September 2021 | Volume 11, Issue 3

Sentinel Trust℠

Together, families prosper℠

OnWatch

In This Issue:

Starting with a SOLID (FAMILY) FOUNDATION

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Are you contemplating starting a family foundation or are you less than thrilled with how your existing foundation is functioning? Defining and reflecting on your objectives may be the best way to get on a solid foundation. After all, it is hard to know how to pack for your charitable journey if you are unsure of your final destination.

What are the key reasons for a foundation? A pending or recent liquidity event may drive the desire to fund a foundation to avoid capital gains taxes and generate charitable income tax deductions. Assets passed to a foundation can escape estate taxes. Beyond the tax objectives, a family may consider a foundation to achieve greater and longer-term philanthropic purposes. Senior generation members sometimes establish foundations to create multi-generational legacies. Families can use the foundation to convey moral and social values and to teach younger members about philanthropy, budgeting, investments, and fiduciary responsibility. Foundation meetings can serve as a proxy for a family reunion and a reason to work together in a capacity that might not otherwise be available. Whatever they may be, a foundation's purposes are relevant to and should affect how it is formed, funded, and administered.

Memorialize the Mission and Vision

Once you define your objectives, a mission statement can convey the foundation's purpose. It should explain, in simple and concise terms, the reason for the foundation's existence. A good mission statement need not be lengthy to be effective. In fact, it may be only a single sentence or short phrase. While the mission statement defines what the foundation is currently, a "vision statement" can define where the foundation is headed in the future. For foundations with legacy intent, well-crafted and documented mission and vision statements can serve as guides for future generations and decision-making.

Structure and Governance

Given the objectives, is a private foundation the best structure? Foundations have specific legal and tax limitations and requirements. Examples include:

- Limitations on the deductibility of contributions to the foundation
- Restrictions on the foundation's ownership of business interests and on transactions between the foundation and "prohibited parties" (e.g., family members and related entities)
- Significant mandatory annual distribution requirements
- Administrative burdens and recordkeeping
- Restrictions on the use of the foundation's assets

Many families decide to use alternative approaches, like donor-advised funds, in lieu of or in addition to a foundation to reduce or eliminate these constraints.

If you determine that a foundation is a good fit for your circumstances, developing a governance structure is key to long-term viability. A private foundation has a board of directors or trustees that serves as a decision-making body. The makeup of the governance board may include family members, key advisors, donors, and/or members of the community. Much like when forming a successful board in an operating business, forming a foundation board requires consideration of the varying skill sets, expertise, and experience of the proposed members.

Board service requirements and expectations, term limits, and leadership role rotation should be well-defined and documented. Will only the founder and her children be eligible to participate? What about spouses and other family members? How can non-board family members participate and remain connected to the foundation? Can a family member who does not embody the values of the mission serve on the board? Resolving these difficult questions at the onset can alleviate future conflict.

Succession Planning

Although the senior generation typically retains control at the outset, the foundation should address succession planning early on. Family foundations may exist for multiple generations, but the further a foundation is from its founder, the more difficult it may be to find willing participants. Later-generation members may not have known the founder. They may be focused on school or starting a career or family. They may not be interested in the foundation's charitable objectives. Successful family foundations identify ways for even the youngest of family members to participate and develop ties to the foundation to create enthusiasm that may lead to willingness to accept the challenges of future leadership. Allowing non-family members to serve on the board also can help alleviate potential succession issues by expanding the pool of eligible board participants.

How long do you want your foundation to exist? Should it be limited to the founder's lifetime or a fixed number of years, or should it last forever? The answer directly affects how the foundation's assets should be invested and the size and scope of grants it makes. Foundations that will sunset within a generation may be more conservatively invested and have a spend-down policy that allows for distributions of the foundation's corpus as well as its income. Families wishing to grow and sustain the foundation in perpetuity may limit grant-making to the IRS-required minimum (5% of asset value annually) and take a longer-term approach to investing, including establishing a growth-oriented, higher risk asset allocation.

Grant Making and Impact

What kind of impact does the foundation hope to achieve? Start with defining the parameters for which grants will be made. The foundation's purpose may be very specific, which might drive grant frequency. For example, a foundation issuing scholarships may need to coordinate its foundation meeting and ability to issue grants in time for fall tuition payments. To achieve the foundation's objectives, the size and capabilities of the foundation's staff should be determined based upon the need to intake, review and organize grant requests and to evaluate recipients' accomplishments.

Foundations vary widely on their approaches to distributing funds. Some foundations support numerous charities with modest amounts while others issue a limited number

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of very large grants. There is no right or wrong answer on grant strategy, but the boundaries of grant size and number should be defined within a foundation's operating procedures.

Careful thought should be given to geographic and purpose limitations. Societal needs, economic developments and changing family member interests can have a huge impact over time. Although senior family members may have the legal right to place restrictions on foundation activities, overly restrictive policies risk making the foundation less relevant to the community and to subsequent generations of family members.

Disciplined Process

Encouraging family members to submit grant requests helps engage them with the foundation. However, there can be friction and hurt feelings if there is no process for evaluating and approving or denying the requests. Creating some discipline and required due diligence around the grant-making process can reduce the potential for these types of problems within the family. That discipline also can enhance the foundation's effectiveness at meeting its objectives. Due diligence required before grant approval might include activities like:

- Documenting how the grantee proposes to use the funds and how its activities correlate with the foundation's objectives;
- Reviewing recent years' tax returns, financial statements, budgets and annual impact reports;
- Interviewing of development directors, board members and other benefactors;
- Requesting and reviewing periodic reports by the grantee on its use of the funds; and
- Conducting site visits.

Many foundations use a basic application form that seeks both qualitative and quantitative data. Although grant dollars are issued with a measure of good faith, the foundation should follow-up with the organization to determine if the project was completed, to check in on the health of the charity, and to assess what future needs may exist. A foundation might use a simple follow-up letter or a more comprehensive and involved interview or site visit perhaps 6-12 months after funding. Such interactions can create synergy between the foundation and the charity, which allows for even greater impact.

Separate Identities

Foundation founders inevitably try to maintain strict control over their charitable progeny. Truth be told, they'd like to treat the money as their own. Unfortunately, this can be a recipe for problems:

- In exchange for tax-exempt status and contribution deductibility, the tax law subjects the foundation to stringent restrictions on the use of the foundation's assets, transactions between the foundation and the family, and investments the foundation can make. Violation of these rules can result in incredibly harsh, confiscatory penalties.
- Annual federal and state filings must be made on a timely basis. These require appropriate record keeping, board meeting minutes, board consents and other formalities.
- Family members tend to be turned off by parental controls that diminish the significance of their input, involvement and charitable interests. Shutting out the younger generations is a recipe for the long-term failure of the foundation's purposes and can result in its ultimate liquidation.

A successfully run foundation can achieve many personal, family, and philanthropic goals. Careful consideration should be given to a foundation's purpose, mission, governance structure, and administrative requirements before formation. Your CPA, attorney, family office, and other consultants can assist in this process. Giving money away may sound like an easy task, but creating a vehicle for sustainable and long-lasting impact on the organizations it supports is truly a team sport. ■

An ESOP is Not an EMERGENCY EXIT

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An aging business owner has a limited set of options for her business, each with potential challenges:

- Give it to the family — but what if they are not interested, capable or competent, and what if you need money to live on?
- Sell it to the family — but what if they don't have the money to pay for it and you don't want to pay taxes on the gain?
- Sell it to a third party — but what if the buyer decides to cut costs by firing your devoted long-time employees, and what about those taxes?
- Sell it to the employees — but what if they don't have the money to buy it from you and, what about those pesky capital gains taxes?

The Employee Stock Ownership Plan (ESOP) can be a very tax-effective way to transition ownership to the very people who helped build the business — its employees — but it's not for everybody.

How It Works

In the most basic approach, the Company (which must be a corporation, not a partnership or LLC) establishes a trust (the ESOP) for the benefit of eligible employees. The ESOP borrows money from a bank or other lender and purchases shares from the aging owner. Over subsequent years, the Company contributes cash to the ESOP to be used to pay off the lender.

There are significant tax advantages:

- Company contributions to the ESOP are tax deductible even though the money is used to buy stock. The Company also can contribute its own stock and receive a tax deduction for its value.
- Under certain circumstances, including that the ESOP must own at least 30% of the stock, the aging seller can defer gain by reinvesting the sales proceeds in other securities.
- Employees are not taxed until they receive distributions from the ESOP. Appreciation in the stock value is taxed as capital gains, and the employee can defer the tax by rolling distributions over to an IRA.
- If the Company is an S corporation, the ESOP's share of corporate earnings is not taxed. If the Company is a C corporation, dividends paid to the ESOP can be deducted by the Company.

The tax law creating ESOPs prescribes rules for assuring that the ESOP benefits employees fairly and does not overly benefit the most highly paid employees. The stock must be valued periodically by an independent appraiser. When an employee terminates employment, the Company must repurchase his shares at the appraised value. The aging owner's continuing role can be flexible.

The Catch

The repurchase obligation is perhaps the greatest potential stumbling block. The Company must consistently generate enough cash to contribute to the ESOP (to pay for the share), conduct its normal business, and make necessary capital investments. A "perfect storm" may be created if there is a major business downturn that requires letting employees go, creating potentially sizable repurchase obligations when the business can ill-afford to part with the cash.

Perhaps most importantly, the Company needs management continuity and a strong ownership culture to convince banks, suppliers, and customers that it can continue to operate successfully for a smooth transition as the founder phases out.

That effective ownership culture requires well informed and highly involved employees who think and act like owners. The Company must provide a financially meaningful ownership stake, share performance data, educate employees for business literacy and company operations, provide opportunity for feedback, and build employee involvement to deeply ingrain respect for the role of each employee for its continued success.

An ESOP clearly is not for everyone. But well positioned and well prepared, an ESOP may be the ideal solution for a founder who is ready to exit and wants to leave a business thriving in the hands of the employees who helped build it.

Jump Starting EDUCATION SAVINGS

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Most investors understand that the sooner you start saving, the more time there will be for the earnings to compound. So-called "529 plans" (named after the Internal Revenue Code section that describes them) are tax-advantaged savings plans designed to cover future education expenses. They allow income taxes on earnings within the account to be deferred and, ultimately, eliminated when they are distributed for qualifying educational expenses. Most people fund 529 plans with their annual exclusion gifts (currently up to $15,000 per donee) each year. Imagine the power of compounding without taxes in a 529 plan! But do you have to wait until the bouncing little baby student is born to start making the annual gifts and to start the benefit of tax-deferred earnings?

There are two catches. First, there can be no annual exclusion gifts until there is a donee. Second, to open a 529 savings plan, there must be a beneficiary with a social security number (and you can't get a social security number for an unborn person). These details seem to suggest that you can't start the benefits of annual gifting and compound, tax-deferred growth until a baby is born. Of course, you certainly could start funding a standard savings account ahead of a birth, but the earnings would be taxable and both the savings and earnings will be included in your taxable estate if you die before you transfer them to the wee one.

Fortunately, there is a little-known workaround in the 529 plan rules that lets you start saving and benefiting from tax deferral long before there is a twinkle in the parents' eyes.

That workaround is a provision that allows you (or your designee) to change the beneficiary of a 529 plan as often as once per year. This is not a loophole; rather, it is an integral part of the rules intended to provide flexibility in the event the designated beneficiary does not ultimately need the money (e.g., because he doesn't go to college, gets financial aid, etc.).

So one option would be to create a 529 plan in the name(s) of, say, a close relative. Make annual gifts to the plan and start the benefits of tax-free earnings compounding. Later, when a child is born, get a social security number and change the designated beneficiary to the newborn. If there are multiple births, you can deposit or rollover funds into multiple 529 plans. Voila — you have added potentially many years of gifts and of tax-deferred earnings to the plan! ■

Sentinel Trust Company is a family-owned, multi-family office focusing on the unique needs of affluent families and their closely held companies and foundations. Sentinel Trust provides advice on investment, tax, and estate strategies, serves as corporate trustee, and provides lifestyle services with a personal touch.

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Founded in 1997 as the successor to two established, investment-focused single family offices, Sentinel Trust offers the stability of an institutional firm, the entrepreneurial spirit of a young firm, the personal feel of a family office, and the in-house technical skills of independent planning and investment management firms.

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