FUNDING TOMORROW'S HEROES

Awarding Scholarships Lifts Individuals for the Benefit of All

Nurses, doctors, and scientists are delivering critical care to victims of the pandemic and working on treatments and vaccines to help us eventually defeat it. But before these heroes could save lives, someone had to change theirs by helping them afford their degrees and professional training.

Education lifts individuals along with their families and entire communities. Financial help to pay for it can be one of the most powerful gifts you can possibly bestow. With a private foundation, you can donate to a school's scholarship program, but you also have the option of running your own and selecting the recipients.

Running your own scholarship program enables you to put your own personal stamp on it. You can focus on kids (and adults) who have faced challenges, demonstrated potential, or embodied values that make them especially worthy of assistance. For example, one Foundation Source client was an indifferent student and had to work during his high school years, leaving him little time to devote to academics and transcript-enhancing extracurricular activities. Nonetheless, he went on to achieve great success as an entrepreneur. He designed a scholarship to help kids like his younger self—students with B- averages who hold down jobs in high school and are unlikely to get help from other quarters.

FIRST THINGS FIRST

In designing a foundation scholarship program that complies with IRS regulations, much will depend on how the recipients are selected and who does the selecting.

If your foundation funds an educational institution's scholarship program, and you are not involved in the selection of individual recipients, IRS approval may not be required. However, if you want to design your own scholarship program, and you want to select the recipients yourself, your scholarship program must be approved, in advance, by the IRS.

Financial help to pay for education is one of the most powerful gifts you can possibly bestow.

In approving these programs, the IRS looks for:

- A selection process that is objective and nondiscriminatory;
- A large selection pool of potentially eligible individuals known as a "broad charitable class;"
- Selection criteria that aligns directly with the charitable purpose of the scholarship program; and
- Systems to monitor whether recipients performed the activities for which they were selected.

PRACTICAL TIPS AND BEST PRACTICES

Do you want your scholarship program to address broader social goals or prefer simply to fund individuals on a case-by-case basis? Most scholarship programs consider applications one at a time. However, it is possible to design a scholarship program that fulfills a broader goal, such as bolstering the number of individuals with a specific skill or career specialty (e.g., a scholarship program to increase the number of female epidemiologists). Whichever path you choose, you will want to think about what sort of impact you want to achieve and what your foundation can afford to do. Here are some factors to keep in mind:

Award size

Budgets typically drive the size and number of scholarships foundations award. Some foundations opt for impacting as many students as possible by structuring their programs to award tiered scholarships. They give a large number of nominal awards under $1,000, a few mid-level awards in the mid-five figures, and a small number of full rides. This option shares your foundation's commitment to a larger audience of recipients, but your funds will only represent part of the recipients' overall financial aid package. Other foundations offer fewer, high-impact awards that help students avoid applying for support through multiple sources.

Geography

Consider whether you wish to limit scholarships to local or regional schools, any accredited post-secondary U.S. academic institution—or even study abroad. Also, consider if you'll impose geographical limitations on your candidate pool.

Grad or undergrad?

Graduate study is a popular choice for foundation fellowships because the school's mission and the foundation's mission often align. For example, it might make strategic sense for a foundation dedicated to improving public education to fund fellowships at a teacher's college. Others feel that investing in undergraduate degrees is the right tactic to level the playing field in education, while some go further by targeting community colleges to capture a higher number of first-generation scholars.

Selection Criteria

Scholarships do not have to be based on financial need to be considered charitable. Should your foundation fund the neediest candidate, the one with the best academic transcript, or perhaps the one who has demonstrated resilience in the face of devastating setbacks? Will you consider only full-time students, or include part-timers in order to facilitate work-study?

Scholarships do not have to be based on financial need to be considered charitable.

Ongoing Eligibility

Should you decide to maintain support for your scholarship recipients on an ongoing basis, what standards must they continue to meet? For example, do they need to maintain a specific GPA? Can they switch schools or majors? Take a year off?

Displacement

Federal law requires schools to reduce the financial aid package of private foundation scholarship recipients by the amount of the foundation scholarship grant, whether the scholarship grant is sent directly to the school or the student. Normally, schools will reduce their component of their financial aid package and leave the student loan portion of the aid package to the student. This practice, known as "displacement," obviously helps the school more than the student. With help from a company like Foundation Source, your foundation's scholarship program can be designed to maximize the benefit to your chosen recipient, rather than to the school.

If you'd like to forge a distinctive philanthropic legacy, there's no more powerful tool than a well-designed scholarship program. With planning and perhaps a little professional help, you can easily wield that tool to put your personal stamp on the future.

ABOUT FOUNDATION SOURCE

www.foundationsource.com

Foundation Source is the nation's largest provider of comprehensive support services for private foundations. Our complete outsourced solution includes foundation creation (as needed), administrative support, active compliance monitoring, philanthropic advisory, tax and legal expertise, and online foundation management tools.

Now in our third decade, Foundation Source provides its services to more than 1,650 family, corporate, and professionally staffed foundations, of all sizes, nationwide. We work in partnership with wealth management firms, law firms, accounting firms, and family offices as well as directly with individuals and families. Foundation Source is headquartered in Fairfield, Connecticut.

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Foundation Source

GRANTS TO INDIVIDUALS

Using Your Private Foundation to Give Directly to People in Need

Although private foundations routinely grant to charities and other nonprofit organizations, many philanthropically inclined individuals don't realize that foundations may also make grants to individuals. Our foundation clients use these types of grants to provide relief to victims of forest fires, hurricanes, and terminal illness. The recipients can use the funds to pay for everything from roof tarps to emergency cooking and heating equipment.

As long as certain procedures are followed, the IRS permits private foundations to make hardship and emergency grants to individuals without seeking prior approval. Based on IRS publication 3833, Foundation Source has created a streamlined process and forms for our clients to make the following types of grants:

Emergency Assistance grants provide financial aid for individuals and households that have experienced some kind of life-altering emergency, tragedy, or natural disaster that has rendered them unable to meet their basic needs (e.g., flood, fire, violent crime, physical abuse, or trauma). Recipients don't have to demonstrate financial need, and they may use the funds to pay for food, clothing, shelter, transportation, medical treatment, and professional counseling.

Hardship Assistance grants are designed to ameliorate the transitory hardship caused by job loss, family illness, or other temporary displacement. To be eligible for assistance, applicants must demonstrate financial need.

Medical Emergency/Distress Relief is typically given to those in need due to the physical and mental trauma inflicted by a life-threatening illness. Potentially eligible applicants include persons in need of short-term counseling because of the stress resulting from a medical emergency or extreme illness. Because of the urgency of the situation, as with emergency assistance grants, the applicant is not required to provide the foundation with financial background.

As long as certain procedures are followed, the IRS permits private foundations to make hardship and emergency grants to individuals without seeking prior approval.

COMPLIANCE CONSIDERATIONS

Although emergency and hardship grants are permitted by federal tax law, a foundation must be certain that its charter documents (such as bylaws for a corporation or trust instrument for a trust) do not prohibit this type of support. Foundations established by Foundation Source are permitted by their charter documents to make these emergency and hardship grants to individuals.

The IRS permission to make emergency and hardship grants is conditional, provided that the foundation:

- Does not require the recipient to spend the grant funds in a particular way (the funding is "no strings attached," with no purpose specified)
- Makes the grant on an objective and nondiscriminatory basis
- Complies with basic record-keeping requirements showing how and why a particular household or individual was selected for assistance

Foundation Source's process is designed to ensure these standards are met. Among other things, the application process uses specially designed forms that document the recipient's need for assistance; the objective criteria applied to assess need; the process by which recipients were selected; and the name, address, and amount distributed to each recipient. The forms, which are available through the client's Private Client Advisor, enable payments to be made either directly to the individual applicant or to a third party creditor to whom the applicant has a financial obligation such as a utility company, landlord, or healthcare provider.

FINDING AND SELECTING QUALIFIED RECIPIENTS

The group of individuals that may properly receive assistance is called a "charitable class." The IRS requires that the charitable class be large or open-ended enough so that the total number of members comprising the class cannot be precisely quantified.

For these reasons, a charitable class limited to "red-haired men named Smith, aged 26, who drive a white Corvette and majored in U.S. History," would not pass muster, whereas "disenfranchised men in their twenties" might.

If a foundation were to make grants only to people known to its board, the class would not be sufficiently large or open-ended. Therefore, a foundation should consider developing a means of identifying persons in need of assistance that extends beyond its board's immediate sphere of social contacts. This may be accomplished in a variety of ways: obtaining referrals from clergymen, local charities, community organizations and social workers, reading newspaper and magazine articles, and establishing other channels.

Grants to individuals provide a unique opportunity for foundations to help those who have fallen on hard times reclaim their health, their financial security, and their well-being.

Case Example: Helping Families Avoid Homelessness

Our clients, Barbara ("Barb") and Stephen Miller, have put the ability of private foundations to make emergency and hardship grants to individuals to inspired use, preventing individuals and families from becoming homeless.

In exploring how to alleviate hardship, the Millers learned that discrete, one-time problems were often enough to plunge even stable, working families into crisis, often resulting in homelessness. Barb explains: "Our typical client is a single mother who has a job, some sort of assistance for housing or subsidized housing, and perhaps receives food stamps. If something happens—the car breaks, or a child gets sick—then the mom has to miss work for a couple of days, causing her to fall behind on her rent."

To prevent this downward spiral, the Millers make a one-time grant of less than $1,000 directly to the individual. Because they intervene at the crisis point, they enable recipients to stay in their homes. "If we fix the car or pay the rent, they're not up against a five-day eviction notice," Barb says.

The foundation's work has produced astounding success rates. In the past four years, the foundation has helped over 600 individuals and achieved lasting impact. Follow-up reports indicate that after one year, over 90 percent of grant recipients were still stable.

So, how did a family foundation accomplish all of this? "We came to Foundation Source with this idea for an emergency fund and asked how to do it," Barb says. "Foundation Source helped us structure the fund. They set up the application process, gave us the mechanism to grant to individuals, and disbursed the payments."

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Foundation // Source

IMPACT INVESTING BY PRIVATE FOUNDATIONS

Putting Assets in Service of Mission

Imagine that your foundation is dedicated to eradicating childhood asthma in your home state. One day, you are listening to the local news during your morning commute and you hear a report about an aging coal-fired power plant where the sulfur dioxide emissions are so bad as to be implicated in the high incidence of childhood asthma in the neighboring towns.

A week later you are reviewing the foundation's investment portfolio and realize that you own a good chunk of shares in an energy company—the very same energy company that owns the power plant. In fact, the dollar amount of the company's stock in your investment portfolio is almost equal to the dollar amount you are putting into your childhood asthma eradication efforts.

WHAT SHOULD YOU DO?

This is a common conundrum for private foundations. Many foundations that are established to solve society's most pernicious problems have investments as their lifeblood. Their assets need to be invested in profitable businesses in order to sustain operations and grow. So what happens when a foundation's mission is directly contradicted by its own investments? What if the very ills a foundation fights are exacerbated or even caused by the behavior of business entities found in its own portfolio?

It can sometimes seem as though the foundation's assets and its grantmaking programs are in direct opposition to each other or at the very least, failing to work together to accomplish a charitable mission. And since many foundations invest 95% of their assets while distributing about 5% for charitable purposes, it's even conceivable that the damage done by the investments exceeds the good accomplished by the distributions! Over the last decade, more foundations have been attempting to address this issue and get all of their horses pulling in the same direction. These foundations want their investments to enhance their philanthropic efforts or at least not run counter to them. If the 5% distributions are regarded as the "do good" portion of the foundation, the goal for the other 95% might at least be conceived as "do no harm."

If the 5% distributions are the "do good" portion of the foundation, the goal for the other 95% might at least be conceived as "do no harm."

In recent years, a movement has emerged around this idea, and it is coalescing around the term "impact investing." Impact investing is a broad tent, and many different individuals and institutions claim a seat under its canopy, each employing different tools and approaches. What these diverse actors have in common is a desire to use their foundation funds (both endowment assets and grant dollars) to generate a positive social or environmental impact in addition to providing a financial return.

With a broader aim of putting 100% of foundation endowment assets and grant funds in service of the greater good, we will be examining four different approaches to impact investing, ranging from fiscally conservative to financially risky:

- Community Investing
- Socially Responsible Investing
- Program-Related Investing
- Social Venture Capital Investing

A "SAFE" INTRODUCTION: COMMUNITY INVESTING

One of the easiest ways to dip a toe into impact investing waters is by simply moving your money from a traditional bank to a community development financial institution (CDFI) such as a community bank or community credit union. These financial institutions are common throughout the

United States, and you have probably heard of them without realizing that they have a social mission tied to their financial products.

CDFIs are government regulated and government insured, just like other financial institutions. They offer checking and savings accounts, money market accounts, certificates of deposit, and all the other usual services you'd expect from a traditional bank. They provide market-rate (or very close to market-rate) interest to depositors and from a consumer's perspective, are comparable to commercial banking institutions, albeit with a less extensive network of ATMs.

The real difference between traditional banks and community banks is what they do with the money on deposit. Rather than lend it out to large corporations outside the community, community banks invest it locally through loans for affordable housing projects, home mortgages in low-income areas, and new businesses. Many low-income neighborhoods have benefited from CDFIs that use their deposits to build that same community, rather than siphoning funds out for the benefit of outside parties.[1] The Calvert Foundation, for example, directed Calvert Community Investment (CCI) notes to help rebuild communities in the Gulf Coast region devastated by hurricanes Katrina and Rita. These same notes offer investors a range of terms, including interest rates that vary up to 2% payable at maturity.

Community investing can be a relatively low-risk cash management strategy, an easy way for a foundation or philanthropic individual to put more financial assets in the service of a charitable mission. To look for a CDFI in your community, go to www.cdfifund.gov for a listing of CDFIs by city and state.

SOCIALLY RESPONSIBLE INVESTING

The concept of Socially Responsible Investing (SRI) has been around for more than 30 years. It began with a simple idea: don't hold the stock of companies that actively work against your values. So an environmental grantmaker might screen "Big Oil" out of its portfolio and a health grantmaker might avoid "Big Tobacco." Other common screens filter out companies that have interests in gambling, alcohol, pornography, dealings with repressive governments or defense contractors. Because this approach focuses on what an investor does not want to hold in his/her portfolio, tools that help them filter their investments have been dubbed "negative screens."

There are different approaches to impact investing, ranging from fiscally conservative to financially risky.

Critics point out that while employing negative screens to eliminate "sin stocks" may help an investor sleep better, they don't necessarily accomplish much else. The companies that are screened out are usually very large and very profitable, and a few conscientious investors selling their stock or just declining to buy it will not affect their share price. And by screening out a whole host of potentially profitable sectors, an investor employing negative screens may be limiting their ability to earn returns on par with the market as a whole. As most investment advisors benchmark performance against broad market measures, portfolios employing negative screens are widely thought to under perform.

In recent years, investors and their advisors have taken a new approach to socially responsible investing, one that involves "positive screens." Instead of shutting out objectionable companies, a positive screen actively seeks out companies demonstrating the kind of corporate social responsibility that philanthropic investors would like to encourage. The primary positive screens are around Environmental, Social, and Governance practices, collectively known as "ESG screening." Rather than focus on what you don't want companies to do, ESG screening selects companies based on the positive things they are doing.

Some recent studies challenge the widely held belief that one needs to accept lower returns in exchange for socially responsible investing (SRI). ESG-screened companies disprove the myth that SRI isn't profitable. Some previous research has found no statistically significant difference between the performance of traditional funds and SRI funds. In fact, as The Forum for Sustainable and Responsible Investment reported, a 2012 meta-analysis by DB Climate Change Advisors of more than 100 academic studies found that incorporating environmental, social, and governance data in investment analysis is "correlated with superior risk-adjusted returns at a securities level."[2]

Beyond being good philanthropy, ESG screening is increasingly accepted as just good business. ESG investing has become more mainstream during the past five years, fueled by rising investor interest and recognition that social and environmental impacts are creating material financial risks for

[1] As a result of the Community Reinvestment Act, commercial banks must also lend a certain amount within the communities in which they operate. These commercial banks accomplish this, among other ways, by investing in or lending to community banks, which in turn actually lend within the community.

[2] DB Climate Change Advisors. *Sustainable Investing: Establishing Long-Term Value and Performance.* (June, 2012). Retrieved from http://www.ussif.org/performance

companies and investors. In other words, polluting the environment to make a quick buck today is what investors might call a "short-term play." That is, it's not going to be an effective strategy over the long haul as governments, consumers, and investors increasingly penalize companies with poor ESG practices through loss of business, lawsuits, bad publicity, and costly clean-up.

Done well, investing in ESG-screened funds can be a natural part of a private foundation's investment strategy that carries no more risk than traditional investing in the stock market.

A new hybrid of philanthropy and private equity investing blurs the lines, allowing foundations to do well by doing good.

BANKER TO YOUR GRANTEES: PROGRAM-RELATED INVESTING

When we think of a private foundation supporting a charitable cause, most of us think in terms of grants—money given away with no expectation of it ever coming back. But foundations can also make loans and provide loan guarantees in support of their mission. Such loans are defined by the IRS as Program-Related Investments (PRIs) and are an increasingly common tool among private foundations. PRIs come out of the foundation's grantmaking purse and as such, they qualify towards the foundation's 5% distribution requirement. However, while grant dollars go out the door never to return, PRI dollars are generally recovered in part or in whole, and may even earn some return for the foundation in the form of interest or appreciation.

To qualify an investment as a PRI, the foundation must satisfy three requirements laid out by the IRS:

- The primary objective of the PRI must be to significantly further the foundation's charitable mission.
- The production of income or appreciation of property must not be a significant motivating factor.
- The investment must not attempt to influence legislation or elections; a PRI may not be used to support candidates for office or lobby elected officials.

Taken together, these requirements dictate that if the foundation were driven purely by financial considerations, it wouldn't make the PRI. In practice, this means that the loan or investment will usually have some downside that makes it unattractive to commercial investors: high risk, low return, and illiquidity are common traits among PRIs. Foundation Source Chief Legal Officer Jeffrey D. Haskell has jokingly described PRIs as "bad investments for a good cause." Evidently, the IRS concurs: Because PRIs fulfill a foundation's charitable purpose, they are exempt from the normal rules that prohibit the foundation from making so-called "jeopardizing" investments.

Most foundations first experiment with PRIs in the form of a loan to an organization they already know well, oftentimes a prior grantee. For example, they may offer their community church a very low-interest loan to finance the construction of a new facility. They may provide a no-interest line of credit to their favorite art museum to help smooth out the bumpy financial times between blockbuster shows. They may co-sign a loan to allow a housing agency to access funding from a commercial bank, which, absent a default, doesn't even require them to actually put a dime out the door.

There are myriad ways foundations creatively use Program-Related Investments. For greater detail, please see our article, ***Program-Related Investments: An Overview***.

GRADUATING TO THE BIG LEAGUES: MISSION-RELATED INVESTMENTS

Traditionally, philanthropists give away money and investors make money. The former want to create change and the latter want to pocket it. You'd think that the two goals would be incompatible, but a new hybrid of philanthropy and private equity investing blurs the lines, allowing foundations to do well by doing good. Similar to private equity investing, foundation donors make investments in private companies or venture capital funds—the difference being that these investments go beyond mere financial returns to provide social and economic benefits. Foundations that engage in mission-related investing use their endowment funds to invest in profit-seeking solutions aligned with their mission. These often are social, environmental, and economic challenges that cannot be easily met through grants alone.

The determination as to whether these "social venture" investments are PRIs or MRIs, depends on whether they exist primarily to return a financial profit or to accomplish a social good. Let's take two examples for that foundation fighting childhood asthmas:

In our first example, the foundation becomes aware of a promising drug that's in development. It's only effective against a rare variant of childhood asthma, so it doesn't have much commercial potential and is therefore unlikely to make it into production. The foundation could provide a seed money loan for the drug's development and this "poor investment for a good cause" would qualify

as a PRI and count toward its 5% distribution requirement.

In our second example, the foundation becomes aware of a terrific new company that's developing an inexpensive, electric car capable of going 500 miles before recharging. This is a very exciting investment opportunity for a whole host of reasons. From a financial standpoint, an extended-range, inexpensive, electric car has tremendous market appeal; from a mission standpoint, it's also attractive because car emissions contribute to childhood asthma. Clearly, investing in this start-up would be compatible with the foundation's fiscal goals and mission objectives. However, because the venture foremost is considered a good investment from a financial standpoint, it qualifies as an MRI and not a PRI.

Keep in mind that MRIs, unlike PRIs, are subject to jeopardizing investment rules and that a private foundation can be subject to excise taxes for making imprudent investments. For this reason, involvement in any of the activities outlined here and below should be based on a well-considered investment policy that includes a thoughtful asset allocation strategy among different classes of risk.

THREE MAIN APPROACHES TO MRIs

There are different ways to do mission-related investments. You can buy stock in a well-established company that's aligned with your mission, you can invest in a social investment fund, and you can do angel investing in start-up companies that have a social mission.

Buying Stock in Well-Established Companies:
An obvious investment choice for a foundation dedicated to environmental conservation might be a tech giant that's developing more affordable solar panels. But what about a granola manufacturer that buys Brazil nuts, which only grow in healthy rainforests, at above-market rates in order to incentivize forest preservation?

Social Investment Funds:
A foundation willing to take some risk with a portion of its investment capital can become an investor in one of the tiny but growing crop of "social investment funds." Traditional venture funds raise capital from private investors and select a portfolio of young companies in which to invest. They provide not only funding to the young company, but also expertise and connections, all in exchange for an ownership stake and often, a seat on the board of directors.

Social investment funds take this same approach, but focus on finding and funding potentially profitable businesses with a social mission. Managed by professionals who charge a service for their fees, these funds seek target companies, known as "social enterprises," that focus on providing positive social impact as well as financial returns. Examples might include technologies that provide clean water, facilitate remote access to health care, or improve public safety. And social venture funds aren't limited to technology start-ups. They can support fair trade suppliers, companies that provide healthy, organic school lunches, car-sharing services, and much more.

Social investment funds are often dedicated to a specific issue. For example, Good Capital's Social Enterprise Expansion Fund (SEEF) provides growth capital to social enterprises that address the root causes of inequity in the U.S. and around the world. Another fund, Root Capital, aims to grow rural prosperity in poor, environmentally vulnerable places in Africa and Latin America. And Expansion Capital Partners, LLC, invests in "clean technology" companies in the U.S. and Canada that create economic value with less energy and materials, or less waste and toxicity.

Because the concept of social venture investing is still in a nascent stage of development, these funds often lack traditional track records and transparency. New tools have been developed to help social investors track and evaluate the social impact of their investments, such as the Global Impact Investment Ratings System (GIIRS, pronounced "gears"). Some funds (and some funders) are rigorous in defining and measuring the social impact of their portfolio companies while others seem to be satisfied with the idea that they are "supporting good work."

Angel Investing:
"Angel investors" are "first-in" funders who personally evaluate individual investment opportunities and use their own funds to invest directly. Where social investment funds rely on the expertise of a professional management team, angel investing might be considered the "do-it-yourself" approach to social investing.

Angel investors typically take on very high risk in early-stage companies in the hopes of a commensurately high reward if one of their companies turns out to be the next Google. For private foundations and individual philanthropists who are willing to put in the time and effort themselves to grow social enterprises, an angel approach to

social investing can be attractive because it allows them to use not only their money, but also their networks and expertise to help a young social enterprise get up and running.

In some cases, angels band together to form networks or loose affiliations that share the work of doing due diligence on potential investments. Each member then decides if he or she wants to take part in the investment. A well-known social angel network, Investors' Circle, is an environmentally focused, international group of angel investors founded in the early 90s. Today, there are many such networks including Toniic, an international group of social investment angels founded by KL Felicitas Foundation donors Charly and Lisa Kleisner. There are also communities of angels that come together on "Investor Days" around the country to hear pitches for start-up social enterprises, sponsored by entities such as the Unreasonable Institute in Colorado and Impact Engine in Chicago.

For the foundation that looks closely at its current investment portfolio and finds a lack of alignment with its grantmaking objectives, there are many options to put both pools of assets to work for positive social outcomes. From relatively low-risk cash management options with community development financial institutions to high-risk angel investing in social enterprises, every philanthropist can become an impact investor. The key to success is to take an incremental approach, starting with a small portion of assets at first and then expanding as you gain experience and confidence.

If you are intrigued by the possibilities of impact investing, contact Foundation Source at 800-839-0054 to learn more about how we support innovative philanthropy.

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