CHAPTER I: THE BASIC RULES FOR GOVERNING A FAMILY FOUNDATION

Once the donor has determined the most appropriate giving mechanism, such as a private foundation, the board of trustees begins to play a role in governance. Usually with the guidance of the donor, the board sets policy for managing foundation affairs, investing the endowment's portfolio, and making grants.These board activities are subject to state and federal laws and regulations. State law covers the trust and corporate activities of the board, such as obtaining nonprofit corporate status, and establishes the fiduciary duties of board members (both trust and corporate).

Because exact regulations differ from state to state, new board members should be briefed by legal counsel on their responsibilities to protect the foundation and invest its assets prudently, among other duties. Federal law, principally the Internal Revenue Code, sets the requirements for obtaining tax-exempt status, determines what donations qualify as charitable deductions for tax purposes, and specifies annual reporting requirements, again for tax purposes.

State law pertaining to family foundations changes infrequently compared with federal tax law.The latter is constantly undergoing modification throughActs of Congress, new regulations of the Internal Revenue Service or the Treasury Department, or letter rulings or other issuances of the IRS. Every family foundation board is advised to have access to competent legal counsel and a qualified accountant to brief board members, adopt appropriate administrative procedures, and file tax forms.

Setting up and governing a foundation is a relatively simple matter and a family foundation can be run in a virtually risk-free environment, provided proper procedures are followed at all times. Although it is difficult to compare one area of law with another, it is safe to say that foundation law is no more stringent than any other law that regulates areas where the public trust is involved.Trustees should know the basic rules for governing a family foundation. A brief discussion of these rules follows.

WHAT FAMILY FOUNDATION TRUSTEES MUST DO EACH YEAR

Six major rules govern what a private foundation and its trustees must do each year.These requirements include important fiduciary responsibilities for trustees, and even if you and the other trustees engage professionals to perform some of these tasks, you bear the ultimate responsibility for all actions and omissions of the foundation. Also, as you will see in Chapter II, it is certainly possible to comply with each of the following rules and still not measure up as an effective foundation trustee.

Rule #1. All Foundation Assets Must Be Classified andValued

The value of the assets of your foundation determines how much money must be distributed annually in charitable grants (called the payout). Generally, a private foundation must pay out at least five percent of its assets each year (see Rule #2). Trustees must determine the exact type and amount of those assets to plan properly for grantmaking each year. Determining the required annual payout is a fairly technical process, but help in making the calculation is not difficult to obtain. If you decide to make the determination without outside assistance, simply follow the process described in the Internal Revenue Code and tax regulations. If you feel you need assistance, try getting in contact with other, more experienced foundation trustees or staff in your city or area. You will be pleased to discover how willing other foundation trustees are to help you get started. If you prefer to have professionals handle technical matters, consult your foundation attorney or accountant.

Rule #2. Distribute at Least Five Percent of Assets for Charitable Purposes Each Year

This technical matter can be handled the same way you handled the valuation rule. Most foundation trustees choose to rely on their professional advisors to help them determine payout requirements. This rule addresses the heart of the foundation matter: making charitable grants. Because much of Chapter II focuses on grantmaking and the trustee's role in grantmaking, this subject is left to that chapter.

Rule #3. File Appropriate IRS Returns and Forms

Foundations must report all their activities to the IRS each year. Form 990-PF asks for a detailed report on investments, and expenditures for administrative and grants purposes. It requires a report on the board and its current members. The task of completing form 990-PF is somewhat technical and is usually handled by the foundation's accountant or attorney. Most states have additional filing and reporting requirements as well.

Rule #4. Pay Foundation Excise Tax on Net Investment Income

Tax-exempt foundations are required to pay a tax purportedly to cover the costs of IRS audits of all tax-exempt organizations. Currently that tax is two percent of net investment income; under special circumstances, however, it can be reduced to one percent. (One special circumstance for obtaining a reduction in excise tax involves demonstrating that the foundation has maintained a progressively rising proportional level of grantmaking according to a formula provided by the IRS.)

Rule #5. Keep Adequate Records

Always make sure that someone, somewhere, has on file the following required records:

- Records of all financial transactions, including information related to investments, income, and expenditures;
- All records related to grants;
- Minutes of board and committee meetings;
- Tax returns and other information related to dealings with the IRS;
- Personnel records;
- Documentation of leases, capital purchases, and sales; and
- Any special records that may be required by the foundation's activities, such as those related to the process of "expenditure responsibility" (see Chapter II, page 14).

One of the trustees, or, if present, a foundation staff member, normally performs required record keeping. Reviewing these records is a good place to begin learning the history of the foundation (see Chapter II).

Rule #6. Invest the Foundation's Assets to Preserve Its Corpus and Long-Term Grantmaking Ability

If, as is true with most private foundations, you are investing to exist in perpetuity, this rule will be very important. It will enable you to determine the purchasing power of the foundation endowment, and it is also an important part of your fiduciary responsibility to invest funds prudently. (There will be more about investments in the discussion of prohibitions in the following section.)

WHAT FAMILY FOUNDATION TRUSTEES ARE PROHIBITED FROM DOING

What are the prohibitions? The IRS has established specific prohibitions by which foundations and their trustees must abide. These prohibitions are logical and intended to uphold the integrity of the foundation and its activities.

Prohibition #1. Avoid Self-Dealing

Self-dealing is perhaps the most significant restriction to understand in your role as a family foundation trustee. It is defined as almost any financial or business transaction between the foundation and certain foundation insiders, called "disqualified persons," and is intended to prevent abuses of foundation assets or benefits.

An experienced foundation person once described self-dealing in this way: "If you are a foundation trustee and own an office supply store, you cannot sell the foundation one paper clip, even at a reduced price. You can give it all the paper clips you wish, but no exchange of money can take place." The following persons are considered disqualified persons with respect to private foundations:

- **All substantial contributors to the foundation.** A contributor becomes "substantial" if he or she gives or bequeaths more than $5,000 to the foundation and if a gift is for more than two percent of the total gifts and bequests received from the beginning of the foundation until the time of the gift in question.
- **All "foundation managers" of the foundation.** All trustees, directors, or officers of a foundation are considered disqualified persons. In addition, an employee of the foundation who is given the authority to make administrative or policy decisions on behalf of the foundation is also considered a disqualified person.
- **Owners of businesses that are substantial contributors to the foundation.** If a business owner owns more than 20 percent of the business in question, he or she is considered to be the owner of that business.
- **Family members.** Any family member of a substantial contributor, a foundation manager, or a 20 percent owner is a disqualified person. Family members include an individual's spouse, ancestors, children, grandchildren and great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren.

- **Corporations owned by other disqualified persons.** If other disqualified persons and their family members own more than 35 percent of the voting power of a corporation, the corporation itself is also considered a disqualified person.
- **Partnerships owned by other disqualified persons.** If disqualified persons own more than 35 percent of a partnership's profits, the partnership itself is considered a disqualified person.
- **Other entities owned by disqualified persons.** A trust, estate, or unincorporated enterprise is considered a disqualified person if disqualified persons own more than 35 percent of it.
- **Government officials** are also disqualified persons for purposes of the self-dealing rules.

The following activities are defined as acts of self-dealing between a family foundation and one of its disqualified persons:

- Sale, exchange, or lease of property;
- Loan of money or other extensions of credit;
- Provision of goods, services, or facilities;
- Compensation, pay, or reimbursement of expenses to a disqualified person (see following paragraph);
- Transfer of foundation income or assets to, or for the use or benefit of, a disqualified person; and
- Certain agreements to make payments of money or property to government officials.

For the purposes of these rules, whether the transaction is of benefit or detriment to the foundation is irrelevant. Certain necessary professional services, such as legal and accounting expenses, are exempted from this prohibition if they are reasonable and necessary. Foundations may also reimburse trustees for their expenses in performing board services as long as the activity reimbursed was necessary for the operation of the foundation, and the amount reimbursed was reasonable. Although few foundations do so, private foundations may also pay trustees a fee for their service on the board, as long as this meets the reasonableness test.

Prohibition #2. Dispose of Excess Business Holdings

The total voting stock of a business corporation owned by a private foundation and its disqualified persons cannot exceed 20 percent of the voting stock of that corporation. There is a similar restriction on a family foundation's ability to own an interest in a partnership or other business enterprise. The purpose of this prohibition is to prevent tax-exempt organizations from engaging in unfair competition against for-profit businesses. It is also intended to prevent the trustees of a foundation from being distracted from their charitable activities by the foundation's business interests.

Prohibition #3. Do Not Invest in Jeopardizing Investments

A private foundation cannot invest its assets or income in such a manner that the investments endanger the foundation's ability to carry out its charitable purpose. This rule does not mean that a foundation cannot include some high-risk investments in its investment portfolio. It does mean, however, that the IRS can assess penalties if it finds that the foundation's investments are excessively risky or speculative.

Prohibition #4. Do Not Engage in Prohibited Lobbying and Legislative Activities

Private foundations are prohibited, generally, from trying to influence specific legislation at any level of government. There are four exceptions to this rule:

- Engaging in nonpartisan analysis, study, or research and making the results of this work available to the general public or to governmental authorities;
- Providing technical advice or assistance to a governmental body or agency in response to a written request;
- Appearing before or communicating with any legislative body on an issue that might affect the existence of private foundations themselves, such as tax-exempt status or the deductibility of gifts to the foundation; and
- Engaging in or funding the examination and discussion of broad social, economic, and similar problems if these are the kinds of problems the government might be expected to deal with ultimately.

Before engaging in any activity of this type, it is advisable that the board confer with its legal counsel regarding the specific rules applicable to the situation.

Prohibition #5. Do Not Try to Influence Elections

Private foundations cannot influence elections. They cannot support, with money or otherwise, a political candidate for elected office. Under very carefully defined limits, however, a private foundation may engage in voter registration drives, if the activities of the foundation are nonpartisan, not confined to one specific election period, and carried out in five or more states. Requirements also cover the foundation's sources of income for these activities and definitions of its required minimum expenditures for this and other charitable activities. To be safe, be sure to consult with legal counsel before engaging in such an activity.

SUMMARY

These are the basics of what is required and prohibited in your role as a family foundation trustee. Each of the eleven items listed above needs some detail and discussion for you to fully incorporate these rules into your mind and work, but that will come with experience. These rules will become second nature to you. If you would like to explore one or more of these topics on your own in more detail, a good place to start are the publications *Family Foundations and the Law: What You Need to Know* and *The Foundation Desk Reference: A Compendium of Private Foundation Rules.* Please see the list at the end of this chapter and the Resource Map in Chapter IV for a full listing of other resources.

Chapter II details how these rules can be translated into the day-to-day operations of the foundation and the responsibilities of a trustee. As you will see, being an effective trustee requires much more than simply understanding the rules.

ADDITIONAL RESOURCES

Please refer to the Resource Map in Chapter IV for additional information about the following organizations and publications. This map provides a listing of resources by category: Boards & Governance, Family and Family Dynamics, Management and Operations, Grantmaking and Evaluation, and Philanthropy—General.

ORGANIZATIONS

Association of Small Foundations
Council on Foundations
National Center for Family Philanthropy
National Center for Nonprofit Boards
Regional Associations of Grantmakers

BOOKS

Duties and Responsibilities of Directors and Trustees of Illinois Private Foundations
Family Foundations and the Law: What You Need to Know
Foundation Desk Reference
Foundation Trusteeship: Service in the Public Interest
Governance (Family Foundation Library)
Handbook on Private Foundations
How to Manage Conflicts of Interest: A Guide for Nonprofit Boards
Law & Responsibilities: A Primer for Trustees, Directors and Officers of Michigan Private Foundations

MAGAZINES & NEWSLETTERS

Foundation News & Commentary
Family Matters (Legally Speaking)
National Center Journal
Trusts and Estates

For a list of specific articles related to the subjects discussed in this chapter, please contact the National Center at 202.293.3424.