Private Foundations in Transition: Governance Issues in 2010

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I. Introduction

A. Private vs. Public. Charitable organizations, those entities that are exempt from federal income tax under section 501(c)(3), are divided into two basic groups: public charities and private foundations. Certain charitable organizations, such as churches, are deemed by Congress to be public. Others will be classified as such only if they demonstrate to the IRS that they can pass a public support test. The rest are private foundations. IRC Sections 508 and 509. Private foundations generally have less favorable tax treatment than public charities.

B. Corporate vs. Trust. A foundation may be formed as either a non-profit corporation or as a trust. There are at least five differences to consider.

1. State law. Corporations are subject to state corporate law requirements for formation and annual corporate reporting to the secretary of state; trusts typically are not. Conversely, standards of conduct may be higher for trustees than for directors and officers. See II B, below.

2. Flexibility. Though arguably more difficult to establish, corporations are more flexible in their operation, especially if a change in purpose or mission is called for. All state laws provide a mechanism for amending corporate Articles and Bylaws; changes to irrevocable trusts usually require court action.

3. Operating foundations. The corporate form is preferred if the foundation will be operating any sort of program.

4. Foreign operations or grants. If the foundation contemplates foreign operations or grants, and expects to receive contributions from a corporate donor, then the foundation should be in corporate form, not trust form. IRC Section 170(c)(2) disallows a deduction to a corporate donor for contributions to a non-corporate entity that uses such funds outside the United States.

5. UBTI. If the foundation incurs unrelated business taxable income ("UBTI"), it will be subject to income tax at either the corporate or trust rate depending on its structure. Because trust income tax brackets are so compressed, tax on comparable amounts of UBTI will generally be higher for trusts than for corporations.

C. Grant-making vs. Operating. Of the nation's over 72,000 foundations, the majority are non-operating, grant-making private foundations. The minority--about 5,000--are operating foundations. The Foundation Center, Foundation Growth and Giving Estimates, 2008, www.foundationcenter.org.

1. Grant-making. Grant-making private foundations support a charitable mission primarily by making grants for stated purposes, either to a public charity or, in some cases, to individuals or foreign entities. Although generally exempt from income tax, they must pay an excise tax on net investment income imposed under IRC Section 4940. If governed with care, they are generally able to avoid the private foundation penalty excise taxes described in IRC Sections 4941- 4945.

2. Operating. Operating foundations support a charitable mission primarily by conducting research, directly providing charitable services, or, as in the case of certain very large foundations formed by pharmaceutical manufacturers, making in-kind distributions directly to persons in need. The Foundation Center, Foundation Growth and Giving Estimates, 2008. The tax treatment of a "private operating foundation" is generally less favorable than a publicly supported charity but more favorable than that of a grant-making private foundation. Although an operating foundation is generally exempt from income tax, it will be classified as a "private operating foundation" for tax purposes only if it meets the stringent requirements of IRC Section 4942(j)(3) and Treas. Reg. 53.4942(b)-1, (b)-2 and (b)-3. Some private operating foundations qualify as "exempt operating foundations"—and are not subject to the private foundation excise tax on net investment income. IRC Section 4940(d)(2). If governed with care, operating foundations are generally able to avoid the private foundation penalty excise taxes described in IRC Sections 4941- 4945.

II. Baseline governance

A. The role of the mission statement. A mission statement can be a useful tool for preserving the founder's intentions for the foundation. Mission statements can also express the goals of the foundation's board. Care should be taken to distinguish between purpose restrictions imposed by the donor and binding on successor directors or trustees and non-binding expressions of preferences.

B. The role of the board. The directors (or trustees if the foundation is established in trust form) are charged with overall management responsibility, including assuring that the foundation abides by its governing documents, mission statement and other policies and procedures.

1. <u>Fiduciary considerations</u>. Directors, officers, and trustees, as well as key employees, are all fiduciaries of the foundation, though the required standards may differ.

    a. <u>Conduct</u>. State law standards of conduct for trustees may be higher than for corporate directors and officers.

    b. <u>Liability</u>. Conversely, state law limitations on liability may be higher for directors and officers than for trustees.

2. <u>Independence</u>. Use of outside board members, or independent trustees, should be considered.

3. <u>Policies</u>. Directors (or trustees) should consider adopting the various policy statements (investment policy, spending policy, conflict of interest policy, etc.) addressed elsewhere herein.

4. <u>Governing document</u>. The governing document(s) should set out the general powers of the board, their number, tenure and qualifications, their manner of selection, and their succession.

5. <u>Sub-committees</u>. Larger foundations may have sub-committees with oversight over specific functions, such as audit and compensation.

6. <u>Employees</u>. Larger foundations may also use officers (or other employees) to carry out day-to-day functions.

C. <u>The role of Congress, the IRS, the states and the sector</u>.

1. <u>Overview</u>. There is no separate federal regulatory agency for the supervision of private foundations, despite occasional recommendations to that effect. However, for over a century, Congress has remained keenly interested in private foundation activities, focusing primarily on issues such as size, duration, distribution history, self-dealing and business operations. The most obvious result has been increasingly stringent tax regulation—and increasing oversight by the Internal Revenue Service. The states have exercised their authority to a far lesser degree, generally expending limited resources primarily on donor solicitation problems. The charitable sector itself, whether independently or at the request of Congress, has become increasingly active, both in making legislative recommendations and in setting preemptive voluntary standards.

a. Private foundations before the Tax Reform Act of 1969.

i. With the accumulation of the unprecedented fortunes of the late 19th century, there came the establishment of the first large private foundations. Among these were the Russell Sage Foundation in 1907; the Carnegie Corporation of New York in 1911; and the Rockefeller Foundation in 1913. McCoy at 1-4 to 1-5.

ii. Over the next half-century, there were sporadic waves of Congressional suspicion and inquiry. Significant among these were the Walsh Commission, which investigated the role of foundations in the economy (1916); the Ways and Means Committee hearings on the business activities of foundations (1947); the Cox and Reece Committees, which focused on foundations and subversive activities (1952-1954); and the Patman Committee (1961-1969), which recommended many of the provisions found in the Tax Reform Act of 1969. Fremont-Smith, 67-77.

iii. Prior to enactment of the Tax Reform Act of 1969, certain restrictions on self-dealing, jeopardizing investments, and unreasonable accumulation of income were already part of the Internal Revenue Code. These applied only to the type of charitable organization that would later be categorized as a "private foundation" in the 1969 Act. Fremont-Smith at 60-61; Internal Revenue Code of 1954, Sections 503 and 504.

b. IRS as the de facto regulator of private foundations. Given the considerable economic benefits resulting from tax-exempt status, it is not surprising that the Internal Revenue Service, as the ultimate arbiter of tax exemption, has become the de facto regulator of all tax-exempts, including private foundations. The Division of the IRS specifically tasked with oversight is the Tax Exempt and Government Entities Operating Division.

c. 2010 developments.

i. General. It does not appear at this point in 2010 that there will be significant legislation affecting private foundations this year. However, the Council on

Foundations is continuing efforts to urge Congress to replace the current two-tier excise tax on net investment income with a single flat tax at a revenue neutral rate. One study puts that rate at 1.32 percent. See H.R. 4090, introduced on November 17, 2009, that would amend IRC section 4940 to impose a flat 1.32 percent excise tax on net investment income.

ii. Disaster declarations. The IRS Commissioner has declared the earthquakes in Haiti (Notice 2010-16, 2010-6 I.R.B. 396) and in Chile (Notice 2010-26, 2010-14 I.R.B. 1) to be "qualified disasters" enabling company private foundations to provide assistance to affected employees.

iii. Proposed supporting organization regulations. Some Type III supporting organizations ("Type III SOs") have become private foundations as a consequence of the Pension Protection Act of 2006 ("PPA") and various guidance issued thereunder.

a) Regulations proposed last fall, 74 Fed. Reg. 48672 (Sept. 24, 2009), create standards for determining whether a Type III SO is functionally integrated or not, and prescribe a 5 percent payout requirement for those that are not. Payout would generally be calculated using the private foundation rules, although the proposal would not allow the use of set-asides. However, it would allow the SO to first apply any excess distributions carried forward before applying current-year distributions, the opposite of the private foundation rule. The proposal does not limit the number of organizations a Type III non-functionally integrated SO can support, but does require that one-third of the minimum distribution amount be paid to the supported organizations with respect to which the SO meets the responsiveness test. This would effectively limit the ability of Type IIIs to be broad-based grantmakers. Finally, the proposal includes examples of how a Type III charitable trust can demonstrate that it meets the responsiveness test by showing a close and continuous working relationship with its supported organizations and establishes the parameters for an annual required notice to the supported organizations.

b) Reforms enacted in the PPA removed the ability of Type III charitable trusts to meet the responsiveness test by demonstrating that the beneficiaries of the trust had the power under state law to enforce the terms of the trust. This led trustees for Type III charitable trusts to conclude, at the end of the one-year grace period provided by the PPA, that some of those trusts no longer qualified for supporting organization status and had, as a consequence, become private foundations. Based on the examples in the proposed regulations, some of these trustees now believe that some charitable trusts can demonstrate the required close and continuous working relationship and so do qualify as supporting organizations. Announcement 2010-19, 2010-14 I.R.B. 1, prescribes a process for these trusts to seek rulings that they are Type III SOs and to seek refunds of the private foundation excise tax they paid on their net investment income.

iv. <u>Program-related investments</u>. The IRS is expected to propose amendments this year to the section 4944 regulations dealing with program-related investments, Treas. Reg. § 53.4944-3. The ABA's Tax Section submitted seventeen proposed new examples for inclusion in the regulations on March 10, 2010. These examples, which revise and update examples that the Tax Section first submitted in 2002, illustrate the following key issues:

a) If an activity is charitable when conducted in the U.S., it is likewise charitable if conducted in a foreign country;

b) Efforts to preserve and protect the natural environment and endangered species serve a charitable purpose;

c) Raising the living standards of needy families in underdeveloped or developing countries serves a charitable purpose;

d) The recipients of loans and working capital need not themselves qualify for charitable assistance because they are "merely the instruments" by which the charitable purposes are served;

e) The presence of a seemingly high projected rate of return should not, alone, prevent an investment from qualifying as a program-related investment because determination of the significant purposes for an investment requires a facts and circumstances analysis that takes into account all of the objective facts and circumstances of an investment, including evidence of the motive behind the investment, and the potential production of income or property appreciation is merely a factor in the analysis;

f) Program-related investments may be properly accomplished by or through loans to individuals, tax-exempt organizations, or for-profit domestic or foreign organizations, as well as by or through equity investments in for-profit domestic or foreign organizations, including limited liability companies;

g) Providing credit enhancement, whether in the form of a guarantee, letter of credit, or otherwise, for a borrowing by a third party that accomplishes a charitable purpose may qualify as a program-related investment; and

h) The existence of an "equity kicker" as part of the overall return does not prevent an investment from qualifying as a program-related investment.

v. Request to modify and update Rev. Proc. 92-94. The Council on Foundations has asked the Treasury Department to modify and update Rev. Proc. 92-94, which provides guidance to private foundations on making determinations that foreign nongovernmental organizations are the equivalent of U.S. public charities. The request asks Treasury:

a) To implement the recommendations of the IRS Advisory Committee for Tax Exempt and Governmental Entities by authorizing the creation of equivalency determination information repositories ("EDIRs") that can make equivalency determinations on which third parties can rely;

b) To update the Revenue Procedure to reflect the changes the IRS made in calculating the public support test and recommends that foundations be permitted a two-year reliance period;

c) To make clear that sponsoring organizations of donor advised fund may rely on the Revenue Procedure; and

d) To clarify several technical issues that have troubled grantmakers, including: (i) how to treat support from a foreign government; (ii) application of the prohibition on lobbying and political activity in countries that do not bar such participation; (iii) whether the nondiscrimination statement required of US educational organizations must be extended to schools outside the US; and (iv) the ability of grantmakers to make equivalence determinations for foreign organizations that have been in existence less than five years.

2. Private foundation penalty excise taxes. Enacted as part of the Tax Reform Act of 1969, the penalty excise taxes reinforce the role of basic fiduciary principles in the private foundation arena. Private foundations that willfully and repeatedly (or willfully and flagrantly!) incur a liability for the penalty excise taxes risk having their status as a private foundation terminated involuntarily —and becoming subject to an onerous termination tax that recaptures the benefits of tax-exempt status. IRC Section 507(a) and (c); Treasury Regulations Sections 1.507-1; 1.507-4 through 1.507-9.

a. <u>Self-dealing and the duty of loyalty</u>. The penalty excise tax on self-dealing punishes those individuals (and certain related parties) who breach the fiduciary duty of loyalty by entering transactions with the foundation, including sales, loans, leases, and the furnishing of goods, services and facilities. The rule, which has many important exceptions, applies only to "disqualified persons" and "foundation managers." Both these terms are broadly defined in IRC Section 4946 and Treasury Regulation Section 53.4946-1.

The initial tax on "disqualified persons" is equal to 10 percent of the "amount involved with respect to the self-dealing"; the initial tax on "foundation managers" is 5 percent, with a $20,000 maximum per act of self-dealing. A confiscatory second tier tax is imposed if the parties fail to correct the self-dealing within the time provided by the statute. IRC Section 4941 and Treasury Regulations Sections 53.4941(a)-1 through 53.4941(e)-1.

b. <u>Failure to distribute</u>. Private foundations are subject to a 30 percent excise tax if they fail to make "qualifying distributions" in an amount equal to five percent of the average monthly net fair market value of their investment assets; the distribution for any given tax year must be made before the end of the following tax year.

With some important exceptions, the term "qualifying distributions" generally includes all amounts paid (including program-related investments) to accomplish a charitable purpose; certain assets used directly to carry out a charitable purpose (*note: this does not include investment assets*); and certain amounts set-aside for a specific project that has a charitable purpose.

As noted above, the initial excise tax is a hefty 30 percent of the undistributed amount. If the underdistribution is not corrected, the second tier tax is 100 percent.

IRC Section 4942 and Treasury Regulations Sections 53.4942(a)-1 through 53.4942(b)-2.

c. <u>Excess business holdings</u>. The penalty excise tax on excess business holdings punishes those private foundations that own too great an interest in an operating business. "Excess holdings" is generally defined in relation to "permitted holdings" of 20 percent of an entity's total voting stock or total profits interest. The initial tax (imposed if the securities are not divested within any available safe harbor period) is 10 percent of the value of the excess holdings. The second tier tax for failure to divest within the permitted time is 200 percent of the value of the excess holdings. IRC Section 4943 and Treasury Regulations Sections 53.4943-1 through 53.4943-11.

d. Jeopardizing investments and the duty of care. This penalty excise tax targets investments that jeopardize the carrying out any of a foundation's exempt purposes. It is intended to punish both the foundation that makes the investments and the "foundation managers" who approve them. The implementing regulations focus on the adequacy of the investment process: an investment is jeopardizing if the foundation managers have "failed to exercise ordinary business care and prudence." The initial excise tax (imposed on both the foundation and the negligent foundation managers) is 10 percent of the value of the jeopardizing investment; the initial penalty on investment managers is limited to $20,000 per investment. If the foundation fails to dispose of the
jeopardizing investment, there are second tier taxes as well. IRC Section 4944 and Treasury Regulations Sections 53.4944-1 through 53.4944-6.

e. Taxable expenditures. IRC Section 4945 attempts to ensure that private foundation monies are spent for exclusively charitable purposes by taxing certain suspect expenditures. "Taxable expenditures" is defined in the statute to include expenditures for lobbying or electioneering (including voter registration); certain grants to private individuals (unless grant-making procedures are approved by the IRS); and certain grants to private foundations and supporting organizations (unless there is special oversight). The initial tax on the foundation is 20 percent of the amount of the expenditure; the initial tax on the foundation managers who approve such expenditures is 10 percent, with a ceiling of $20,000 per expenditure. A second tier tax applies unless an amount equal to the taxable expenditure is restored to the private foundation. IRC Section 4945 and Treasury Regulations Sections 53.4945-1 through 53.4945-6.

3. Private foundation excise tax on net investment income. Separate and apart from the private foundation penalty excise taxes is a two percent excise tax imposed on the net investment income of every

private foundation, defined to include capital gains. Under certain circumstances, the two percent tax may be reduced to one percent. IRC Section 4940 and Treasury Regulations Section 53.4940-1.

4. Unrelated business income tax (UBIT). The first UBIT provisions were enacted in 1950 to discourage tax-exempt entities, including private foundations, from unfairly competing with for-profit businesses. Today, the amount of income subject to tax ("unrelated business taxable income" or "UBTI") is computed under the special rules of IRC Sections 511 through 515, while the tax itself is computed under IRC Section 11 (for corporations) or IRC Section 1(e) (for trusts). IRC Section 511(a) and (b). A specific $1,000 deduction prevents imposition of the tax on very small amounts. IRC Section 512(b)(12).

   a. Unrelated trade or business income. Business income received by a private foundation is wholly taxable as unrelated business taxable income if it arises from activities unrelated to the foundation's charitable purpose. IRC Sections 512 and 513. A special rule treats all income or gain from S corporation stock as income from an unrelated trade or business. IRC Section 512(e). Garden-variety interest, royalties, and rents are expressly excluded from the definition of unrelated business taxable income. IRC Section 512(b).

   b. Unrelated debt-financed income. Unrelated debt-financed income is included in the computation of unrelated business taxable income. IRC Section 514(a). As originally enacted in 1950, the unrelated debt-financed income provisions focused narrowly on rental income from debt-financed, sale-leaseback real estate transactions. IRC Section 514, prior to amendment by the Tax Reform Act of 1969. The concern was that charities were using their profits tax-free to purchase large amounts of commercial real estate, i.e. the tax-exempt rental income received by the charity was being used to pay off the installment purchase price. Senate Report No. 2375, Revenue Act of 1950. Under the Tax Reform Act of 1969, the unrelated debt-financed income provisions were substantially broadened to apply to gross income from any type of debt-financed property, including gain on disposition of that property. IRC Section 514.

IRC Sections 511-514 and Treasury Regulations Sections 1.511-1 through 1.514-(d)-1.

5. The Internal Revenue Service. In addition to determining whether a private foundation is tax-exempt, the IRS processes annual information returns, collects excise tax and unrelated business income tax, conducts audits and provides guidance.

    a. Tax-exemption. A private foundation is tax exempt only if it receives a favorable determination letter from the Internal Revenue Service in response to a timely filed Form 1023. IRC Section 508 and Treasury Regulations Section 1.508-1 through 1.508-4.

    b. Form 990-PF. A private foundation must annually file Form 990-PF with the IRS. This information return includes financial statements, a summary of grant-making activity, lists of contributors and managers, and a calculation of the excise tax on net investment income. IRC Section 6033 and Treasury Regulations Sections 1.6033-2(a) and 1.6033-3(a). Returns must be made available for public inspection during a three-year period beginning on the last day prescribed for filing the return. IRC Section 6104(d).

    c. Form 4720. Any initial private foundation penalty excise tax is self-assessed on Form 4720. Treasury Regulation Section 1.6033-2(j).

    d. Form 990-T. Unrelated business income tax is calculated and paid with Form 990-T. IRC Section 6012 and Treasury Regulations Sections 1.6012-2(e) and 1.6012-3(a)(5). Returns must be made available for public inspection during a three-year period beginning on the last day prescribed for filing the return. IRC Section 6104(d).

6. The States. Potential requirements include registration and annual reporting, generally with the state attorney general; application for tax exemption; and annual corporate reports for non-profit corporate form foundations. All requirements must be complied with.

    a. Registration and the state attorneys general. Every state requires some form of charity registration, usually with the state Attorney General's office, which usually has jurisdiction over non-profits, including private foundations, organized or operating within its state. Most states require an annual filing as well (some solely to regulate charitable solicitation), and the Internal Revenue Code requires that a copy of the foundation's Form 990-PF be filed with the state. IRC Section 6033(c)(2).

b. <u>State corporate law requirements</u>. Foundations in corporate form may have additional filing requirements under the state non-profit corporation act. See B.1. above.

c. <u>State income tax requirements</u>. Receipt of a tax exemption from the IRS establishes the foundation's exemption under federal tax law, but does not necessarily do so under the governing state law(s). Some states will accept a copy of the federal tax exemption letter to establish state tax law exemption; other states have a separate exemption application procedure.

d. <u>State regulation of investments</u>. Modern state statutes apply fiduciary principles to those responsible for the investment of a charity's portfolio, including the portfolio of a private foundation portfolio. For private foundations that are trusts, the applicable statute is the Uniform Prudent Investor Act ("UPIA"), completed by the Uniform Law Commissioners in 1994 and subsequently adopted by 45 states and the District of Columbia. For private foundations that are corporations, the UPIA counterpart is the Uniform Prudent Investment of Institutional Funds Act ("UPMIFA"), completed by the Uniform Law Commissioners in 2006 and subsequently adopted by 43 states and the District of Columbia. Detailed information on UPIA and the states in which it has been enacted is available at www.nccusl.org. A separate website, www.upmifa.org, features information on UPMIFA.

e. <u>Other Governance</u>.

i. <u>Uniform Oversight of Charitable Assets Act.</u> A committee of the Uniform Law Commission is drafting this act, which, if adopted by the Commission, would replace the Uniform Supervision of Charitable Trustees Act, enacted in whole or in part in several states. The draft would:

a) Clarify and codify the common-law right of state attorneys general to supervise charitable assets located in their states;

b) Require every charity, including private foundations, to file a brief registration in the state in which it is organized, the state where it has its principal place of business and in any state in which it holds substantial assets;

c) Require charities to notify the state's attorney general prior to dissolution; and

d) Require persons filing suit against, or on behalf of, a charity to give notice to the attorney general, who would be authorized to intervene in the litigation and to participate in any settlement discussions.

The next step in the process is presentation of the draft to the assembled Uniform Law Commissioners.

ii. Uniform Supervision of Charitable Trustees Act. About a dozen states enacted some version of this Act, although a few subsequently repealed their enactment. Many of the states that adopted the Act limited its application to charitable trusts, thereby excluding nonprofit corporations from its registration requirements.

iii. California Nonprofit Integrity Act. California's 2004 Nonprofit Integrity Act applies to private foundations as well as public charities and applies to foundations that do business or hold property in California, not just those that are incorporated or domiciled in the state. However, the California Attorney General has clarified that making grants in California or maintaining accounts with California financial institutions do not subject an out-of-state corporation to the Act (it remains unclear whether the California Attorney General would seek to apply the Act to out-of-state charitable trusts based on their activities in California).

a) The Act applies only to charitable organizations with at least $2 million in annual revenue. This threshold excludes many private foundations from the Act's coverage.

b) Key aspects of the law include mandatory independent audits; a mandatory review of executive compensation (CEO and CFO) by the board or a board committee; and mandatory public disclosure of the audit report (but not including any management letter).

7. The sector. Over the past several years, there has been considerable work within the nonprofit community on voluntary self-regulation.

a. Panel on the Nonprofit Sector. Responding to a request from Senators Charles Grassley and Max Baucus, the then-chair and ranking member of the Senate Finance Committee, Independent Sector convened a working group called the Panel on the Nonprofit Sector. Working through an elaborate system of subcommittees, the Panel developed two key documents. The first made a series of recommendations to Congress concerning areas where federal legislation might be needed to address abuses within the sector. Congress subsequently enacted some of these recommendations in the Pension Protection Act of 2006. The second, *Principles for Good Governance and Ethical Practice: A Guide for Charities and Foundations*, released in October 2007, outlines 33 practices designed to support board members and staff leaders of charitable organizations as they work to improve their own operations. The 33 practices are organized under four subheadings: i) legal compliance and public disclosure; ii) effective governance; iii) strong financial oversight; and iv) responsible fundraising.

b. Council on Foundations. The Council's members have worked on three projects related to self-regulation, each taking a different approach.

i. Community foundations. Beginning in 1999, the Council's community foundation members began developing standards for what it means to be a community foundation. There are 41 National Standards for community foundations divided into six key areas: (i) mission, structure and governance; (ii) resource development; (iii) stewardship and accountability; (iv) grantmaking and community leadership; (v) donor relations; and (vi) communications. Compliance is based on a rigorous peer-review process and is valid for five years. Community foundations confirmed in compliance receive the right to use a special seal denoting their status and access to certain marketing and communications tools. See Community Foundations National Standards Board, www.cfstandards.org.

ii. Stewardship principles for family and independent foundations and for corporate grantmakers. The Council has in place stewardship principles for its major private foundation constituency groups. These principles include recommended practices and are backed by sample documents and policies. The Council's board has just taken the first step toward integrating these principles into a single document applicable to all grantmakers. See www.cof.org.

iii. Recommended best practices in managing foundation investments. The Council's Board also approved a board statement on investment management practices consisting of seven recommended best practices. In addition, the Board approved on an interim basis practice tips for each of the best practices. The Council will be seeking comment on these from Council members, but also welcomes outside comment as well; to contribute, contact Janne Gallagher.

III. Governance In The Spotlight

A. Introduction. Commencing with the United Way executive compensation scandal of 1995, continuing through intense media scrutiny—led by the Boston Globe—of organizations such as the Smithsonian and the Red Cross, amplified by highly publicized private foundation abuse cases such as Yeckel v. Abbott, involving the Dallas based King Foundation (citation and discussion below at page 29), and continuing further with today's undiminished interest in non-profit executive compensation and benefits, the spotlight has been clearly focused on non-profit behaviors in general and private foundation governance in particular. When perceived abuses are exposed in the non-profit community, they tend to be front page news. Coupled with this concern is the special treatment that non-profits in general and private foundations in particular enjoy through their income tax exemption. The latter has led to the growing movement, discussed below, calling for even more government oversight of private foundation grant-making activities.

B. Management.

1. Policy Considerations. To combat perceived abuses, many feel that private foundations should be required to be less insular, by imposing requirements to expand Board representation and by making private foundations subject to Sarbanes-Oxley like reporting, operating and governance requirements. The pre-emptive adoption of a Sarbanes-Oxley type governance structure may increase transparency and accountability, and lessen the risk of inadvertent violations of state law and the imposition of federal excise taxes.

a. Composition of the Board. Foundations should consider the use of outside directors (or trustees), unrelated to the donor or donor's family.

b. Committees of the Board. Similar to Board composition, foundations should consider forming and utilizing committees which are tasked with specific functions. This may allow for the development of more expertise and independence within the governance structure.

c. Delegation. Similar to the formation and use of committees, delegation of authority over specific functions may increase independence of the Board from the donor or donor's family. This is perhaps particularly true with respect to audit and other risk management functions.

d. Conflicts of interest. Boards should consider the adoption of a conflicts of interest policy, which will reduce the risk of violating self-dealing prohibitions for both state law purposes and federal excise tax purposes. If adopted, such a policy should be reviewed at least annually, and acknowledged by each board member and key employee. Particular attention should be placed on potential transaction between any such persons and the foundation, and the relationship that any such person has with any foundation grantees.

e. Training and succession. Foundations, regardless of governance structure, should provide for board or trustee succession, and provide a mechanism for training new directors or trustees.

2. Federal tax considerations. As discussed above, at II.C.2., the Tax Reform Act of 1969 imposed six excise taxes on private foundations, five of them being penalty taxes for errant behavior on

the part of the foundation and its managers. All of the penalty taxes were increased by the Pension Protection Act of 2006, which indicates a continuing, and perhaps growing, concern of Congress that inappropriate behaviors have continued by foundations and their managers. The most common area of concern is compensation and benefits of foundation board members (or trustees) and key employees, especially when related to the foundation's founders.

a. Self dealing. Perhaps the most important of the private foundation penalty taxes is found in IRC Section 4946, which prohibits virtually all dealings between a foundation's "disqualified persons" and the foundation. Unlike public charities, which allow such transactions on an "arm's-length basis," foundations are prohibited from entering into such transactions, period. Several important exceptions, which are discussed below, to the self-dealing prohibition exist, but these must be strictly and carefully adhered to, to avoid the imposition of this penalty tax.

i. Disqualified persons. Disqualified persons are broadly defined to include substantial contributors to the foundation, foundation managers, owners of substantial contributors, and family members of any of these people. The purpose of the definition is to include the founder and the founder's family (though siblings and nieces and nephews are excluded from the definition). IRC Section 4946(a) and Regulations thereunder.

ii. Covered transactions. Self dealing can include any direct or indirect sale, exchange, or leasing of property, lending or borrowing of money, furnishing of goods, services or facilities, compensation or virtually any other type of financial transaction between the foundation and any disqualified person. IRC Section 4941(c) and Regulations thereunder.

C. Investments.

1. Policy Considerations.

a. Prudence. In an investment context, prudence requires a comprehensive, principled and timely consideration of a number of complex factors, including the individual asset itself, the relationships among assets within the portfolio and general economic conditions—as well as the purposes and terms of the private foundation. Those charged with investment responsibility must have the necessary skill as well as sufficient time to devote to the task at hand. Implementation and review of a written investment policy that clearly states investment objectives, including risk and return parameters, is strongly recommended.

i. Relationship to the foundation's mission. Investments that directly further the foundation's mission may, if appropriate processes are in place, meet the required standards of prudence. See, e.g. Stetson and Kramer, Risk, Return and Social Impact: Demystifying the Law of Mission Investing by U.S. Foundations (FSG Social Impact Advisors, 2008), www.fsg-impact.org; Godeke, Mission-Related Investing (Rockefeller Philanthropy Advisors, 2008), www.rockpa.org

b. Diversification. Diversification is generally the outcome of a prudent investment policy.

2. State law considerations.

a. Uniform Prudent Investor Act. As noted above, the UPIA applies to those private foundations that are trusts. Section 2(c) lists representative factors for the trustee to consider in investing and managing trust assets: general economic conditions; inflation or deflation; tax consequences; the role of the investment within the overall trust portfolio; expected total return; other resources of the beneficiaries; needs for liquidity, income and preservation or appreciation of capital; and the asset’s special relationship, if any, to the purposes of the trust. Section 3 of the UPIA requires a trustee to diversify, with a limited exception for a trustee who “reasonably determines that because of special circumstances, the purposes of the trust are better served without diversifying.”

b. Uniform Prudent Management of Institutional Funds Act. A private foundation organized as a corporation is an “institution” within the scope of UPMIFA, i.e. it is a person, other than an individual, organized exclusively for charitable purposes and it is not a trust. UPMIFA, Section 1(4).

i. Investment provisions. UPMIFA includes investment provisions that are expressly intended to conform to those of the UPIA. UPMIFA, Prefatory Note; Fremont-Smith at 314. In particular, the factors to be considered by the institution when managing its investments mirror the list set forth in the UPIA. UPMIFA, Section 3; UPIA, Section 2. In addition, UPMIFA includes a diversification requirement, with the same limited exception set forth in the UPIA. UPMIFA, Section 3; UPIA, Section 3.

ii. Endowment provisions. To the extent that the foundation's governing document restricts the annual expenditure of part or all of its funds, those funds constitute an endowment to which the UPMIFA endowment expenditure rules apply. Under UPMIFA, private foundations must consider seven enumerated factors before making an expenditure from a restricted fund: (1) duration and preservation of the fund; (2) the purposes of the foundation and the fund; (3) general economic conditions; (4) effect of deflation and inflation: (5) the expected total return from income and the appreciation of investments; (6) other resources of the private foundation; and (7) the foundation's investment policy. UPMIFA, Section 4.

3. Federal tax considerations. Modern private foundations have a wide array of investment alternatives, some of which can have unintended tax consequences. Although private foundations are generally exempt from income tax, ill-considered investments can subject them to the unrelated business income tax as well as penalty excise taxes. Significantly, both the UPIA and UPMIFA cite tax consequences as one factor to consider when making an investment decision.

a. Unrelated business income tax.

i. Unrelated business taxable income from partnerships. For a typical private foundation, income from a partnership investment is the most common source of unrelated business taxable income (“UBTI”). The partnership may be publicly traded—or a private offering such as private equity fund or private hedge fund. The partnership income may come from operating a business or from debt-financed property—but in either situation, it is almost always unrelated to its partner's charitable purpose. As a result, the private foundation must take it into account when computing its unrelated business taxable income. IRC Section 512(c).

A careful reading of the tax section of the private offering memorandum—or a review of prior year Schedules K-1—will alert the astute investment manager to the potential presence of UBTI. (UBTI must be reported on the Schedule K-1 issued by a partnership to a tax-exempt entity.)

Example: Private Foundation invests in Hedge Fund, which is organized as a limited partnership. Hedge Fund has substantial debt-financed income, all of which is unrelated to Private Foundation's charitable purpose. The amount of UBTI allocable to Private Foundation will be reported on the Schedule K-1 issued by Hedge Fund to Private Foundation. Private Foundation must take this UBTI into account on its Form 990-T.

Example: Private Foundation invests in Investment Partnership, which is organized as a limited partnership. All of the investment income earned by Investment Partnership is from dividends, interest, and capital gains; none of the income is from debt-financed property. No UBTI will be reported on the Schedule K-1 issued by Investment Partnership to Private Foundation.

ii. Unrelated business taxable income from S corporations. Less commonly, a private foundation will receive or invest in S corporation stock. All income allocated from an S corporation, including from the sale of S corporation stock, is deemed to be UBTI. IRC Section 512(e).

b. Taxes on self dealing. Self-dealing is an issue if the private foundation buys securities or other investments from a disqualified person—or invests together with disqualified persons, such as family members, typically in an investment partnership.

Example: Private Foundation, which has substantial assets, makes a substantial contribution to a Family Limited Partnership; the other partners are family members, all of whom are disqualified persons. The Family Limited Partnership gains access to certain types of investments only because of the presence of the Private Foundation as a partner. See PLRs 200611034, 200420029, 200148069.

c. Tax on jeopardizing investments. As noted above, the tax on jeopardizing investments under IRC Section 4944 focuses on the "manner" of investment. The tax is unlikely to be imposed if foundation managers exercise "ordinary business care and prudence." Significantly, there are no per se jeopardizing investments. Treasury Regulations Section 53.4944-1(a)(2).

Example: Ninety percent of the portfolio of Private Foundation was invested with Bernie Madoff.

Example: After a very cursory review, the foundation managers invest 50 percent of Private Foundation's portfolio in stocks of companies with no prior earnings record.

d. Excess business holdings. Most typically, a private foundation acquires excess business holdings by gift or bequest, not by investment. Very large private foundations may encounter an excess business holdings issue if they hold (alone or with their disqualified persons) a large interest in a hedge fund or private equity fund.

Example: Private foundation holds a 10 percent interest in Family Limited Partnership, which in turn holds a 30 percent interest in Venture Capital Fund.

D. Compensation and reimbursement.

1. Policy considerations. Foundations are funded with "before tax" dollars and it is reasonable that the public has some interest in the activities of the foundation. Further, foundations exist to support charitable endeavors, and funds expended by the foundation beyond its reasonable needs, for compensation and benefits, reduce the amounts available for public charity. Excessive compensation (including reimbursement of lavish expenses) is the

most common issue raised in the media and in litigation involving foundations. See, for example, the recent case of *Yeckel v. Abbott*, Ct. of App. TX, Third District, No. 03-04-00713-CV (6/4/09), affirming the jury verdict awarding over $5 million in actual damages for payments of excessive compensation to the foundation founders' grandson and one other [former] employee. At the time that Yeckel's sister "blew the whistle" to the Texas Attorney General, the foundation was paying more in salary and benefits than in charitable distributions. [The Court of Appeals did overrule the jury's award of over $10 million in punitive damages.] It is cases such as this that lead to proposals to prohibit the payment of any compensation to family members or other disqualified persons for services performed for the foundation.

a. <u>Transparency</u>. Compensation to the top five officers and directors must be reported on Form 990PF.

b. <u>Tax rules</u>. IRC Section 4941 prohibits acts of self-dealing between a foundation and its disqualified persons. Compensation, including reimbursement of expenses, to a disqualified person is specifically prohibited, except for personal services which are reasonable and necessary to carrying out the exempt purposes of the private foundation. IRC Section 4941(d)(2)(E).

   i. <u>Reasonable and necessary</u>. The amount that may be paid to a disqualified person must not be "excessive," and must bear a reasonable relation to that person's job aptitude, the duties performed, and perhaps most important, what would be paid to an unrelated person to perform the same duties.

   ii. <u>Personal services</u>. Compensation may be paid to disqualified persons only for personal services that are necessary for the foundation to carry out its charitable purposes. The IRS has taken a strict view as to the types of services permitted, and views legal, investment management and banking services as the only permitted personal services for which reasonable compensation may be paid to a disqualified person.

   iii. <u>Other self-dealing</u>.

      a) <u>Shared resources</u>. Private foundations often share resources with their disqualified persons. A family foundation may share space and staff with a family office. Companies regularly provide space and staff to the company foundation. When this is the case, the foundation must carefully observe the limits imposed by the prohibition on self dealing.

The foundation <u>may not</u> pay rent to the disqualified person, even if the rent is substantially below market. The prohibition on self-dealing prohibits a disqualified person's leasing of property to the foundation unless the lease is without charge. IRC Section 4941(d)(1)(A). If the disqualified person is unwilling to provide space for free, the foundation must rent space on the market from someone who is not a disqualified person.

The Foundation <u>may not</u> reimburse the disqualified person for its use of computers, photocopiers, telephones and other office equipment and supplies. The self-dealing rule prohibits the furnishing of goods, services, or facilities between a private foundation and a disqualified person, IRC Section 4941(d)(1)(C), unless the disqualified person provides the goods or services free, IRC Section 4941(d)(2)(C). The foundation may purchase its own equipment and office supplies from persons who are not disqualified and, where this is feasible, may contract directly with utility companies for telephone and similar services.

The Foundation <u>may</u> reimburse the disqualified person for personal services provided to the foundation by an employee of the disqualified person. This falls within the exception to self-dealing, noted above, that permits a private foundation to pay compensation to a disqualified person who provides services to it.

b) <u>Pledges and tickets</u>. Pledges and tickets are a frequent subject of inquiries to the legal staff at the Council on Foundations.

i) Pledges. A private foundation may not pay a pledge made by one of its disqualified persons if the pledge was legally binding on the person that made it. Because the payment would relieve a disqualified person of a legal obligation, it is considered a transfer of the foundation's assets to the disqualified person. Treas. Reg. § 53.4941(d)-2(f)(1). Whether a pledge is enforceable by the charity that received it is a question of state law.

ii) Tickets. Can a private foundation purchase tickets to a charity event and allow a disqualified person to use them? In general, this is an act of self-dealing unless either: i) the tickets are considered as compensation to the disqualified person and the total value, taking into account other compensation paid, if any, does not cause the person's compensation to be unreasonable; or (ii) attending the event is reasonable and necessary to the disqualified person's performance of his job with the foundation. IRS guidance is sparse and consists mainly of a few PLRs. This leaves unanswered a number of important questions including whether, if the disqualified person's attendance is necessary for her position at the foundation, can her spouse also attend? What about her children? Is showing the foundation's support for a grantee a sufficient reason to allow use of a foundation- paid ticket? If the foundation has made a grant to support a series of concerts, can a disqualified person attend every performance in the series in order to evaluate the success of the grant?

E. Grant-making.

1. Policy considerations. By focusing on key policy considerations, a private foundation can more readily align its grant-making with its mission.

a. One year vs. multi-year.

i. One year. A one-year grant gives the private foundation an opportunity to build a relationship with a grant recipient, without making a long-term commitment.

ii. Multi-year. From the recipient's standpoint, a multi-year grant has distinct advantages in terms of planning, budgeting, and staffing. A private foundation that wants to make a long-term impact should consider multi-year grants. Multi-year commitments do require particular care in drafting the agreement. Does the funding agreement create a legal obligation to make payments in the future years or is such payment conditional on the grantee meeting certain targets? Does the grantmaker want to reserve the right to withdraw from the agreement if economic circumstances change? The sharp downtown in the economy at the end of 2008 left some grantmakers scrambling to find the resources to meet their multi-year commitments and unable to fund new initiatives.

b. Grant alternatives.

i. Set-asides. In limited circumstances, the tax rules (see below) permit a private foundation to "set-aside" funds for a specific long-term project.

ii. Program related investments. In certain circumstances, an investment, loan or loan guarantee may serve a private foundation's charitable purposes better than a grant. For example, loans facilitate a "recycling" of scarce grant monies, of particular importance in an economic downturn. The tax rules (see below) may permit such grant alternatives to be treated as qualifying distributions for purposes of IRC Section 4942.

iii. Technical assistance. Some foundations supplement their grants with technical assistance that may range from encouraging improvements in grantees' financial administration to strengthening their governance.

iv. Direct program activities. It doesn't have to be all about grants. Private foundations can make direct expenditures for charitable purposes and some do so regularly. A private foundation does not have to be classified as a private operating foundation in order to run a program and in many cases there is no reason to seek that status. One drawback for private non-operating foundations is that their expenditures for direct program activities must be reported as administrative expenses on Form 990-PF and this can lead someone reviewing the form to conclude, incorrectly, that the foundation is spending too much on overhead.

c. Responsiveness. During the long history of private foundations, some scholarly commentators and community leaders have argued that private foundations should be more responsive to basic needs. See, e.g. National Committee for Responsive Philanthropy, "Criteria for Philanthropy at Its Best," which recommends a minimum 50 percent grant commitment "to benefit lower-income communities, communities of color and other marginalized groups." www.ncrp.org/paib. Others argue that private foundations should continue to support diverse missions that contribute to community betterment in a variety of ways. For a debate on these issues, see http://www.cofinteract.org/taijournal/index.php/2009/03/31/mandates-or-leadership-imperative-the-ncrp-debate-aaron-dorfman-antonia-hernandez-and-paul-brest/.

d. Geographic limitations. Some corporate and family foundations choose to limit their grant making to their own local communities. Others make grants only for the benefit of a single foreign country, e.g. for the advancement of women in Turkey.

e. Grant review and evaluation. Private foundations are not under a legal obligation to evaluate the success of programs they fund. However, evaluation is a key aspect of grantmaking. Although evaluations typically do not occur until a grant is nearing conclusion or has concluded, to be meaningful they must be planned for before the grant is made. Both grantmaker and grantee should be in agreement from the outset on goals for the project that are measurable, the data that will be collected to do the measurement, and how the results will be analyzed. Many grantmakers conduct process evaluations – they expect reports from grantees that document what the grantee did with the grant funds and measure such factors as how many people were served, for how long, and at what cost. Evaluating whether a grant-funded program produced real change is much more difficult and can be significantly more expensive. However, in the absence of such evaluations, grantmakers may waste money supporting programs that do not work. Setterberg & Wilbur, *The Complete Guide to Grantmaking Basics* (Council on Foundations 2008) includes a chapter on evaluation. More extensive resources are available through Grantmakers for Effective Organizations, www.geofunders.org/home.aspx.

2. Tax rules.

a. Qualifying distributions. Private foundations are required to make minimum distributions for charitable purposes each year. Technically, this requirement is that qualifying distributions (i) be made for charitable purposes; (ii) of at least a minimum amount; and (iii) reported to the IRS each year.

i. Charitable purposes. Distributions are most commonly made to domestic charitable organizations recognized as such by the IRS. This includes public charities, certain governmental entities so long as for charitable purposes, supporting organizations (excluding non-functionally related type III supporting organization unless expenditure responsibility is performed), private operating foundations, other non-operating private foundations under specified circumstances and, under specified circumstances, individuals for charitable purposes.

ii. Minimum amount. Foundations must distribute a minimum amount each year, or the penalty excise tax for failure to distribute will be assessed on the shortfall. The amount is commonly referred to as 5% of investment assets, though the actual amount is subject to a more complicated formula that is calculated each year on the foundation's Form 990PF.

iii. <u>Annual report</u>. Both the amount, and the recipients, of the foundation's grants must be reported each year to the IRS, which is done as part of the Form 990PF.

b. <u>Taxable expenditures</u>. IRC Section 4945 prohibits the use of foundation grants for certain lobbying or political purposes, and grants for non-charitable purposes. The Section further defines procedures for grants made to individuals and to organizations other than public charities.

i. <u>Lobbying and propaganda</u>. IRC Section 501(c)(3) prohibits any charitable organization, including private foundations, from participating in any political campaign. IRC Section 4945 further specifically prohibits private foundations from making any direct or indirect payments to influence the outcome of any specific public election, or to carry out any voter registration drive except under certain circumstances specifically allowed in Section 4945(f).

a) Although there is a specific prohibition on participating in political campaigns and voter registration drives, and lobbying. foundations may engage in certain activities under specified terms and conditions

b) Foundations may engage in nonpartisan analysis, study, or research, which lead to a balanced, unbiased point of view. Regulations Section 53.4945-2(d). Foundations may also provide technical advice or assistance to governmental entities in response to a written request by such entity. Regulation Section 53.4945-2(d)(1)(vii). Foundations may also engage in "self-defense" lobbying, with any legislative body that is considering legislation which could affect the existence of the foundation, its powers and duties, its tax-exempt status, or deductibility of contributions to the foundation. Finally, a foundation may expend funds for examinations and discussions of broad social, economic and similar problems, such as pollution, so long as such efforts are not directed to specific legislation. It should be noted that these prohibitions are directed to the foundation, and not to opinions expressed by its officials.

ii. Expenditure responsibility. Although most grants are made to qualified, domestic charitable organizations, private foundations are permitted to make qualifying distributions to individuals and to other organizations provided the foundation conducts "expenditure responsibility," a tax code due diligence procedure. Generally, expenditure responsibility involves a pre-grant inquiry, a written grant agreement, and reporting, both by the grantee back to the foundation, and by the foundation to the IRS. Expenditure responsibility should also be considered by foundations as a best practice even where not required by the IRC.

a) Supporting organizations. To combat perceived abuses, the Pension Protection Act of 2006 imposed a number of new requirements on supporting organizations. Payments to type I, type II, or type III functionally integrated supporting organizations will count as qualifying distributions, unless a disqualified person with respect to the foundation controls the supporting organization, in which case, expenditure responsibility must be performed. Payments may still be made to type III non-functionally integrated supporting organizations, but such payments will be deemed to be taxable expenditures unless expenditure responsibility is performed by the foundation. Further, even if the foundation performs expenditure responsibility, any such payments will not count toward the calculation of the minimum required distribution. See Regulation Section 53.4945-5(a)(4).

b) Private Foundations. As noted above, there are two types of private foundations. Payments made to private operating foundations do not require expenditure responsibility. Payments made to non-operating, or grantmaking, private foundations do not require expenditure responsibility, but must meet certain other requirements, similar to expenditure responsibility, to be considered qualified. The receiving foundation must in turn expend the funds received by the end of the tax year following the year of receipt, that distribution must be in addition to the receiving foundation's other required minimum distribution, and the distributing (or donor) private foundation must keep sufficient records to reflect that the receiving foundation has made its distribution within the required time period.

3. Special situations.

a. Scholarships and other grants to individuals. Foundations may make grants to individuals for charitable purposes, provided the foundation complies with record-keeping and reporting requirements. There are three categories of grants that qualify:

i. Poverty or temporary distress. Foundations may distribute money directly to an indigent for basic living needs or to people who are in crisis. Examples of these types of distributions could include providing money to someone to repair their home after a tornado or food to a homeless person. These distributions do not require pre-approval from the IRS but must be extensively documented.

ii. Furtherance of charitable activities. Distributions may be made to individuals to conduct activities in furtherance of charitable activities. This might include, for example, payments of salary or operating costs for research for a charitable purpose. Similar to the previous category, these distributions do not require pre-approval from the IRS, but do require extensive record keeping.

iii. Scholarships. Unlike the first two areas of grants to individuals, foundation grants for scholarships require pre-approval by the IRS.

a. The general rule is that foundations may make scholarship grants to students for study or travel so long as the awards are made in accordance with objective and nondiscriminatory standards. These scholarship policies and procedures must be approved by the IRS prior to any scholarships actually being granted. This pre-approval may be part of the foundation's initial application for exemption. If the foundation determines to award scholarships after the exemption has already been granted, then a separate application must be made to obtain approval for the scholarship program.

b. The administrative details of operating a scholarship program may be even more daunting than the pre-approval process. This involves, for example, setting up a process to obtain applications, evaluating and selecting candidates, and monitoring their ongoing progress.

c. To assist in, or perhaps to avoid, the many administrative complexities involved in running a scholarship program, foundations may instead collaborate with one or more schools to operate the scholarship program, or to conduct their program with the assistance of a community foundation or other service provider who actually administers the scholarship process.

b. <u>Program-related investments</u>. "Program-related investments," including both below-market loans and certain types of equity interests, are another way for a private foundation to achieve its charitable purposes. If properly structured, they will be treated as "qualifying distributions" and, in addition, will not be treated as "jeopardizing investments." They (i) must have a charitable purpose as their primary purpose; (ii) must not have a significant purpose of producing appreciation or investment income; and (iii) must not be used by the recipient for lobbying. IRC Sections 4942(g)(1) and 4944(c); Treasury Regulations Sections 53.4942(a)-3(a)(2)(i) and 53.4944-3. See also ABA Section of Taxation Comments on Proposed Additional

Examples on Program-Related Investments, March 3, 2010, www.abanet.org/tax/pubpolicy.

i. <u>L3Cs</u>. At least six states have enacted low-profit limited liability company (L3C) statutes. Not themselves tax-exempt, L3Cs are a type of limited liability company, with special features designed to facilitate program-related investment, e.g. the state enabling statute typically requires articles of incorporation to prohibit lobbying activity. Given the ability to use regular LLCs for the same purposes (and the failure of Congress to grant L3Cs preferred status under the excise tax provisions), some characterize this new vehicle as a solution waiting for a problem. See Resolution of the Committee on Limited Liability Companies, Partnerships and Unincorporated Entities, Section of Business Law, American Bar Association.

d. <u>Foreign grant making</u>. Private foundations that make grants to foreign charities should pay special attention to the private foundation excise tax rules of IRC Sections 4942 and 4945. For lesser-known charities, also consider review of the terrorist list compiled by the U.S. Treasury's Office of Foreign Assets Control, posted at www.ustreas.gov/offices/enforcement/ofac/sdn.

i. <u>Ensuring grants to foreign charities are "qualifying distributions."</u> If the grant is made through a U.S.-organized public charity or private operating foundation—or if the foreign charity itself has received a determination that it is a public charity or private operating foundation—it will be a "qualifying distribution" described in IRC Section 4942(g). Some foreign charities have established qualified U.S. "friends of" affiliates in order to facilitate such grants.

If there is no such related U.S. organization and the foreign charity has not obtained status as a public charity or a private operating foundation, then further documentation, which may include an affidavit or opinion of counsel, is required. Treasury Regulations Section 53.4942(a)-3(a)(6) and Rev. Proc. 92-94, 1992-2 C.B. 507.

ii. Ensuring grants to foreign charities are not taxable expenditures. If the foreign grantee has not obtained status as a public charity, the private foundation must take steps (including the exercise of expenditure responsibility), to ensure that the grant will not be treated as a taxable expenditure under IRC Section 4945. Treasury Regulations Sections 53.4945-5(a)(5), 53.4945-5(b)(5), 53.4945-6(c)(2)(ii) and Rev. Proc. 92-94, 1992-2 C.B. 507.

F. Termination.

1. Policy considerations.

a. Perpetual vs. spend-down? Donors and /or drafters often assume that a private foundation will be perpetual. Although generally permitted to have perpetual life under state law, private foundations may also have a limited term or, to the same effect, mandate a measured spend-down of their assets. Limited duration is appropriate for donors who do not intend the foundation to continue beyond their lifetimes—or who want the foundation's assets to have an immediate impact.

b. Split-up. As governance of a perpetual family foundation moves from one generation to the next, family members may be unable to agree on mission, grants or investments. If the private foundation is substantial, one solution is to transfer its assets to two or more private foundations (either existing or newly created), each controlled by one of the warring family factions. (Implementation of well-developed governance policies may avoid this result.)

2. Tax considerations.

a. Termination of private foundation status by transfer of assets to certain public charities. As noted above at C.2., involuntary termination of private foundation status under IRC Section 507(a)(2) can result in the imposition of the confiscatory termination tax described in IRC Section 507(c). However, the statute does provide alternatives to this draconian result. The simplest tax-friendly exit strategy is described in IRC Section 507(b)(1)(A): a complete distribution to one or more public charities described in IRC Section 509(a)(1), all of which have been in existence (and so described) for a continuous period of at least 60 months before the distribution. IRC Section 507(b)(1)(A); Treasury Regulations Section 1.507-2; Rev. Rul. 2003-13, 2003-1 C.B. 305; Publication 4779.

b. Private foundation split-up. In the split-up situation described above at 1.b., the same person or persons "effectively control," directly or indirectly, the transferor foundation and the transferee foundations. If, at least one day after the liquidating transfers, the transferor foundation gives the appropriate notice of voluntary termination to the IRS, it will pay no termination tax because it will have no assets. (The termination tax is imposed on the lower of the foundation's net asset value or its aggregate tax benefits.) Under the relevant regulations, the successor foundations succeed to various tax attributes and tax obligations of the transferor foundation. IRC Section 507(a)(2), 507(c), 507 (b)(2); Treasury Regulations Section 1.507-3(a)(9); Rev. Rul. 2002-28, 2002-1 C.B. 941; Publication 4779.

3. Special situation.

a. Conversion to a donor advised fund. A private foundation "converts" to a donor advised fund by transferring all of its assets to the sponsoring organization of the fund under the fund's implementing agreement. If the sponsoring organization is a public charity described in IRC Section 509(a)(1), and meets the relevant five-year requirement, the transaction will fall within the ambit of IRC Section 507(b)(1)(A). As a result, no termination tax will be imposed under IRC Section 507(c) and no notice to the IRS will be required.

G. Conclusion: Policies and Procedures. It may be helpful to think of foundation governance at two levels, first, what is the minimum required, and second, what are best practices.

1. Minimum standards of conduct. A combination of state law requirements as to fiduciary behavior, and the federal excise penalty taxes set the minimum acceptable levels of behavior for foundation directors, trustees, officers and key employees. The consequences for failing to adhere to these minimum levels of behavior include federal excise taxes imposed on both the foundation and its managers, and possible legal action for damages brought by the governing state attorney general.

2. Governance best practices. Complying with the minimum levels of conduct should not be viewed as the end of one's duties in managing a foundation's activities. Foundation governance should go beyond that, to incorporate as many of the "best practices" suggested throughout this outline as appropriate to promote integrity, vitality and well-considered accomplishment.

IV. Additional Resources.

A. The reader is encouraged to consult the following additional resources. Please note that this list is suggestive of several resources that the authors of this outline know to be particularly helpful, and not exhaustive of all available resources.

B. Books

Fremont-Smith, Marion R., *Governing NonProfit Organizations* (Harvard University Press, 2004).

McCoy, Jerry J. and Miree, Kathryn W., *Family Foundation Handbook* (CCH Incorporated, 2006).

Setterberg, Fred and Wilbur, Colburn S., *The Complete Guide to Grantmaking Basics* (Council on Foundations 2008),

C. Monographs

Godeke, Steven, with Bauer, Doug, *Mission-Related Investing* (Rockefeller Philanthropy Advisors, 2008), www.rockpa.org

Stetson, Anne and Kramer, Mark, *Risk, Return and Social Impact: Demystifying the Law of Mission Investing by U.S. Foundations* (FSG Social Impact Advisors, 2008), www.fsg-impact.org

D. Websites

Association of Small Foundations, www.smallfoundations.org

Community Foundations National Standards Board, www/cfstandards.org

Council on Foundations, www.cof.org

Foundation Center, www.foundationcenter.org

GEO (Grantmakers for Effective Organizations), www.geofunders.org/home.aspx.

Grantcraft, a project of the Ford Foundation, www.grantcraft.org

National Conference of Commissioners on Uniform State Laws, www.nccusl.org.

Panel on the Nonprofit Sector, www.nonprofitpanel.org

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