PAPER 13 (2002).

22. *Id.* at 14.

23. *See* SCOTT C. FITHIAN, VALUES-BASED ESTATE PLANNING: A STEP-BY-STEP APPROACH TO WEALTH TRANSFER FOR PROFESSIONAL ADVISORS (2000).

24. *See id.*

25. *Id.* at 16.

26. *Id.* at 19.

nance.[27] Anything in excess of that is eligible for lifetime wealth transfer strategies to heirs, to charity, or to both.[28]

Next, clients determine the quantity and quality of the desired family legacy.[29] This involves an exploration of how clients feel about their kids and money, how family wealth can benefit heirs without harming them, and how it can help them grow and advance in life without destroying their incentive.

Thus, the third planning priority is to determine the quantity and quality of the social capital legacy after the clients have provided for themselves and their family.[30]

"Social capital" takes two alternative forms: involuntary payment of taxes and voluntary contributions to charity.[31] The allocation of involuntary social capital is determined by government while the use of voluntary social capital can be controlled by the client.[32] The tools Fithian uses in his Legacy Planning System™ are very detailed, and the process is intricate. The wealthier the client, the more useful his approach will be. In any case where taxes are an issue, however, it may be helpful to determine which one of the following basic planning goals provides the primary motivation:

1. *Financial Independence*

When financial independence matters almost exclusively, the planning focus is upon retaining maximum control over assets and income. Taxes and the dilution of inheritance are entirely subordinate concerns.[33]

2. *Maximum Inheritance*

This goal seeks maximum wealth transfer to descendants. Clients are interested in strategies that reduce taxes through charitable techniques only if they do not reduce the family inheritance.[34]

3. *Tax-Effectiveness*

The motive behind this goal is to minimize tax costs as wealth is transferred to younger generations. Strategies that reduce taxes are preferred over

27. *See id.* at 20–21.
28. *See id.* at 21.
29. FITHIAN, *supra* note 23, at 21.
30. *See id.* at 21–22.
31. *Id.* at 36.
32. *Id.*
33. *Id.* at 21.
34. *Id.*

those that maximize inheritance, because the former allows more effective use of charitable planning techniques.[35]

4. *Wealth Control Through Charitable Planning*

Reducing taxes with charitable gifts, after providing for a prescribed amount of family legacy, achieves the goal of retaining control over wealth distribution. The motive is total control over how wealth is disposed. Charitable planning is the means, after a certain amount for heirs is funded.

5. *Maximum Philanthropy*

The goal here is to eliminate taxes through charitable gifts, without regard to the effect upon inheritance. Philanthropy is the higher value. Family legacy is limited to what can pass to heirs without taxes. Charitable planning strategies take precedence over those that other clients commonly use.[36]

Estate tax repeal would alter the methods employed to achieve these goals, but the process of applying values to plan the disposition of wealth would remain a valid one. While the focus of tax planning would shift to income taxes and gift taxes, the broad issues would be the same.

Whatever system one uses, developing an understanding of what matters most to clients and discovering their primary values, priorities and goals are essential to the design of the most appropriate estate plan. This allows consideration of the role of philanthropy as an inherent part of the process. It then builds the foundation for a giving plan that produces the greatest results with the highest satisfaction. The next step is to establish a clear vision of what the clients hope to accomplish with their charity.

II. SHARPEN THE FOCUS OF PHILANTHROPY

In this second level of the process the client and advisor should explore several questions regarding purposes and preferences for giving to sharpen the focus of the plan. First, what issues or fields of interest do the donors feel strongly about? This is the threshold question. The answer to that question informs all the others.[37]

35. FITHIAN, *supra* note 23, at 22.
36. *Id.* at 22–23.
37. Common areas of interest include (1) human services interests such as youth, poverty, employment, housing, elderly, domestic abuse, substance abuse, and disaster relief; and (2) other main categories such as education, religion, health, arts and culture, conservation, wildlife, environment, and international relief and development.

Most people want to support a variety of charities in their community at some level. But "checkbook philanthropy" without clear direction will not produce the greatest results. Therefore, donors should ask a series of questions to refine their giving goals.

Will the fund be broad-based in its charitable support, will it be narrowly focused on one or a few organizations in the fields of interest, or will it need to have a primary focus while allowing lesser grants to a variety of charities? What is the geographic focus? Are the clients interested primarily in supporting community-based charities, programs with statewide impact, or national or international efforts? Do the clients prefer supporting small charities or large organizations, start-up philanthropic ventures or seasoned ones? What level of involvement with supported charities do the donors desire: grant makers only, volunteer fundraisers recruiting other donors, or stronger commitment through service as governance or program volunteers? What is the main motive for giving? Is it altruism, faith, family tradition, business experience, community involvement, or loyalty to institutions that have benefited the family? Does the source of the family's wealth have a bearing upon that determination?[38]

To approach philanthropy strategically, the family gift vehicles should concentrate their focus on those issues of greatest importance to the donors and on those organizations that are most effective in addressing them. An analogy to the concentrated light of a laser makes a good mental model. Diffuse light, while illuminating, has little power, but light intensely focused in a laser can cut through steel. Thus, concentrating philanthropic efforts with a laser-like focus can have the greatest impact.

The experience of the Bill & Melinda Gates Foundation is a case in point.[39] According to its co-chairman, Bill Gates' father, the foundation initially had no particular goals.[40] When the founders became aware of how many third-world children were still dying from diseases that had been eradicated elsewhere, the foundation started to concentrate its focus on global health.[41] "We try to find the things we can afford to do that will have the greatest impact. In global health, the bulk of our work falls under the category of prevention, which is something vaccines accomplish so efficiently."[42] As the Gates Foundation narrowed its focus, it was able to find efficient methods of attacking a major problem, resulting in large-scale so-

38. *See, e.g.*, VIRGINIA M. ESPOSITO, NAT'L CTR. FOR FAMILY PHILANTHROPY, SPLENDID LEGACY: THE GUIDE TO CREATING YOUR FAMILY FOUNDATION 17, 18–19 (2002).

39. William H. Gates, Sr., *Some Thoughts on Philanthropy and Net Worth*, 28 ACTEC J. 77 (2002).

40. *Id.* at 79.

41. *Id.*

42. *Id.* at 80.

cial benefit.[43] The magnitude of its resources makes the Gates Foundation unique. Yet almost any family fund can establish a grant making process that is strategic in focus and designed for maximum impact.

Where donors do not have strong leanings toward any area, strategic focus may be derived from existing studies of the greatest needs in the community. For example, in Little Rock a consortium of churches produced a study called the Nehemiah Project that identified the ten most pressing community needs, thus giving faith-based initiatives important new guidance.[44] If that kind of research is not available, donors may commission a community needs assessment, perhaps in partnership with other foundations. Collaborating with community foundations in some cases may make such assessments feasible.

To further sharpen the focus of giving, advisors will find it useful to understand the charitable motivations of different donor types. In *The Seven Faces of Philanthropy*,[45] Russ Alan Prince and Karen Maru File categorize donors in seven segments based upon their primary motives for giving.[46] The authors acknowledge that no framework for analyzing donors is perfect and that individuals often admit to more than one motive.[47] Nevertheless, their system of classification offers valuable insight. The characteristics of their seven donor segments may be summarized as follows.

A. The Communitarian: Doing Good Makes Good Sense

Communitarians are business owners who find philanthropy to be good for business.[48] It not only improves business conditions in the community; it also provides networking opportunities through service on nonprofit boards. This group prefers local charities or local chapters of national ones. From their business perspective they prefer nonprofits which are well managed and can demonstrate results. They often desire long-term active involvement.[49]

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43. *Id.*

44. Nehemiah Project, *at* http://www.nehemiah-group.org (last visited Aug. 3, 2003). *See also* ROBERT LEWIS, THE CHURCH OF IRRESISTIBLE INFLUENCE 187 (2001).

45. *See generally* RUSS ALAN PRINCE & KAREN MARU FILE, THE SEVEN FACES OF PHILANTHROPY: A NEW APPROACH TO CULTIVATING MAJOR DONORS (1994).

46. *Id.* at 13–16.

47. *Id.* at 13.

48. *Id.* at 18.

49. *Id.* at 29–30.

B. The Devout: Doing Good Is God's Will

The Devout are motivated to give out of gratitude for God's blessings and in obedience to God's commands to be good stewards and to help other people. The philanthropy of this group is almost exclusively directed toward religious institutions and faith-based service organizations. Because they have trust in the donees, the Devout tend to give without as much investigation, but that is changing as a result of high profile scandals in recent years.[50]

C. The Investor: Doing Good Is Good Business

Investors are interested in the tax advantages of giving and in doing philanthropy as part of a comprehensive estate and financial plan. Because they view a contribution as an investment, they are likely to carefully evaluate a charity's management and performance record. They are looking for proven results to obtain the greatest return on their investment of social capital, as they do when they invest money in a stock or a business.[51]

D. The Socialite: Doing Good Is Fun

Socialites enjoy benefiting charity through entertaining, fundraising events, and social functions. Socialites leverage their networks of friends, family, and business associates to support select nonprofits through such events. Socialites are less interested in the management or program operations of the charities they support, but they carefully choose ones that they believe can present a compelling case and which will be supported by their social networks. Socialites tend to support arts and educational organizations.[52]

E. The Altruist: Doing Good Feels Right

Altruists are motivated by selfless generosity and by the sense of purpose and personal fulfillment they derive from giving. Their philanthropy is directed primarily toward social causes such as alleviating poverty. Like the Devout, Altruists view charity as a moral imperative, but they typically are not affiliated with traditional religious institutions. While they associate giving with personal growth and spiritual development, they pursue it indi-

50. *See id.* at 31–42.
51. PRINCE & FILE, *supra* note 45, at 43–55.
52. *See id.* at 56–68.

vidually rather than in community. Altruists tend to examine the integrity of nonprofit managers more than program service results.[53]

F. The Repayer: Doing Good in Return

Repayers typically have benefited from the service of an institution, usually a school or hospital, and are motivated to give from a sense of gratitude. Their philanthropy is mostly focused upon educational and healthcare charities, and often just one or a few of them. This group believes more strongly than any others that the privilege of wealth brings a greater responsibility to give. Repayers are especially concerned with effectiveness of services and achieving demonstrated results, yet only a third of them prefer to be actively involved.[54]

G. The Dynast: Doing Good Is a Family Tradition

The source of wealth for most Dynasts is an inheritance that may include an interest in a family business passed down along with a family tradition of philanthropy. Dynasts give because a philanthropic ethic has been instilled in them from childhood. They support a broader range of charities than any other group. Although they generally prefer not to be actively involved, they do carefully evaluate charities before they give. They seek organizations which are doing the right things and doing things right. They want to direct their giving where they can see the greatest results.[55]

The Investor is the closest model for the strategic approach to philanthropy advocated here. But note from the above summary that effectiveness and efficiency are also important to Dynasts, Repayers and Communitarians. This should be important to every donor. By one account, the chronic underperformance of the nonprofit sector creates the potential to improve results by anywhere from twenty to fifty percent.[56]

Therefore, measuring results is the next level of analysis. After one narrows the focus upon mission, he should investigate who is best at executing that mission. Which organizations are the high performers in the area of interest, which charities employ funders' dollars to achieve outcomes with the greatest social impact, and how does one even begin to measure that all are questions the philanthropist should explore.

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53. *See id.* at 69–80.

54. *See id.* at 81–93.

55. *See id.* at 94–106.

56. *Thomas Tierney Looks Under Philanthropy's Hood*, HALFTIME MAG., Sept.–Oct. 2002, at 31.

III. MEASURE THE EFFECTIVENESS OF NONPROFIT ORGANIZATIONS

Recent accounting scandals show that even corporate earnings can be tricky to calculate. Measuring the social benefits produced by nonprofits clearly is tougher than tallying the bottom line earned by business. While changes in corporate law may accelerate the process, waves of reform began rolling over the nonprofit sector long before Enron and WorldCom.[57] All of the reform movements concern accountability, but they differ significantly in approach.

A. Models of Accountability

Paul Light has identified three models of accountability amidst four tides of reform.[58] Each model offers a different approach to measuring organizational improvement.[59] The compliance model assumes that effectiveness flows from adherence to a set of standards characteristic of excellent organizations.[60] The performance model involves defining desired outcomes and measuring actual results against those goals.[61] The capacity building model emphasizes building organizational capacity: the human, financial, and technological resources required to produce, sustain and enhance results.[62]

Mr. Light describes the four tides of reform: (1) scientific management, which encourages best practices; (2) liberation management, which emphasizes outcomes measurement; (3) war on waste, which urges reorganization for maximum efficiency; and (4) watchful eye, which concentrates on greater public disclosure.[63] All four tides of reform influenced a controversial article by former Senator Bill Bradley, who contends that a combination of best practices, cost cutting, improved effectiveness and higher endowment spending rates could equate to over 100 billion dollars per year in additional resources for the nonprofit sector.[64]

The accountability model for scientific management is compliance, and the model for the other three tides is some combination of performance

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57. PAUL C. LIGHT, MAKING NONPROFITS WORK: A REPORT ON THE TIDES OF NONPROFIT MANAGEMENT REFORM 1 (2000).

58. *See id.* at 46–63.

59. *Id.*

60. *Id.* at 47.

61. *Id.* at 19–20.

62. *Id.* at 48.

63. LIGHT, *supra* note 57, at 2.

64. Bill Bradley et al., *The Nonprofit Sector's $100 Billion Opportunity*, HARV. BUS. REV., May 2003, at 94.

and compliance.[65] Capacity building is the most powerful model in this author's opinion. While it does not figure strongly in any of the reform movements, it is at the heart of the venture philanthropy movement.

1. *Compliance Model of Accountability*

The premise of the compliance model is that following the best practices of highly effective organizations will result in improved performance.[66] Several organizations have proposed standards or codes of conduct. After soliciting comment on an exposure draft, the Better Business Bureau Wise Giving Alliance published its Standards for Charitable Accountability on March 3, 2003.[67] The purpose of these standards is to help donors make good giving decisions. A charity can earn the Better Business Bureau imprimatur by documenting compliance with its twenty standards.[68]

In 1998 the Maryland Association of Nonprofit Organizations ("Maryland Nonprofits") published a code that has received much attention.[69] Maryland nonprofits' program is based upon the *Standards for Excellence: An Ethics and Accountability Code for the Nonprofit Sector.*[70] The "Standards" uphold the values of honesty, integrity, fairness, respect, trust, responsibility and accountability.[71] They consist of fifty-five benchmarks applied across several areas of program operations, governance, human resources, financial management and fund raising.[72] The Maryland program also includes certification of compliance with the award of a Seal of Excellence.[73]

65. LIGHT, *supra* note 57, at 46–63.

66. *Id.* at 47.

67. Better Bus. Bureau Wise Giving Alliance, *Charity Standards*, *at* http://www.give.org/standards (last visited August 5, 2003).

68. *Id.*

69. Standards for Excellence, *Standards for Excellence in the Nonprofit* Sector, at http://www.standardsforexcellence.org (last visited August 5, 2003).

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

The Minnesota Council of Nonprofits has a similar code called *The Principles and Practices for Nonprofit Excellence.*[74] It consists of nine key principles and eighty-seven best practices.[75] Minnesota, however, has no certification component. The purpose of this program is to improve the performance of nonprofits by educating both organizations and the public.[76] The *Principles and Practices* is an educational tool and model; it expressly is not intended to be relied upon by funders in making grant decisions.[77]

There is natural resistance to the imposition of any set of rules. Indeed, for whatever reasons, only thirty charities to date have received the Seal of Excellence in Maryland.[78] Nevertheless, standards such as these developed by nonprofits to enhance the performance of nonprofits have the potential to elevate the entire sector. Participants in the Maryland Standards for Excellence program believe it has helped their organizations.[79] Maryland Nonprofits recently published on its website an impact analysis showing significant improvement in nonprofit governance and practices among those organizations adopting the "Standards."[80] It is difficult, if not impossible, however, to prove the link between those improvements and increased effectiveness.

One common standard states that a nonprofit should have procedures for evaluating the efficiency and effectiveness of its programs and for measuring the outcomes achieved for program participants. That standard leads to consideration of the second model of accountability.

2. *Performance Model of Accountability*

The movement for performance measurement in the nonprofit sector has been gaining ground for many years.[81] Beginning with the area of financial accountability, it has expanded to develop metrics for program outputs, quality of service, program relevance, key performance indicators, and client satisfaction.

The strongest advocate for outcomes measurement is the United Way of America.[82] Beginning in the mid 1990s it began a nationwide initiative to encourage its local affiliates to employ outcomes measurement as a grant

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74. Minn. Council of Nonprofits, *Principles and Practices for Nonprofit Excellence, at* http://www.mncn.org/info_principles.htm (last visited August 5, 2003).

75. *Id.*

76. *Id.*

77. *Id.*

78. Interview with Amy Coates Madsen, Program Director, Maryland Nonprofits (Mar. 13, 2003).

79. Standards for Excellence, *supra* note 69.

80. *Id.*

81. LIGHT, *supra* note 57, at 19.

82. *Id.*

allocation tool.[83] The United Way has made a tremendous effort to develop materials on outcomes measurement, not only for its local affiliates but also for training nonprofits to identify desired outcomes, to establish key indicators and to use the results to improve performance.[84] *Measuring Program Outcomes: A Practical Approach*[85] is an excellent manual on how to implement this process. Because local charities understand the heavy weight this carries in funding decisions, the United Way has widely influenced the use of outcomes measurement in the nonprofit sector.[86]

The Roberts Foundation of San Francisco has developed a fascinating approach to measuring the outcomes and impact of the jobs programs that it supports.[87] Through the Roberts Enterprise Development Fund, this foundation invests in nonprofits that train and employ homeless and low-income people in small business enterprises.[88] For several years the foundation has collected and analyzed social outcome data on each of the client-employees of the supported enterprises.[89] The data on the societal cost savings of each employee (for example, reduced welfare and increased taxes paid on wages) is blended with the increase in value of the enterprise to derive a social return on investment (SROI) calculation.[90] The foundation publishes that data in SROI reports, which resemble stock reports, for each of its portfolio enterprises.[91] The foundation also helps each enterprise create a comprehensive social outcome measurement system called the Ongoing Assessment of Social Impacts (OASIS).[92]

While performance measurement enables charities to demonstrate current program results, it does not provide a basis for evaluating the organization's capability to fulfill its mission in the long run. That gap is addressed by the capacity building model.

3. *Capacity Building Model of Accountability*

This model shifts the emphasis from building effective *programs* to building effective *organizations*, nonprofits which are capable of sustaining, improving and adapting their services over time. Leading advocates of the

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83. *Id.*
84. *Id.* at 21.
85. United Way of Am., *Measuring Program Outcomes: A Practical Approach*, *at* http://national.unitedway.org/outcomes/resources/mpo/ (last visited August 5, 2003).
86. LIGHT, *supra* note 57, at 19.
87. The Roberts Enter. Dev. Fund, *REDF Portfolio Social Outcomes*, *at* http://www.redf.org/social_intro.htm (last visited August 5, 2003).
88. *Id.*
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.*

capacity building model are Christine Letts, William Ryan and Allen Grossman, the authors of *High Performance Nonprofit Organizations.* "The capacity for strong performance in *organizations* provides the foundation for lasting social benefits."[93] The key requirement for programs to succeed is the capacity of the organization to perform well.[94] Thus, it is not just performance but the capacity to perform that should be evaluated.

Under the sponsorship of Venture Philanthropy Partners and others, McKinsey & Company has published an outstanding study that offers a definition of nonprofit organizational capacity, identifies seven crucial elements thereof, and provides a "Capacity Assessment Grid" as a tool to measure it.[95] From its study of thirteen successful efforts, the report draws three broad conclusions regarding capacity building: (1) "the act of resetting aspirations and strategy is often the first step in dramatically improving an organization's capacity," (2) good management is essential, including a professional chief operating officer who knows how to make the organization function well; and (3) capacity building requires patience.[96]

What is required to build an organization's capacity to maximize its social impact? The McKinsey & Company report identifies the following seven elements of nonprofit capacity, and its Capacity Assessment Grid provides a valuable tool for measuring the level of an organization's capacity in each area:[97] (1) Aspirations: mission and vision are expressed in clear and concise statements, and goals are described in measurable terms. (2) Strategy: strategies are aligned with aspirations and designed to move the organization towards its performance targets. They insure program relevance and exploit new opportunities. They also are integrated with the other elements of capacity to achieve the greatest social impact. (3) Organizational Skills: performance measurement, analysis and adjustments; planning, marketing, fund-raising; building relationships and strategic alliances; risk management and legal compliance. (4) Human Resources: progressive practices are in place for recruiting and developing board members, CEO, management, staff and volunteers. (5) Systems and Infrastructure: systems are the processes for managing operations and financial and human resources. Infrastructure includes the physical assets and technological infrastructure providing information management and communications. (6) Organizational Structure: board structure and organizational design are inte-

93. CHRISTINE W. LETTS ET AL., HIGH PERFORMANCE NONPROFIT ORGANIZATIONS: MANAGING UPSTREAM FOR GREATER IMPACT 3 (1999).

94. *Id.* at 3–4.

95. McKinsey & Co., *Effective Capacity Building in Nonprofit Organizations*, *at* http://www.venturephilanthropypartners.org/learning/reports/capacity/full_rpt.pdf (Aug. 2001).

96. *Id.* at 15.

97. *See id.* at 37–67.

grated with aspirations, strategies and skills as well as systems and human resources. (7) Culture: an organization's culture consists not only of its shared values and beliefs but also its "performance culture." All personnel are systematically employed and rewarded for their collective contribution to meeting performance measures so that attention to performance influences everything they do.[98]

The Philanthropic Capacity Building Resource (PCBR) Database includes excellent examples of a variety of capacity building grants.[99] This resource was created by the Human Interaction Research Institute with support from a partnership of five major foundations.[100] The database contains about two hundred program profiles each of which describes the capacity building program, its structure, and provides contact information for further details.[101] The goal of the PCBR Database project is to disseminate information about effective capacity building efforts to stimulate similar activities by other foundations.[102]

Capacity building has implications for the accountability of funders as well. In a chapter entitled "Virtuous Capital: Investing in Performance," Christine Letts and colleagues use a venture capital analogy to advocate a more strategic approach to grant making.[103] Venture capitalists look for high performing companies with innovative product potential, and venture capitalists take on greater risk seeking greater reward.[104] Venture capitalists evaluate many opportunities, then make significant investments in a very few with the greatest prospects.[105] Venture capitalists' early-stage investments are applied first to building companies, particularly in developing management.[106] They add value through the depth of their engagement by bringing expertise to the board, making valuable connections, recruiting and mentoring management talent.[107] Venture capital is patient capital; long-term investment is a given from the outset.[108] Nevertheless, additional investment commitments are conditioned upon demonstrating progress toward performance measures that will lead to long-term growth.[109]

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98. *See id.*

99. Human Interaction Research Inst., *Welcome to the Philanthropic Capacity Building Resource (PCBR) Database*, *at* http://www.humaninteract.org/pcbrdatabase.htm (last visited Aug. 6, 2003).

100. *Id.*

101. *Id.*

102. *Id.*

103. LETTS ET AL., *supra* note 93, at 169.

104. *Id.* at 173.

105. *Id.* at 183.

106. *See id.* at 172.

107. *See id.*

108. *Id.* at 181.

109. LETTS ET AL., *supra* note 93, at 173.

The growing application of the venture capital model to philanthropy is confirmed in a *Business Week* cover story entitled "The New Faces of Philanthropy."[110] Those featured as the most generous and innovative donors approach charity work as "fully engaged venture capitalists."[111] But how is this approach different? It is more ambitious, attacking major problems; it is more strategic, systematically working toward the heart of the problems; it is more global, as in the Gates Foundation example; and it demands results as continued support is conditioned upon producing measurable results.[112]

B. Implications for Donors

All three accountability models can be useful to donors in rating charities and in developing grant-making policies. There is at least one excellent evaluation tool for each of these models: Maryland Nonprofits' *Standards for Excellence* for the compliance model,[113] the United Way's *Measuring Program Outcomes* for the performance model,[114] and McKinsey & Company's Capacity Assessment Grid for the capacity building model.[115] Using all of these tools, and others like them, advisors can help donors create customized templates for approaching grant decisions in a strategic manner.

The compliance model provides checklists of best practices in all areas of nonprofit management and operations.[116] Any model code of conduct must be considered in the light of local circumstances, so funders should not require rigid adherence to a single set of standards. Yet organizations that meet high benchmarks have a greater probability of being good stewards of their philanthropic support.

The performance model provides data on the specifics of what a charity is trying to accomplish and what results it is actually producing.[117] Thus, supporting the development of capacity for outcomes measurement also benefits funders by generating valuable information.[118] That support involves the costs of initial training and continued technical assistance.[119]

110. John A. Byrne, et al., *The New Face of Philanthropy*, BUS. WK., Dec. 2, 2002, at 82.
111. *Id.*
112. *Id.*
113. Standards for Excellence, *supra* note 69.
114. United Way of Am., *supra* note 85.
115. McKinsey & Co., *supra* note 95.
116. LIGHT, *supra* note 57, at 47.
117. Peter F. Drucker, Address at the FaithWorks National Summit (May 5, 1999) (As Peter Drucker asks, "what business are you in" and "how's business." *The Second Nonprofit Revolution*).
118. United Way of Am., *Outcome Measurement Resource Network*, *at* http://www.unitedway.org/outcomes/resources/What/why.cfm (last visited Aug. 6, 2003).
119. *Id.*

Underwriting those costs, independently or in collaboration with other funders, can help take a nonprofit to the next level of performance.

The capacity building model with the venture capital analogy offers the most exciting instruction for donors seeking to make a real difference. Investing in organizational capacity above particular programs is more likely to have the greatest impact.[120] Adding value by contributing expertise and relationships multiplies that effect.[121] Concentrating major support on a few good prospects further amplifies results.[122] Long-term commitments build strong organizations in contrast to short term funding of temporary projects.[123] All of these factors leverage invested dollars to lift charity to a higher level. Looking for additional leverage is the next stage in the process.

IV. LEVERAGE THE GIFTS FOR GREATEST IMPACT

Searching for excellence, measuring effectiveness, and building capacity all have the effect of enhancing the results of donated funds. As donors research high impact gift opportunities they may look for those factors that enable charities to leverage their financial resources, human resources and other assets. Donors also can consider ways to multiply their gifts by combining them with the contributions of others.

A. Leveraging Financial Resources

1. *Matching Gifts*

Working with matching gift programs is a way to create direct financial leverage. Clients can take advantage of both sides of the match equation. They can look for programs that will match the dollars they give. On the other hand, they can offer matching gifts to attract additional donations from others.

Matching gift opportunities are found in various forms. Many large companies offer matching gift programs to their employees.[124] Foundations sometimes make matching gifts to encourage support for a particular institution (for example, a double match for new contributors to the annual fund drive). A lead donor to a major campaign may stimulate participation by

120. LETTS ET AL., *supra* note 93, at 171.
121. *See id.* at 179–80.
122. *See id.* at 181.
123. *Id.*
124. *See, e.g.*, CURT WEEDEN, CORPORATE SOCIAL INVESTING: THE BREAKTHROUGH STRATEGY FOR GIVING AND GETTING CORPORATE CONTRIBUTIONS 136–37 (1998). For example, in 1995 Wal-Mart allocated over forty percent of its charitable contributions ($21,200,000) to its employee matching gift program. *Id.* at 137.

offering a matching gift challenge.[125] In whatever form, where one donated dollar turns into two, effective philanthropy is the end result.

2. *Giving Partnerships*

Another way individual donors and foundations can leverage their gifts is to join with others in funding an effort of common interest.[126] What may be too costly for one to accomplish may be feasible if several join together. Giving partnerships of women, entrepreneurs and others united around a philanthropic interest are increasingly common. For example, nearly three hundred "partners" support Social Venture Partners of Seattle, a pioneer in venture philanthropy that uses a capacity building model for supporting twenty-eight "investee" nonprofits.[127] The newer Acumen Fund, Inc. has brought together several major foundations and corporations, along with individual philanthropists, to comprise its forty-investor membership.[128] Thus, collaboration among funders can create leverage as well as collaboration among nonprofits.

Combining the collaborative efforts of both funders and grantees can be a highly effective strategy. A giving partnership may make group grants, which are strategic investments in a cluster of charities that coordinate service delivery to a common client population.[129] Maximum impact can be achieved through capacity building grants strengthening a whole group of organizations, amplifying the synergy created through their joint efforts.

3. *In-kind Donations*

Many organizations are able to leverage their financial support by soliciting in-kind contributions. Essential supplies and services acquired by gift reduce the amount of cash required for operations and free up financial support to meet other budgetary needs. This shows evidence of good stewardship and is something to look for when evaluating charities.

In-kind donations to the American Red Cross for disaster relief illustrate how important such gifts can be.[130] Major corporations gave millions of dollars worth of supplies and services in support of the Red Cross re-

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125. RENTA J. RAFFERTY, DON'T JUST GIVE IT AWAY: HOW TO MAKE THE MOST OF YOUR CHARITABLE GIVING 70–71 (1999).

126. *See, e.g.*, Soc. Venture Partners, *A Community of Social Investors*, *at* http://www.svpseattle.org (last visited Aug. 6, 2003).

127. *Id.*

128. Bynre, *supra* note 110, at 92.

129. PAUL CONNOLLY & CAROL LUKAS, STRENGTHENING NONPROFIT PERFORMANCE: A FOUNDER'S GUIDE TO CAPACITY BUILDING 89 (2002).

130. *See* Am. Red Cross, *Supporters: Corporate Donations Leading Our Lifesaving Efforts*, *at* www.redcross.org/sponsors/corporatelist.html (last visited Aug. 6, 2003).

sponse to September 11.[131] Personal goods for the families of victims and for relief workers included the following: food and water from Campbell's Soup and Anheuser-Busch, clothing from Sara Lee/Hanes and The GAP, toiletries from Colgate Palmolive, and supplies from 3M. Delta Airlines, Six Continent Hotels, and MGM Mirage provided travel and lodging for volunteers and families of victims. Federal Express shipped supplies, and BMW donated sport utility vehicles for disaster operations. Communications and technology support came from AT&T (prepaid phone cards), Sprint PCS (cell phones with air time), Compaq (computers and network equipment), and IBM (secure wireless communications networks in New York and Washington). Gannett Publishing ran ads encouraging gifts in its ninety-eight newspapers, including *USA Today*, and on its twenty-one television stations. The aggregate of those in-kind gifts contributed greatly to the Red Cross effort and provided resources which otherwise would have cost many millions of dollars to purchase.[132]

4. *Income Generating Ventures*

An increasing number of nonprofits are seeking ways to generate new revenue streams from business ventures compatible with their missions. To support that trend, a partnership of the Pew Charitable Trusts, Goldman Sachs Foundation and Yale School of Management is sponsoring the first ever National Business Plan Competition for Nonprofit Organizations.[133] Twenty finalists have been selected from among 655 applications from nearly every state and from both large and small organizations.[134] Fifty-eight percent of the proposals concern service-related ventures and twenty-seven percent product-related businesses.[135] For example, the venture proposed by CompuMentor of San Francisco is DiscounTech, which is a web-based service that sells donated and discounted software and hardware technology to nonprofits at the lowest possible costs.[136] The Ninety-Second Street YMCA proposes "Live from Ninety-Second Street Y," a multi-media

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131. *Id.*

132. *Id.* While many charities could be cited as examples, the American Red Cross provides within a single organization excellent illustrations of several key points in this article. As one of the largest charities, its national operations have global reach. Yet, the soul of the organization is a volunteer movement built upon local chapters similar in many respects to other community-based nonprofits. *Id.*

133. Yale Sch. of Mgmt., *The Goldman Sachs Foundation Partnership on Nonprofit Ventures*, *at* http://www.ventures.yale.edu (last visited Aug. 6, 2003).

134. *Id.*

135. *Id.*

136. *Id.*

venture using satellite broadcasts and the internet to sell the Y's programming to educational and community organizations world-wide.[137]

Advisors can access the searchable database of revenue producing business ventures provided by Community Wealth Ventures for leads to a great variety of ideas.[138] Each entry contains a short description of the venture and link to the parent nonprofit.[139]

Thus, nonprofits can leverage their resources and expertise by finding new ways to make money with mission-related business ventures. Generating revenue from such sources and soliciting in-kind gifts provide financial leverage within the organization. From the outside funders create financial leverage with matching gifts and collaborative funding programs.

B. Leveraging Human Resources

Leveraging an organization's human resources can be equally significant. Just as in-kind gifts of goods and supplies cut costs and leverage financial resources, the donation of time and services reduce the expense of human resources. The magnitude of this volunteer resource is astounding. Over ninety million Americans contribute more than twenty billion hours of service each year.[140] Arkansans do their share and then some: nearly 500,000 Arkansans volunteered over twenty-five million hours with nonprofit organizations during 2000.[141] Charities that effectively recruit, train and deploy a large volunteer force in their programs highly leverage the human resource factor.

This type of leverage is measurable. For instance, the average volunteer-to-paid staff ratio is forty-to-one for local chapters of the American Red Cross.[142] An army of unpaid Red Cross volunteers working for weeks in a major disaster represents an enormous value in man (and woman) power.[143] Habitat For Humanity, scouting, Big Brothers/Big Sisters and other youth organizations quickly come to mind as additional examples of programs

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137. *Id.*

138. Comty. Wealth Ventures, Inc., *Resources*, *at* http://www.communitywealth.com/resources.htm (last visited Aug. 6, 2003).

139. *Id.*

140. VIRGINIA A. HODGKINSON & MURRY S. WEITZMAN, GIVING AND VOLUNTEERING IN THE UNITED STATES 1 (1996).

141. Angela Duran, *Nonprofit Sector Makes a Big Impact on the Arkansas Economy*, 16 POLICY POINTS 4 (2002).

142. Interview with Candy Carey, Executive Director, Central Arkansas Chapter of the American Red Cross (May 22, 2003).

143. Am. Red Cross, *Stories That Haven't Been Told*, *at* http://www.redcross-cmd.org/Chapter/untoldstories.doc (last visited Aug. 6, 2003). Nearly 55,000 volunteers worked in the September 11 disaster relief operation, the largest such mobilization in the history of the American Red Cross. *Id.*

executed primarily by a large corps of volunteers. Beyond saving personnel costs, these programs would not even be feasible without the volunteers who carry them out.

While the number of recruits is important, an organization must have the infrastructure for managing its volunteers to make effective use of this vital resource. According to a recent study conducted by Public/Private Ventures, there are three critical factors to the successful engagement of volunteers: screening, training, and ongoing management and support.[144] Screening increases the odds that volunteers will be effective in their assignments and reduces the chance of enlisting those who might pose a risk.[145] Training is important to equip volunteers to be most productive.[146] Proper management and staff support ensures that volunteers' time is well spent and increases retention of experienced volunteers.[147] Thus, good management of volunteers is essential to achieve the greatest leverage with this human resource. There are costs involved, however, so financial support for volunteer infrastructure can be a significant capacity building investment.

Investing in the continuing growth of managers and staff also pays great dividends. It equips them to share expertise within the organization and to have significant influence outside as well.[148] Likewise, the leadership development of governance volunteers yields internal benefits that carry over to the community at large.[149] Evaluating the strength of the board, the quality of management, and the depth of efforts to develop them all are important factors in doing due diligence on prospective donees.

C. Leverage Through Collaboration

Collaboration with other nonprofits and strategic alliances with business are additional ways for a charity to make the most of its resources. Working with other nonprofits can eliminate duplication and save costs (major themes of the war on waste reform movement) and create synergies

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144. Jean Baldwi Grossman & Kathryn Furano, *Making the Most of Volunteers*, *at* http://www.ppv.org/pdffiles/mostvolunteer.pdf (last visited Aug. 6, 2003).

145. *Id.*

146. *Id.*

147. *Id.*

148. For example, the American Red Cross sent Candy Carey and other key leaders to an intensive nonprofit management course taught by Christine Letts and others at Harvard. From the author's personal observation as American Red Cross Central Arkansas Chapter Chairman, that program equipped the participants to lead local units and the American Red Cross to a new level of performance and to provide leadership in the nonprofit sector beyond their own organizations. Interview with Candy Carey, *supra* note 142.

149. For an approach to estimating the market value of volunteer growth and development, *see* JACK QUARTER ET AL., WHAT COUNTS: SOCIAL ACCOUNTING FOR NONPROFITS AND COOPERATIVES 137 (2003).

that enable them to achieve more together.[150] Strong relationships with key corporate partners can develop in-kind and financial resources, strengthen programs, and enhance image and public awareness.

1. *Collaboration with Other Nonprofits*

Collaboration with other charities is important to look for, because there is evidence that such efforts improve performance in many different contexts. In a study of twenty-six innovative organizations, Paul Light found that nearly all of them participated in some type of partnership, though the nature of the relationships took many different forms.[151]

Partnerships may be classified in three types depending upon the degree to which power is shared: cooperation, coordination, and collaboration.[152] In each category, the nature of the relationship can be further segmented by the level of resource commitment involved.[153] Thus, cooperative partnerships include sharing information, promoting other nonprofits, and contributing resources to projects sponsored by another.[154] Coordinating partnerships involve short-term joint projects, cost sharing (including back office consolidation), and more long-term joint ventures.[155] Collaborative partnerships involve joint planning to address community problems, creating new systems to deliver services, and, at the extreme, full consolidation through the merger of organizations.[156]

The evolving relationships among local Red Cross units in Arkansas demonstrate these concepts.[157] All units work together to coordinate statewide disaster response.[158] The Central Arkansas Chapter, the state's largest, performs accounting, fundraising, and other administrative support functions for several Certified Service Delivery Units (CSDUs).[159] Those units are former chapters which were unable to meet the criteria for maintaining their charters.[160] The CSDU status enables the local unit to retain its dedicated force of volunteers without all of the administrative requirements

150. LIGHT, *supra* note 57, at 60.

151. PAUL C. LIGHT, SUSTAINING INNOVATION: CREATING NONPROFIT AND GOVERNMENT ORGANIZATIONS THAT INNOVATE NATURALLY 237 (1998).

152. LIGHT, *supra* note 57, at 60.

153. *Id.*

154. *Id.*

155. *Id.*

156. *Id.*

157. The following observations are derived from the author's experience as a former American Red Cross Central Arkansas Chapter Chairman.

158. This is coordinated through the State Service Council. AMERICAN RED CROSS, BUILDING CHAPTER LEADERSHIP TEAMS, SERVICE DELIVERY NETWORK 5 (1998).

159. Interview with Candy Carey, *supra* note 142.

160. *Id.*

of operating a chapter to focus exclusively on service delivery.[161] The Central Arkansas Chapter leverages its resources in this way to increase the efficiency of Red Cross operations in the state.[162] Other local units have survived and thrived through the enhanced efficiency and capacity achieved in a merger of two or more chapters.[163]

2. *Collaboration with Business*

With the right fit, strategic relationships between nonprofits and businesses can provide tremendous benefits to both. For example, City Year, the Boston-based urban youth service corps, initiated a partnership with Timberland merely by asking for a gift of fifty pairs of boots.[164] Ten years later, Timberland was providing full uniforms to all of City Year's youth corps participants.[165] The company became City Year's major corporate sponsor, contributing $1,000,000 a year in cash and in-kind donations, as well as providing essential assistance with taking the program to a national scale.[166] In return, City Year helped Timberland develop a corporate culture of community service that gives employees forty hours of paid time off to volunteer.[167]

Returning to the American Red Cross model, its partnership with many major corporations yielded financial support for the September 11 response in the form of corporate gifts, foundation grants, employee matching gifts, customer contribution initiatives, and blood donation drives, all in addition to the multi-million dollar value of in-kind gifts described above.[168] The unprecedented scope and scale of those combined corporate gifts illustrate the potential impact of such strategic relationships at a national level.

Corporate partnerships with individual chapters of the American Red Cross offer good examples of effective collaborations at the local level also. The Greater Chicago Chapter has a key relationship with W.W. Grainger, Inc., a Fortune 500 company with headquarters in Lake Forest, Illinois.[169]

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161. *Id.*

162. *Id.*

163. For example, the Fayetteville and Benton County chapters recently merged to form a single unit serving one of the fastest growing Standard Metropolitan Statistical Areas in the nation. Interview with Candy Carey, *supra* note 141.

164. JAMES E. AUSTIN, THE COLLABORATION CHALLENGE: HOW NONPROFITS AND BUSINESSES SUCCEED THROUGH STRATEGIC ALLIANCES 1 (2000).

165. *Id.*

166. *Id.*

167. *Id.*

168. Am. Red Cross, *Supporters: Corporate Donations Leading our Lifesaving Efforts*, *at* http://www.redcross.org/sponsors/corporatelist.html (last visited Aug. 6, 2003).

169. Sagient, *Portfolio*, *at* www.sagient.com/portfolio/redCross.asp (last visited Aug. 6, 2003).

Grainger makes products that enable businesses to keep facilities up and running in the event of a disaster.[170] The company enlisted a large number of its employees to be trained as Red Cross volunteers in the Chapter's Ready When the Time Comes disaster response program.[171] Grainger then recruited volunteers from other Chicago companies, ultimately providing a total of nearly 500 new disaster volunteers.[172] Following September 11, those volunteers answered telephones, staffed blood drives, and assisted passengers stranded at Chicago O'Hare Airport.[173]

The Greater Chicago Chapter's partnership with Grainger demonstrates significant benefits for both parties. The Chapter gained a large number of new and highly capable volunteers as well as additional benefits from having new friends and supporters.[174] As a leader in disaster preparedness products for business, the company acquired the goodwill of an affiliation with the nation's leading disaster relief agency and from identification with the widely admired American Red Cross brand image.[175]

Beyond boosting employee morale and enhancing image, such partnerships can even create competitive advantage for business. Strategically selecting high performing grantees can be the most cost effective way for a corporation to improve its "competitive context."[176] In a recent article entitled, *"The Competitive Advantage of Corporate Philanthropy,"* Porter and Kramer contend that companies can improve the quality of their business environment by taking a strategic approach to philanthropy.[177] Leveraging the efforts and infrastructure of nonprofits can produce both social and economic benefits far greater than those possible by individual philanthropists, foundations or governments.[178]

The prime example cited is Cisco System's Networking Academy, a web-based distance-learning curriculum in network administration designed primarily to train economically disadvantaged students. While creating job opportunities for the targeted group, Cisco is addressing its own chronic

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170. *Id.*

171. *Id.*

172. *Id.*

173. *Id.*

174. *Id.*

175. In responding to the unprecedented challenge of September 11, the Red Cross briefly considered some new initiatives with its Liberty Fund which were criticized as inconsistent with donor intentions and with its own traditions of disaster fundraising. The governing board corrected that, and the American Red Cross once again is listed among the most effective humanitarian service organizations. *See* Reshma Memon Yaqub, *To Give Well, Give Wisely*, WORTH, Dec.–Jan., 2003, at 88.

176. Michael Porter & Mark Kramer, *The Competitive Advantage of Corporate Philanthropy*, HARV. BUS. REV. Dec. 2002, at 57.

177. *Id.*

178. *Id.*

shortage of qualified network administrators. After only five years, the program has almost 10,000 academies in all fifty states and 147 countries, with 115,000 graduates and 263,000 students currently enrolled. By exploiting its unique expertise and global presence, and by collaborating with other technology companies, Cisco was able to create a new program with tremendous worldwide social impact that also benefitted Cisco and its entire industry. No foundation, university, or government agency could have developed such a program as effectively or as quickly.

Whether with business or with other nonprofits, collaborative efforts can make charities more effective and more efficient. Therefore, looking for successful partnerships should be one aspect of a donor's due diligence when examining charitable prospects.

V. DESIGN THE INFRASTRUCTURE TO SUPPORT PHILANTHROPY

Designing the infrastructure to sustain philanthropy involves funding with tax-efficient assets, determining the role family will play, and creating the most effective type of family charitable fund.[179] The choice of entity is a two-tiered process. The first step involves determining whether the tax classification will be a donor advised fund, a private foundation or a supporting foundation. If it is a foundation, the second step is deciding whether it will be a trust or nonprofit corporation.[180]

A. Identifying the Most Tax-Efficient Assets for Philanthropy

Although discussion of the tax treatment of lifetime and testamentary gifts of every kind is not possible here, the following examples illustrate that some assets make more efficient gifts than others. Determining which assets work best in funding philanthropy is an important part of the plan.

1. *Qualified Retirement Benefits*

Like other items of income in respect of a decedent ("IRD"), retirement plan benefits are subject to both income taxes and estate taxes (at least upon the death of the second spouse). The recipients of the IRD are entitled to a deduction for estate taxes paid on the IRD,[181] nevertheless the combined taxes exact a heavy toll. Accordingly, qualified retirement benefits are often the least efficient assets to distribute to heirs. Although recent changes in the required minimum distribution regulations improve the tax deferral

179. *See, e.g.*, Clark & Sare, *supra* note 12.

180. David R. Hodgman, *Designing Private Foundations – Avoid the Cookie-Cutter Approach*, 25 EST. PLAN. 481, 483 (1998).

181. 26 U.S.C. § 691(c) (2000).

allowed to descendants, the heavy tax burden still makes retirement benefits desirable assets to use for testamentary charitable gifts.[182]

Unless Congress enacts pending legislation, lifetime gifts of retirement benefits will remain inefficient because distributions to charity are fully taxable to the participant.[183] The CARE Act would allow direct rollovers of Individual Retirement Account ("IRA") benefits to charity and would allow charitable remainder trusts to be excluded from income.[184] The exclusion generally would be available to donors over the age of seventy and a half, but the Senate version makes the exclusion available for distributions to charitable remainder trusts when the donor reaches the age of fifty-nine and a half.[185]

Under certain conditions, a special rule allows favorable treatment to employer securities distributed in a lump sum distribution upon retirement.[186] While other assets are rolled over to an IRA, employer securities can be distributed outright to the participant who must recognize income only in an amount equal to the cost basis of the stock.[187] Those securities then can be contributed to a charity or to a charitable remainder trust with a deduction measured by the full fair market value of the stock.[188] To qualify for this special rule, the employee must have been a plan participant for five years and must be either fifty-nine and a half, terminated from service, or disabled.[189] If the employee still owns the stock at death, the net unrealized appreciation is an item of IRD with the usual adverse tax consequences.[190] Therefore, the appreciated employer stock remains a good candidate for a testamentary charitable gift if it is not donated to charity or to a remainder trust during the lifetime of the donor.

2. *Life Insurance*

Life insurance acquired in an irrevocable life insurance trust can be totally exempt from estate taxes and income taxes. Through such techniques, insurance proceeds can be transferred to heirs with maximum tax efficiency. So as assets are allocated among family objectives and charitable objectives

182. Kallina & Ackerman, LLP, *Simplifying the Required Minimum Distribution Regulations*, PLANNED GIVING ONLINE (Apr. 26, 2001).

183. Charity Aid Recovery and Empowerment Act, S. 476, 108th Cong. § 102 (2003); Charitable Giving Act of 2003, H.R. 7, 108th Cong. § 102 (2003).

184. *Id.*

185. *Id.*

186. 26 U.S.C. § 402(e) (2000).

187. Dan Rice, *Charitable Planning With Lump Sum Distributions*, *in* GIFT PLANNER'S DIGEST (Dec. 6, 2002).

188. *Id.*

189. *Id.*

190. *Id.*

life insurance often is maintained for family and is not the primary asset used for philanthropy.

Life insurance, however, can play a key role in planning for philanthropy. It often benefits family to replace other wealth set aside for charity. A traditional technique is to donate appreciated assets to a charitable remainder trust, which then sells the assets and reinvests the proceeds to generate greater income for the donors. A portion of the new income can be used to purchase life insurance in an irrevocable family trust to replace the assets donated to the charitable remainder trust.

If qualified retirement plan benefits will be left to charity, life insurance can be used to replace that wealth for family. At age fifty-nine and a half, plan distributions can be made to pay the premiums, but only on an after-tax basis. Also, some insurance products are designed to be purchased inside a qualified plan with the option of selling the policy later to the insured or a grantor insurance trust on a tax-favored basis.

Suppose the client is making an extended multi-year gift to a major endowment campaign. The amount of the gift could be leveraged by applying those contributions instead to purchase a life insurance policy.[191] The leverage is increased if a second-to-die policy is used. Life insurance also can be used to endow the continuation of annual support for favorite charities after the death of the donor.[192]

3. *Stock and Stock Options*

The contribution of closely held stock to a private foundation is disadvantaged by the deduction limitations and the excess business holding rules discussed below.[193] Unrestricted, highly appreciated marketable securities, however, are good assets for lifetime gifts, even to private foundations, because they are deductible at full fair market value and avoid the donor's capital gains taxes on the appreciation. This treatment of stock gifts to private foundations applies to "qualified appreciated stock," defined as long-term capital gain stock for which market quotations are readily available on an established securities market.[194]

The special rules applicable to incentive stock options and non-qualified stock options as well as restricted stock require careful analysis for both lifetime and testamentary charitable planning with those assets.[195] S

191. Stephan R. Leimberg & Albert E. Gibbons, *Life Insurance as a Charitable Planning Tool: Part I, Estate Planning*, *in* GIFT PLANNER'S DIGEST (June 26, 2002).

192. *Id.*

193. *See* discussion *infra* Part V.C.1.

194. 26 U.S.C. § 170(e)(5) (2000).

195. Darryl D. Ott & Robert Lew, *Navigating Stock Options and Other Stock Rights*, *in* GIFT PLANNER'S DIGEST (Apr. 11, 2001).

corporation stock involves additional planning issues concerning eligible S corporation shareholders and the pass-through tax treatment of business income.

4. *Assignment of Income Issue in Pending Sale*

An event that commonly drives major gifts during the donor's lifetime is the opportunity to sell the family business or other highly appreciated assets.[196] The owners often want to avoid some of the tax on the sale by dedicating a portion of the proceeds to charity. This strategy requires that the gift precede the sale. If the gift does not occur before the sale becomes legally binding, however, the gain subsequently realized by the charity is deemed an assignment of income by the donor. That result defeats the objective of avoiding taxes on part of the capital gain. So when a serious buyer emerges, there is often a rush to establish a family fund for the gift of an interest in the business. Where such a scenario is foreseeable, the owners are well advised to establish a gift vehicle in advance, even if only with modest funding. Then, the vehicle is in place if the need suddenly arises in the context of a quickly developing opportunity. Because of the limitations on the charitable deduction for gifts of non-marketable assets to a private foundation,[197] the vehicle will be either a donor advised fund or a supporting organization.

5. *Mortgaged Property*

When a charity receives income from mortgaged real estate or other encumbered property that is unrelated to its exempt purpose ("unrelated debt-financed income"), the income generally is taxable as unrelated business income.[198] The donation of mortgaged property also is considered a bargain sale. Accordingly, if the property is appreciated, the donor will recognize taxable income on a portion of the gift. Furthermore, mortgaged assets contributed to a private foundation in some cases violate the self-dealing rules that prohibit certain transactions between foundations and their founders.[199]

As shown by these examples, the most favorable tax treatment for gifts of certain assets can require contribution to a public charity. A private foundation, however, affords the greatest amount of control and management participation by family members.[200] Therefore, the donor's preferences re-

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196. Palmer v. Comm., 62 T.C. 684 (1974).
197. *See* discussion *infra* Part V. C. 1.
198. 26 U.S.C. § 514 (2000).
199. *Id.* § 4941 (2000).
200. *See* Heather Larkin Eason, *supra* note 12.

garding the level of involvement of children and other relatives becomes another important design consideration.

B. Determining The Role of Family

1. *The Founder's Family Legacy*

One of the issues in the design of the family foundation is how long the founder intends it to last. Some intend their funds to be either fully disbursed to charity during the founder's life or upon death, or to sunset a certain number of years thereafter. Others desire to leave a long lasting legacy in the form of a perpetual foundation bearing the family name. They want their descendants to know who they were, what they accomplished, and what their values were. A common desire is to impart to future generations an ethic of generosity and to use the foundation as a tool to teach the core values embraced by the family. In this way the family foundation can exert a positive influence on generations to come.

The founder's desire for a family legacy raises a number of issues. How can the foundation articulate, preserve, and transmit the founder's philanthropic intentions with the passage of time and the succession of heirs? How can those core values be preserved while adapting to changes in society's needs?[201] As discussed below, those issues influence the choice of legal entity.

2. *The Family's Role in Determining Mission*

At this point the founders have defined their values, and the application of those values to charity expresses the foundation's mission. Where the foundation is intended to survive the founder and descendants will be involved in its management, it may be important to include them in developing the vision for the foundation. Suggestions for creating a foundation mission statement, and involving family in the process are provided in *Splendid Legacy: The Guide to Creating Your Family Foundation*.[202] One suggestion is to hold a family retreat for that purpose with the family attorney or professional facilitator serving as discussion leader.[203] A mission statement should answer the question, "what good for whom."[204]

201. Charles H. Hamilton, Nat'l Ctr. for Family Philanthropy, *Living the Legacy: The Values of a Family's Philanthropy Across Generations*, 3 NAT'L CTR. J. 12 (2001).

202. ESPOSITO, *supra* note 38, at 17.

203. *Id.* at 27.

204. EMIL ANGELICA, CRAFTING EFFECTIVE MISSION & VISION STATEMENTS 5 (2001). For example: "The mission of the Joseph P. Kennedy, Jr. Foundation is to provide leadership in the field of mental retardation and service to persons with mental retardation, both those born

3. *Family Participation in Management*

The role family members will play in governance is a key foundation design factor. This is a two-staged issue. What will be the composition of the original board? How will family members figure in management succession?

Some family foundations name all the children to serve with the founders on the initial board. As the number of descendants increases, foundations may provide for representation of each family branch. The vision may be for the foundation to preserve unity through participation in a common philanthropic cause as the family grows larger and more geographically dispersed. The larger the group, however, the greater the danger of differences over grants and procedures. Accordingly, it may be wise to provide a mechanism for dividing the foundation along family branch lines. Sometimes a child who is not employed in the family business will be tapped to manage the family foundation. Other foundations choose board members with relevant expertise, whether members of the family or not. Trusted advisors and experts in the areas of interest are likely candidates. For example, Bill Gates' father is a retired attorney with experience in advising philanthropists.[205] The Gates' foundation was formed when Mr. Gates, Sr., volunteered to screen gift solicitations for Bill, and a structure was needed to organize the effort.[206]

4. *Involving Younger Generations*

It is not a given that the next generation will share the interests of the founder's vision for philanthropy. So confirming that interest is a prerequisite to participation. Establishing a junior board may facilitate cultivating an interest among younger family members. For example, the Frees Family Foundation has an advisory board for descendants aged ten to twenty-one years.[207] Grants recommended by this young group must follow foundation guidelines and must be approved by the regular board.[208] Perceived advantages of this program include: (1) smoothing inter-generational transfer of responsibility; (2) enhancing interest and active participation in the future;

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and unborn, and their families." JOSEPH FOOTE & DORNA L. ALLEN, NAT'L CTR. FOR FAMILY PHILANTHROPY, SPLENDID LEGACY, THE GUIDE TO CREATING YOUR FAMILY FOUNDATION 17, 29 (2002).

205. Gates, *supra* note 39.

206. VIRGINIA ESPOSITO & JOSEPH FOOTE, NAT'L CTR. FOR FAMILY PHILANTHROPY, SPLENDID LEGACY, THE GUIDE TO CREATING YOUR FAMILY FOUNDATION 51 (2002).

207. *Id.* at 97.

208. *Id.*

(3) training for foundation management; (4) stimulating creation of new ideas; and (5) instilling the values of philanthropy and volunteerism.[209]

The structure of the board, planning for succession, and the ongoing role of family in management all have a bearing upon the design of a family philanthropy vehicle.

C. Designing the Family Charitable Entity

After developing all of the parameters discussed above, the ultimate task is to design an appropriate structure for the family charitable fund. The primary vehicles include donor advised funds, private foundations, and public charity supporting organizations.[210] One way to approach the design process is to address the following three questions in order:

> (1) Does the client prefer a donor advised fund for simplicity and ease of administration, or does the client prefer to establish a family foundation for greater control;
>
> (2) If a foundation, does the client want the complete control afforded by a private foundation, or is it more important to avoid the private foundation rules by using a public charity supporting organization; and
>
> (3) Will the choice of entity under state law be a charitable trust or a nonprofit corporation?

1. *Private Foundations*

Understanding the differences between private foundations and public charities is crucial to these design decisions. Private foundations offer the greatest degree of independence and control in the operation of a family charitable fund.[211] Along with those benefits come a number of burdens, however.

Maintaining a private foundation requires greater administrative effort and expense than the other alternatives. Tax compliance involves paying an excise tax on investment income, filing more complicated annual tax returns, avoiding private foundation penalty taxes, and seeing that certain grants are spent for the intended purpose.[212] Foundation managers also are responsible for establishing their own grant procedures and investment poli-

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209. *Id.*
210. For a comprehensive comparison of these alternatives, see Eason, *supra* note 12.
211. *Id.*
212. *Id.*

cies as well as overseeing investment managers. Written records of the actions of the governing board should be kept.

Most problematic, however, are the special tax rules and restrictions that apply exclusively to private foundations. First, the measure of the deduction for contributions of long term capital gain property is limited to cost basis instead of fair market value for all assets other than qualified appreciated stock.[213] Second, the percentage limitations on annual contributions are decreased from fifty percent to thirty percent with respect to cash contributions and from thirty percent to twenty percent with respect to capital gain property.[214] Third, private foundations must pay a one to two percent excise tax on net investment income, and quarterly estimated tax payments of the tax are required.[215] The tax applies to capital gains on the sale of donated property as well. Fourth, private foundations are required to make annual minimum distributions based upon five percent times a calculation of average net asset value for the year.[216] Fifth, private foundations are subject to rules prohibiting self-dealing[217] and requiring disposition of closely held business interests within five years.[218]

These rules have important implications for the choice of charitable vehicle. If the foundation will be funded with appreciated assets other than qualified appreciated stock, the gift fund must qualify as a public charity for the charitable contribution deduction to be measured by fair market value instead of cost basis and to qualify for the higher percentage limitation on charitable deductions.[219] The five percent minimum distribution requirement will limit the ability of a private foundation to accumulate income for an endowment.[220] Also, a private foundation must have sufficient income or liquidity to meet the five percent distribution requirement.[221] The required disposition of closely held business interests makes planning with such assets more difficult for private foundations.[222] Transactions such as a sale of property between a donor (or related parties) and the donor's private foun-

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213. 26 U.S.C. § 170(e) (2000).

214. *Id.* § 170(b)(1) (measuring percentage limitations against adjusted gross income).

215. *Id.* § 4940 (2000).

216. *Id.* § 4942 (2000). The Charitable Giving Act (H.R. 7) under consideration by Congress at the time of this writing includes a provision that would no longer allow private non-operating foundations to take overhead expenses into account in calculating the five percent minimum distribution requirement. If this act is enacted it would increase the amount private foundations are required to distribute each year.

217. *Id.* § 4941 (2000).

218. *Id.* § 4943 (2000).

219. 26 U.S.C. § 170.

220. *Id.* § 4942.

221. Type III supporting organizations also have certain income distribution requirements.

222. 26 U.S.C. § 4943.

dation are strictly prohibited, even at fair market value.[223] Furnishing of facilities (leases) from a disqualified person to a private foundation also is prohibited unless leased for free.[224] Leases from a private foundation to a disqualified person must be at fair rental value.[225]

One or more of those issues may require a gift vehicle which qualifies as a public charity. In such cases the choice will be between a donor advised fund and a supporting organization. Consider first the simplicity of a donor advised fund set up with a community foundation.

2. *Donor Advised Funds*

A donor advised fund is established by an agreement between the donor and a qualified charity. The agreement provides that the donor may make recommendations or "advise" the charity on how the donor's gifts will be distributed to charitable grantees.[226] The charity must have the absolute legal right to control distributions, as well as the right to control the investments.[227]

Donor advised funds ("DAFs") developed as the component funds comprising most of the assets of local community foundations that qualify as publicly supported charities.[228] For such funds to be automatically tax exempt, they must meet the requirements to be treated as component parts of a "community trust."[229] If a component fund fails to meet those requirements, it will be treated as a separate private foundation entity.[230] The community trust regulations define a component fund as a fund created by gift or other transfer to a qualified community trust provided that the fund is not subject to any "material restriction" or condition by the donor.[231]

In recent years the use of such funds has been adopted by national "community" trust charities as well as charitable gift funds established by several major investment firms, the Fidelity Charitable Gift Fund being most prominent among them.[232] Whether the rules applicable to component funds of local community foundations also cover DAFs of national charities is unclear. In recent years the I.R.S. has granted exempt status to national

223. *Id.* § 4941 (2000).
224. *Id.* § 4941(d)(2)(c).
225. *Id.* § 4941(d)(2)(D).
226. Emanuel J. Kallina, II et al., *Charitable Giving With Donor Advised Funds - Part I*, PLANNED GIVING ONLINE (April 19, 2000).
227. *Id.*
228. *Id.* Community foundations are covered by Treasury Regulation. § 1.170A-9(e)(10), which refers to them as community trusts.
229. Kallina, *supra* note 226.
230. *Id.*
231. Treas. Reg. § 1.170A-9(e)(10) (as amended in 2002).
232. Kallina, *supra* note 226.

organizations primarily consisting of DAFs, but only where they contained self-imposed private foundation-like rules that require minimum distributions and restrict individual and political expenditures.[233] Committing to maintain a policy of distributions exceeding the five percent private foundation test was important, as were certain restrictions to prohibit the inurnment of any private benefit to the donor-advisors.[234] Furthermore, the Bush administration's fiscal year 2001 budget proposal contained a provision that would apply private foundation type restrictions to DAFs, including the five percent minimum distribution rule.[235] Those developments should be taken into account when comparing DAFs with other vehicles.

In selecting a community foundation or other DAF provider to work with, considerations include the range of philanthropic services available, investment alternatives and performance, administrative reliability, and fee structure. Also of critical importance is the policy on successor advisors. Policies differ among providers on how long they permit a DAF to last and on how many generations are eligible to serve as successor advisors.

DAFs established in a community foundation have the following advantages: (1) they are simple to set up; (2) they are professionally managed; (3) they provide a convenient way to leave a charitable legacy; (4) they lack the administrative and accounting burdens of foundations; and (5) they can provide access to a number of philanthropic support services.[236]

The trade-off for obtaining those advantages is relinquishing legal control over charitable grants and fund investments.[237] Also, investment alternatives often are limited to a few mutual funds or the pooled investment fund of a community foundation. Some providers limit how long a DAF may continue following the donor's death before it must be fully distributed.

Accordingly, many clients prefer to create their own family foundations, especially for larger funds, which justify the increased administrative effort and expense. These stand-alone foundations can be established in perpetuity, and family can have complete control over investments and charitable grants. The next set of design parameters relates to private foundation classification under federal tax law, if the decision is made to utilize a separate foundation.

233. Internal Revenue Serv., *Charities & Non-Profits*, *at* http://www.irs.gov/charities/article/0,,id=96386,00.html.

234. *Id.*

235. *Id.*

236. Eason, *supra* note 12.

237. *Id.*

3. *Private Foundation Versus Supporting Organization Status*

Every § 501(c)(3) charity is classified as a private foundation unless it meets one of two measures of public support under §509(a)(1) and § 509(a)(2), or unless it qualifies as a supporting organization under § 509(a)(3).[238] A supporting organization must be organized and operated exclusively for the benefit of, or to perform the functions of, or to carry out the purposes of one or more public charities.[239] Also, a supporting organization cannot be controlled by substantial contributors or other disqualified persons, and its relationship with the supported charities must fit within one of three types.[240] Type I and Type II supporting organizations are directly controlled by the supported charities either by a majority board overlap (like brother-sister corporations) or by election of a majority of the governing board (like parent-subsidiary corporations).[241]

Type III supporting organizations involve some of the most creative planning opportunities. Although a majority of the governing board must be non-family members, the founders can have the right to elect them in annual elections, and the non-family board members can be close and trusted friends and advisors.[242] The charter documents of the supporting organization must designate the supported charities by name, and the nature of the affiliation between them must meet certain tests. A detailed guide on how to qualify supporting organizations can be found elsewhere.[243] For clients who will tolerate these constraints, particularly the requisite lack of control, a supporting organization can be set up as a separate family foundation while avoiding most if not all of the private foundation restrictions.[244]

4. *Private Foundation Design*

Where retaining total control is a priority, clients will prefer a private foundation. As relevant here, private foundations are classified as operating foundations or non-operating foundations.[245] Examples of operating foundations include privately funded museums, religious retreat centers, or public

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238. 26 U.S.C. § 509 (2000). The first two are not relevant to a privately funded charity.

239. *Id.* § 509(a)(3)(A).

240. *Id.* § 509(a)(3)(B)–(C).

241. Treas. Reg. § 1.509(a)-4 (as amended in 1981).

242. Jeffrey D. Davine, *Everything You Ever Wanted To Know About Type 3 Supporting Organizations*, GIFT PLANNER'S DIG., June 28, 2000.

243. *Id.*

244. Type III supporting organizations have their own set of distribution requirements, and if they engage in activities that would be prohibited transactions for private foundations, then those activities may adversely affect qualification as a supporting organization. *Id.*

245. BARBARA L. KIRSCHTEN & CARLA NEELEY FREITAG, CHARITABLE CONTRIBUTIONS: INCOME TAX ASPECTS, BNA TAX MANAGEMENT PORTFOLIO A-121 (2002).

policy think tanks. An important planning distinction is that gifts to operating foundations are treated just as favorably as gifts to public charities.[246] Nevertheless, operating foundations are less common in philanthropic planning; the great majority of private foundations are non-operating foundations that function primarily as grant-makers. The Gates Foundation is an example of such a non-operation foundation.

a. Private foundation with DAF

Even where a private foundation is the vehicle of choice, it may establish a DAF at a community foundation to achieve a number of advantages.[247] First, a gift of appreciated property other than qualified appreciated stock can be contributed to the DAF and still qualify for deductibility at fair market value and for the higher percentage limitations.[248] This practice also avoids the 2% excise tax on the capital gain that would otherwise be imposed if sold by a private foundation.[249] Second, a private foundation faced with a year end deadline for meeting the 5% minimum distribution requirement can make a gift to a DAF to extend the time for making grant determinations.[250] Advisors should watch for legislative and other developments on whether similar minimum distribution requirements will be imposed on DAFs, however. Third, if the family eventually becomes weary of the administrative obligations, a private foundation may be terminated by a complete distribution to a DAF.[251] That scenario may even be the ultimate plan for management succession when all board members have become unable or unwilling to continue serving as foundation managers. Fourth, a DAF provides a way for a private foundation to make grants anonymously. Fifth, this arrangement can make available a number of philanthropic support services provided by many community foundations, including access to grant making expertise, facilitating grants to international organizations (gifts to which are subject to special rules), and even outsourcing some of the administrative burdens of running a private foundation.[252]

Establishing a relationship with a community foundation also can be extremely useful for a supporting organization. It can facilitate qualification by helping the supporting organization establish the types of relationship

246. 26 U.S.C. § 170(b), (e) (2000).

247. Bryan Clontz, *Symbiotic Ways Private Foundations Use Community Foundations*, GIFT PLANNER'S DIG., August 14, 2002.

248. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

required with a supported public charity.[253] It also can give the supporting organization a wider range of possibilities for charitable grants, given that the supporting organization's charter documents must designate a narrow range of supported charities.

b. Employing family members

A common question is whether a private foundation can employ children or other family members. The private foundation self-dealing rules generally prohibit transactions between family members and the foundation, but there is an exception for the payment of compensation "for personal services which are reasonable and necessary to carrying out the exempt purpose," if the compensation is not "excessive."[254] Permitted services include legal, accounting, and investment advisory services as well as administrative services such as managing the grant making process.[255] The potential for self-dealing penalty taxes require caution here, but employment of family members by a private foundation is feasible so long as the services provided are reasonable and necessary and the compensation is not excessive. Supporting organizations also must be cautious in employing family because "intermediate sanctions" may be imposed upon payment of excessive compensation to insiders.[256] Self-dealing penalty taxes and intermediate sanctions can be avoided with careful documentation of benchmarks for compensation.

5. *Charitable Trust Versus Nonprofit Corporation*

Whether classified as a supporting organization or private foundation, a family foundation will be set up under state law either as a trust or as a nonprofit corporation.[257] Key issues in the choice of entity include flexibility, fiduciary liability, and long-term control of the foundation.

a. Flexibility

The corporate form is much more flexible than a trust, and it is more adaptable to changing circumstances. Members can easily amend articles and bylaws to accommodate circumstances unforeseen at the outset. The

253. Clontz, *supra* note 247.
254. 26 U.S.C. § 4941(d)(2)(E) (2000).
255. TURNEY P. BETTY, PRIVATE FOUNDATIONS—SELF DEALING (SECTION 4941), BNA TAX MANAGEMENT PORTFOLIO A-24 (2002).
256. 26 U.S.C. § 4958 (2000).
257. Hodgman, *supra* note 180, at 482.

statutory powers granted to corporations are very broad.[258] The combination of less restrictive charter documents and modern nonprofit corporation codes gives the corporate form an inherent adaptive capacity for the long run.[259]

In contrast, a charitable trust instrument is irrevocable.[260] The trustees generally must abide by the purposes and powers originally prescribed in the trust agreement. An independent Trust Protector may be named with authority to amend the trust to fix problems unforeseen by the settlor.[261] Otherwise, it is necessary to have a court proceeding to authorize a modification of the original trust terms, either under the common law doctrine of *cy pres* or under state reformation statutes.[262] In any case, the ability to modify the governing instrument in response to changed circumstances is much more limited for a trust as compared with a corporation.

b. Fiduciary liability

A comparison of the standards for fiduciary liability strongly favors the corporate form. For foundations that have no employees, own only marketable securities, and conduct only grant making activities, the fiduciary liability will not be as significant. Otherwise, it will be extremely important. Trustees may be liable for simple negligence in managing a trust, while directors normally are not liable for mere mistakes in judgment. Instead, directors must have committed gross negligence or intentional misconduct.[263] Trustees are held to the highest standard of fiduciary conduct, the "punctilio of an honor most sensitive."[264] A trustee generally is subject to personal liability for contracts made in the course of the administration of the trust.[265] Trustees also are personally liable for the negligence and other torts committed by their agents or employees.[266] One of the trustees' greatest concerns is the personal liability to which they may be exposed merely

258. *See, e.g.*, ARK. CODE ANN. § 4-33-302 (Lexis Repl. 2001).

259. Hodgman, *supra* note 180, at 483.

260. *Id.*

261. David R. Hodgman, *Drafting Flexible Irrevocable Trusts–Whom Do You Trust?*, 23 EST. PLAN. 221 (1996).

262. *See, e.g.*, ARK. CODE ANN. § 28-69-401 (Lexis Supp. 2001).

263. For a general discussion of comparative liability in states following the standards of the Revised Model Nonprofit Corporation Act see James Edward Harris, *The Nonprofit Corporation Act of 1993: Considering the Election to Apply the New Law to Old Corporations*, 16 U. ARK. LITTLE ROCK L. J. 1, 11 (1994).

264. Robert J. Rosepink, *Punctilio of an Honor–A Trustee's Duties*, 28 ACTEC J. 101 (2002).

265. RESTATEMENT (SECOND) OF TRUSTS § 262 (1959).

266. RESTATEMENT (SECOND) OF TRUSTS § 264 (1959).

by holding title to real estate where environmental problems are discovered.[267]

In contrast, corporate directors usually are not personally liable for the contractual obligations of the corporation.[268] Also, directors are not personally liable for the negligence of the corporation's agents and employees, absent unusual circumstances such as gross negligence in the selection and hiring of the employee or agent.[269] Furthermore, most modern nonprofit corporation statutes not only permit indemnification of directors, but in certain cases statutes even make it mandatory.[270] While trustees sometimes are entitled to indemnification out of trust assets, trust provisions that exonerate trustees from liability may be unenforceable.[271] Also, if there is any possibility that some of the income of the foundation may be subjected to the unrelated business income tax, the trust tax rates are much higher than corporate rates.[272]

All these considerations recommend the corporate choice of entity when the foundation has employees, conducts active operations, or owns real estate. Otherwise, those concerns will not be as great, and clients may prefer the less formal operation of a trust as compared with a corporation that must conduct board meetings, keep minutes, and generally operate corporate manner.

c. Lasting control

In some cases the relative inflexibility of a trust instrument may help accomplish the client's objectives. An irrevocable trust instrument specifying the focus of the donor's philanthropy may be more likely to preserve the donor's wishes for the long-term direction of the foundation.[273] Provisions that lock in family succession may be more feasible with a trust.[274] In addition Type III supporting organizations generally must be trusts; the ability of the named charitable beneficiaries to compel an accounting under state trust law helps qualify the foundation as a supporting organization.[275]

267. Rosepink, *supra* note 264, at 117.
268. *See* Harris, *supra* note 263, at 13.
269. *Id.*
270. *See, e.g.*, ARK. CODE ANN. § 4-33-852 (LEXIS Repl. 2001).
271. Rosepink, *supra* note 264, at 112.
272. 26 U.S.C. § 1 (2000).
273. Hodgman, *supra*, note 261.
274. *Id.*
275. Treas. Reg. § 1.509(a)-4 (as amended in 1981).

6. *Hybrid Concept: Trust Sole Member of Corporation*

An interesting idea for a hybrid approach is to create a trust that is the sole member of a nonprofit corporation.[276] The operations of the foundation can be conducted in the nonprofit corporation with greater flexibility in management and limited liability for directors. The trust instrument can specify the philanthropic wishes of the founder and provide for succession of trustees among family members. The trustees elect the directors of the corporation, and the trustees must approve any amendments to the corporate charter documents. This hybrid structure may provide a way to take advantage of the strengths of both types of entities, preserving donor intent for mission and succession, protecting the directors, yet affording sufficient flexibility in operation and adaptability to changed circumstances.

CONCLUSION

More than 2,000 years ago Aristotle described the basic framework for strategic philanthropy:

> To give away money is an easy matter and in any man's power, but to decide to whom to give it and how large and when, and for what purpose and how, is neither in every man's power nor an easy matter. Hence, it is that such excellence is rare, praiseworthy, and noble.[277]

Even today the key requirement is to ask the right questions. This article has addressed the who, what, when, where, why, and how of giving, although not quite in that order, in the context of developing a LEVEL FIVE GIVING PLAN.™

The question of *who* regards who has the desire and capacity to add philanthropy to their planning and who among the family will be involved. The question of *what* involves what amounts will be allocated among the hierarchy of objectives and what assets are most tax efficient for each one. The question of *when* concerns when gifts will be made: during life, upon death, or retained life interest with charitable remainder. The question of *where* is about sharpening the focus of one's interests, determining which charities are most effective in those areas, and which ones most successfully leverage their resources. The question of *why* relates to charitable motives, clarifying values, and establishing the purpose and mission of the family charitable fund. Finally, the question of *how* addresses the choice of vehicle (donor advised fund, private foundation, or supporting organization) and the

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276. Hodgman, *supra* note 180, at 483.

277. Strategic Philanthropy, *Determining the Appropriate Vehicle for Philanthropic Activities*, *at* http://www.stratphilanthropy.com/giving.html (quoting Aristotle).

choice of entity (trust, nonprofit corporation, or the hybrid model) as well as the tax planning techniques covered elsewhere.

As trusted advisors to people of means, attorneys are positioned to help clients explore these significant questions. When we do so, we add value to the services that we provide, we engage clients in a process that can be deeply rewarding to them, and we enhance our own professional satisfaction. Most importantly, by facilitating a strategic approach to philanthropy, we can amplify the profession's positive influence. But that will not happen if we fail to take the initiative. Though lawyers have made many great contributions to society, we have not yet reached our full potential to stimulate strategic, effective, and efficient philanthropy.