COUNCIL on FOUNDATIONS

Navigating Legal and Ethical Issues

Types of Foundations

Community Foundation: A community foundation is a tax-exempt, nonprofit, autonomous, publicly supported, philanthropic institution composed primarily of permanent funds established by many separate donors of the long-term diverse, charitable benefit of the residents of a defined geographic area. Typically, a community foundation serves an area no larger than a state.

Corporate Foundation: A corporate (company-sponsored) foundation is a private foundation that derives its grantmaking funds primarily from the contributions of a profit-making business. The company-sponsored foundation often maintains close ties with the donor company, but it is a separate, legal organization, sometimes with its own endowment, and is subject to the same rules and regulations as other private foundations.

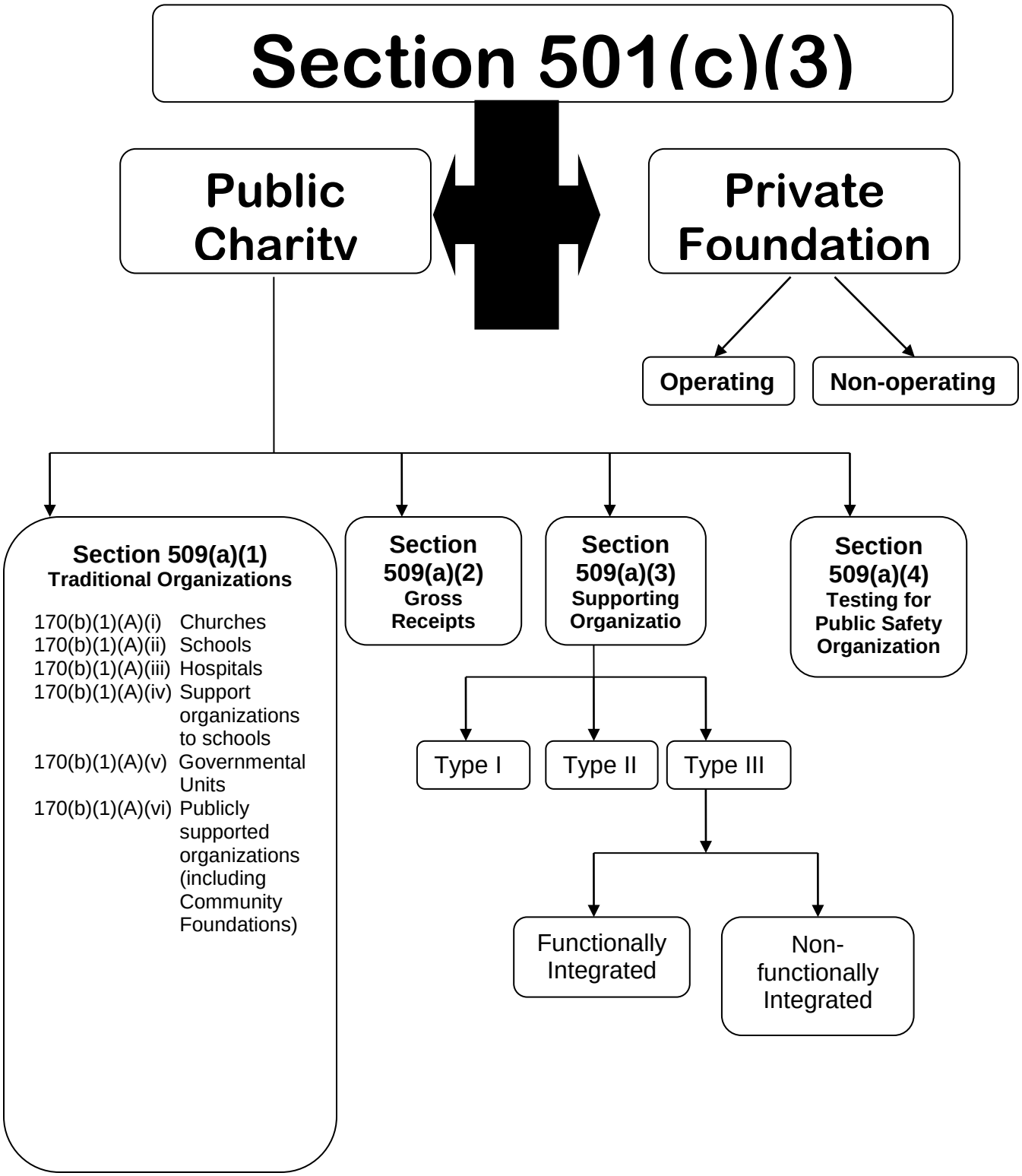
Family Foundation: "Family foundation" is not a legal term, and therefore, it has no precise definition. The Council on Foundations defines a family foundation as a foundation whose funds are derived from members of a single family. At least one family member must continue to serve as an officer or board member of the foundation, and as the donor; they or their relatives play a significant role in governing and/or managing the foundation throughout its life.

Independent Foundation: Private independent foundations make grants based on charitable endowments and generally do not actively raise funds or seek public financial support. They are distinct from private family foundations in that they are run by boards made up of community, business and academic leaders and not by the benefactor or members of the benefactor's family. Of the largest private foundations in the United States, most are independent foundations, although they may have begun as family foundations.

Operating Foundation: Also called private operating foundations, operating foundations are private foundations that use the bulk of their income to provide charitable services or to run charitable programs of their own. They make few, if any, grants to outside organizations. To qualify as an operating foundation, specific rules, in addition to the applicable rules for private foundations, must be followed.

Public Foundation: Public foundations, along with community foundations, are recognized as public charities by the IRS. Although they may provide direct charitable services to the public as other nonprofits do, their primary focus is on grantmaking through a competitive grantmaking program.

Types of Section 501(c)(3) Charities



Private Foundation Rules

Tax on Investment Income (Section 4940)

1. Tax is on NET investment income = Gross investment income (including realized capital gains) less investment expenses.
2. Test for reducing tax to one percent has two parts:

   Part One

   Calculate previous 5-year average payout percentage

   Multiply 5-year percentage times current year assets

   Example: 5-year average of 6% times current year assets of $1,000,000 = $60,000

   Part Two

   Calculate difference between current year tax if calculated at 2% and 1%

   Example: Income (less expenses) was $70,000. $1,400 (2%) - $700 (1%) = $700
3. To qualify, qualifying distributions before the end of the current tax year must equal part one plus part two ($60,000 + $700 = $60,700).

Acts of Self-Dealing (Section 4941)

1. Penalty on self-dealer is 10 percent of amount involved.

   Penalty on foundation manager is 5 percent (up to $20,000 per act).
2. Definition: The use of foundation assets to enter into any financial transaction between the foundation and a disqualified person.
3. Disqualified persons = Directors, officers, trustees, foundation managers who have similar duties (such as an executive director), and substantial contributors to the foundation ($5,000 and 2 percent rule).

   Also includes family members of the persons above such as ancestors, spouse, children (and their spouses), grandchildren (and their spouses).
4. Examples of self-dealing: loans, furnishing goods or services, paying rent to a disqualified person, excessive compensation.
5. Main exception: compensation for personal services that is necessary and reasonable.
6. Reasonable is what similar foundations pay similar persons for similar services.
7. Paying for spouse travel is self-dealing unless spouse has legitimate foundation duties or the travel expenses paid are treated as income to the foundation manager.

The Five Percent Payout Requirement (Section 4942)

1. Basic Rule: each year every private foundation must have "qualifying distributions" equal to roughly five percent of its net investment assets.

2. 5 percent applies only to net noncharitable use assets

3. Assets measurement to which the 5 percent applies = a 12-month average.

4. What expenses count as "qualifying distributions?"
   - -- Grants to eligible charities or individuals.
   - -- Necessary and reasonable expenses in administering your grant program.
   - -- Direct charitable activities (in house research, publications)
   - -- Assets acquired for use directly in carrying out charitable purposes (furniture, computers, office building).
   - -- Set-asides.
   - -- Program-related investments.

4. Investment expenses (investment manager or broker fees) do not count.

6. Excise tax on investment income is a credit.

7. Carryover: excess distributions may be carried forward and applied to future years

8. Penalty: 30 percent of the undistributed amount.

Excess Business Holdings (Section 4943)

1. Basic Rule: a private foundation may not own a controlling interest in a for-profit company.

2. Penalty: 10 percent of the holdings that exceed the limits.

3. The limit is generally 20 percent but you must add up what the foundation owns PLUS all shares owned by disqualified persons.

4. Safe Harbor: if the foundation owns less than 2 percent of the holdings, it does not matter how much disqualified persons hold.

5. The foundation has 5 years to divest assets received after 1969 before the penalty is applied; an additional grace period of 5 years may be obtained if the foundation has shown good faith in divesting.

The Jeopardy Investment Rules (Section 4944)

1. Basic Rule: private foundations must not make any investments that jeopardize the carrying out of their exempt purposes.

2. Penalty: 10 percent of the investment involved can be applied to the foundation and 10 percent to the foundation manager (up to $10,000 on the initial tax and up to $20,000 on the additional tax if not corrected).

3. No investments are violations *per se*. Some receive special scrutiny such as puts, calls and straddles.

4. Major exception = program-related investments (PRIs). To qualify as a PRI, the investment's primary purpose must be charitable and no significant purpose of the investment can be to produce income.

Rules Against Taxable Expenditures (Section 4945)

1. The Grocery List of No-Nos
   - Partisan political activity
   - Lobbying
   - Voter registration unless specific rules followed
   - Grants to individuals unless specific rules followed
   - Grants to organizations that are not "public charities" or certain supporting organizations unless expenditure responsibility rules are followed
   - Expenditures for non-charitable purpose

2. Some exceptions to Lobbying Prohibition
   - Self-defense
   - Technical assistance
   - Regulations
   - Nonpartisan analysis, study or research
   - Private lobbying on person's own time at no expense to foundation.

3. Grants to Non-Charities -- Expenditure Responsibility Required

4. Grants to Individuals – Special rules must be followed

5. Grants for non-charitable purposes - Not allowed at all

6. Penalty: 20 percent on the amount of the expenditure can be applied to the foundation and 5 percent to the foundation manager (up to $10,000 on the initial tax and up to $20,000 on the additional tax if not corrected).

Intermediate Sanctions (Section 4958)

(Public Charities Only)

1. In 1996, Congress added new intermediate sanction penalties that apply to all public charities and Section 501(c)(4) organizations. However, these sanctions are more limited than the private foundation rules.
2. IRS now has the authority to impose excise tax penalties on disqualified persons (insiders) who receive excess benefits either through compensation or some form of financial transaction (sale, lease, etc.). Similar penalties can be applied to organization managers who participate in approving such transactions with the knowledge that they will provide excess benefits. No penalty tax can be applied to the organization itself, although egregious cases may still result in removal of tax-exempt status.
3. These rules are retroactive for any excess benefit transactions made after September 14, 1995.
4. Insiders (or disqualified persons) are defined as individuals who are in a position to exercise substantial influence over the affairs of the organization, whether by virtue of being an organization's manager (officer, director, etc.) or otherwise. The Pension Protection Act of 2006, enacted on August 17, 2006, expands the class of disqualified person for donor advised funds and supporting organizations. Disqualified persons now also include donors and donor advisors with regard to transactions with the relevant donor advised fund; investment advisors to assets of donor advised funds; and disqualified persons of supporting organizations considered disqualified persons of the supported organization.
5. An excess benefit transaction occurs when a disqualified person: (a) engages in a non-fair market value transaction with the organization (the organization does not get fair value); or (b) receives unreasonable compensation from the organization. The IRS will apply existing tax law standards for fair market value determinations. In addition, the Pension Protection Act of 2006 bars grants, loans, compensation and similar payments from donor advised funds to donors, advisors and related parties. Receipt of such payment is automatically an excess benefit transaction subject to penalty. Supporting organizations may not make grants, loans, compensation or similar payments to the organization's substantial contributor, members of the contributor's family or businesses they control. Supporting organizations may not make loans to any disqualified persons.
6. The tax is two-tiered. The first level of penalty is 25 percent of the excess benefit on the disqualified person and 10 percent on an organization manager ($20,000 maximum) who participates in the transaction knowing it to be excessive. The second tier is 200 percent of the excess benefit on the disqualified person if the transaction is not corrected in a specified time period.

Grants to Non-Charities

Most foundations may make grants to non-charities. Each foundation should examine its governing instruments (certificate of incorporation and bylaws or trust agreement) to ensure that the foundation is not limited to making grants to organizations recognized as described in Section 501(c)(3) of the Internal Revenue Code.

While foundations may make grants to non-charities, they may do so only if two conditions are met. First, the grant funds must be used only to further the charitable activities of the grantee. Secondly, the foundation must exercise expenditure responsibility. Failure to exercise expenditure responsibly will result in the payment being classified as a "taxable expenditure" and the foundation being assessed significant penalties. The five basic steps for completing expenditure responsibility are:

1. Pre-grant inquiry. The foundation must make a reasonable investigation of the grantee to make sure it is capable of performing the activity to be funded.
2. Written agreement. The grantee must sign a written agreement that specifically sets out what charitable activities are to be accomplished. In most circumstances, general purpose grants are not permitted. The agreement must also contain certain conditions:
    - Grantee must repay any portion of the grant that is not used for the grant's purposes
    - Grantee must retain a record of grant expenditures and make its records available for inspection
    - Grantee must agree that the funds will not be used: (i) To carry on propaganda, or otherwise to attempt, to influence legislation (within the meaning of section 4945(d)(1); (ii) To influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive within the meaning of section 4945(d)(2)); (iii) To make any grant which does not comply with the requirements of section 4945(d)(3) or (4), or (iv) To undertake any activity for any purpose other than one specified in section 170(c)(2)(B).
    - Separate account. Unless the grantee is another private foundation, the grantee must establish a separate account for the funds. Charitable dollars cannot be commingled with noncharitable dollars.
    - Regular reports. The grantee must provide regular reports on the expenditure of the funds and the progress made in fulfilling the charitable purpose of the grant.
3. Report to IRS on the tax return. For any year in which either an expenditure responsibility grant is made or funds granted in a previous year remain unspent by the grantee, the foundation must complete a special section of IRS Form 990-PF to indicate that expenditure responsibility payments were made.

While most expenditure responsibility grants are to other exempt (but not charitable) organizations, it is permissible for a foundation to make grants to any entity so long as all these conditions are met. While public charities are not required to exercise expenditure responsibility

when they make grants to non-charities, it is often prudent to follow as many of these steps as is reasonable under the circumstances.

Note: The Pension Protection Act of 2006 (H.R. 4), enacted August 17, 2006, requires private nonoperating foundations to exercise expenditure responsibility in making grants to Type III supporting organizations (other than "functionally integrated") and any supporting organization if a disqualified person of the private foundation directly or indirectly controls either the supporting organization or a supported organization. Grants made to such organizations may not be counted as a "qualifying distribution" for purposes of Section 4942.

The Pension Protection Act also requires donor advised funds to exercise expenditure responsibility in making grants to private nonoperating foundations, Type III supporting organizations (other than "functionally integrated"), or any supporting organizations if the donor, advisor or related party controls a supported organization the grantee supporting organization. In addition, all grants to non-charities from a donor advised fund require the expenditure responsibility.

See www.cof.org/ppa for more details on these rules and for the definition of a supporting organization.

International Grantmaking

1. The simplest grants are those to U.S. charitable organizations for use overseas or to U.S. organizations that re-grant to with multiple foreign charities. Examples include: The international arm of the American Red Cross, Catholic Charities and other US relief organizations, U.S. "friends of" organizations, CAF America, United Way International, and Give2Asia.

2. Foreign charities may also voluntarily apply for and obtain an IRS letter that says they are a charity. While a foundation may make grants to any foreign organization that has obtained such a letter the same as it would to a U.S. charity, it is rarely in the best interest of a foreign entity to obtain such a letter.

3. Grants to foreign governments also require relatively little documentation, but must be for exclusively charitable purposes. Foreign universities are often governmental entities.

4. For all other grants to all other foreign entities, foundations have two choices:

   a. Expenditure responsibility – see the steps outlined above

   b. Equivalency determination - the private foundation must represent to the IRS that the foreign organization is the equivalent of a U.S. public charity. Accordingly, the grantmaker must collect a great amount of organizational and financial information about the proposed grantee. Samples of forms relating to international grantmaking for private foundations can be found at http://www.usig.org/forms.asp.

5. Terrorism Concerns: On September 14, 2001, President Bush signed Executive Order 13224, entitled "Blocking Property and Prohibiting Transactions With Persons Who Commit, Threaten to Commit, or Support Terrorism" (the "Executive Order"). The Executive Order prohibits transactions with designated persons (including individuals and organizations) deemed by the Executive Branch to be associated with terrorism. It blocks any assets controlled by or in the possession of such individuals and organizations and those who support them.

   The Executive Order has neither a knowledge nor an intent requirement. Even if an organization has no intent to support terrorism and does not know it is providing support to such individuals or organizations its assets can be frozen by the government. The government does not have to provide any pre-freeze notice or opportunity to respond to the freeze, nor is there any requirement of prior notice of a determination of terrorist status. Under the Executive Order, our government has the authority to freeze all assets of individuals and organizations identified as terrorists, controlled by terrorists, supportive of terrorists or otherwise associated with terrorists. The Executive Order specifically prohibits donations to such individuals and organizations and all transactions involving property frozen under the Executive Order.

Under the Executive Order, the government may also freeze the assets of other parties who assist, sponsor or provide financial, material or technological support for, or provide other resources to or in support of, acts of terrorism or such individuals and organizations or are “otherwise associated with” such individuals or organizations. Prohibited transactions include financial support, in-kind support, material assistance and technical assistance. Humanitarian donations, including food, clothing and medicine, to such individuals and organizations are included under the Executive Order. It also appears the Executive Branch believes the Executive Order extends to re-granting by charitable grantees.

Further, the USA PATRIOT Act (the "Patriot Act") signed into law on October 26, 2001, imposes civil fines and terms of imprisonment for providing material support or resources to be used in terrorist acts or by foreign terrorist organizations. It applies to any individual or organization who “willfully provides or collects funds with the intention that such funds be used” to carry out acts of terrorism or who knowingly conceals the source of funds used to carry out terrorism or to support foreign terrorist organizations.

The U.S. Treasury Department has issued "Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities" addressing how charities can reduce the likelihood that charitable funds will be diverted to terrorist purposes. Available at http://www.treasury.gov/press-center/press-releases/Documents/0929%20finalrevised.pdf

The USIG website also contains useful information on complying with recent anti-terrorist legislation and orders.

Conflicts of Interest: A Broad Spectrum

1. Types. There are many types of conflicts of interest. Some actions involving conflicts of interest violate the Federal law against self-dealing and some violate state conflict of interest rules.

2. Federal Level. Legal conflicts on the Federal level involve either self-dealing or intermediate sanctions. In almost every case in which a legal violation has arisen, the conflict of interest involved participation by a member of the governing board where his or her vote could result in a direct, tangible, economic benefit. An example would be a foundation's board hiring one of the board members to perform all its legal work. [Note that this conflict of interest does NOT rise to the level of self-dealing if the compensation is for necessary work and the amount is reasonable.]

3. State Level. Many state trust laws prohibit any action by trustees where there is an economic conflict of interest. State incorporation laws normally give the board member with the conflict a way to resolve the situation. Generally, the board member with the conflict must disclose the conflict and not participate in the vote. Where economic conflicts of interest occur, it is always wise to consult legal counsel.

4. Conflicts where there is no legal violation. There are other, less obvious conflicts of interest that do not violate state or Federal law. These conflicts involve grants to charities where a foundation manager has an interest (he or she or a family member works for the potential grantee or is on the grantee's board). Is there a conflict? Yes. Is it a legal conflict? No, because approving such a grant does not provide a direct economic benefit to the foundation manager with the conflict. Is there a moral conflict? Most foundations would say so. Thus, many foundations adopt a policy on conflicts of interest with grantees. A typical policy would require that: 1) foundation managers disclose any conflicts they might have with potential grantees; and 2) a foundation manager with a conflict cannot participate in any vote involving any grantee where the conflict exists.

The Range of Conflicts of Interest

Ethical

Approving a grant to mountain club that owns mountain trails where board member's second cousin occasionally hikes.

Approving a grant to charity where board member's child is a volunteer.

Approving a grant to charity where board member is on the board of the grantee.

Approving a grant to charity where board member's child is a junior staff person.
(no earmarking)

State conflict?

Hiring trustee's law firm to perform necessary legal services.

Self - Dealing
(for Private Foundations)

Paying rent to a trustee for space in a building owned by the trustee.

Hiring a trustee's construction firm.

Making a no-interest loan to a trustee.

Per se Illegal

Investments & Board Responsibilities

Uniform Prudent Management of Institutional Funds Act (UPMIFA)

1. UPMIFA provides model law for states to pass with modern guidance on what state standards should be for investments by charities. UPMIFA has been enacted in Connecticut.

3. Key points of UPMIFA:

   a) Rarely applies to trusts unless the funds are held by the charity
   b) Adopts a total return concept
   c) Expressly addresses standards of diversification of assets, pooling of assets, total return investment and whole portfolio management
   d) Sets a prudent standard for the expenditure of funds from an endowment, allowing organizations to expend below the historic dollar value of a fund in some instances
   e) Requires full consideration of present and future financial needs, and thus, the risks of inflation cannot be ignored.
   f) Sets a prudent standard for the selection of and delegation to an investment manager
   g) Authorizes the board to delegate investment decisions to outside managers (mutual funds).
   h) To restrict use of appreciation, donor must explicitly state no use of "net appreciation"
   i) Restrictions to use only "income" do not prevent prudent use of appreciation.
   j) Applies retroactively even if gift instrument uses language such as "spend income only"

Prudent Investor Rule

1. From 1830 to the mid-20th century, the law of trusts was very restrictive.

2. Many states had "legal lists" and stocks were not on them.

3. Restatement of Trusts, Third (1992): The key points of the Prudent Investor Rule:
   i) No investment is *per se* prudent or imprudent.
   ii) No investment is risk free.
   iii) New standard of care: each investment must be viewed in light of the total portfolio (endowment) and overall investment strategy.
   iv) Prudence (and exercising fiduciary duty) is demonstrated by process.
   v) Tustees are authorized to delegate investment decisions and have a duty to delegate when they do not possess the requisite skills.
   vi) Trustees must invest with a view to safety of capital and to securing a reasonable return -- must protect endowment's purchasing power in relation to inflation.

Federal and State Reporting

General

There are both federal and state reports that must be filed annually by your foundation. Be sure that your accountant is familiar with preparing and filing such reports. Their purpose is to ensure that foundations adhere to their exempt functions and to provide the public with sufficient information to effectively use and monitor them.

A private foundation is obligated to file a Federal information return, Form 990-PF, with the Internal Revenue Service. On this return, the foundation must disclose its assets, liabilities, income and expenses. It must list its substantial contributors, officers and others. The Form 990-PF asks very specific questions about the activities of the foundation and is designed to identify any improper actions. Public charities, including supporting organizations, are required to file a Form 990.

State law may also require the filing of an annual report, which will often include a copy of the federal form. Generally, the state's Attorney General has the primary responsibility for the supervision of the activities of the foundation, its managers and employees.

Note that the instructions to the Form 990-PF require the private foundation to submit a copy of the form to the Attorney General of each state with jurisdiction over the private foundation. Thus, although Connecticut law does not specifically require a private foundation to report to its Attorney General, each Connecticut private foundation is nonetheless required to submit a copy of its Form 990-PF to the Attorney General.