

ASSOCIATION OF SMALL FOUNDATIONS

Primer Series

Brief papers on key small foundation topics

Legal Essentials for Small Foundations

*By Sara Beggs, Association of Small Foundations,
and Miranda Perry*

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Legislation signed into law on August 17, 2006 contained provisions that will affect your foundation operations. This version of Legal Essentials for Small Foundations gives detailed information about those changes. It is particularly important to understand how new regulations affect grants to supporting organizations (509(a)(3) public charities) and the excise taxes on net investment income. We hope you find this to be helpful. For more information on the provisions of the Pension Protection Act, please see our [Legislative Update](#) page at www.smallfoundations.org.

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DISCLAIMER: The Association of Small Foundations cannot be held liable for the information provided in this Primer. We strongly encourage you to consult your attorney to ensure compliance with federal and state laws.

Introduction

Managing and running a foundation is fantastic work. You will soon discover, however, that in addition to the joy of grantmaking comes the sometimes critically important task of complying with myriad tax and other laws governing grantmaking, investment strategies, and public disclosures, to name just a few.¹

This Primer is a summary to give you a basic understanding of some of the more important laws relevant to running a foundation. Having this familiarity with the applicable laws and regulations will enable you to comply with many of them on your own and to recognize when to hire legal or accounting help for the rest. With that purpose in mind, this Primer does not attempt to provide a comprehensive treatment of foundation law. It is not intended to provide legal advice and should not be relied upon as such. Rather, it is important that you consult attorneys and accountants who have an intimate knowledge of the issues that private foundations commonly face. The Association of Small Foundations (ASF) can help you find such an attorney in your area.

¹ This Primer is based on and updates its predecessor by Miranda Perry et al. *Legal Essentials*. Washington, DC: Association of Small Foundations, 2002. www.smallfoundations.org.

I. Grantmaking Issues

Assuming your private foundation is a traditional grantmaking foundation, the bread and butter of its charitable activities will be disbursing grants to other nonprofits. You need to be aware of a few federal rules related to grantmaking. The Internal Revenue Code (IRC) requires each private foundation to make minimum annual charitable disbursements. It also imposes very specific rules about what types of expenses can meet this requirement, as well as stringent rules regarding types of expenditures (known as "taxable expenditures") that your organization should never make.²

A. Distribution Requirements

How Much and What Counts? Every year, private foundations must distribute an amount equal to 5% of their net investment assets through qualified charitable expenditures. Qualified charitable expenditures, which the IRC terms "qualified distributions," include:

- ◆ Grants for charitable purposes except those to certain supporting organizations (explained further in section I.B. below);
- ◆ Reasonable and necessary administrative expenses attributable to conducting the foundation's charitable activities (also explained further in section I.B. below);
- ◆ Direct charitable activities, such as seminars and publications or maintaining a historic site or running a library;
- ◆ Payments to acquire assets used to conduct charitable purposes, such as buying a computer to track the foundation's grants;
- ◆ Charitable set-asides, which are funds ear-marked for future, specific long-term charitable activities under specific rules; and
- ◆ Program-related investments, such as reduced-interest loans to students with financial need or loans to community nonprofits in economically disadvantaged areas.

Expenses that are not considered qualifying distributions include investment fees such as management fees, brokerage fees, and portions of salaries, or board meeting expenses related to overseeing investments, (i.e., if 50% of your board meeting is spent discussing investments, only 50% of the meeting expenses can be counted as a qualifying distribution.)

In addition, legislation passed in August of 2006 prohibits foundations from counting grants to:

² The discussion of grantmaking presented here addresses the requirements applicable to traditional grantmaking foundations. Operating, pass-through, and pooled common fund foundations must comply with separate requirements not addressed here.

- ◆ Type I or II supporting organizations if any foundation insiders or “disqualified persons” directly or indirectly control either the supporting organization or its supported organization; and
- ◆ Type III supporting organizations that are not "functionally integrated."

While these grants are allowed if foundations exercise expenditure responsibility, they will not count toward the 5% payout in any circumstances. See below for more information on making grants to supporting organizations.

By When? Although your foundation must make its qualifying distributions annually, you actually have until the end of the subsequent tax year to make the required distributions for the tax year in question. To illustrate, foundations have until December 31, 2006, to make the required distributions for 2005. This rule applies to new foundations, enabling them to get up and running before having to address required distributions. A new foundation can also prorate the required distribution if it has a short taxable year. For example, imagine a new foundation that forms on April 1 of 2005. Because it was only in existence for three-fourths of 2005, its required distribution is only three-fourths of what it normally would be. Lastly, all foundations can carry-forward excess distributions for 5 years. This means that a foundation that exceeds the distribution requirements in 2005 can apply the excess distributions to the 5 following years.

Penalties for Distributing Too Little? The penalty for failing to make your required distributions within the 1-year time period is 30% of the shortfall. Failure to correct within 90 days of receiving a notice of deficiency from the Internal Revenue Service (IRS) will trigger an additional penalty tax equal to 100% of the undistributed income.

Penalties for Wrong Type of Expenditures? In addition to requiring your foundation to make a certain level of charitable distributions annually, the IRC also has strict requirements concerning what types of expenditures your foundation can and cannot make to meet the distribution requirements. It imposes these requirements through a tax on expenditures it considers inappropriate, which it terms “taxable expenditures.” These include grants for non-charitable purposes, grants to certain types of organizations and individuals that do not comply with the requirements set forth below, and disbursements for prohibited activities such as lobbying, electioneering, or voter registration.

The initial tax for a taxable expenditure is 20% of the amount of the taxable expenditure (imposed on the foundation) plus a 5% tax on the foundation manager who knowingly and willfully agreed to the expenditure (generally, without relying on a reasoned written legal opinion from counsel). If your foundation does not timely correct an improper expenditure, an additional tax of 100% of the amount of the expenditure can be imposed on the foundation and an additional tax of 50% can be imposed on the manager.

B. What You Can Fund Without Worry

A private foundation can make a grant to almost any organization or individual, as long as it is for a clearly defined charitable purpose. There are, however, some additional requirements when making grants to “nontraditional” recipients. Also, certain grant activities necessitate following specific guidelines to avoid it being a taxable expenditure.

Although your foundation does have quite a bit of leeway in what it can fund, the penalties for straying into forbidden areas are substantial. Therefore, knowing the rules concerning required distributions and taxable expenditures from the outset will save you a lot of trouble later, and it is important to consult legal counsel whenever venturing into a gray area.

1. Administrative Expenses and Grants to Public Charities and Governmental Units

What Administrative Expenses Count? As an initial matter, administrative expenses must be “reasonable and necessary” in order to count toward the distribution requirement. These are expenses directly attributable to running your foundation’s charitable programs, such as reasonable personnel and overhead costs, fund-raising expenses, travel for site visits, and accounting and tax services. Please note, however, that the portion of your administrative expenses attributable to the production of income will not be a qualifying distribution. Therefore, it is important to allocate your expenses between charitable activities and income production. For example, if a portion of your staff’s time is devoted to each, you must allocate their salaries accordingly.

What Grants Count? Grants for charitable purposes will likely comprise the bulk of your foundation’s required distributions. These include grants made directly to 509(a)(1) & (2) public charities, which are relatively straightforward, and grants made to other private foundations, non-charitable organizations, or individuals for charitable purposes, for which you must simply follow some additional procedures.

Due to recent legislation regarding supporting organizations, grants to certain 509(a)(3) public charities will no longer count toward the minimum distribution. Read on for more information.

Giving to 509(a)(1) or (2) Public Charities: You can easily make grants to public charities with a 509(a)(1) or (2) designation by verifying their IRS status. There are few documentation requirements for these organizations, but you still must comply with the restrictions against lobbying, influencing public elections, and special rules for funding advocacy.

It is critical that you check the grantee’s current status by requiring grantees to provide a copy of their IRS determination letter and attest to it being current in a grant agreement. Prior to August 17, 2006 when the Pension Protection Act of 2006 was signed into law, simply having “public charity” status was sufficient for most foundations to fund an organization. It is now critical that

foundations know that their public charity grantees are organizations of the type described in 509(a)(1) or 509(a)(2) due to the fact that funding certain 509(a)(3) supporting organizations (also public charities) require expenditure responsibility AND do not count toward the 5% payout. Even organizations that have been supported previously by the foundation should be required to show their status to ensure they are not 509(a)(3) public charities.

Giving to Supporting Organizations (509(a)(3) Public Charities): If your foundation is interested in funding a supporting organization or 509(a)(3) public charity, it is important that you understand new rules guiding these grants. The new law prohibits foundations from counting the following grants as a qualifying distribution:

- ◆ Grants to Type I or II supporting organizations if any foundation insiders or “disqualified persons” directly or indirectly control either the supporting organization or its supported organization; and
- ◆ Grants to Type III supporting organizations that are not "functionally integrated."

In addition, foundations must exercise expenditure responsibility for each of these grants.

As of August 17, 2006, it is extremely difficult to follow the above rules, as the IRS has not yet provided the necessary regulations and defining terms that will allow organizations to identify whether a supporting organization is Type I, II, or III and which are “functionally integrated.” When this clarification is made, this rule will become substantially easier to follow. In the meantime, we advise you to visit the Legislative Update section at www.smallfoundations.org for the latest information on making grants to these types of organizations.

Giving a Large Grant to a Small Organization: The main twist to be aware of in making grants to public charities comes if your grant is relatively large compared with the grant recipient’s overall base of public financial support. In that case, you should consult with counsel to avoid a problem known as “tipping.” In a nutshell, most public charities must meet a test that shows that a minimum percentage of their funding comes from a broad cross-section of donors from the general public, and not one donor or one foundation. Unless done with care, a very large grant from a single foundation could affect whether or not the charity still meets that test after receiving the grant. If you wish to make a large grant, make sure your counsel can work with the intended recipient to structure the grant to avoid the problem of tipping.

Giving to Governmental Units: Like making grants to public charities, making grants to governmental units is also fairly simple. Such units, however, won’t have a determination letter or be listed at www.guidestar.org. Therefore, to ensure that the organization in question is a governmental unit, you can usually simply obtain documentation of the grantee’s governmental status (such as a copy of the legislative action creating the governmental unit in question).

2. Grants to U.S. or Foreign Organizations that Are Not Public Charities

Giving to U.S. Organizations that Are Not Public Charities: You might also wish to make grants to other organizations that are not charities to use for charitable purposes. Such organizations might be fraternal orders such as the Rotary, trade associations, labor unions, and chambers of commerce. To make such grants, you must simply engage in an extra procedure known as “expenditure responsibility,” which is basically a series of steps that you take to ensure the funds will be used for charitable purposes. Exercising **expenditure responsibility** requires the following:

- ◆ A pre-grant inquiry in which your foundation takes reasonable steps to investigate a potential grantee’s capability of and commitment to executing the contemplated charitable activity;
- ◆ The grantee must sign a written agreement that both outlines the intended charitable activities and describes the grant’s limitations as specified by Treasury regulations (such as prohibiting political activities);
- ◆ The grantee must provide regular reports on the grant’s financial status, compliance with terms of the grant and progress made toward achieving the grant purposes, as specified by Treasury regulations;
- ◆ The private foundation must list expenditure responsibility grants on its Form 990-PF in the year that they are made and each year in which they are outstanding, including grant recipient information, the grant amount, the grant’s charitable purpose, a description of the grant and its status; and
- ◆ Any grantee that is not a recognized charity must use a separate account for the grant funds, to avoid commingling grant and non-grant funds (does not apply to private foundations that are grant recipients).

Giving to Non-U.S. Organizations: Expenditure responsibility can also be used to make grants to non-U.S. organizations for charitable purposes. Alternatively, you can engage in equivalency determinations to make such grants, in which your foundation makes a good-faith determination that the recipient organization is the equivalent of a U.S. public charity. This determination can be based on either an affidavit from the recipient organization or on an opinion of counsel. The affidavit or opinion, as the case may be, must set forth sufficient facts concerning the recipient organization’s operation and support to enable the IRS to determine that it would likely qualify as a public charity. (See the ASF Primer *International Grantmaking: Opportunities for Small Foundations* for details on international grantmaking, including new anti-terrorist provisions of federal law.)

Giving to Another Private Foundation: Your foundation may wish to make grants to another private foundation or an organization controlled by your foundation for a charitable purpose. Such a grant will count as a qualifying distribution for your foundation if two requirements are met, in addition to exercising expenditure responsibility mentioned above. First, the recipient foundation must meet its normal 5% distribution requirement for the year in which the grant is received, as well as the preceding year. After meeting both of these payout requirements, the recipient foundation must then expend the total amount of the grant from your foundation within 12 months after the end of the tax year in which it was received.

3. Grants to Individuals

Your foundation might also wish to make grants to individuals, perhaps for scholarship purposes or simply to assist those in need.

Grants to Individuals for Travel, Study, or Similar Purposes: The first purpose for which foundations commonly make grants to individuals is to award travel fellowships, scholarships, or research grants to individuals. Making grants for travel, study, or other similar purposes requires obtaining prior written approval from the IRS for the procedure you will use to make such grants. (If a third party such as a church or university actually selects grant recipients and your foundation simply supplies the funding, this is unnecessary.) To obtain such approval, your foundation must show that the grant award process meets the following criteria:

- ◆ The grant selection process is objective and non-discriminatory; grantees must be selected from a group large enough to be considered a charitable class;
- ◆ The grant process is designed to achieve a specific objective of the grant recipient, for example, funding a study or enhancing a skill of the grantee such as teaching or artistic skills;
- ◆ The foundation can document the grantee's fulfillment of these intended activities; and
- ◆ Those involved in the selection process should adopt and follow a conflict of interest policy, ensuring that they will not benefit, directly or indirectly, from the choices made.

Grants to Individuals for Disaster Relief, Economic Distress, etc.: Foundations may also make grants to individuals in poverty or in need of special assistance due to circumstances such as floods or tornados to take care of basic living needs such as food and shelter. These grants differ from that above as there is no required outcome or action in response to the grants. These grants must be made in an objective and non-discriminatory fashion. They do not require prior approval from the IRS, but do require careful recordkeeping. In special circumstances (for

example, the 2001 terrorist attacks in New York and Washington, DC), the IRS may waive certain rules that would otherwise apply. The foundation should have written proof (e.g., grant application) of the recipient's charitable need and inability to presently meet that need.

Grants to Individuals for Artistic Achievement, etc.: Similar to grants for economic distress or disaster relief, foundations may give grants for artistic or literary achievement without prior approval from the IRS, as there is no required outcome or action in response to the grants. Again, careful recordkeeping is essential and foundations should avoid any appearance of impropriety.

C. Influencing Public Policy: Very Doable, But Know the Rules

Chances are, you have become involved in the foundation community because you wish to make the world a better place. This desire may extend to an interest in influencing public policy. In fact, some foundations find that the most effective way to achieve their mission is by attempting to influence public policy. Typically, advocacy tries to change the policies of systems and institutions, whether those institutions consist of a government program, regulations, laws, judicial decisions, or certain electoral activities. By changing institutions, advocacy can affect large numbers of people—often by addressing *barriers* to change. At the community level, advocacy tries to help citizens come together and work effectively to deal with their problems—the philanthropic equivalent of teaching people to fish instead of feeding them.

Foundations often avoid advocacy because it is confused with lobbying, and lobbying is more highly regulated. Advocacy and lobbying are *not* synonymous, however. Advocacy includes any activity that supports or opposes a cause or issue, whereas lobbying is narrowly defined and only includes communications that are intended to influence specific legislation. Lobbying is a type of advocacy, but only one of the many types.

Small foundations need not—and should not—shy away from advocacy. By supporting advocacy activity, small foundations can leverage their grant funds and ultimately make a larger impact than by solely funding direct services. In many instances, it may just be the most effective way for your foundation and your grantees to accomplish your goals. Examples of advocacy include using private dollars to engage public dollars, facilitating meetings to build unified messages and agendas, and funding nonprofits involved in litigation, advocacy, and education. (See the ASF Primer, *Funding and Engaging in Advocacy: Opportunities for Small Foundations*, for details on grantmaking and advocacy.)

1. Prohibited Public Policy Work

First, we'll review the few types of advocacy that are prohibited, so we can then move on to all that small foundations *can do* in advocacy. Though certain activities have special requirements that must be followed, there are only two main types of advocacy that private foundations **should not engage in**:

Partisan Political Activity: Under no circumstances can small foundations engage in or fund political campaign activity, which has the intent of influencing the outcome of a public election. Your foundation may not make direct contributions to a candidate, endorse a candidate, pay for the salaries of campaign workers, fund partisan or area-specific voter registration, or pay for the publication of written materials that speak out either for or against a candidate. What is more difficult to determine is when a foundation may engage in voter education, for example, by publishing a pamphlet explaining where candidates stand on issues important to the foundation. This should be done only with the advice of legal counsel with experience in this area.

Lobbying and Grants Earmarked for Lobbying: Lobbying by private foundations or earmarking grants for lobbying is prohibited. There are two types of lobbying: direct lobbying and grassroots lobbying. Direct lobbying is when an organization communicates with a legislator to express a view about specific legislation. Grassroots lobbying is when an organization asks the public to communicate with legislators to express a view about specific legislation. This leaves room for a foundation to issue a passive report on pending legislation, but does not allow a critical review of legislation that identifies it as either desirable or undesirable, and urges readers to support or oppose it by communicating with legislators. The laws define "legislation" broadly to include any action by Congress, state legislatures, local councils, and the public (with respect to a referendum, initiative, constitutional amendment, or similar procedure).

The penalties for violating these prohibitions can be harsh, and in extreme cases could include a revocation of your foundation's tax-exempt status in addition to the imposition of the penalty taxes imposed on any taxable expenditure.

Any communication that does not fit within these narrow definitions is not lobbying. In addition, Congress permits several exceptions to this rule, which are listed below.

2. Ways to Be Involved in Public Policy Work

Now that you know the two main activities that should be avoided, here is a list of just some of the activities you can be involved in. The list below includes those activities carved out as exceptions to its broad prohibitions on political activity and lobbying, as well as those activities that simply do not fall under the strict definition of “lobbying.” Therefore, your foundation **can safely engage in** the following activities if you follow the specific rules:

Make general support grants to organizations that do advocacy, including lobbying. When making a general support grant, grant agreements or other oral or written communications do not need to prohibit the grantee from using the funds for advocacy (including lobbying) purposes, as there is no legal reason to impose such restrictions.

Make project grants for specific advocacy activities. For instance, they can specifically fund: a public education campaign; a litigation effort; publication of a research report; a grantee’s work with an administrative agency to implement a new law; or a candidate debate. Private foundations can even fund a specific project whose budget contains a line item for lobbying, but it should be stated in a grant agreement that the grant cannot be greater than the project’s budgeted non-lobbying expenses for that year. (Remember: Grants cannot be earmarked for a legislative purpose.)

Make general support grants to public charities that engage in nonpartisan voter registration (though not exclusively in voter registration), and earmarked grants to public charities that have received a written section 4945(f) ruling from the IRS. Grant funds cannot be earmarked for specified locations. Supporting voter registration that does not follow these guidelines is not allowed. Rely on experienced legal counsel when engaging in this activity.

Fund or conduct studies of broad social, economic, or policy issues, so long as the discussion does not address specific legislation. Also, fund or conduct a nonpartisan analysis or study of a legislative issue.

Educate the public on issues, by writing letters to the editor, putting information up on its Web site, hosting a public forum, taking out ads, and a variety of other activities.

Conduct and disseminate comprehensive nonpartisan analysis or research on a legislative issue, even expressing a view (specific rules apply). For example, a small foundation could produce a report discussing the need for more after-school programs for children, and the best way to fund such a program.

Respond to a written request from a legislative body for technical assistance on pending legislation.

Request government officials to enforce an existing law or issue an executive order.

Engage in “self-defense” lobbying concerning legislation that affects the foundation’s existence, powers and duties, tax-exempt status, and the deductibility of contributions to private foundations.

Engage in voter education efforts. Small foundations may engage in nonpartisan voter education efforts such as conducting: public education and training sessions about participation in the political process; nonpartisan get-out-the-vote drives; candidate debates and forums, or candidate education on public interest issues. Use caution here—rely on experienced legal counsel to ensure that your voter education efforts steer clear of influencing public elections.

Of course, foundation officers and directors may still **undertake private lobbying** on their behalf, on their own time, and at their own expense.

II. Operating and Administrative Issues

While grantmaking is the most visible and rewarding aspect of board membership, complying with the rules governing your foundation's operation and administration is crucial. Doing so will keep your foundation out of trouble with the IRS and state and local authorities, allowing you to spend more time and energy on grantmaking.

Many of the operating and administrative rules your foundation will face are imposed by the federal tax code. These rules are expressed through a series of taxes that penalize certain abusive practices that were becoming widespread many years ago. The taxes usually have two levels. First, a small, initial tax is levied when the problem is first discovered. Then, if the foundation fails to correct the problem within a certain time, a much larger tax is assessed. Sometimes, an additional tax is levied on the foundation manager who participated in the problematic activity.

A. Excise Tax on Net Investment Income

Although private foundations are not subject to an income tax, each private foundation must pay an annual excise tax on its net investment income. Congress imposed this tax in 1969 to pay for the costs of auditing and monitoring private foundations.

How much? The tax is usually 2% of investment income less the expenses attributable to producing such income (such as brokerage fees, investment management fees, and trustee fees pro-rated to reflect time spent managing investments).

What types of investment income are used to calculate the excise tax? Under prior law, only specified investment income (interest, dividends, rent or royalties and any capital gains associated with the assets that produce that type of income) was subject to the excise tax. Recent legislation now expands the definition of investment income to include all types of investment income for tax years beginning after August 17, 2006. New types specifically include:

- ◆ All items of income that arise from ordinary and routine investments, including income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments.
- ◆ Capital gains from appreciation on all types of property. For example, under the Act, gains recognized from options, straddles, and hedging transactions will be taxed, as well as gains made upon the sale of tangible personal property, such as art collections.
- ◆ Capital gains from the sale of assets used to further a tax-exempt purpose. For example, a foundation will be taxed on the capital gain earned on the sale of a building which had been used free of cost by local public charities.
- ◆ Even gains recognized on the sale of furniture or equipment used by a foundation generally will be subject to tax unless otherwise excluded as described below.

Certain gains are excluded, such as a gain from any portion of property used for at least one year for the foundation's tax-exempt purpose, if the entire property is immediately exchanged following such period solely for property of "like kind," which is also used primarily for the foundation's tax-exempt purpose.

An additional change prevents foundations from carrying back losses from the sale or other disposition of property to offset gains in prior years.

How Can We Pay the 1% Tax Instead of 2%? If a foundation's qualifying distributions (as explained in Section I, above) meet certain requirements, it may be able to reduce the excise tax from 2% to 1%. To obtain this reduction, a foundation must show that the qualifying distributions that it paid out before the end of the tax year (as opposed to within the 12-month grace period) equal or exceed the sum of (1) the average percentage of assets distributed by the foundation for the previous 5 years multiplied by the current year's net investment assets and (2) 1% of net investment income.

When Are Payments Due? If the annual estimated tax is expected to be \$500 or more, foundations must pay the excise tax on a quarterly estimated basis. The first of the quarterly payments is due 4-1/2 months after the start of the foundation's tax year, or May 15 for foundations on a calendar year basis. Failure to file and pay in a timely manner will result in penalties.

B. Self-dealing

To prevent the misuse of foundation funds and assets for the personal gain of foundation managers and their friends and families, the IRC contains strict rules concerning "self-dealing." Basically, self-dealing involves most direct or indirect transactions (often financial transactions) between a foundation and a "disqualified person" regardless of whether the prohibited transaction would benefit the foundation and is otherwise a fair and reasonable transaction. As explained below, however, some transactions between a foundation and disqualified persons, such as paying reasonable compensation for services, do not constitute prohibited self-dealing.

These rules are very complicated and can be quite frustrating to foundation managers, as they arise in a number of seemingly innocuous situations. Because of the complexity of these rules, foundation managers should consult counsel anytime they are contemplating a transaction with a disqualified person. This Primer simply seeks to provide foundation managers with an overview of what constitutes self-dealing, answer a few of the most-commonly asked questions on self-dealing, and alert foundation managers to additional situations that should raise their "self-dealing radar."

1. Prohibited Self-dealing Transactions

In a nutshell, self-dealing occurs whenever a foundation and a **disqualified person** (defined below) enter into one of the following **prohibited transactions**:

- ◆ The sale, exchange, or leasing of property;
- ◆ The lending of money or extensions of credit;
- ◆ The furnishing of goods, services, or facilities for money (for example, purchasing office supplies, printing services, or insurance from a disqualified person);
- ◆ The transfer of the income or assets of the foundation to a disqualified person or the use of such assets by or for the benefit of a disqualified person (which includes satisfying an enforceable, personal charitable pledge previously made by a disqualified person); and
- ◆ The payment of money or property to a government official.

Disqualified persons with whom foundations may not enter into the above-described transactions are generally individuals with a close relationship to the foundation and other entities controlled or owned by individuals with a close relationship to the foundation. These include the following individuals and entities:

- ◆ Officers, directors, trustees, and others with similar powers and authority;
- ◆ Substantial contributors to the foundation (defined as any person who has contributed more than \$5,000 to the foundation, but only if that amount is greater than 2% of the total contributions received by the foundation in the period spanning its inception and the end of the taxable year in which the contribution is received) and individuals or entities who own at least 20% of entities (such as the voting power of a corporation or the profit's interest of a partnership) that are substantial contributors (contributions by spouses are aggregated for this purpose);
- ◆ Family members (including spouses, ancestors, descendants, and spouses of descendants but excluding siblings) of the aforementioned;
- ◆ Any corporation, partnership or trust of which any of the above disqualified persons hold 35% or more of the ownership or beneficial interest; and
- ◆ Certain government officials.

2. Penalties

The penalties for self-dealing are taxes on the parties involved in the transaction. An initial tax equal to 10% of the amount involved in the prohibited transaction is imposed on each disqualified person who is a party to the self-dealing transaction. A second tax of 5% of the transaction's value can also be imposed on any foundation manager who knowingly participated in the transaction. If the act of self-dealing is not corrected within a certain time, an additional tax of 200% of the transaction amount can be levied against the disqualified person who is a party to the self-dealing, and an additional tax of 50% can be imposed on the foundation manager.

3. Common Self-dealing Issues

As mentioned, there are a variety of transactions into which a foundation and disqualified person can enter. At the same time, however, there are certain transactions that seem quite innocuous, such as attending a fund-raiser using a ticket purchased by the foundation, which can trigger the rules. Following are briefs description of some of the more common self-dealing issues your foundation may face.

Compensation for Board or Staff: Perhaps the most important exception to the self-dealing rules is that foundations may compensate disqualified persons (such as family members) for providing services to the foundation in certain circumstances.³ In a nutshell, the services must be reasonable and necessary to carry out the tax-exempt purposes of the foundation, and the compensation must not be excessive.

These decisions should not be taken lightly, as it is an area of increased scrutiny by Congress and the media. It is of utmost importance that the individuals deciding compensation be informed and knowledgeable about the actual duties performed as well as the compensation levels for similar persons doing similar work in similar foundations.

Some foundations engage a group of independent decisionmakers to determine things such as trustee or staff compensation, in order to follow their conflict of interest policy. Particularly in family foundations, obvious conflicts of interest occur when hiring a family member to be staff. Similarly, it is impossible for board members to make decisions about their own board compensation without there being a serious conflict of interest. That said, it is sometimes

³ It is important to note that considerations other than federal law will also affect these decisions. For example, does your foundation's governing document (bylaws or trust agreement, as applicable) permit paying a family member for service to the foundation? Also, check to see if your state has regulations pertaining to paying family members, as is the case in California. For more information on hiring family members, please see "Compensation for Services in a Family Foundation," by Janice E. Rodgers, Esq., Quarles and Brady LLC, reprinted in the *New Foundation Guidebook: Building a Strong Foundation*. Association of Small Foundations, 2003. p. 35. See also the *ASF Primer, Trustee Compensation for Small Foundations*.

impractical or even costly to engage independent decisionmakers, leaving many foundations to acknowledge the obvious conflict of interest and depersonalize the decision as much as possible.

How Do You Determine if the Services Are Reasonable and Necessary? Basically, the work must further the foundation's charitable purposes, and the extent of the services provided must be reasonable in light of your foundation's specific activities. Moreover, the employee holding the position must be qualified to perform those services. For example, imagine a foundation that gives out grants to groups engaged in an emerging area of scientific research, such as biomarkers. Given the number of grants awarded per year or meetings held, does the position require a full-time executive director, or is a part-time position more appropriate? Given the technical knowledge required to evaluate grant applications, does the position require an employee with an advanced scientific degree?

For Which Services Can a Disqualified Person Be Compensated? The IRC also requires that services provided outside of normal board duties (such as reviewing grants) be "personal services" for compensation to be acceptable. The regulations define "personal services" very narrowly, usually being "professional and managerial in nature." Therefore, a foundation could pay a disqualified person to prepare its tax returns, but could not hire a disqualified person to provide landscaping services for its office.

How Is Reasonable Compensation Determined? In addition to the services being reasonable and necessary, the compensation paid for those services must be reasonable.

It is critical that you consider several factors to determine if the compensation is reasonable. First is assessing the duties the disqualified person is actually performing for the foundation. For example, in setting board compensation, you should consider what the actual duties of the board member are, what level of expertise or knowledge is required to perform them, and how much time the board member or trustee actually spends on foundation business. For example, a \$75,000 salary is excessive for a board member who spends only a few hours a month on foundation business, but might not be excessive if he or she devotes as much time to it as a full-time job, acting as the CEO.

It is important to know what similar foundations pay similar persons for similar work. ASF conducts an annual member survey listing salaries of foundation CEOs and other paid staff (to assist comparison, the study includes both asset size and geographical area). Compensation includes not only salary and wages, but also bonuses, fringe benefits, retirement benefits, housing and automobile allowances, Directors and Officers Liability Insurance, club memberships, resort meetings, or other lavish items, and compensation to family members.

Lastly, ask yourself if you would pay the same amount to a stranger to perform the services. If you would pay a stranger less, then the contemplated salary is probably too high, risking the imposition of the self-dealing rules.

As a practical matter, you should document compensation decisions and their basis in detail when made. Should the IRS later question any such decisions, this will be much more valuable than after-the-fact justifications made at the time of an IRS challenge.

Reimbursement of Travel and Other Expenses: You may also reimburse disqualified persons for reasonable out-of-pocket expenses necessary for the operation of the foundation. This allows you to reimburse disqualified persons who are board members for their own travel expenses, but not those of their spouses or other family members (unless, of course, the family member is also a board member).

Ways to Cover Expenses of Family Members, Spouses, etc. In practice, however, your foundation can pay for spousal and family travel in two circumstances. One way is to count reimbursement of spousal and family travel expenses as part of the board member's total compensation package, similar to other non-salary benefits, including reporting them as such for tax purposes on a Form 1099 or W-2. However, the total compensation for that board member must still be reasonable. The second is to develop a legitimate foundation duty of the family member that necessitates his or her presence at the board meeting. It is extremely important that these be **real duties** and responsibilities and that they be **well documented**. For example, you might create an advisory committee, composed of your children or grandchildren, to train younger generations in your family's traditions and operations. This committee might review and recommend grants in a certain area of interest to that generation, such as providing internet access to impoverished neighborhoods. In that case, reimbursing the advisory committee members for reasonable expenses of attending meetings or training conferences is legitimate.

Office Space: You may wonder whether you may lease office space to your foundation. The answer is counter-intuitive. Although a disqualified person may not lease office space to a foundation for a fee (even fair market rate or below), a disqualified person may provide office space at no charge at all. Also somewhat counter-intuitive is that the foundation may not reimburse the disqualified person for expenses such as real estate taxes, insurance, utilities, or janitorial service. The foundation could, however, pay a portion of those costs by paying the service provider directly, so long as it is not paying a disqualified person's obligation.

Tickets to Fund-raisers: Some of the public charities to which your foundation makes grants may hold fund-raising events such as banquets or concerts for which admission will be charged. Because the attendee receives a personal benefit from attending, such as a meal or entertainment, the self-dealing rules normally prohibit a foundation from purchasing tickets to such events for its disqualified persons. In some cases, however, attendance can be justified as part of the foundation's charitable purpose (for example, evaluating and reviewing the activities of the grantee). In that case, the ticket could be viewed as a necessary and reasonable administrative expense for which the foundation could pay. Even in that event, however, the foundation cannot pay for the spouse's ticket.

4. Developing Your Self-dealing Radar

As you can see, the self-dealing rules arise in a variety of seemingly innocent contexts, and addressing them all is far beyond the scope of this Primer. However, because they arise so frequently, having a “self-dealing radar” that can warn you of potential trouble areas and alert you of the need for legal counsel is helpful. To that end, below are some potential practices of foundations that at a minimum might raise a conflict of interest if not self-dealing issue:

- ◆ Foundation owns an apartment building, and the daughter of a board member rents there at market rate;
- ◆ Foundation’s trustees all live in New York, but hold annual board meeting in Miami in January, and foundation pays for travel expenses;
- ◆ Foundation trustees live scattered around the United States, so foundation holds board meetings in a convenient city, and foundation pays travel expenses for board members and their spouses;
- ◆ Foundation gives grants nationwide, and as part of grant evaluation, conducts site visits. Ordinarily, one board member conducts a site visit, but the foundation’s Hawaii grant garners the interest of all board members, who fly out to review the grantee;
- ◆ Foundation pays \$20,000 honoraria to trustees for annual board service that requires minimal time obligation;
- ◆ Board member donates a house he’s living in (with mortgage) to the foundation, and the foundation continues to pay the mortgage;
- ◆ Board member pledges personal donation to her alma mater, then has foundation make the payment through a grant; and
- ◆ Foundation makes a grant to a nonprofit that employs a trustee’s spouse and the foundation earmarks the grant for the spouse’s salary.

Obviously, this is not an exhaustive list, and any time you have even the slightest doubts as to whether or not something constitutes self-dealing, you should consult your counsel.

5. Conflict of Interest Policies

While foundations are not required by federal law to have a conflict of interest policy, it is strongly recommended that all foundations adopt and follow one. Recently, the IRS began to request that organizations applying for tax-exempt status have some means of dealing with conflicts of interest if they do not have an actual policy. It is likely this will become part of the 990-PF as well.

A conflict of interest can occur any time a trustee's or staff's outside involvements (such as business interests, family relationships, political affiliations, or other charitable activities) intersect with those of the foundation. In instances where there is a potential benefit from the foundation in a personal, direct, or economic way, it can be difficult for the trustee or staff to make unbiased decisions. Some examples of conflicts of interest are:

- ◆ A foundation trustee serves as a board member of a grant applicant;
- ◆ A foundation wants to pay necessary and reasonable compensation to one of its board members to manage the foundation's investments; or
- ◆ A foundation board wants to make a general operating grant to a small college attended by a board member's daughter.

It is natural for conflicts of interest to occur, as trustees or directors are likely to be affiliated with many organizations in their communities, on both a professional and personal basis. A problem does not arise because of the mere existence of connections, even if it is determined to be an actual conflict of interest. Rather, problems arise when the proper steps are not taken to address the conflict of interest.

What Should We Include in Our Conflict of Interest Policy? The foundation should require that:

- ◆ Board members, staff, and volunteers disclose the connections, if any, they have to any organization or person that the board is considering for involvement in foundation activities. Some boards use a disclosure statement at the beginning of each year to identify the bulk of potential conflicts. Any interests that arise throughout the year should also be disclosed.
- ◆ Board determines whether the interest or connection is actually a conflict, and if a conflict, then whether it is material enough to be of practical importance. After understanding the circumstances of the potential conflict, the interested persons should excuse themselves from the discussion and vote to decide whether or not it is an actual conflict of interest.
- ◆ Persons with the conflict of interest may make presentations to the board regarding the decision, but after such a presentation, he/she should leave the meeting during the discussion and vote on the transaction that presents the conflict.

- ◆ Financial conflicts should be resolved, when possible, by collecting competitive bids to ensure a fair price for every significant transaction.
- ◆ The board keeps a record of the action it takes for every conflict of interest that arises.

Each trustee should sign the policy document, and the board should review the policy annually. If a board or staff member acts in spite of having a conflict, the foundation should consider taking disciplinary steps.

For more information, see sample conflict of interest policies at: <http://www.irs.gov/pub/irs-tege/eotopice00.pdf> or http://www.mncn.org/info/template_pacc.htm.

What Is the Difference Between a Self-dealing Violation and a Conflict of Interest? While some conflicts of interest may violate federal self-dealing rules or even state regulations, other conflicts of interest raise ethical rather than legal issues. In addition, the self-dealing rules generally prohibit activities whereas the conflict of interest policy gives foundations a way to address certain conflicts. It is critical to understand, however, that following a conflict of interest policy does not relieve a foundation from following the very detailed self-dealing rules.

C. Public Disclosure Requirements

To facilitate accountability to the public, Congress requires that each private foundation make certain tax information available to the general public. Although these rules are not burdensome, it is important that you be familiar with them and comply with their requirements.

What Must I Make Public? Specifically, your foundation must make copies of its Forms 990-PF for the 3 most recent years, its Form 990-T (unrelated business income tax return, if any), and its Form 1023 (application for tax exemption) and all related correspondence. First, these documents must be available for inspection at the foundation's office (or an alternative site if there is no foundation office) by any member of the general public who requests them during normal business hours. In addition, your foundation must either post these documents on the World Wide Web or provide "take-home" copies of them upon a request made either in person or in writing (you may charge a reasonable fee for copying and mailing costs). Directing the public to www.guidestar.org is a simple way to have these posted. This electronic posting is sufficient in most cases. However, when requested by the public, foundations must provide signed copies of their three most recent 990-PFs. (GuideStar does not include signatures and has some lag time between your filing and when it is posted.)

Penalties for Non-compliance: Although failure to comply with the disclosure requirements will not trigger fines on the foundation, the person who fails to comply with these rules can be

fined up to \$20 a day. The maximum penalty for failing to provide the Forms 990-PF is \$10,000; however, there is no maximum penalty for failing to provide Forms 1023 or 990-T.

You should also discuss with your attorney whether your state imposes further disclosure requirements. For example, New York requires private foundations to publish notices in area newspapers informing readers of their right to inspect a foundation's tax forms.

D. Tax Filing and Recordkeeping Requirements

1. Tax Filing Requirements

Filing the 990-PF: All private foundations, regardless of asset size, must file an annual return with the IRS. This form, called the Form 990-PF (Return of a Private Foundation), is due on the 15th day of the 5th month following the close of the foundation's taxable year, or on May 15th for those foundations using a calendar year.

Form 990-PF presents detailed financial information, and will usually be prepared by or with the extensive help of a foundation's accountant or lawyer. However, because the foundation's managers are ultimately responsible for the information reported in the Form 990-PF, it is useful if they have an understanding of its requirements and participate in its preparation. To that end, the instructions to the form are helpful, as is IRS Publication 578 (Tax Information for Private Foundations and Foundation Managers).

Penalties for Not Filing: Failure to file a complete Form 990-PF on time can trigger fines for both the foundation and, possibly, its manager. For small foundations (with gross receipts less than \$1 million a year), the penalty is \$20 a day, up to a maximum that is the smaller of \$10,000 or 5% of the foundation's gross receipts. For foundations with gross receipts over \$1 million a year, the fine is \$100 a day, up to a maximum of \$50,000. If, after failing to file a complete Form 990-PF on time, the foundation manager does not comply with a request from the Secretary of the Treasury to file by a reasonable date, the manager can personally be fined \$10 a day, up to \$10,000.

Filing the 990-PF with Appropriate States: The IRS also requires any foundation with assets over \$5,000 to file a copy of its Form 990-PF (and Form 4720, if applicable), with the attorney general of the state in which the foundation's principal office is located, the state in which the foundation was created, and in any other state in which the foundation reports or is registered. Each foundation should also discuss with its local attorney whether state law imposes any additional filing requirements.

2. Recordkeeping

Sound management principles suggest that each foundation maintain careful records. As fiduciaries, board members have a duty to account for the foundation's assets, receipts, and distributions. Moreover, careful recordkeeping will facilitate compliance with IRS and state reporting requirements.

Governing Documents: If your foundation is organized as a corporation, make sure you keep the following on file: your Articles of Incorporation, as approved by the Secretary of State or other appropriate state agency (plus any amendments thereto); your Bylaws (plus amendments); and copies of minutes from past board meetings. If your foundation is organized as a trust, you should maintain an original copy of the trust instrument.

All IRS Correspondence and Tax Filings: You should also have a separate file with copies of all of your tax documents. This will include your Form 1023, along with any attachments or correspondence; your Form SS-4 and its approval (with the Employer Identification Number); your Form 2848 (power of attorney); your determination letter; copies of your Forms 990-PF; and copies of any state returns.

Operational and Administrative Documents: In addition to your foundation's tax and organizational documents, you should also keep on hand records stemming from the operation and administration of your foundation. These include employee records; financial asset records such as bank accounts, stocks, bonds, mutual funds, and other investment assets, reports from outside managers, appraisals, monthly valuations, contracts, agreements, deeds, insurance binders and legal documents; documentation of receipts and expenditures for administrative expenses; and grant records and files on grantseekers.

E. Liability

Unfortunately, in today's litigious society, anyone—including your foundation—may be the target of a lawsuit. In that event, both the foundation itself and its governing body will need protection. While state and federal law may provide some protection for your board members and volunteers, immunity will extend to your organization in only a few states. Moreover, these laws often contain no protection for legal expenses, which are often the most expensive component in litigation. Therefore, you should carefully consider what type of insurance your foundation should carry.

General Liability Insurance: All private foundations should consider general liability insurance, which covers personal injury and property damage. Examples of claims that would be covered under your general liability insurance include accidents on the foundation's premises, fire, theft and accidental loss.

Directors and Officers Liability Insurance: You should also carefully consider purchasing a Directors and Officers Liability Policy (D&O policy). A D&O policy will protect your foundation's officers and directors against a variety of claims alleging mismanagement within a foundation that are not covered under the foundation's general liability policy, such as harassment, wrongful termination, employment discrimination, conflicts of interest, libel, slander, breach of contract, and violations of the tax laws. Among other provisions, **a good D&O policy should contain the following:**

- ◆ A Duty to Defend provision that offers full defense coverage, even if the allegations against your foundation are found to be groundless or false;
- ◆ Unlimited coverage for legal expenses (meaning that legal expenses do not count toward the policy's coverage limit), with such expenses to be paid as incurred;
- ◆ Coverage for allegations of anti-trust violations or mismanagement of funds;
- ◆ Full employment liability coverage;
- ◆ Coverage for accusations of harassment by a third party; and
- ◆ Protection for assets of a director held in a spouse's name.

Thing to Consider when Insuring the Foundation: Several considerations will affect whether or not purchasing a D&O policy is appropriate for your foundation. The main consideration is whether your board is comfortable relying solely on general liability insurance. Additional concerns include the size of the foundation's staff, whether or not the foundation has an office, the number and size of grants made per year, the number of contracts into which the foundation enters, whether the foundation directly conducts its own charitable programs, the number of investments that the foundation holds, and the cost of obtaining a policy.

ASF has negotiated a group D&O policy for its members. For \$750 in premium costs per year, you can receive \$1 million in coverage, including unlimited coverage for legal expenses. Complete details are on the ASF Web site, www.smallfoundations.org.

III. Investment Issues

A. Excess Business Holdings

What Are Excess Business Holdings? To prevent certain abuses that could stem from allowing a nonprofit to control a for-profit enterprise (such as propping up stock prices), the IRC prohibits private foundations from owning more than a small portion of any business enterprise.

Specifically, the IRS prohibits a foundation, together with its disqualified persons, from holding more than a 20% interest in a given business enterprise. If, however, the foundation shows that a third person or persons who are not disqualified persons with respect to the foundation effectively control the business, this limit can increase to 35%. The IRC also provides a *de minimis* “safe harbor.” A foundation, together with related foundations, can own up to 2% of any business enterprise without worrying about the holdings of disqualified persons.

Five-Year Grace Period: A foundation usually has 5 years to sell off any excess holdings given to it in order to reach the 20% or 35% minimum, as applicable. A foundation may also apply for a 5-year extension by showing that it has made serious efforts to sell its outstanding holdings and that the size or intricacy of the holdings makes divestiture in the initial 5-year period impractical.

Penalties: Failure to divest within the time limits will trigger a tax of 10% of the value of the excess holdings, with a possible additional tax of 200% if corrections are not made in a timely manner.

B. Standards for Investment Decisions

In order for your foundation to continue (and perhaps expand) serving its philanthropic goals, maintaining its financial well being is critical. Be sure to know both the federal and state laws when developing your investment policy, as certain states have more stringent standards than the IRC imposes. Fortunately, advances in asset management standards give today’s trustee or director much more freedom to invest and manage a foundation’s assets than in previous generations.

1. Federal Law Considerations: Jeopardy Investments

What Are Jeopardy Investments? Congress discourages foundations from engaging in imprudent and risky investments that may squander their assets by penalizing a foundation for any investment that “jeopardizes the carrying out of its exempt purposes.” This rule, known as the “jeopardy investment rule,” is found in section 4944 of the IRC.

What Qualifies as a Jeopardy Investment? Unfortunately for the small foundation manager, there is no precise list of what types of investments necessarily run afoul of the rule. Instead, the IRS takes the “we know it when we see it” approach. For example, Treasury regulations state that a manager violates the jeopardy investment rule when he or she “fails to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of the investment, in providing for the long and short-term financial needs of the foundation to carry out its exempt purpose.”

That being said, the IRS has, however, stated that the following investments will be closely scrutinized:

- ◆ Trading in securities on margin;
- ◆ Trading in commodity futures;
- ◆ Investments in working interests in oil and gas wells;
- ◆ Purchasing “puts,” “calls,” and “straddles”;
- ◆ Purchasing warrants; and
- ◆ Selling short.

Prudent Investor Rule: Since the jeopardy investment rules were written, however, standards in asset management and fiduciary duties have advanced considerably. Many states have adopted the prudent investor rule, which focuses on a portfolio’s total return and its overall investment strategy. Instead of evaluating the appropriateness of each asset in isolation, investment decisions are reviewed as part of an overall strategy with certain risk and return objectives appropriate for the trust’s needs. As a result, many types of investments that were previously considered risky are now considered much more acceptable. Thus, it is possible for a foundation manager to invest in the “closely scrutinized” categories without running afoul of the jeopardizing investment rules. In practice, the IRS imposes penalties only if a foundation has clearly squandered its assets, and particularly if there is any element of self-dealing as well. Program-related investments (PRIs) are not considered to be jeopardy investments.

Penalties: In those rare cases where the IRS does find a violation of the jeopardy investment rules, the penalty is a tax on the foundation of 10% of the value of the jeopardy investment. A similar tax of 10% of the investment’s value may be imposed on any foundation manager who knowingly makes such an investment, unless he or she demonstrates that his or her participation was either not willful and is due to reasonable cause (such as pursuant to a reasoned opinion of counsel). Failure to remove the jeopardy investment from the foundation’s portfolio in a timely manner can trigger an additional 25% penalty on the foundation and an additional 5% penalty on the manager.

Exceptions for Program-Related Investments: Additionally, the IRC provides an exception for otherwise imprudent investments that are designed to further a foundation’s charitable purposes. To qualify for this exception, known as a “program-related investment,” an investment must (1) have a charitable purpose as its primary purpose and (2) not have the production of income or the appreciation of property as a significant purpose of the investment. For example, making an interest-free loan to an urban renewal organization should qualify as a program-related investment because it has a charitable purpose (urban renewal) and is not designed to produce income.

2. State Law Considerations

In addition to the federal law considerations discussed above, state law will also inform your investment decisions. The exact standards of conduct to which you must adhere in managing your foundation’s assets will vary depending on whether your foundation is a corporation or trust and on any specifics in your state’s laws with respect to each. Luckily for today’s foundations, most states have adopted standards for asset management that provide quite a bit of flexibility so long as the investment manager exercises that discretion responsibly. That being said, many states require that preservation of principal be the most important investment criteria for charitable entities. With that in mind, a foundation board would be wise to adopt a written investment policy that follows state law.

If your foundation is organized as a trust, state fiduciary law will determine the standard by which investment decisions are measured. Most states now follow some form of the “prudent investor rule” described above.⁴

⁴ A majority of states have codified the common law prudent investor rule by adopting a version of the Uniform Prudent Investors Act (UPIA). The UPIA reflects the major changes in asset management advanced by the common law prudent investor rule, such as the focus on the total portfolio instead of individual assets. Although the UPIA governs only trustees and other fiduciaries, the drafters of the UPIA noted that its “standards can be expected to inform the investment responsibilities of directors and officers of charitable corporations.” Thus, if you are a board member of a nonprofit corporation in a UPIA state, familiarizing yourself with its requirements is worthwhile.

If your foundation is organized as a corporation, investment decisions will most likely be governed by an adaptation of the Uniform Management of Institutional Funds Act (UMIFA), which has been adopted in all but three states. The UMIFA applies to incorporated or unincorporated charitable organizations but not to trusts, although it shares many characteristics of the prudent investor rule discussed. Among its key elements are the following:

- ◆ The nonprofit corporation is allowed to use (that is, spend) appreciation on endowment funds, whether realized or unrealized;
- ◆ Directors and officers are urged to take a total return approach, which looks at both income and appreciation rather than just the generation of income;
- ◆ Directors and officers are allowed to invest in an unlimited range of assets and are not restricted to specific types of assets;
- ◆ Inflation must be taken into account in developing and overseeing the nonprofit corporation's overall investment strategy;
- ◆ Delegation of investment responsibility is permitted, and this duty may be delegated to either employees or managers;
- ◆ The standard of prudence is a standard of business care and prudence; and
- ◆ Restrictions on investments imposed by a donor can be released by the donor, or, if the donor is no longer alive, the institution can ask the court to release the restrictions.

IV. Terminating the Foundation

For a variety of reasons, you may at some point face the task of terminating your private foundation. Perhaps you limited its life to a set number of years when you created it, or perhaps your family has decided that other methods of philanthropic activity best suit its needs. You are not alone in making this decision; terminations of private foundations occur fairly frequently. Such action, however, can be complex and legal counsel should be consulted.

Follow IRC Guidelines: As you may have guessed from reading about how the IRC governs other areas of private foundation operation, it ensures that foundations terminate in accordance with its rules by (and by now, this should be no surprise) imposing a significant penalty tax on any foundation that terminates without following specific requirements. These rules ensure that when the foundation terminates, it is not escaping the minimum payout rule and other requirements it may have difficulty meeting. Basically, the IRC provides three options for voluntarily terminating your private foundation (this Primer does not address involuntary termination, because by reading this publication we hope you have avoided some of the pitfalls that might trigger an involuntary termination).

Option 1 – No Transfer of Assets: One option is to simply terminate your organization's private foundation status without transferring its assets or changing its form in any way. This option, however, triggers such a harsh termination tax (which in some cases can reach all a foundation's assets) that in practice very few, if any, terminating foundations pursue it.

Option 2 – Transfer Assets to a Charitable Organization: A more common option is to transfer all of the foundation's net assets to a public charity, donor-advised fund or another private foundation. You would likely choose this course if your family decided to close your foundation down entirely and cease all its operations. In giving to a public charity, the only legal limitation is that any recipient must have been a public charity for at least 60 months before the distribution (of course, your foundation's governing instrument may have its own requirements). In transferring your foundation's assets to a donor-advised fund, you will not maintain final legal control over the assets (because the sponsors of donor-advised funds can accept or reject your recommendations as to how distributions are made), but you can have some input into how they are ultimately used. If you transfer all of your assets to either of these recipients, the termination is effective immediately. You do not need to provide the IRS with notice of this type of termination.

If you transfer all of your foundation's assets for charitable purposes (such as to another private foundation), you can terminate your organization's private foundation status by notice to the IRS when it has no assets at all.

Option 3 – Convert to a Public Charity: The last option is to convert your organization’s status to that of a public charity and operate it as such for 5 years. In some instances, your organization might be able to generate enough broad public support to qualify as a traditional public charity. This is usually the case only if your organization has operated a facility of some sort (such as a museum) that brings in a dependable stream of income from the public or generates other funds related to its exempt purposes.

Most of the time, however, it may be difficult for your organization to generate enough support from the broad public to qualify as a traditional public charity. In that respect, the IRC provides you with an out: you can convert your foundation to what is known as a supporting organization, which is basically a charitable entity that is closely involved in one way or another with one or more public charities. You might choose this option if your foundation already has a close connection to a public charity, but remember, even though your organization will continue to exist in a different form, you will have significantly less control than those maintaining private foundations. Here, one attractive possibility is to become a supporting organization for a community foundation, which would still allow you to make nonbinding suggestions concerning the disposition of your assets.

Converting to a public charity (whether traditional or a supporting organization) requires notice to the IRS. You must give such notice in advance, before beginning the 60-month period, and the notice must contain:

- ◆ The name and address of the private foundation;
- ◆ A statement of its intention to terminate its private foundation status;
- ◆ The IRC section under which it seeks classification as a public charity and the type of public charity for which it seeks classification;
- ◆ The date its regular tax year begins; and
- ◆ The date the 60-month period begins.

In addition, you must revise the foundation’s governing documents and make any other necessary changes to your foundation’s structures to conform to the requirements for public charities.

References and Resources

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Funding and Engaging in Advocacy: Opportunities for Small Foundations, by the Association of Small Foundations.

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