October, 2007

Legal Basics: What Every Foundation Leader Should Know

COUNCIL on FOUNDATIONS

<u>Tax on Investment Income (Section 4940)</u>

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:

3. <u>Part One</u>
   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

4. <u>Part Two</u>
   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

5. To qualify, qualifying distributions <u>before the end of</u> the current tax year must equal part one plus part two ($60,000 + $700 = $60,700).

<u>Acts of Self-Dealing (Section 4941)</u>

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
   - Influencing public elections
   - Lobbying
   - Voter Registration
   - Grants to Individuals
   - Grants to Organizations that are not "public charities"
   - 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 (H.R. 4), 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.

Reasonable Compensation

1. Self-Dealing Rules. Reasonable compensation is a major exception to the rule against self-dealing for private foundations. For example, it is perfectly legal for the creators of a family foundation to pay a family member to staff the foundation. Similarly, a private foundation may pay trustee or director fees to family members on the governing board. In all such cases, the payments are legal so long as the work to be performed is *necessary* for the operations of the foundation, the amount compensated is *reasonable* and the services are considered *personal*.

2. What are Personal Services? Most positions in the governance of a foundation are considered personal (foundation president, governing board members, etc.) In addition, IRS has specified a fairly short list of personal services that includes legal services, accounting services, investment counseling, general banking services and serving as broker for the foundation (but not as a dealer who buys from the foundation and then sells to third parties). Most other types of services – even if the fees are reasonable – will not fall under the exception from self-dealing (i.e. real estate management or interior decorating).

   NOTE: The personal services requirement does not apply to the intermediate sanction rules for public charities.

3. What is reasonable? There is no precise salary amount or trustee fee that defines the limit of reasonable compensation. "Reasonable" is defined as what similar persons are paid for similar work at similar organizations. Thus, to insure that a total compensation package is reasonable, it is wise to obtain factual information about what level of compensation is paid by similar foundations. When hiring outside professionals, the market rate for that area is the norm.

Grants to Non-Charities

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 expenditure responsibility steps must be followed from the start of the grant through to the date that the last dollar is spent by the grantee.

The five basic steps for completing expenditure responsibility are not that different from the normal grantmaking procedures used by many foundations. They are:

1. Pre-grant inquiry. The foundation must make a reasonable investigation of the grantee to make sure that the grantee is capable of performing the charitable activity to be funded.

2. Written agreement. The grantee must sign a written agreement with the foundation that specifically sets out what charitable activities are to be accomplished with the funds to be granted. In most circumstances, general purpose grants are not permitted. The agreement must also contain certain limitations (such as prohibiting the use of any of the funds for lobbying).

3. 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.

4. Regular reports. The grantee must provide regular status reports on the expenditure of the funds and the progress made in fulfilling the charitable purpose for which the funds are earmarked.

5. Report to IRS on the tax return. When filing the Form 990-PF tax return for any year in which a payment for an expenditure responsibility grant is made, the foundation must indicate that expenditure responsibility payments were made and must add a schedule to the form with a brief description of each grant indicating the grantee, the amount, the charitable purpose and the current status of the grant.

While most expenditure responsibility grants are to other exempt organizations, it is permissible for a foundation to make grants to any entity - even a for-profit company - so long as all these conditions are met. Further, while public charities such as community foundations 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.

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 to Type I and II supporting organizations if a disqualified person of the private foundation directly or indirectly controls a supported organization.

The Pension Protection Act requires donor-advised funds to exercise expenditure responsibility in making grants to private nonoperating foundations, Type III supporting organizations (other than "functionally integrated"), Type I and II supporting organizations if the donor or advisor controls a supported organization, organizations not described in section 170(b)(1)(A) of the Internal Revenue Code, and organizations that are not charitable.

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. Foundations considering making grants directly to overseas charities also need to be mindful that the USA Patriot Act and Executive Order 13224 prohibit contributions to individuals and organizations that support terrorism. 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.

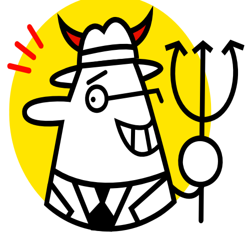
4. Conflicts where there is no legal violation. There are other, less obvious conflicts of interest that do not violate state or Federal law. These conflicts involve grants to charities where a foundation manager has an interest (he or she or a family member works for the potential grantee or is on the 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)
- Hiring trustee's law firm to perform necessary legal services. ← State conflict?
- 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



Uniform Management of Institutional Funds Act (UMIFA)

1. Adopted by National Conference of Commissioners on Uniform State Laws in 1972 -- UMIFA has now been adopted in some form in all states except Alaska, Pennsylvania and South Dakota.
2. UMIFA provides model law for states to pass with modern guidance on what state standards should be for investments by charities.
3. Key points of UMIFA:
   a) Rarely applies to trusts unless the funds are held by the charity
   b) Adopts a total return concept
   c) Sets a standard for prudent use of appreciation in invested funds.
   d) Requires full consideration of present and future financial needs, and thus, the risks of inflation cannot be ignored.
   e) Authorizes the board to delegate investment decisions to outside managers (mutual funds).
   f) To restrict use of appreciation, donor must explicitly state no use of "net appreciation"
   g) Restrictions to use only "income" do not prevent prudent use of appreciation.
   h) Applies retroactively even if gift instrument uses language such as "spend income only"

Note: In July 2006, the Uniform Law Commissioners adopted a revised UMIFA, the Uniform Prudent Management of Institutional Funds Act (UPMIFA). UPMIFA updates standards of investment management by bringing it in line with the Uniform Prudent Investor Act. UPMIFA expressly addresses standards of diversification of assets, pooling of assets, total return investment and whole portfolio management and modifies the rules governing expenditures from endowment funds by eliminating the "historic dollar value" rule in UMIFA. The new rules provide a more flexible spending standard making decisions about whether to make expenditures from endowment funds. The revisions need to be adopted by each state before they become effective and states may vary as to when and what extent they adopt these new standards.

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.

Legal Brief
Conflicts of Interest

by Jane C. Nober

With Congress and the media focusing on corporate governance and foundation administration, it is a good time to make sure that all grantmakers have a strong conflict of interest policy in place. Both private foundations and public charities (such as community foundations) should have clear guidelines on financial or other interests that must be disclosed and transactions that must be scrutinized or avoided. The policy should cover both board members and foundation staff. A robust conflicts policy can not only help a grantmaker stay on the right side of the law but can also keep the organization from engaging in behavior that gives even the appearance of conflict.

While the Tax Code does not require that a charitable organization have a conflicts policy in place, it would be difficult to achieve or demonstrate compliance with applicable provisions of the law without such a document. As the IRS moves forward with its plan to audit selected community foundations, it will no doubt look for evidence that an organization has a comprehensive policy—and that it is enforced.

The Law on Conflicts

Board members or trustees of a charity have fiduciary duties to the organization. This means that they must be careful stewards of the charity's assets and must put the charity's interests first. On occasion, however, a board member's other involvements—business interests, family relationships or political or other charitable activities—may make it impossible for him or her to provide disinterested advice to the charity. Especially when the matter affects the financial interests of a board member, this duality of loyalties may become a conflict of interest.

In addition, for private foundations, Section 4941 of the Tax Code prohibits a variety of financial transactions between the foundation and "disqualified persons." This category includes substantial contributors to the foundation and its managers, plus members of both those groups' families and businesses in which they have a large stake. Specifically barred transactions include rent payments to a disqualified person and loans from the foundation to a disqualified person—even when the terms of the deal would benefit the foundation substantially.

There's also a general prohibition on the use of a private foundation's income or assets "by or for the benefit of " a disqualified person. That means that a foundation's grants and other expenditures must not provide tangible economic benefits to disqualified persons. An exception to the bar on self-dealing allows foundations to pay disqualified persons reasonable compensation for very limited personal services that are necessary to the foundation's operation.

For public charities, such as community foundations, financial transactions between the charity and its board members—as well as other "insiders"—are covered by the intermediate sanctions rules in Section 4958 of the Tax Code. Insiders also include major donors, charity executives and their families. If any payments to such insiders—including salaries and payments for goods or services—exceed fair market value, the insiders, and possibly members of the organization's board, will be subject to penalty excise taxes.

In addition to those federal rules, some states have laws that regulate whether a board member or other charity official may participate in voting or other actions when the board member has a financial interest in the outcome.

Getting into Compliance

Legal rules help shape the outlines of the conflicts policy that a charity should have. Both private foundations and public charities should have written rules—approved by the board—that require board members and executives to disclose business or other ties that may result in a conflict of interest or bias (for or against) making a particular grant or investment. Ideally, this disclosure happens on a regular basis—say, at the beginning of the year or when a director's term begins. At the very least, foundation managers must be required to make full disclosure when a relevant matter is under consideration by the foundation.

Depending on what the manager's conflict is, it may be appropriate for him or her to abstain from voting on or even discussing the matter. For example, if a partner in the foundation's investment management firm serves on the board, he or she should not vote on any resolution to retain or dismiss the firm. The minutes of the board or committee meeting should note this abstention.

Foundation staff, too, should be required to disclose positions or interests that may give rise to conflicts. Does the program officer have a spouse who works at a potential grantee? Does the program officer personally receive consulting fees from nonprofits that may apply for funds? Depending on the size and activities of the foundation, it may be wise to have a parallel conflicts policy for staff members.

In addition, foundations should prepare themselves for situations where there may be no legal conflict but there may be the *appearance* of conflict. A board member's printing firm, for example, might seek the contract to produce the community foundation's annual report. One approach is to bar board members from doing business with the foundation. Another approach is to mandate a rigorous bidding process so that foundation managers can be confident that the best bid—even if it comes from a foundation insider—will win.

The stronger and more comprehensive a foundation's conflict of interest policy is, the easier it should be to spot conflicts and address them before they become a problem. Furthermore, when a foundation has evidence that it has gone through the procedures required by its conflicts policy, it will more easily be able to defend its actions to the media or government authorities.

Some conflicts, once disclosed, turn out not to be conflicts at all. Where a foundation board member serves on the board of an organization seeking a foundation grant, the foundation may generally make the grant without penalty. Disclosing this tie provides other board members with an opportunity to learn about the applicant charity from their colleague. Foundation policy may require that the board member abstain from voting on the grant, although there is no federal legal requirement that he or she do so. Because the board member's dual role has been disclosed, other board members may weigh his or her comments appropriately.

But some conflicts cannot be cured by disclosure. Where a community foundation proposes to pay above-market rates to a fundraising firm operated by the executive's spouse, no amount of disclosure can make the problem go away. Where a private foundation's investment manager uses foundation assets to manipulate the price of a stock held by disqualified persons, there's a genuine conflict (and probably an act of self-dealing, too).

Feeling Conflicted?

Conflicts of interest often give rise to interesting questions for the legal staff at the Council on Foundations. In next month's column, I'll address some of the most commonly asked questions. Submit your questions to a web discussion in July. Check www.cof.org for details.

Resources

John A. Edie. *Family Foundations and the Law*, 3rd ed. (Washington, DC: Council on Foundations, 2002). To order, call 888/239-5221 or visit www.cof.org and click on "Publications." Order #805, $30, Non- Members $55.

John A. Edie & Janne Gallagher, "Memo to Community Foundations and Public Foundation Members of the Council on Foundations regarding Intermediate Sanctions Regulations" (May 31, 2001). PDF available online at www.cof.org/files/documents/ legal/checklist.pdf. (This memo contains a checklist for assessing compliance with the intermediate sanctions rules.)

Jane C. Nober, *Company Foundations and the Self-Dealing Rules*, 3rd Ed. (Washington, DC: Council on Foundations, 2002). To order, call 888/239-5221 or visit www.cof.org and click on "Publications." Order #1013, $20, Non-Members $35.

Lawrence M. Brauer and Charles F. Kaiser III, "Tax-Exempt Health Care Organizations Revised Conflicts of Interest Policy" PDF available for download at www.irs.gov/pub/irs tege/topice00.pdf. (This article contains a sample conflict of interest policy for a healthcare organization, not a grantmaker, but does provide insight into the IRS's thinking in this area.)