Becoming a Philanthropist: It's More Than Just Writing Checks

There are many factors to consider when becoming a philanthropist or starting a charity

Key points

- Establishing a new charity requires many important considerations
- Adopting a strategic vision for the charity brings discipline and focus to philanthropy
- Prudent investing and fundraising are key to a charity's growth potential

Just as an individual goes through life cycles, so does a charity. From the start-up phase to adopting a strategic vision to looking at ways to grow the charity, there are many steps to consider at each important phase of the charity's lifetime.

Start-up

A first critical phase in the life cycle of a charitable organization is the start-up period. Let's take a look at some of the most important aspects of establishing a new charity.

Formation

Some organizations are established by a trust under a will; others are established during the donor's life. A charity is formed by a legal document—a charitable trust instrument or articles of incorporation for a nonprofit corporation. There is much more involved, however, to get up and running.

Establishing tax-exempt status

All charities with more than minimal assets must file an exemption application with the Internal Revenue Service, known as the Form 1023. If filed on a timely basis, once the application is approved, the charity will be tax-exempt for federal income tax purposes under section 501(c) of the Internal Revenue Code from the date of its formation. Some states also require a charity to file an application for exemption from state income tax. If the charity will be an active operating entity, it may also wish to obtain a sales tax exemption and exemption from real estate taxes for property it uses in carrying out its charitable activities.

Public charities versus private foundations

For federal income tax purposes, all charities are categorized as either public charities or private foundations, based on their purposes or funding sources. Charities that are churches, hospitals, or universities are automatically treated as public charities by virtue of their exempt purposes. Other charities, such as United Way-type organizations, achieve public charity status because they are broadly supported by the general public. Charities that do not meet either a purpose test or support test are "private foundations." Typically, most family foundations, which are funded by a single donor or family, are private foundations. As discussed below, private foundations are subject to additional restrictions on their operations and activities.

Governance

Charities formed as nonprofit corporations need bylaws in addition to articles of incorporation. Charities formed as trusts will have provisions regarding the trustees in the trust documents. Both kinds of charities may find it helpful to develop a mission statement that fleshes out its purposes and goals more fully. While charitable trustees are generally appointed under the trust, nonprofit corporations will need to appoint directors. It is also important to consider how to educate trustees and directors about their responsibilities. In addition to its directors or trustees, a charity may find it helpful to establish an advisory board. A member of an advisory board is not a director or trustee, but he or she can be a useful sounding board for an organization. Members of an advisory board may have knowledge about the field in which the charity works, the community, or other charities working in the same area. Some advisory board members may function as fundraisers for the charity.

Staffing up

Staffing needs for a start-up charity will vary depending upon its mission and activities. Some charitable organizations will be private foundations without a staff, writing a few checks a year, and needing assistance from an investment advisor, accountant, a lawyer, and in some cases a back-office administrator. Other charities may be more active and need to consider professional staff: for example, an executive director, program officers, and/or financial officers. If a charity employs paid staff, it will need to establish a compensation policy and ensure that it pays only "reasonable compensation." In addition, it will need to establish personnel policies and arrange for payroll processing and payments.

Investing

Tax considerations

Tax-exempt charities have some different investment considerations than taxable investors. Unlike most investors, tax-exempt entities do not pay tax on most of their investment income. However, proper planning is required to maximize tax-free income. For example, taking on debt can be very costly for a charity, because often the income from a debt-financed asset will be subject to tax, while the same income from an investment not encumbered by debt will be tax-free. In addition, private foundations are subject to an excise tax of 1.39% on net investment income.

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Prudent investing

As the stewards of charitable assets, trustees and directors of charities have a fiduciary duty to make sure that the charity invests prudently. Under modern investment theory and modern charitable law, that does not mean that a charity needs to restrict itself from certain categories of investments, but it does mean that the charity needs to act responsibly in developing and monitoring its investment portfolio.

Private foundation restrictions

Private foundations have additional considerations regarding their investment portfolios. Under the excess business holdings rule, a private foundation generally may not own more than 20% of the voting stock, profits interest, or beneficial interest of a trade or business, or 35% if the charity and "disqualified persons" (more on that below) do not have control over the business. Further, under the "jeopardy investment" prohibition, a private foundation may not make investments that would "jeopardize" its endowment.

Setting investment and spending policies

A charity that is starting out needs to consider its charitable budget and how to manage its investments to provide an income stream for its activities. For a private foundation, a starting point for the budget is the requirement to pay out 5% of the charity's assets annually in grants or direct charitable activities. This 5% payout requirement is a minimum: early on, a private foundation needs to set a spending policy to determine what percentage it wishes to spend overall—and how to allocate that amount across grants, administrative spending, and direct charitable activities. Operating charities will likely have more complex budgets, but they similarly will need to establish a spending policy that considers how to allocate income and principal between current charitable activities and an endowment for the future. Similarly, the charity needs to establish an investment policy, regarding the kind of assets it will invest in, the income stream it will seek, and how it will raise funds to meet its charitable payment obligations.

Grantmaking

When a charity starts up a grant program, it needs to consider how it will select grantees, how it will distribute grant payments, and how much reporting from grantees it will require. For example, does it want to solicit applications on a website? Will it set up a grants review committee to advise the directors or trustees, or will they review grants themselves? Will it make grants annually, or throughout the year? Will grants be for a one-year period, or multiple-year grants? Will its approach be smaller grants for many charities and beneficiaries, or larger grants to a smaller number of charities? If the charity is a private foundation, as many grantmakers are, it is subject to additional restrictions that it will need to consider in setting up a grant program. For example, will it make grants to individuals, other private foundations, or non-charitable entities, all of which require additional diligence in grantmaking and reporting, known as "expenditure responsibility." Must all grantees provide reports, or only those required under the applicable federal regulations?

Operating as a private foundation

Private foundations are subject to a number of additional restrictions on their operations and activities. Among the most important are the 5% annual payout requirement and the "self-dealing" rules that restrict private foundations from engaging in certain transactions with "disqualified persons." Disqualified persons include officers, directors, and trustees; substantial contributors; and certain related businesses and family members. Not all self-dealing transactions are inherently unfair: For example, a disqualified person cannot sell property to a private foundation, even if it is a "bargain sale" providing a discount from fair market value. In addition, private foundations are subject to investment and ownership restrictions on business holdings and jeopardy investments, discussed above, and are prohibited from making non-charitable expenditures, including lobbying and political campaign activities.

Moving beyond start-up—adopting a strategic vision

What is strategic philanthropy? Strategic philanthropy brings discipline and focus to philanthropy. We all want the world to be a better place, but no matter how great the resource, we can only do so much. Strategic philanthropy helps charities to look at their philanthropic goals and to focus philanthropic efforts to try to have greater impact.

How does a charity become strategic?

There are a variety of ways, but some of the most common strategies involve:

- *Focusing a mission more narrowly*
- *Evaluating grant programs to determine what works*
- *Engaging with charitable grantees to build a program, rather than simply funding the charity*

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- *Requiring grantees to meet certain benchmarks to receive funding*
- *Working collaboratively with other charities to fund larger projects together*
- *Working with the community to determine community needs*

Growing a charity

A charity's mission, program, and staff may grow over time, and its assets may need to grow with it. Some operating charities—schools and hospitals for example—will receive income from carrying on their charitable activities. But other charities, such as private foundations and relief organizations that do not charge for their services, grow through prudent investing and fundraising. Adopting a fundraising program may require a return to thinking like a start-up: a charity needs to consider who its core constituency is and how it wants to seek funds from them. The charity generally needs to meet state law requirements for fundraising, including in most states, annual filings. The charity also needs to consider whether it wishes to fundraise through volunteers, its own paid staff, or outside fundraising consultants.

With careful consideration of prudent investing and fundraising and the development of a solid strategic vision, your charity has the best chance to make the greatest philanthropic impact.

