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AND ASSOCIATES

## Legal Issues for Grantmaking Professionals

*March 7, 2013 – Delaware Valley Grantmakers, SGP series*

## ▶ GOAL

# REVIEW CRITICAL LEGAL ISSUES FOR GRANTMAKING PROFESSIONALS—FROM EXTERNAL TO INTERNAL

**Discuss current, changing environment for charities**

**Explain charitable status, liability exposure, and limited protection**

**Review fiduciary responsibilities, changes in the law**

**Highlight foundation-specific issues**

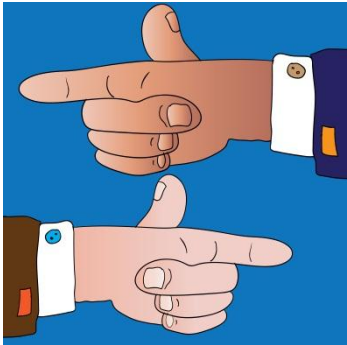
**Provide recommendations**

**Case study!**



# ▶ CHANGING ENVIRONMENT

CHARITIES ARE HIGHLY REGULATED AND UNDER INCREASING SCRUTINY



## U.S. SENATE FINANCE COMMITTEE

- Pension Protection Act

## U.S. HOUSE WAYS AND MEANS COMMITTEE

- Focusing on exempt hospitals

## IRS

- Audits, initiatives on politicking, compensation, UBI

## ATTORNEYS GENERAL

- Enforcement of solicitation laws, national cooperation

## MEDIA

- Constant scrutiny and scandals



## ▶ CHANGING ENVIRONMENT (CONT.)

CHARITIES ARE HIGHLY REGULATED AND UNDER INCREASING SCRUTINY

### 9/11

- Charities used to channel terrorist funds
- Treasury Department Guidelines

### ENRON – SARBANES-OXLEY ACT

- Whistleblower, Document Retention Policies (required)
- Audit Committee, Financial Statement Certification (recommended)

### EVOLVING BEST PRACTICES

- Independent Sector “Code of Ethics”
- Panel on the Nonprofit Section “Principles for Good Governance”



# ▶ CHANGING ENVIRONMENT (CONT.)

FEDERAL, STATE, AND LOCAL REGULATORY STRUCTURES ARE SIGNIFICANT AND GROWING

## FEDERAL

- Pension Protection Act
- Treasury Department - legislating by form

## STATE

- Solicitation Act, real estate, sales tax changes
- Lobbying regulation

## LOCAL

- Lobbying regulation
- Real estate tax challenges
- Gaming



# ► BENEFITS AND LIMITS OF EXEMPT STATUS

## EXEMPT STATUS HAS SIGNIFICANT, BUT LIMITED BENEFITS



### BENEFITS OF EXEMPT STATUS

- Exemption from Federal and state income tax, Federal unemployment tax, and *possibly* real estate and sales tax
- Ability to receive tax-deductible charitable grants and contributions, Federal grants and loans, and tax-exempt bond proceeds
- Public perception – “doing good”
- Preferential postal rates

### LIMITS OF EXEMPT STATUS

- Unrelated business income tax
- Increasingly, subject to real property and sales tax
- Social security, wage, and unemployment taxes



# ▶ DISADVANTAGES OF EXEMPT STATUS

## EXEMPT STATUS HAS DISADVANTAGES



### DISADVANTAGES OF EXEMPT STATUS

- Costs of obtaining and maintaining status
- Highly regulated
- Extensive limitations on operations, contracting, compensation, and solicitation
- Restrictions on investments, fund management, distribution requirements, and excise taxes
- Public access to, and disclosure of, documents and information



# CHARITABLE ORGANIZATION AND OPERATIONS

AN EXEMPT ORGANIZATION MUST BE ORGANIZED AND OPERATED FOR EXEMPT PURPOSES, AND CERTAIN ACTIVITIES ARE RESTRICTED OR PROHIBITED

## ORGANIZATION AND OPERATION FOR EXEMPT PURPOSES

- Articles, Bylaws
- Operation consistent with and in furtherance of mission

## RESTRICTED ACTIVITY

- Lobbying
- Private benefit
- Unrelated business





# ▶ OPERATING PROHIBITIONS

AN EXEMPT ORGANIZATION MUST BE ORGANIZED AND OPERATED FOR EXEMPT PURPOSES, AND CERTAIN ACTIVITIES ARE PROHIBITED



## PROHIBITED ACTIVITY

- Politicking
  - Different from lobbying
  - Prohibited for both public charities and private foundations
- Private inurement
  - Prohibited for all charitable organizations
  - Penalties different from public charities vs. private foundations



# ► FIDUCIARY DUTIES

THE BOARD OF DIRECTORS IS RESPONSIBLE FOR GOVERNANCE, OVERSEEING THE OPERATIONS OF THE ORGANIZATION IN FURTHERANCE OF ITS CHARITABLE MISSION

## POSITIVE FIDUCIARY OBLIGATIONS

- Reasonable person standard
- Operation consistent with and in furtherance of mission
- Fiduciary obligations
  - Duty of care
  - Duty of loyalty
  - Duty of obedience

## NEGATIVE, PROHIBITED CONDUCT

- Conflicts of interest – state and Federal law
- Public charities – excess benefit, Intermediate Sanctions
- Private foundations – self-dealing, excise taxes



## ► FIDUCIARY DUTIES (CONT.)

UNDER THE PA NONPROFIT CORPORATION LAW, A DIRECTOR HAS DUTIES OF CARE, LOYALTY AND OBEDIENCE

### DUTY OF CARE

- Director must serve in good faith, in a manner reasonably believed to be in the best interests of the corporation and with such care, including reasonable inquiry, skill and diligence, as a person of ordinary prudence would use under similar circumstances.

### JUSTIFIABLE RELIANCE

- Directors are entitled to rely in good faith on information, opinions, reports, or statements, including financial statements and other financial data, prepared or presented by officers, employees, lawyers, accountants, Board committees.



## ► FIDUCIARY DUTIES (CONT.)

THE DUTIES OF LOYALTY AND OBEDIENCE ARE BOTH *NEGATIVE* AND *POSITIVE*

### DUTY OF LOYALTY

- Undivided loyalty to the mission and basic well-being of the organization
  - Prohibited from using position to further conflicting interests
  - Prohibited from engaging in self-dealing

### DUTY OF OBEDIENCE

- Take action to ensure that the organization operates to further its mission in compliance with legal requirements
  - Federal tax laws and regulations
  - Legislative/regulatory developments
  - State laws and regulations governing nonprofits and solicitation of charitable contributions



# ▶ LIABILITY EXPOSURE - CHARITY

CHARITIES ARE NOT SHIELDED FROM LIABILITY

## LIABILITY IS FOUND WHERE:

- Duty: nonprofit had duty of care with respect to those harmed
- Breach: nonprofit breached its duty
- Injury: harm actually occurred
- Cause: breach of duty of care was proximate cause of harm

## MOST LIKELY LAWSUITS FOR CHARITIES:

- Employment disputes
- Automobile accidents
- Harm to staff, volunteers, and clients
- Intellectual property



# ▶ LIABILITY EXPOSURE - CHARITY

DIRECTORS SHOULD BE MOST CONCERNED WITH UBTI AND POSSIBLE LOSS OF TAX-EXEMPTION

## INCREASED UBTI

- Contributions are decreasing
- Charities starting new, earned income social ventures
- Failure to distinguish between related and unrelated activity can result in UBTI

## OTHER JEOPARDY TO EXEMPTION

- Political activity, lobbying, private benefit and inurement will threaten your charity's exempt status
- Conflicts of interest, international grantmaking, or excessive compensation can make your charity an audit target
- Loss of exemption leads to damaged donor relations, taxable bonds, and inability to receive charitable contributions



# ▶ LIABILITY EXPOSURE - DIRECTORS

DIRECTORS CAN BE PERSONALLY LIABLE FOR CRIMINAL AND TAX LIABILITIES RELATED TO THEIR ACTIONS AS DIRECTORS

## PERSONAL LIABILITY OF DIRECTORS

- Criminal and tax liability (intermediate sanctions, employment)
- Piercing of “corporate veil” in cases of serious breaches of fiduciary obligations (self-dealing, willful misconduct, or recklessness)

## PROTECTION - CHARITIES

- Charitable immunity abolished
- Lawful operations, good governance, insurance and indemnification

## PROTECTION – DIRECTORS, OFFICERS

- State, Federal statutory protections
- Insurance, indemnification



# ► FIDUCIARY DUTY - RECENT DEVELOPMENTS

REGULATORS HAVE INCREASED FOCUS ON FIDUCIARY DUTIES AND INVESTMENT PRACTICES POST-MADOFF

## FEDERAL FOCUS

- Proposed Federal prudent investor rule, IRS concern regarding jeopardy investments

## STATE INVESTIGATIONS

- State Attorneys General investigate directors and officers for violation of fiduciary duties

## EVOLVING BEST PRACTICES

- Closer monitoring of investment decisions and statements
- Adoption or review of Investment and Conflict of Interest Policies

## RECENT CASE LAW

- *In Re: Lemington Home for the Aged*





# ▶ PA – ENDOWMENT INVESTMENT AND SPENDING

IN PENNSYLVANIA, ENDOWMENT MANAGEMENT IS GOVERNED BY THE NONPROFIT CORPORATION LAW AND PRUDENT INVESTOR RULE

## **PENNSYLVANIA NONPROFIT CORPORATION LAW ("ACT 141")**

- Governs distribution of income from endowment
- Board may elect "total return" investment and distribution policy
- Board sets percentage (2% to 7%) of income distribution each year

## **PRUDENT INVESTOR RULE**

- Governs permitted investments
- Board invests and manages endowment assets as a prudent investor would
- Permitted investments include every kind of property and investment, including mutual funds



# ▶ PRIVATE FOUNDATION CLASSIFICATION

CHARITABLE ORGANIZATIONS CLASSIFIED AS PRIVATE FOUNDATIONS ARE MORE HEAVILY REGULATED

## PUBLIC CHARITIES

- IRC §§ 509(a)(1), (2), (3)
- Public charity support test or supporting organization status

## PRIVATE FOUNDATIONS

- Subject to stricter regulation than public charities
- Non-operating private foundation
- Operating private foundation
- Exempt operating private foundation



# ▶ PRIVATE FOUNDATIONS – DISTRIBUTION REQUIREMENT

PRIVATE FOUNDATIONS ARE REQUIRED TO DISTRIBUTE 5% OF THEIR INVESTMENT ASSETS ANNUALLY

## QUALIFYING DISTRIBUTIONS

- Five (5) percent of the average market value of investment assets each year, in support of exempt purposes
- Failure to make qualifying distributions subjects a private foundation to excise tax on undistributed amount

## CALCULATION OF DISTRIBUTION AMOUNT

- Investment assets include stocks, bonds, real estate, and other assets
- Assets held for the foundation's charitable purposes are excluded from the calculation



# ▶ PRIVATE FOUNDATIONS – EXCISE TAXES

PRIVATE FOUNDATIONS ARE SUBJECT TO EXCISE TAX ON INVESTMENT INCOME AND EXCESS BUSINESS HOLDINGS



## NET INVESTMENT INCOME TAX

- Two (2) percent tax on net investment income each year, including capital gains but excluding unrelated business income
- Tax may be reduced to one (1) percent if qualifying distributions exceed a set amount

## EXCESS BUSINESS HOLDINGS

- Combined holdings of a private foundation and its disqualified persons may not exceed 20%



# ▶ PRIVATE FOUNDATIONS – EXCISE TAXES (CONT.)

PRIVATE FOUNDATIONS AND FOUNDATION “DISQUALIFIED PERSONS” ARE SUBJECT TO EXCISE TAXES FOR SELF-DEALING

## SELF-DEALING

- Financial transactions between a private foundation and its officers, directors, and substantial contributors (including family members of such individuals) known as “disqualified persons” (“DQP”)

## TRANSACTIONS TO AVOID

- Sale, lease, or exchange of property
- Loan
- Furnishing of goods, services, or facilities to DQP for a fee, *unless for fair market value*
- Payment of compensation or expenses for DQP
- Transfer to or use by a DQP of foundation income or assets



# ▶ PRIVATE FOUNDATIONS – EXCISE TAXES (CONT.)

PRIVATE FOUNDATIONS AND FOUNDATION MANAGERS ARE SUBJECT TO EXCISE TAX ON TAXABLE EXPENDITURES

## TAXABLE EXPENDITURES

- Grants for non-charitable purposes and certain lobbying or political purposes
- Approval, oversight procedures, and grants to individuals and organizations other than public charities

## EXPENDITURE RESPONSIBILITY

- Grant oversight required for grants to other private foundations and certain supporting organizations



# ▶ PRIVATE FOUNDATIONS – JEOPARDY INVESTMENTS

## PRIVATE FOUNDATIONS ARE SUBJECT TO EXCISE TAX ON JEOPARDY INVESTMENTS

### JEOPARDY INVESTMENT

- Bad or risky investments that jeopardize foundation's exempt purposes
- No per se jeopardy investments, but certain types of investments are given closer scrutiny by the IRS
- Program-related investments are not jeopardy investments

### AVOIDING JEOPARDY INVESTMENTS

- Exercise ordinary business care and prudence for long and short term financial needs of the foundation
- Make investment decisions on a per investment basis, and take into account the foundation's entire portfolio
- Consider size of the investment in relation to the total amount of investment assets
- Rely on qualified investment advice



# ▶ PRIVATE FOUNDATIONS – DEVELOPMENTS

PRIVATE FOUNDATIONS ARE CHANGING ASSET ALLOCATIONS AND GRANTMAKING AND DEBATING PERPETUITY VS. “SUN SETTING”

## RECESSION – IMPACT

- Changing investment allocations
- Operating expense reductions
- Strategic grantmaking

## PERPETUITY VS. LIMITED LIFE SPAN DEBATE

- Asset preservation or deliberate “sun setting”
- Increase in private foundation terminations

## LEGISLATION

- Net investment excise tax change





## ► RECOMMENDATIONS

SIMPLE ACTIONS YOU CAN TAKE TO PROTECT YOUR ORGANIZATION AND YOURSELF

**UNDERSTAND FIDUCIARY DUTIES OF DIRECTORS**

**IMPLEMENT POLICIES AND PROCEDURES TO MAXIMIZE AVAILABLE PROTECTION UNDER FEDERAL AND STATE LAW**

**IMPROVE COMMITTEE STRUCTURE**

**UNDERTAKE PERIODIC REVIEWS OF OPERATIONS**

**TAKE ADVANTAGE OF JUSTIFIABLE RELIANCE**



# ► RECOMMENDATIONS – KEY POLICIES

IMPLEMENT KEY POLICIES AND PROCEDURES TO MAXIMIZE PROTECTION UNDER FEDERAL AND STATE LAW

## IRS STANDARD – CONFLICTS OF INTEREST

- Adopt Conflicts Policy and Annual Disclosure Statements

## SOX POLICIES

- Whistleblower Policy
- Document Retention Policy

## INVESTMENT MANAGEMENT POLICY

- Prudent asset allocation tailored to distribution requirements

## GIFT ACCEPTANCE POLICY

- Document donor intent; properly classify restricted assets



# ► RECOMMENDATIONS – COMMITTEE STRUCTURE

## IMPROVE BOARD STRUCTURE TO MAXIMIZE COMPLIANCE AND MINIMIZE LIABILITY EXPOSURE

### IMPROVE COMMITTEE STRUCTURE

- Executive Committee
  - Day-to-day operations and flexibility
- Compensation Committee
  - Compliance with conflicts and FMV policies
- Personnel Committee
  - Facilitate grievance reporting
- Risk Management Committee
  - Include staff, volunteers, board members, legal counsel, human resources, insurance, and investment advisors, as needed
- Audit Committee
  - May be required by state law, donors, or government grant requirements
- Finance and Investment Committee(s)
  - Gift Acceptance
  - Endowment, Quasi-Endowment Fund Management



# ► RECOMMENDATIONS – PERIODIC REVIEWS

## UNDERTAKE PERIODIC REVIEWS OF THE CHARITABLE MISSION AND OPERATIONS

### REVIEW THE MISSION

- Revisit Articles, Bylaws, Form 1023 Exemption Application
- Compare Forms 990-PF, Audited Financials
- Update Strategic Plans

### REVIEW THE OPERATIONS

- Analyze risks and benefits of programs
- Work with insurance company to implement procedures – reduce liability and premiums
- Improve HR procedures for staff and volunteers, criminal background checks, drug and alcohol tests, use liability waivers



# RECOMMENDATIONS – JUSTIFIABLE RELIANCE

## TAKE ADVANTAGE OF JUSTIFIABLE RELIANCE

### CONSULT PERIODICALLY WITH A TEAM OF PROFESSIONAL ADVISORS

- Lawyer, accountant, insurance advisor, and financial advisor
- Solicit updates on legislative and regulatory changes and industry conditions
- Document advice received
- Share with the Board and other executives



# DISCUSSION OF TRUSTING FOUNDATION CASE STUDY— PROPOSED INVESTMENT IN MONEYBAGS FUND

## QUESTION

- Should Trusting Foundation invest in Moneybags Fund?

## ISSUES

- Conflict of interest (real and the appearance of impropriety)
- Unrelated business taxable income
- Jeopardy investment
- Self-dealing (private inurement)
- Excess business holding



## **IRS**

[www.irs.gov](http://www.irs.gov)

[www.stayexempt.org](http://www.stayexempt.org)

## **U.S. SENATE COMMITTEE ON FINANCE**

[www.finance.senate.gov](http://www.finance.senate.gov)

## **ASSOCIATION OF SMALL FOUNDATIONS**

[www.smallfoundations.org](http://www.smallfoundations.org)

## **COUNCIL ON FOUNDATIONS**

[www.cof.org](http://www.cof.org)

## **DELAWARE VALLEY GRANTMAKERS**

[www.dvg.org](http://www.dvg.org)

## **LAURA SOLOMON & ASSOCIATES**

[www.laurasolomonesq.com](http://www.laurasolomonesq.com)

## **PANEL ON THE NONPROFIT SECTOR**

[www.nonprofitpanel.org](http://www.nonprofitpanel.org)

## **INDEPENDENT SECTOR**

[www.independentsector.org/accountability](http://www.independentsector.org/accountability)





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