

Legal and Ethical Issues for Foundations

Delaware Valley Grantmakers

Fundamentals of Smart Grantmaking Series

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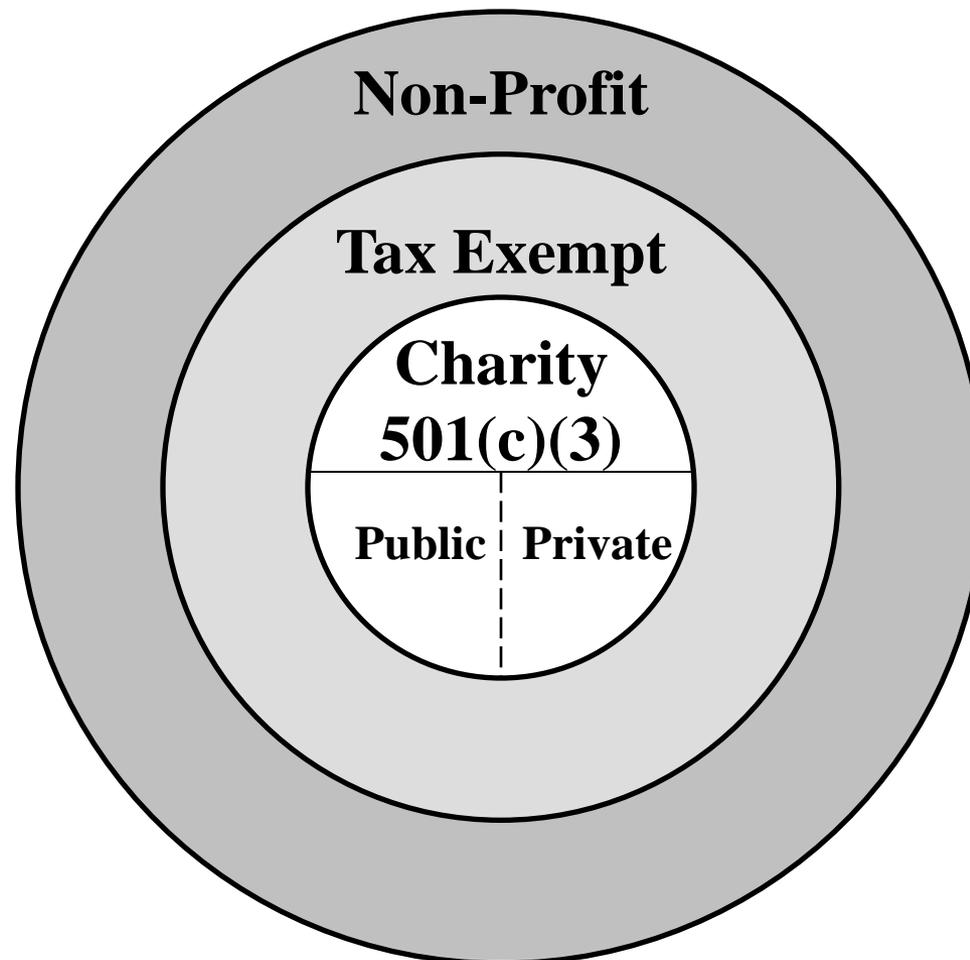
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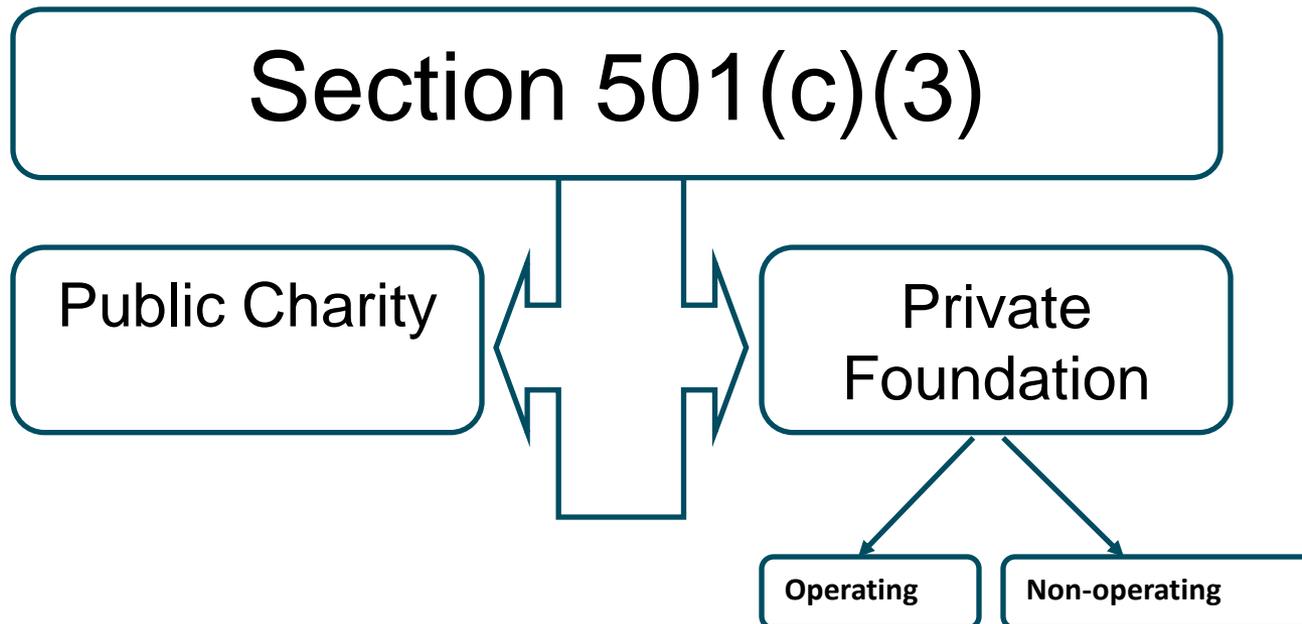
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Legal Context for Foundations

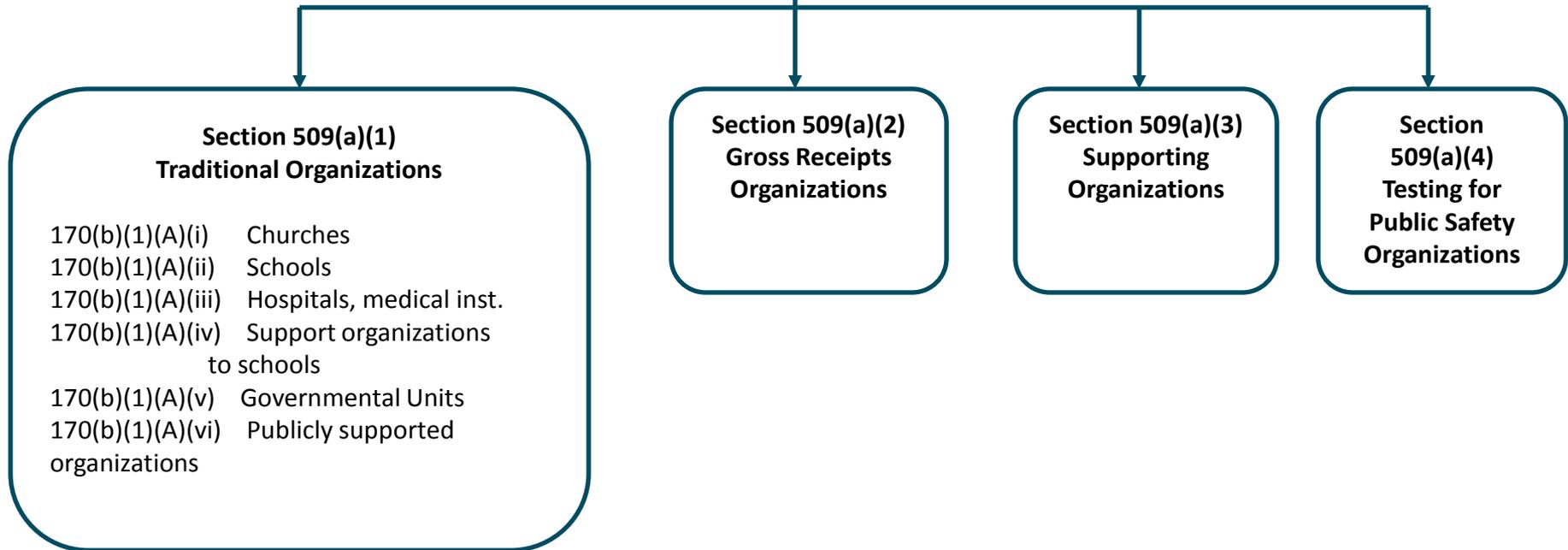
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The Nonprofit Universe





Public Charity



Differences within 501 (c)(3): Private Foundations / Public Charities

- Private Foundations
 - Typically one (or very few donors/funding sources)
 - Less favorable tax deductions for donors
 - Less public oversight = more operating restrictions
- Public Charities
 - Typically supported through diverse sources
 - Greater public input = fewer restrictions
 - Also includes community foundations, public foundations and gift funds associated with commercial firms

Types of Foundations

- Corporate: funds from a profit-making business
- Family: family and relatives play a significant role in governing and/or managing the foundation
- Independent: Board/mgmt not dominated by the benefactor, a family or business
- Operating: provide services or programs (not grants)
- Supporting: connected to another public charity
- Community: permanent collection of funds established to benefit a defined geographic area
- Public: public charities that are mainly grantmakers

The Private Foundation Lifecycle: Times to Watch for Legal Issues

- Birth
 - Governing documents
 - Tax Exemption Application
- Functioning in Society
 - Policies & Procedures
 - Grant making
 - Annual filings and tax returns
- Life Changes
 - Amended Articles
 - Amended Bylaws
 - Mergers
- Death
 - Dissolution, Termination, and/or Conversion

Creating a Foundation

- Create the legal entity under state law
 - Corporation or Trust
 - Take actions required by specific state
- Apply for Exempt Status (Form 1023)
 - Charitable Purposes
 - Funding
 - Operations
- Apply for State Exemption (specific to each state)
 - Income/Franchise Tax
 - Property tax, sales tax, other

Initial Governing Documents

- State
 - Articles of Incorporation / Declaration of Trust
 - Bylaws
 - Policies and Procedures
- Federal
 - Application for Exemption (Form 1023)
 - Determination Letter
 - Policies and Procedures to comply with private foundation rules and best practices

Legal Duties and Responsibilities

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State Law: Three Fiduciary Duties

- Duty of Care
 - Reasonable diligence- awareness and participation
- Duty of Loyalty
 - The foundation comes first
 - Avoid conflicts of interest
- Duty of Obedience
 - Honor donor intent
 - Focus on the charitable mission
 - Observe foundation rules and policies



More State Law Duties

- Investments:
 - Prudent Investors Act
 - Adopted by most states- total return concept; diversification; delegation
 - Uniform [Prudent] Management of Institutional Funds Act
 - Adopted by some states – applies to charitable corporations
- Registration and reporting
- Employment-related
- General Liability

Federal Duties

- Adhere to private foundation rules
- File annual tax return and pay any taxes due: excise tax and unrelated business income tax
 - Form 990-PF or 990 with schedules attached
 - Form 990-T, if applicable
- The following must be made publicly available:
 - Form 990-PF or 990
 - Form 1023
 - Form 990-T

Guidestar: there for all to see



- EEO, Civil Rights, ERISA, and other federal laws may apply

Risks

- Foundation can be held responsible for acts of the organization and its directors
- Directors can be held personally liable for their actions as directors
- Directors can be named as defendants for actions of the foundation
- Defending a case can be expensive for both the individual and the foundation

Protecting Against Risks

- Indemnification
- D & O Insurance
- Charitable Immunity (rarely protects)
- General liability insurance
- Seek guidance and legal advice
- Establish and follow good policies and procedures



Policies and Procedures

- Should be in writing, approved by the Board, reviewed at least annually, followed, and updated as needed
 - Board membership
 - Meeting management
 - Personnel (if any)
 - Records retention
 - Investment and spending
 - Travel & expense reimbursement
 - Attending fundraisers
 - Trustee compensation
 - Whistleblower
 - Conflicts of Interest
 - Grantmaking



Private Foundation Rules

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Private Foundation Rules

- Excise Tax (§4940)
- Payout Requirement (§4942)
- Excess Business Holdings (§4943)
- Jeopardy Investments (§4944)
- Taxable Expenditures (§4945)
- Self-Dealing (§4941)

Penalties for Violating Private Foundation Rules



- “Excise taxes” ~ prohibition
 - Initial (on foundation, sometimes on foundation managers, and disqualified persons)
 - Additional (if late or not corrected)
 - Involuntary termination of foundation (if willful)

Excise Tax on Investment Income

- Generally 2% of net investment income
- New legislation expands types of income taxed
- Reduced to 1% based on payout history over 5 year period
- Timing of grants can lead to tax savings
- Estimated quarterly payments required
- NOTE: Some investments create unrelated business income that is taxable to the foundation (UBIT)



Payout Requirement

- Basic Rule
 - Each year make qualifying expenditures that equal or exceed about 5 % of average assets
 - New foundations have extra year
 - Excess may be carried forward for 5 years
- What counts?
 - Grants and direct charitable activities
 - Program-related investments
 - Reasonable administrative expenses (except for investment management)
 - Cost of assets purchased to carry on charitable activities
 - Charitable set asides

Excessive Business Holdings

- Private foundation may not own a controlling interest in a for-profit company
 - Generally 20 percent
 - Add up what the foundation owns PLUS all shares owned by disqualified persons.
- 2 percent safe harbor
- 5 years to divest assets



Federal Investment Rules

- No investments that jeopardize exempt purposes
 - No per se jeopardy investments
 - Modern portfolio theory - each investment considered within the entire risk/asset allocation of all investments
 - Some investments will attract extra IRS attention
- Penalties apply first to foundation managers, then to the foundation

Taxable Expenditures

- Disallowed expenditure by the IRS
 - IRS prohibits the expenditure; or
 - The foundation makes the expenditure without following special requirements

Taxable Expenditures

- Don't:
 - Engage in *partisan* political activity, fund elections, lobby or earmark grants for lobbying (legislative or electioneering)
 - Make grants to individuals without prior approval of procedures
 - Make grants to non-charitable organizations without expenditure responsibility
 - Make grants for purposes that are not charitable
- But you CAN:
 - Fund charitable organizations that also lobby
 - Support non-partisan research and make the results available to the public

Self-Dealing

- No direct or indirect transactions (typically financial) with “disqualified persons”
- Steps to identify self-dealing:
 - Does the transaction involve a “disqualified person?”
 - Is the transaction listed as self-dealing?
 - Does an exception apply?
- Different from conflict of interest

Self-Dealing

- Who is a “disqualified person?”
 - Officers, directors, trustees, & others with similar authority
 - Substantial contributors to the foundation
 - Family members of those listed above
(spouses, ancestors, descendants and their spouses, but **not** siblings)
 - Entities controlled by disqualified persons.
 - Certain government officials

Self-Dealing

- Transactions listed as self-dealing
 - Sale, exchange, or lease of property
 - Furnishing of goods or services for money
 - Lending of money or extensions of credit
 - Payment, compensation or reimbursement of a “disqualified person”
 - Transfer or use of income or assets of the foundation to a disqualified person
 - Payment of money or property to a government official

Self-Dealing

- Sale, exchange, or lease of property between a foundation and a disqualified person is prohibited...

Does an exception apply?

- If no charge (\$0)

Self-Dealing

- Furnishing of goods, services or facilities between a foundation and a disqualified person is prohibited...

Does an exception apply?

- If goods offered to foundation at no charge and for charitable purpose
- If \$ offered to disqualified person on same basis as to general public AND related to foundation's charitable purpose

Self-Dealing

- Lending of money or extensions of credit to a disqualified person (this includes credit cards!) is prohibited...

Does an exception apply?

- If credit flows from the disqualified person to the foundation, no fees/interest charged, proceeds for charitable purpose

Self-Dealing

- Payment, compensation or reimbursement of a disqualified person is prohibited...

Does an exception apply?

- Foundation can buy D&O insurance
- Foundation can reimburse for reasonable expenses related to foundation work
- Pay reasonable board fees
- Foundation can compensate for reasonable and necessary “*personal services*”

Compensation Exception to Self-Dealing

- Personal Services
 - Foundation Management
 - Legal
 - Accounting
 - Investment



Self-Dealing

- Transfer or use of income or assets of the foundation to a disqualified person is prohibited...

Does an exception apply?

- If benefits are incidental and tenuous
- If board members and/or staff attend an event or performance to evaluate or show support

Self-Dealing

- Payment of money or property to a government official is prohibited...

Does an exception apply?

- Talk to your attorney if this comes up

Self-Dealing

- Review of common issues
 - Compensation for board or staff
 - Loans and credit cards
 - Fulfilling charitable pledge
 - Tickets to fundraisers
 - Travel expenses

Self-Dealing v. Conflicts of Interest

- Self-Dealing is PROHIBITED
- Conflicts of interest that are not self-dealing may be MANAGED
 - What is a conflict of interest?
 - Personal interest differs from the foundation's
 - Adopt and follow Conflicts of Interest Policy
 - Disclosure required
 - Conflicted person should not vote
 - Document recusal in the board minutes

Legal Issues in Grantmaking

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For grants to be legal, they must be...

- For charitable purposes
 - Made to eligible grantees
 - OR -
 - Made for eligible projects/purposes



Eligible grantees

- Public charities are easiest to fund
 - 501(c)(3) & 509(a)(1) – publicly supported
 - or
 - 501(c)(3) & 509(a)(2) – fees supported
- Verify the grantee's tax-exempt status
 - IRS determination letter
- Verify that the grantee's tax-exempt status is current
 - IRS "Publication 78" or GuideStar
- Print & file (or save electronically) – in case of audit

Eligible grantees, special situations

- Funding new charities (“startups”)
- Discretionary grants made by trustee or staff
- Small organizations that could be unintentionally converted to private foundation status by your generosity
- PRIs

Eligible projects/purposes- extra steps

- IRS pre-approval
 - Grants to individuals for travel, study or similar purposes (e.g., scholarships)
- Expenditure responsibility grants
 - Non-501(c)(3)'s for charitable purpose
 - Foreign organizations (*or do a "charity equivalency determination"*)
 - Other private foundations (*+ special spend out requirements*)
- Additional status documentation needed to determine how to proceed
 - Certain 509(a)(3) supporting organizations (need to get advice if grantee has this status)

What you can do with a clear understanding of the rules

- Advocacy and Lobbying Activities
 - You *can* fund and engage in advocacy
 - You *can* fund an organization that lobbies
 - You *can* support non-partisan research and make the results available to the public
 - You *can* lobby in self-defense
 - But, you *cannot* engage in *partisan* political activity, fund elections, lobby or earmark grants for lobbying (legislative or electioneering)

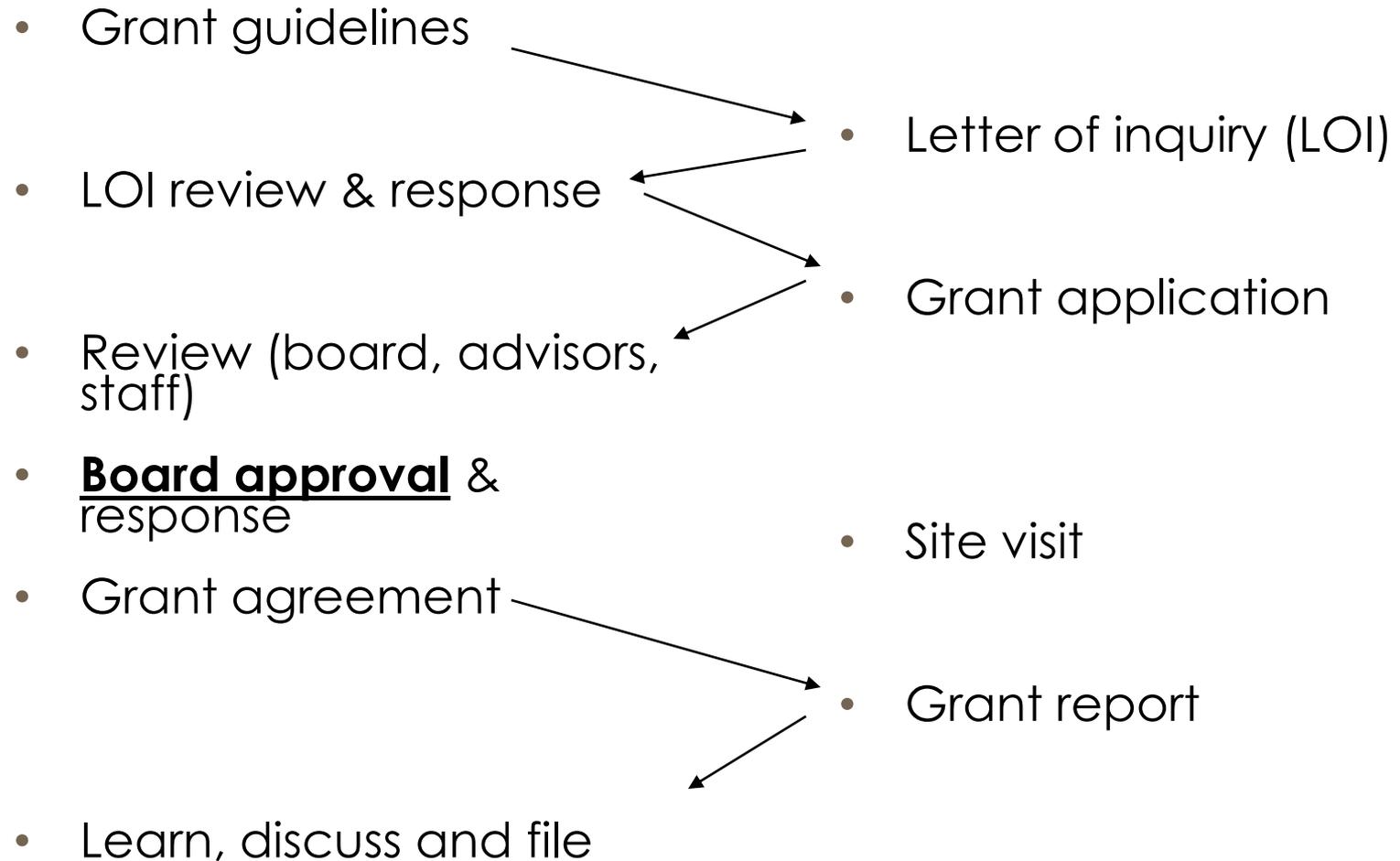
What you really don't want to do

- Certain 509(a)(3) supporting organizations
 - Requires expenditure responsibility – AND – doesn't count toward payout if:
 - Any type if foundation insiders (or disqualified persons) directly or indirectly control the supported organization or the supporting organization
 - Type III – unless they are “functionally integrated”.
 - Get legal counsel!

What you really can't do – it's prohibited

- Taxable expenditures
 - Influence public elections, lobby, earmark for lobbying
 - Grants to individuals for travel, study or similar purposes (including scholarships) without IRS approval of procedures
 - Grants to non-charitable organizations without expenditure responsibility

The grantmaking cycle



Steps to Protect Your Foundation in Grantmaking

- Know the legal rules
- Create a strategy
- Develop grant guidelines- be clear
- Establish process and procedures
 - Fulfill your fiduciary duties
- Obtain Board approval of grants - only legal requirement
 - Document in minutes and retain
- Send grant award letter and agreement; get acknowledgment of acceptance of terms
- Require Grantee Report
 - Ensure compliance with agreement and measure success

Questions

Experiences

Action Steps



Nina L. Cohen

First Vice President and Managing Director, Philanthropic Advisory Services

Nina provides advisory and administrative services to foundations, endowments, and not-for-profit organizations. In addition, she assists individuals, families, and organizations with charitable gift planning and the development of philanthropic strategies.

Prior to joining Glenmede, Nina practiced law for more than twenty years with a concentration in trust, estate charitable gift, and business planning; complex estate and trust administration; elder law; and estate planning for parents of children with developmental disabilities.

Nina received her J.D. (cum laude) from the University of Pennsylvania and is a member of the Pennsylvania Chapter of The Order of the Coif. She received her undergraduate degree in social work (summa cum laude) from Temple University. Active in many community organizations, Nina currently serves on the Board of Directors of the Jewish Community Foundation of Southern New Jersey (past President), the Endowments Corporation of the Jewish Federation of Greater Philadelphia, Hillel of Greater Philadelphia, and is Vice President of Jewish Family & Children's Services of Southern New Jersey. She is a recipient of the professional designation, Accredited Estate Planner, awarded by the National Association of Estate Planners & Councils.

Melanie R. Quackenbush



Administrative Officer & Endowment and Foundation Administrator

Melanie Redmond Quackenbush is an Endowment and Foundation Administrator in Philanthropic Advisory Services in Glenmede's Philadelphia office. Ms. Quackenbush assists Glenmede clients in accomplishing their philanthropic goals through consultations on charitable gifts, grant management, and handling the administrative details of family foundations and charitable trusts.

Ms. Quackenbush comes to Glenmede with experience in the non-profit sector, as well as in the fields of education and journalism. She is a member of both Grants Managers Network (an affinity group of the Council on Foundations) and Emerging Practitioners in Philanthropy, for which she is Treasurer of the Philadelphia chapter. She is a member of the Board of Directors of several local non-profits: Turning Points for Children, the Christian Association at the University of Pennsylvania, and the Main Line Chinese Culture Center, Inc. She is a former member of the Board of Directors of the Advancement Program Council, a Washington, DC-based non-profit organization that served independent schools across the country.

Ms. Quackenbush is a native Philadelphian and graduated with honors from the Pennsylvania Banking Association's School of Trust, Investments and Wealth Management in June 2007. She received her M.B.A. with a concentration in Finance at Drexel University in 2007 and received her B.A. from the University of Pennsylvania in 2000. She also holds Six Sigma Green Belt Certification.

Credits and Resources

- Some of the information in this presentation was obtained from materials produced by the Council on Foundations, Association of Small Foundations, and Private Philanthropy Services.
 - www.cof.org
 - www.smallfoundations.org
- Guidestar: www.guidestar.com
- The Foundation Center: www.fdncenter.org
- Family Foundations and The Law – John A. Edie, Council on Foundations