Setting Up a Philanthropic Spin-Off

How funding structure, leadership selection, and control can determine the success of the new organization.

In the course of supporting innovative programs and efforts to impact the community, state, or the world, many foundations find themselves doing more than just funding programs; they are also running them. Over the past decade there has been an increase in the number of foundations that find themselves in this situation, and for many reasons, decide that their impact could be greater if they "spin off" the program from the foundation.

Transforming a program into an independent entity is a delicate balance. You must provide enough independence that the new organization or effort can forge its own path while also ensuring that the strategy and mission remain in synch with the initial intent.

Funding and leadership structures are the two primary ways parent foundations can guide the new organization's direction. Choices made at the onset for both financing and leadership have implications for the organization's tax status and legal structure.

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Funding the new organization

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- **Endowment —** Creating an endowment is a bit like handing the car keys to your child, but not letting him/her drive. It can be very restrictive, but also gives the new organization a healthy balance sheet and revenue streams in perpetuity. The biggest downside of an endowment is the lack of liquidity. The new organization would need to raise operating funds right away to pay its bills and would likely need to spend much of its capacity at the outset raising or earning those funds.

A large endowment may also impact how the upstart is viewed by others in the funding community. If you set the program up with a large pot of money, others may think it doesn't need their support, even though realistically the organization can't immediately use most of the dollars it has.

- **Multi-year pledge —** The new organization will probably like this option best, as a multi-year pledge provides comfort in knowing that support will be there today and in the near future. It will also motivate them to seek other resources for when the pledge expires.

  Other factors at play here are the restrictions or contingencies placed on future funding and how that pledge will appear in the new organization's financials. If the funds aren't contingent, the new organization will need to recognize the entire pledge in the initial year. This can skew how others view the entity's financial health. A high number of contingencies allows you to exercise greater control over your investment and may protect the new nonprofit from having to recognize the revenue all at once. However, the downside is that restrictions and contingencies can be limiting for the organization as it attempts to get on solid footing.

- **Annual grant —** Doling out funds annually is a bit like helping your child with his college expenses each year without designating a college savings account or promising to help pay for expenses in the future. Your child has to continuously prove to you that he is going to spend your money wisely and keep his grades up. There is no certainty that you will help out again next year, so the organization will need to work hard finding other sources of revenue, which may distract from its mission-centered work or building the infrastructure critical to its success.

Governance and leadership

Control and influence are very powerful things when moving a program out of your organization to stand on its own two feet. Aside from money, the other major source of influence relates to governance and leadership. How much control can you have without being perceived as a "helicopter parent?"

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There are a number of ways to approach governance and leadership; here are a few of the most common.

Board composition

A new organization can deploy a wide spectrum of options when creating its governance structure. These are listed here in order of control from most to least.

- **Mirror board —** Here we would have the new organization's board being comprised of all or part of the parent's governing body. This would give you almost complete control, but is generally not advisable since it may defeat the purpose of creating a new entity. It will also create problems, both in public perception and tax status, when the new organization claims independence.

- **Selecting the entire board —** By seating the entire board of directors, you are able to indirectly steer organizational strategy in the near-term. However, in this situation too, the new organization may face challenges claiming independence as it relates to tax status and public appearance. It may ultimately depend on whether the board plans to expand beyond its original members, when it would expand, and how much overlap there may still be with the parent's board.

- **Selecting a portion of the board —** You may choose to identify a portion of the initial board, and then allow those board members to select their peers for the remaining seats. This strategy dilutes your direct or indirect control and increases the perception and reality of independence, while still providing a level of influence to ensure the organization doesn't go astray.

- **Designated funder seat on the board —** One additional consideration is whether there should be a designated seat on the board to be filled (on an ongoing basis) by an individual from the parent organization. This could be filled by a member of your staff or board. While this seat solidifies the ties between the two entities, it can create ongoing conflicts of interest and may raise concerns about the organization's independence.

Ultimately, the new entity's board will have total authority and responsibility for its success. It is worth exploring how much influence you need to ensure success as you define it while balancing how much influence may inhibit the entity's ability to flourish and grow.

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Leadership selection

Evaluating and hiring a key staff leader (often the executive director) is generally one of the most important roles of a board. Depending on the timeline, the spin-off may or may not have a working board in place by the time it needs a leader to get it up and running. This raises the question of who should help identify and vet candidates, and who has the final say in hiring decisions.

In an ideal setting the new entity's board would be formed and operational a few months prior to undertaking a candidate search and selection process. In reality, most don't have the luxury of time. More than likely, the two processes will happen simultaneously. This raises the question of who should help shepherd the search process and how much influence and control the parent organization should have in that process.

One option is a search committee consisting of members of the new board (or potential members if it is not yet formed), representatives from the foundation, and other key partners or advisors who may round out the committee. It is helpful to include individuals with these skills or experiences:

- Someone who really knows the work; this will often be a foundation representative
- Individuals with networks of potential candidates
- A subject matter expert
- A key partner or community representative

The board will approve the final hire, but a well-rounded search committee is best positioned to recommend a top candidate. For the parent foundation, having a voice on the search committee is an appropriate level of influence in the organization's first major decision.

How funding and control impact tax status

Decisions about funding, governance, and leadership control have an impact on the true "independence" of the new organization — both in the eyes of the public and the IRS. Assuming that your foundation is spinning off a program into a new, standalone, nonprofit entity, it is likely that the new organization may prefer to be structured as a 501(c)(3) public charity for ease of fundraising and fewer limitations on how the organization can operate.

The primary federal requirement for public charity status is to pass the public support test — a series of metrics designed to ensure that the organization receives a wide range of gifts and grants and is not being funded by one person or group.

The new entity must pass one of two tests to retain its status as a public charity:

The one-third test — One-third of the organization's funding must come from other public charities, the government, individuals, and other private sources. Private funding is capped at 2 percent of the total annual support. This is measured on a rolling five-year basis and is first calculated after an organization has been operating for five years.

The 10 percent test — This threshold test allows just 10 percent of an organization's funding to be derived from public sources (with the same limitations on private funding as the one-third test), but with the caveat that the facts and circumstances surrounding the organization must indicate that it is a publicly supported organization. Here's where decisions about control come into play. While there are no hard and fast rules, if the parent organization has chosen all leadership, set the strategy, and is the primary funder of the spin-off, it is not likely to meet the "facts and circumstances" test.

Usual and unusual grants and public support

There is one additional option for meeting the public support test: designating the initial funding you provide as an unusual grant. If a grant is designated as unusual, the entire amount is excluded from the public support test, making it easier for the new organization to pass the one-third or 10 percent test.

To qualify as unusual, the grant and granting organization must meet a multifactor test that looks unfavorably on gifts with material restrictions, funders that continue to exercise control, and contributions made by a person or entity that created the new organization. This means that the amount of control you can have over the new organization must be extremely limited. It would also require that the foundation

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make one lump-sum grant to the new organization, as multiple grants over time are unlikely to qualify as unusual.

The public support test is only relevant if the new nonprofit wants to be structured as a public charity. Though this is often the best option there are other nonprofit legal structures.

- **Private operating foundation —** Operating foundations carry fewer revenue restrictions (but more expense restrictions) than public charities. An operating foundation must make a specific level of annual expenditures on its own or through sponsored programs (regranting is excluded) and meet an asset, endowment, or support test. In addition, the organization would have limitations on lobbying and self-dealing similar to those facing private foundations.
- **Educational organization —** If the new organization is focused on education, it may qualify as an educational organization, for which there is no public support test or limitations on how the entity is governed, funded, or how it relates with the founding funder. To meet the criteria, student instruction must be the primary activity and the organization must maintain a regular faculty, curriculum, and student body.

The for-profit option

We should note that you may choose to operate the spin-off as a for-profit organization, in which case the tax status considerations no longer apply. In addition, this document is intended to capture considerations for moving the program into a new organization, though you could also explore embedding it within an existing organization. This raises other considerations, but would eliminate a number of those we identified throughout this document.

The ultimate goal: independence

While there are many ways for you to move a program out from "under your roof," you should carefully consider the implications of your funding choices and influence on leadership as you undertake the process. Both can impact your spin-off's ability to achieve and maintain a desirable tax status, and ultimately, its success in achieving its mission.

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