FACING IMPORTANT LEGAL ISSUES

by John Sare

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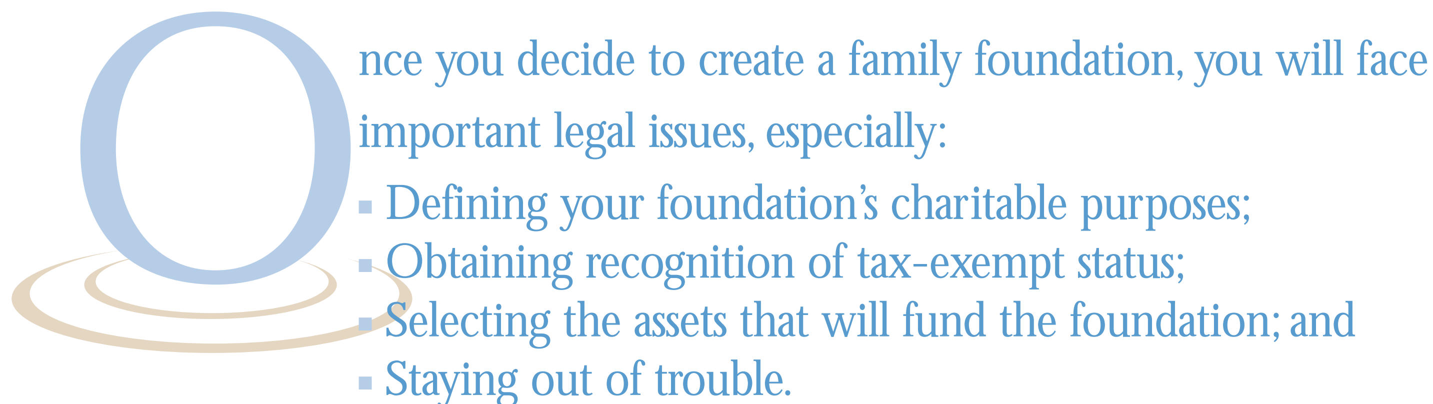

Once you decide to create a family foundation, you will face important legal issues, especially:

- Defining your foundation's charitable purposes;
- Obtaining recognition of tax-exempt status;
- Selecting the assets that will fund the foundation; and
- Staying out of trouble.

You may decide to tackle the legal issues on your own, drawing on the excellent resources cited in the bibliography for this chapter in Resources for Your Library, p. 248. Or you may inquire whether your own lawyer or accountant has had significant experience in this area or can refer you to someone who has. Friends who have created foundations may direct you to advisors who have been helpful to them. In addition, the National Center for Family Philanthropy and the Council on Foundations may have names of professional advisors in your community who have experience with the creation of family foundations.

fig. 1 What Is a "Family Foundation?"

The term "family foundation" is a colloquial expression. The technical term under the Internal Revenue Code is "private foundation" — a concept that entered the tax laws in 1969 to refer to those charitable trusts and nonprofit corporations that are endowed by an individual, a family, or a company for the purpose of making grants to other charitable organizations. Then as now, private foundations (like all other charities) enjoyed a variety of state and federal tax subsidies — namely, exemption from income tax and an ability to receive tax-deductible contributions.

Critics contended in the late 1960s that private foundations abused their special status by (among other things) (1) amassing great wealth without making distributions in support of real charitable causes, (2) retaining unwise investments in family companies in order to prop up the stock price or preserve family control, and (3) paying over-generous compensation to friends and family or making travel and study grants on a discriminatory basis.

Congress eventually concluded that these abuses, perceived and real, warranted special federal regulation, and in 1969 the term "private foundation" took on its distinct legal meaning.

The law now draws a line between "private" and "public" charities and imposes more restrictive rules (described in the section on Staying Out of Trouble, p. 67) on those that are classified as "private." Furthermore, contributions to private foundations qualify for less favorable deductibility treatment than contributions to public charities.

Although there are "private operating foundations" that carry on active charitable or educational programs, most private foundations are grantmaking organizations, technically known as "private nonoperating foundations." Foundations of this type are the focus of this guidebook. Materials cited in the bibliography may be helpful to you if you are still trying to decide whether a grantmaking foundation is an appropriate vehicle for you.

Defining Your Foundation's Charitable Purposes

A family foundation must be "organized" exclusively for tax-exempt purposes recognized by the Internal Revenue Code. The foundation's governing instrument must limit its activities to one or more of the following general purposes: educational, literary, scientific, religious, or charitable.

These purposes (and a handful of others that are rarely relevant) are commonly lumped together under the heading "charitable purposes" or "tax-exempt purposes." The specific purposes you have in mind must fit within one of the recognized tax-exempt categories. If you expect to make grants mainly to well-established charities, such as universities, relief organizations, nonprofit hospitals, arts organizations, religious institutions, and the like, you should have little difficulty specifying suitable purposes in the governing instrument and making grants that will readily qualify under one of the recognized tax-exempt categories.

You may have more novel objectives — such as the woman who wanted to create a foundation to perpetuate her mother's legacy of dressmaking and embroidery, or the man who wanted to provide economic assistance to family farmers to promote the tradition of family farming. If your specific objectives are innovative or even a bit idiosyncratic, your lawyer may be helpful in figuring out whether and how your objectives can be structured to fall within the legal definition of what is "charitable." Fortunately, the legal concept of "charity" is inherently flexible, intended to evolve as the needs of society evolve.

If you wish, you can identify general purposes (educational, charitable, etc.) and then add specific limitations. An "educational" foundation might support only private colleges and universities in Texas or only museums of Asian art. A "scientific" foundation might support only medical research institutions studying prostate cancer. A "charitable" foundation might support only the relief of poverty and construction of charity hospitals in Peru. There are myriad possibilities. When you define a foundation's charitable purposes, you face an important practical and legal issue: Balancing your desire to achieve

fig. 2 What Do We Mean By...?

GOVERNING INSTRUMENT ➢ The term "governing instrument" refers to the document that contains a foundation's statement of purposes. The governing instrument also specifies whether or not a foundation must be perpetual and may spell out special restrictions on succession or control. If a foundation is structured as a charitable trust, the governing instrument is an Agreement of Trust, sometimes referred to as an "Instrument," "Declaration," or "Indenture" of Trust. If a foundation is structured as a not-for-profit corporation, the governing instrument is called the Articles of Incorporation or the Certificate of Incorporation.

BYLAWS ➢ Although the trustees of a charitable trust occasionally elect to adopt Bylaws, the directors of a not-for-profit corporation almost always do so, and in some states it may be required. Bylaws are typically limited to routine matters of governance and say little or nothing about a foundation's purposes.

TRUSTEE and OFFICER ➢ A not-for-profit corporation ordinarily has a "board of directors" or a "board of trustees," and the board appoints a president, a secretary, a treasurer, or other "officers." A charitable trust usually has "trustees" but no officers, although larger charitable trusts may appoint administrative and program "officers." In this chapter, the term "trustee" is used generically — and can mean the trustee of a charitable trust or a member of the board of a not-for-profit corporation. The term "officer" refers to an officer of a not-for-profit corporation or a charitable trust.

specific charitable purposes today, and the virtual certainty that some degree of flexibility will be needed in the future.

To allow yourself flexibility, you may find it helpful if the governing instrument gives you the power to change the charitable purposes, without court approval, at any time during your lifetime. In some cases, you may wish to empower those who control the foundation after your death to amend the charitable purposes — or you may decide that changes of purpose should be prohibited after your death. For an indepth treatment of this subject, see Paul K. Rhoads, "Establishing Your Intent," *Living the Legacy: The Values of a Family's Philanthropy Across Generations.*

Philanthropists often find it appealing to create a foundation that will last in perpetuity. A foundation that pays out the minimum 5 percent a year of its average annual asset value and, net of operating expenses, earns more than that should indeed be able to last forever.

But bear in mind: Forever is a very long time, and the ideas that seem wise at the beginning of the 21st Century may be inappropriate or unworkable a century, or even a decade, in the future.

A few questions are worth asking before setting up an ostensibly perpetual foundation:

- Am I contributing enough money to my foundation to warrant the expense *forever* of the apparatus necessary to manage the assets prudently and give them away responsibly?
- Who is going to run a perpetual foundation? For how many generations can I expect volunteers to shoulder the burden of carrying out the philanthropic objectives I have in mind?
- Is my charitable objective broad enough that I can reasonably expect it to remain viable in perpetuity?
- Should I impose a time limit on my

fig. 3 Tips For Crafting Charitable Purposes

- Bear in mind that vague charitable purposes and excessively limited ones routinely yield confusion, discord, and litigation — sometimes during the founder's lifetime, more often in a family foundation's second or third generation.
- Invest ample time and thought in the development of a statement of charitable purposes and, if appropriate, a mission statement. Write down your ideas. Let your lawyer convert your concepts into suitable "legalese." Then read the lawyer's draft critically and work with your lawyer to improve it.
- Encourage family, friends, and others whom you trust to ask hard questions about your philanthropic ideas and to participate actively in the process of identifying the right charitable purposes and deciding how they are expressed.

fig. 4 Five Key Questions on Charitable Purposes

1. How likely are my charitable objectives to evolve during my lifetime?
2. To what extent are my objectives something that my children or other successors on the board of the foundation will want to pursue?
3. What are the chances that my particular purpose may one day become obsolete or unnecessary?
4. How well have I matched funding with purpose? Too little money? Too much?
5. How can I ensure that later generations won't quarrel over what I mean?

fig. 5 Succession and Changing the Legal Structure of the Foundation

Succession planning is a key aspect of governance. It should be discussed carefully with friends and family and, ultimately, with your legal and financial advisors.

Will the foundation remain in the hands of your family? Will it be placed in the hands of trusted advisors or employees and the people they select? Will it go on perpetually or will it go "out of business" in a generation or two? To what extent, if any, should the governing documents limit eligibility for the governing body or the intended "life" of the foundation? Are your goals for succession best accomplished using a charitable trust or a not-for-profit corporation? Should there be special arrangements if you develop Alzheimer's disease or are otherwise incapacitated for an extended period prior to death?

Many foundations change dramatically after the death or permanent incapacity of the founder. Some divide into multiple foundations, reflecting the geographic dispersion and differences of opinion of the founder's adult children and grandchildren. As a legal matter, the division of a foundation is relatively easy to accomplish, although family discord can complicate the process. The divided foundation enables each branch of the family to pursue its philanthropic goals (and its investment strategies) in the way it sees fit. Such a division should limit opportunities for internecine conflict. If you create a foundation and sense that its division is inevitable, or even desirable given the family relationships, you might wish to leave a letter of instructions outlining your intentions and hopes for the family's future and the future of the foundation. It may be easier for your heirs to endorse the idea of dividing the foundation if you have endorsed it in advance.

A foundation with close ties to a small group of public charities — a favorite university and a favorite museum, for example — might convert into a "supporting organization" of those charities, and in that way enjoy preferred tax treatment as a public charity. A foundation might even pay out all of its assets directly to favorite charities — on the theory that a "middle man" is no longer necessary or appropriate. A foundation lacking wealth of a magnitude that warrants a staff of investment experts and grants officers might conclude, after the founder's death or permanent incapacity, that it should transfer its assets to a community foundation. A community foundation can hold the foundation's assets in a "field-of-interest" or "donor-advised" fund that furthers the goals of the founder but relieves friends and family of administrative burdens — and should reduce administrative costs as well.

foundation — a fixed number of years after my death or for the lives of my children and grandchildren?

- Should I give the board the flexibility to distribute all of the assets, so that future generations can decide when and if it makes sense for my foundation to go out of business?
- If the assets are large enough and the purpose broad enough to warrant a perpetual foundation, what kind of staffing and structure do I envision? Should I create that structure during my lifetime?

Crafting a Mission Statement

The governing instruments of many foundations contain extremely broad charitable purposes, often as broad as the law will allow. Then, to provide a focus for grantmaking, those foundations adopt a mission statement, citing particular charitable causes that will be supported or particular styles ofgrantmaking that are to be favored (such as challenge grants or venture philanthropy). A mission statement can be a helpful way of achieving disciplined grantmaking today while preserving flexibility over the longer term.

fig. 6 How Purpose and Mission Interplay

The following example illustrates the interplay of the legally non-binding mission statement and the legally binding statement of purposes contained in a foundation's governing instrument:

Tom Fox (all names are fictional), a 50-year-old investor, forms a foundation to support the preservation of Civil War battlefields and education about the Civil War. Tom accepts the lawyer's recommendation that the foundation have broad charitable purposes in its governing instrument, but a mission statement — freely changeable at any time — that focuses on the Civil War.

In his late 70s, Tom experiences deteriorating health and concludes that the foundation should shift its support to medical research. He tells his lawyer that he wants to leave the bulk of his remaining assets to the foundation and wants those assets forever dedicated to research into cures and treatments for diabetes and arthritis, with a limitation favoring research by public universities. At the same time, Tom is worried that his adult children are not interested in diabetes, arthritis, or any other health-related issues, and he is concerned that they will not take a serious interest in the foundation. He also has told his adult children that he expects them to contribute their own money to the foundation.

Tom and his lawyer agree as follows: The statement of purposes in the foundation's governing instrument will remain broad and unchanged. A new mission statement will be adopted to express the intention that the foundation support research at public universities into diabetes and arthritis and "in the event they are eradicated, other medical conditions affecting the elderly." Tom will sign a new Will, leaving the bulk of his assets to the foundation but on the condition that the assets passing at the time of his death be used exclusively in furtherance of the mission statement in effect at the time of his death.

Tom likes this structure: During his lifetime, the assets of the foundation are spent in furtherance of the mission that is important to him, but he retains the flexibility to change his mind. At his death, his bequest is limited to the specific purposes set forth in a mission statement he approved during his lifetime, but with built-in flexibility in the event diabetes and arthritis are eradicated. Meanwhile, Tom's adult children and other descendants have some flexibility, too. Although the bequest in Tom's Will is limited to the purposes specified in a mission statement he approved during his lifetime, the mission statement can be changed vis à vis all other assets of the foundation. Therefore, assets Tom gave before his death and any assets his descendants contribute to the foundation in the future can be used in support of whatever charitable purposes future generations deem appropriate.

A foundation's trustees can readily revise or replace a properly crafted mission statement, so that the focus of grantmaking can change without notice to (or approval by) state charities officials or the Internal Revenue Service (IRS).

Obtaining Recognition of Tax Exempt Status

After your foundation is formed, either as a charitable trust or a not-for-profit corporation, your next order of business is to obtain recognition of its tax-exempt status. This process is initiated by filing Form 1023 with the IRS. This form requires the following information:

- A copy of the governing documents;
- A statement of projected activities (for example, investing donated funds and making grants to other charities);
- A list of trustees and officers, their addresses, and the compensation they will receive for their service to the foundation;
- A projected balance sheet for the last day of the current fiscal year; and
- A budget for 3 or 4 fiscal years, including the current one.

Additional disclosures may be necessary if, for example, the foundation has entered into a lease.

Form 1023 and a filing fee ($500 in 2002) are submitted to the IRS. The IRS typically responds with a letter acknowledging receipt and stating an

estimated period of time (customarily about 120 days) within which the IRS expects to issue its determination letter. During the review, the IRS may contact you or your advisors for additional information. Although the IRS query will ordinarily be in writing and will state that the foundation has 2 weeks in which it must respond, extensions are routinely granted, usually by telephone. Written confirmation of these extensions is advisable. The IRS provides a helpful guide to the Form 1023 review process on its website www.irs.ustreas.gov. Nonetheless, completion of Form 1023 by someone who is thoroughly familiar with Form 1023 and with the applicable tax rules can reduce delays.

Once a foundation receives its favorable determination letter from the IRS, the letter should be kept in the foundation's minute book along with its governing instrument, its Bylaws, and a copy of Form 1023. The favorable IRS determination letter — along with the Form 1023, the governing instrument and Bylaws, and minutes of meetings — should be kept permanently in the foundation's minute book. Ordinarily, the determination letter is retroactive to the date the foundation was formed. That means that the foundation is retroactively tax-exempt and that contributions made prior to the issuance of the determination letter are eligible for the charitable deduction. Generally speaking, however, it is not advisable to make a contribution to a foundation until the determination letter has been secured.

States and most local governments recognize the tax-exempt status of foundations that have received favorable IRS determination letters. Additional tax exemptions may be available at the state level — for example, exemption from sales and use tax on goods *purchased* by the foundation or exemption from tax on real property owned by the foundation and used by it to fulfill its charitable purposes.

All states have one or more bureaus with authority to investigate and regulate charities. In most states, those bureaus are part of the Office of the Attorney General or the Office of the Secretary of State. Most states impose registration and annual reporting requirements on charities. Lawyers or accountants thoroughly familiar with local rules and practice may be able to guide you through the state-law requirements. Alternatively, you may wish to speak directly with the charities officials in your state. The staff of the state charities bureau should be thoroughly familiar with the requirements and can send you the necessary forms and instructions. It is increasingly popular to "download" this material from the websites maintained by most state charities officials. The AAFRC Trust for Philanthropy (www.aafrc.org) provides its members with an annual summary of the various states' registration and reporting requirements.

Selecting the Assets That Will Fund the Foundation

Many factors are relevant to the choice of donated assets and the timing of donations to a family foundation. The advice of your lawyer and/or accountant can be particularly valuable in threading through these complicated rules. The bibliography contains citations to several excellent resources on this topic. (See especially, the section of this guide entitled Funding Your Family Foundation, p. 76.) A few examples illuminate the major issues:

Janet Ford creates a foundation in early December. She wants an income tax deduction in the current tax year, so she makes her first contribution the day after the foundation is formed, even though the foundation does not yet have a *favorable IRS determination letter.* She stipulates that the foundation must return her gift if it fails to obtain a favorable IRS determination letter. That is a mistake. Under IRS rules, conditioning a gift to charity on the charity's receiving tax-exempt status makes the gift nondeductible. Janet is better off to wait until a favorable IRS determination letter is safely in hand.

Frank Bass, a filmmaker with a successful production company and a sizeable stock portfolio, is trying to decide which assets he will contribute to a new foundation. He learns from his accountant

that the issues are surprisingly intricate:

- A gift of **cash** is the simplest gift. Valuation is not an issue, and in the year of the gift Frank can deduct an amount up to 30 percent of his adjusted gross income if his gift consists exclusively of cash and he makes no other gifts to charity.
- A gift of **publicly traded securities** with built-in capital gain may be the most economically beneficial gift for Frank. He should be able to deduct the fair market value of the contributed securities, and the foundation will be able to sell the securities without incurring the capital gains tax that Frank would have incurred if he had sold the securities himself. However, he can deduct only up to 20 percent of his adjusted gross income in the year of the gift if his gift consists exclusively of publicly traded securities.
- A donation of **real property, artwork or other tangible personal property, interests in a closely held business, and ordinary income property** (such as a copyright or rights under a contract) would provide very little economic benefit for Frank, because his deduction would be limited to the *lesser* of fair market value or his cost. He also learns that a gift of interests in his closely held business could raise issues under the "excess business holdings" and "self-dealing" rules (discussed later in this chapter). Ultimately, Frank decides his real property, artwork, stock in his closely held production company, and the copyrights from his films should be retained or given to a public charity.
- Because a donation of **mortgaged property** may raise issues under the "self-dealing" rules and the unrelated-business income tax rules, Frank concludes he should not contribute mortgaged assets.

Alice Brady wishes to fund a foundation with publicly traded stock in the company her father founded. The stock is worth about $8 million, but Alice's annual income from her other assets and her job rarely exceeds $300,000. Because of the **deductibility limitations** — primarily, the fact that she cannot deduct more than 20 percent of her adjusted gross income in a given year for a donation of publicly traded stock to a foundation — she discovers that the most she can deduct in the year of her gift is $60,000. Her accountant tells her that she can "roll over" the deductions for an additional 5 tax years, meaning that her total deduction on an $8 million gift would be approximately $360,000 ($60,000 per year in each of 6 tax years). Because of these limitations, Alice decides to contribute only $360,000 worth of stock up front, take deductions over a 6-year period, and defer the rest of her philanthropy until a later date.

A "split-interest" charitable vehicle may be appealing for the philanthropist who wants to make a gift to charity while getting something in return. An interest in property is "split" by dividing the property into two interests — present and future. The classic "split-interest" vehicles are the charitable remainder trust and the charitable lead trust. Although these trusts can be structured in many ways, the basic concepts can be illustrated as follows:

Once Alice Brady decides to contribute only $360,000 of stock to a foundation, her financial advisor points out that her remaining $7,640,000 of stock produces very little income for her and that she has a high exposure to market volatility unless she diversifies. She voices her concerns to her lawyer, who recommends that she create a charitable remainder trust. Using this vehicle, she is entitled to a lifetime stream of payments and, upon her death, the trust remainder passes to the foundation. Because the trust is a tax-exempt vehicle, it is able to sell appreciated assets that Alice contributes and to diversify its holdings without incurring any capital gains tax. Alice anticipates that her income will increase because of the distributions she will receive from the trust. Although the distributions will be taxable to her to the extent they consist of income or capital gains earned by the trust, the creation of the trust entitles Alice to a charitable deduction for the value of the foundation's remainder interest — an amount determined actuarially based on Alice's age at the time of the gift and significantly smaller than the amount of the deduction she would have received if she had donated the assets to the foun-

dation outright. She expects that this additional deduction will offset some of the income and capital gains she plans to receive from the trust.

Philip Harmon has managed to shift a significant amount of his wealth into trusts for his adult children and is now concerned about creating a foundation and providing for his grandchildren. His lawyer recommends a charitable lead trust, which is the mirror image of a charitable remainder trust. In this arrangement, Phil Harmon creates a foundation, which is designated to receive a stream of payments from the trust for a specified period of years, and at the end of that period, the trust property passes in further trust for the benefit of his grandchildren and their families. The value of the family's remainder interest is discounted based on the value of the charity's intervening "lead" interest in the trust, so Phil is able to make a transfer to younger generations of his family at a reduced gift, estate, and generation-skipping transfer tax cost and, at the same time, to transfer assets to a foundation. There is a trade-off: To avoid adverse estate tax consequences from this arrangement, Phil must transfer legal control of the foundation to his adult children and grandchildren. Because of the tables used to calculate the value of the family's remainder interest in a charitable lead trust, it is an especially appealing vehicle during periods when interest rates are low.

Staying Out of Trouble

When you create a foundation, you are creating a new business in a regulated industry. You are committing hundreds of thousands, perhaps millions or tens of millions of dollars, to this business. The IRS, state charities officials, countless journalists, and other watchdogs are looking over your shoulder to make sure you run the business legally and ethically. In the age of the Internet, the availability of information about foundations and the degree of public scrutiny are greater than ever.

You owe it to yourself and the foundation to develop at least a basic understanding of the applicable rules. You may find that a general understanding of these rules will assist you in evaluating the qualifications of prospective advisors. The following summary is aimed at equipping you with a basic understanding of the key rules, but is by no means exhaustive. The bibliography for this chapter, or qualified legal counsel, should be consulted if you wish to pursue these topics in greater detail.

Meeting Annual Reporting Requirements

A private foundation must file an annual report with the IRS, called Form 990-PF. This form is a highly detailed "information return" that

fig. 7 **Tips for Staying Out of the Headlines**

- Be prepared to commit a small but reasonable portion of the annual budget to good governance and compliance with applicable laws.
- Seek out lawyers, accountants, and financial advisors who are honest, experienced in the foundation area, and willing to commit the time and resources necessary to provide thorough and thoughtful advice to the foundation.
- Don't hesitate to ask prospective advisors how many foundations they have created and how many they advise on an ongoing basis. Ask for client references and try to find out if the clients believe they have been well served.
- Don't assume that the advisors who help you run your business, or the advisors who handle your estate planning or prepare your tax returns, are necessarily well versed in the intricate rules that govern private foundations.
- Consider including your professional advisors at all board meetings, perhaps even as members of the board, so they can serve as ready resources to help the family solve legal, ethical, and practical issues.

includes information on assets, investment income, donations, salaries and other expenses, and grants and other expenditures for charitable purposes. If a foundation has violated any of the so-called "private foundation rules" (discussed below), that information must be disclosed in Form 990-PF. Many states also require an annual report, the bulk of which is often a copy of Form 990-PF. Both the IRS and state charities officials typically make these documents available for public inspection, and much of this information is now available on the Internet — for example, at www.guidestar.org.

A foundation is required to provide a copy of its three most recent Forms 990-PF as well as its Form 1023 to any individual who requests a copy. If the request is made in person at a foundation office, the request must be honored immediately. If the request is made by mail, the request must be honored within 30 days. A reasonable fee may be charged to cover photocopying and postage. In lieu of providing a copy, a foundation may post its three most recent Forms 990-PF and its Form 1023 on the Internet. The Form 990-PF and the Form 1023 also must be available for public inspection at the foundation's principal office. Although foundations no longer are required to publish notice of the availability of their annual returns for public inspection, at least one state — New York — has imposed its own obligation to publish this notice.

Form 1023 requires the names and addresses of trustees and officers, plus a phone number for somebody — usually the lawyer filing the application. Form 990-PF requires a list of the names and addresses of trustees and officer, but not telephone numbers. To insulate your home address from the disclosure requirements, you may prefer to use an address "in care of" your office or the office of a lawyer, accountant, or other advisor.

fig. 8 — What in the World is a "Disqualified Person?"

You become a "disqualified person" as soon as you create a family foundation. So do your spouse, your children, grandchildren, great-grandchildren, and their spouses. Your parents and other ancestors are "disqualified persons," but your brothers, sisters, and their descendants are not.

But that is only the beginning! The trustees of a foundation are "disqualified persons," even if they have made no donations to it. For purposes of the "self-dealing" rules, government officials are "disqualified persons," regardless of their connection — or lack of a connection — to the family. And finally, family businesses, trusts, and estates also can be "disqualified persons," depending on the percentage owned or controlled by individuals who are "disqualified persons."

Avoiding Self-Dealing

With narrow exceptions, a foundation's transactions (direct and indirect) with "disqualified persons" will be treated as taxable "acts of self-dealing." That is true even if the transactions are on fair and reasonable terms and are approved by disinterested trustees or officers. Such transactions would include sales, loans, or leases between a foundation and a "disqualified person" and arrangements that result in the use of foundation assets by a "disqualified person."

There are some useful exceptions to the self-dealing rules. For example, a foundation may pay compensation to a disqualified person for services rendered, provided the compensation is not excessive and provided state law does not prohibit the arrangement. The IRS takes the position that the only personal services for which a disqualified person may receive compensation are services as a trustee, officer, or staff member and legal, investment, and banking services. Before a disqualified person is paid for services that fall outside those narrow categories, it is advisable to consult with legal counsel about the implications. A foundation also may reimburse reasonable expenses

incurred by a disqualified person in connection with foundation activities.

The penalty tax is imposed both on the "disqualified persons" who participate in the act of self-dealing and on those trustees and officers who knowingly participate in that act by approving it. This tax (like all of the foundation excise taxes except the tax on net investment income) is imposed at rates high enough that foundations and those associated with them cannot treat the tax as an acceptable cost of doing business.

Holding On to the Family Business

A foundation and its "disqualified persons," in the aggregate, may not ordinarily hold more than 20 percent of the voting equity of a business enterprise, and if they do the foundation is subject to an excise tax. This tax is of great concern to Bill Reed, because he plans to create a foundation by donating to it 80 percent of his family company. He discusses the issue with his lawyer, who explains that there is a special "grace period" for gifts and bequests.

For donated assets, a foundation has 5 years from the date of the gift to divest itself of the excess and, if it fails in that effort but can demonstrate sufficiently diligent efforts to divest itself, it might qualify for a 5-year extension from the IRS. The lawyer points out, too, that the 5-year grace period can be extended if Bill delays his gift and

fig. 9 A Cautionary Tale

Margery and Steve Wilks create a foundation and decide it needs office space. They speak with their son, Bob, and daughter-in-law, Susan, and decide to rent space in an office building owned by a corporation. Although Susan is on the board of the corporation, she receives no compensation for that work, and she is not an officer. Susan owns no stock in the corporation, but she and her children are the sole life beneficiaries of a trust (created by Susan's father) that owns 36 percent of the voting stock of the corporation. The other 64 percent of the voting shares are owned by a group of unrelated investors. The sole trustee of the trust for Susan and her children is a large bank. Susan has no authority to decide whether the trust will retain or sell its stake in the corporation.

The Wilks conclude that the rental fee is fair and that the transaction should be fine because family members own no direct interest in the corporation and because the terms have been negotiated at "arm's length" with a corporation that no family member controls and from which no family member receives compensation.

The Wilks take the lease to their lawyer for review, and the lawyer informs them that there is a tax problem: The corporation that will be leasing space to the foundation is a "disqualified person," she says, and the lease would result in an "act of self-dealing" under the tax laws. She explains the analysis as follows:

1. The trust is a "disqualified person" because more than 35 percent of the beneficial interests in the trust are held for the benefit of individuals (Susan and her children) who are "disqualified persons" because of their family relationship to the Wilks.
2. The corporation is a "disqualified person" because more than 35 percent of the voting power is owned by a "disqualified person" — that is, by the trust described above.

The Wilks' lawyer explains that it is irrelevant for tax purposes whether Susan and her children control the trust or the corporation — and whether the rental fee is fair. The only acceptable solution, from a tax standpoint, is for the foundation to use the space for free. That solution is not financially acceptable to anyone. The Wilks then propose to lease office space from Steve's brother. Their lawyer advises them that siblings are not "disqualified persons," so the lease should be fine. But the lawyer cautions that Steve's brother would become a "disqualified person" if he joined the foundation's board or became a substantial contributor. The Wilks agree that they will not permit Steve's brother to join the board and that the foundation won't accept any contributions from Steve's brother, as long as he is the foundation's landlord.

fig. 10 When Self-Dealing May Occur

- A foundation buys a table at a benefit dinner and distributes the benefit tickets to family members or other "disqualified persons."
- A foundation owns works of art and permits the founder or other "disqualified persons" to exhibit the works of art at home.
- A foundation pays an honorarium to a government official for giving a speech or participating in a seminar.
- A foundation and "disqualified persons" are investors in the same company, and the foundation holds onto an investment in order to "prop up" the stock price.
- A foundation buys an asset from a "disqualified person," even if the terms are economically advantageous to the foundation.
- A foundation invests in a partnership in which other "disqualified persons" are partners.
- A foundation pays excessive compensation to a "disqualified person" for his or her services to the foundation.

makes a bequest instead. In that case, the 5-year grace period ordinarily would not start to run until the shares of the company are actually distributed to the foundation by Bill's estate. Bill's lawyer cautions Bill that he probably should not give a large percentage of his company to the foundation unless he is certain that there will be a public market for it. If the only prospective buyers are members of Bill's family, or trusts for their benefit, their purchase of shares (from the foundation or from Bill's estate) could easily be "acts of self dealing."

Anticipating Taxable Expenditures

Without exception, grants to political campaigns are "taxable expenditures" and as such can result in substantial

fig. 11 "Penalty" Taxes Aren't the Only Weapon of the IRS

Technical compliance with the private foundation rules is a necessary condition of Staying Out of Trouble, but it is not sufficient. As a more general matter, a foundation must be operated prudently and for exclusively charitable purposes. A poorly run foundation risks not only imposition of the excise taxes described in this chapter, but also the loss of its tax-exempt status. The IRS has the power to revoke tax-exempt status if:

- A foundation engages in any political campaign activity (Venturing Into Public Advocacy Is OK...Up to a Point, p.189);
- Any part of a foundation's net profits "inures" to the benefit of insiders;
- More than an "insubstantial part" of the activities of a foundation consists of legislative lobbying or confers a private, rather than public, benefit; or
- A foundation engages in repeated or flagrant violations of the private foundation tax rules.

In the final analysis, a foundation jeopardizes its tax-exempt status whenever the totality of its operations suggests that it no longer deserves the benefit of tax exemption. Furthermore, any amount of political campaign activity or lobbying activity may result in hefty excise taxes under the "taxable expenditure" rules described below — sometimes in tandem with the revocation of a foundation's tax-exempt status.

fig 12 The IRS Isn't the Only Cop on the Beat

If state charities officials investigate a foundation and find abuses (for example, improper benefits flowing to insiders or a lack of sound financial management), the trustees and officers risk removal and may even be forced to pay monetary damages for any financial harm they do to the foundation.

Some states have specific laws about the role of family members in a foundation. For example, if even one family member is being paid by a California foundation that is structured as a corporation, California's corporate statute requires that at least 51 percent of the seats on the board be held by "disinterested" individuals — i.e., people who are not members of the family.

The rule in New York is more typical: If the board is told the "material facts" about a potential conflict of interest — a category that could include not only compensation to a board member but also business transactions with a board member or an affiliated business — and the arrangement is approved by a disinterested majority of the board, the arrangement ordinarily is permissible. New York permits an "interested" director or officer to be present for the vote on such questions, but some states require that the "interested" director or officer exit the meeting before the vote occurs.

The rules noted above apply to not-for-profit corporations. Even more stringent concepts of the "duty of loyalty" may apply if a foundation is created as a charitable trust, unless the governing instrument expressly says otherwise.

The bottom line is this: The transactions of a foundation can be readily subjected to public scrutiny. If you think a reporter could make a financial arrangement look bad on the front page of the local paper, consult with legal counsel before you do it.

excise taxes on the foundation and its managers. The same is true for expenditures to publicize a foundation's support of, or opposition to, a candidate for political office. Such expenditures should be avoided altogether. Lobbying should be undertaken with great care. There are many cases in which lobbying expenses also will be "taxable expenditures." (For more information, see Venturing Into Public Advocacy Is OK… Up to a Point, p. 189.)

Grants to individuals, foreign charities, other private foundations, non-charities, and organizations whose tax status is unknown may be classified as "taxable expenditures" unless the grants are properly structured. Grants to organizations not classified as U.S. public charities ordinarily will necessitate the exercise of "expenditure responsibility." Some of the requirements are:

- A diligent "pre-grant inquiry" about the grant recipient.
- A written agreement requiring, among other things, that the grant recipient:
  1. Provide written reports about its use of the grant money;
  2. Return funds not used for the purpose specified in the grant agreement; and
  3. Not use the funds to engage in political activity, legislative lobbying, or other prohibited activities.

Steering Clear of Jeopardy Investments

Investments by a foundation that "jeopardize" its ability to fulfill its tax-exempt purposes may result in the imposition of an excise tax on the foundation and foundation managers who participate in the investment decision. This rule is analogous to the state-law requirement that a foundation's assets be managed "prudently."

According to IRS Regulations, some types of investments will be "closely scrutinized": margin investments, commodity futures, oil and gas wells, "puts," "calls," and "straddles," warrants, and short sales. There are exceptions for donated assets and for investments that are "program-related" — that is, investments made in furtherance of a foundation's charitable purposes.

fig 13 Obtaining Directors and Officers Liability Insurance

Good governance is a tool for keeping a foundation out of legal trouble. By remaining well-informed, attentive, and honest, foundation trustees should rarely, if ever, be subject to removal or financial sanctions. That is true even if the trustees occasionally, in good faith, make errors of judgment.

Even honest and hardworking foundation leaders can be sued or threatened with suit, however, or can inadvertently violate the private foundation tax rules. For that reason, every foundation should consider obtaining insurance coverage for its trustees and officers. This insurance – commonly known as "directors and officers" or "D&O" insurance — should cover defense costs as well as any damages, taxes, or fines that must be paid.

The component parts of this insurance should be reviewed carefully with counsel, to help the foundation assess whether the insurance is adequate to cover the relevant categories of potential liability.

Some types of insurance may be deemed "non-compensatory" and other types "compensatory," which will affect whether the premium payments must be treated as taxable income by those who are insured. Premiums for "compensatory" insurance — for example, insurance covering liability for the private foundation taxes — must be taken into account when evaluating the over-all reasonableness of the compensation a trustee or officer receives.

Those who receive insurance coverage from a foundation should consult with their own tax advisors about the income tax consequences of the premium payments.

For cases that insurance does not cover or situations in which an advance is needed to cover legal or other expenses, an indemnification from the assets of the foundation also may be appropriate, subject to applicable legal limits.

Ensuring Minimum Distributions

A grantmaking foundation must distribute at least 5 percent of its average annual asset value in furtherance of its charitable purposes. The bulk of these "qualifying distributions" ordinarily consists of grants to appropriate grantees, although the reasonable expenses of administration of the foundation also can be counted toward the minimum distribution requirement. A foundation must meet its 5 percent distribution requirement either in the tax year the requirement arises or by the end of the following tax year. The excise tax for failure to meet the annual distribution requirement is imposed only on the foundation.

Paying Tax on Net Investment Income

A foundation's net investment income is taxed at a rate of 1 percent or 2 percent per year. Qualification for the 1 percent tax rate depends on a somewhat complicated calculation linked to the foundation's qualifying distributions in the current tax year, its average qualifying distributions in prior tax years, and its net investment income. Broadly speaking, a foundation that exceeds its average historical levels for qualifying distributions by at least 1 percent of its net investment income can qualify for a 1 percent, rather than 2 percent, tax on its net investment income. A foundation cannot qualify for the 1 percent tax rate in its first year of operation. Accordingly, it may be advisable to delay sales that will result in a significant capital gain until the foundation's second tax year — and to make grants in the first and second years sufficient to qualify for the 1 percent tax during the second year. In recent years, tax reform packages have routinely sought either the repeal or simplification of this tax, but at press time, neither had occurred.

fig 14

Funding Outside the Box I: Expenditure Responsibility and Scholarships

Phyllis Landers is committed to disaster relief and education in Latin America. She decides she wants her foundation to make grants to organizations based in Latin America or, in some cases, directly to local governments in areas where hurricanes, floods, or earthquakes have occurred. She also wants to award scholarships to students in Latin America who want to study civil engineering and medicine and express an interest in applying their skills in Latin America.

When Phyllis brings up the idea at a foundation board meeting, her lawyer explains that the foundation should not just "write a check." He offers a daunting array of precautions:

- If the grant recipient is an organization not recognized by the IRS as a public charity, a grant agreement and other special steps are required under U.S. tax law.
- Although the tax law does not mandate a grant agreement when the grantee is a foreign government (or a foreign government's agency or instrumentality), it would be prudent for the foundation to put the terms of the grant in writing anyway.
- A scholarship recipient does not have to sign an agreement, but the foundation must instead adopt an objective and nondiscriminatory procedure for the selection of scholarship recipients. This procedure, at a minimum, must:
  1. Require that scholarship winners be selected from a pool sufficiently large to constitute a charitable class;
  2. Enumerate suitable criteria for selecting scholarship winners (for example, academic performance, performance on tests designed to measure ability, aptitude, and motivation, recommendations from instructors, financial need, and conclusions drawn during an interview process concerning ability, character, etc.);
  3. Require that members of the selection committee not be in position to derive a personal benefit if one prospective scholarship winner is selected rather than another one;
  4. Require that the grant either be in the nature of a prize or an award, or for a scholarship for study at an academic institution, or a grant for the achievement of a specified educational objective (producing a report, enhancing an artistic or musical skill or talent, etc.); and
  5. Impose a reporting system, to allow the foundation to monitor the courses taken by the scholarship winner, grades received, degrees attained, articles written, research completed, music composed, etc.
- Before implementation, the scholarship procedure must be filed with the IRS for approval. The procedure is deemed approved if the IRS raises no objections within 45 days.
- Scholarships must be for study at a college or university and must be structured so that they would be excluded from the recipient's gross income — not under current tax law but under the law as in effect until 1986.
- Other rules apply if individuals receive grants that are not scholarships — for example, grants to enhance a scientific or similar skill, to recognize a specific achievement, or to relieve poverty or distress.

Phyllis and the other members of the board discuss these requirements at length and realize that they cannot, as volunteers, adequately handle the workload. The board votes to begin a program of Latin American grants and scholarships — but only after the foundation hires an administrative assistant who can dedicate 1 to 2 days a week to running the program.

fig. 15

Other Exceptions to the Excess Business Holdings Rules

- The threshold of permitted ownership increases from 20 percent to 35 percent if a foundation can establish to the satisfaction of the IRS that the business enterprise is controlled by persons who are not "disqualified persons."
- If a foundation's holdings are 2 percent or less of a business enterprise, then the aggregate holdings of the foundation and "disqualified persons" may exceed 20 percent.
- If a business enterprise receives at least 95 percent of its income from passive sources (such as interest and dividends earned on investments), then the foundation and "disqualified persons" may own any percentage, even 100 percent, of the business.

Summing Up

For the philanthropist who is in the process of creating and running a foundation, the legal issues outlined in this chapter can be distilled into a few basic questions that bear fundamentally on the long-term success of the foundation:

- Have I provided clear guidance about what I envision?
- Have I provided the flexibility that I will need if my charitable goals change with the passage of time?
- Have I defined a mission that is broad enough so that it will endure as long as there is money to fund it?
- Have I structured my philanthropy in a way that best achieves my tax and other financial objectives for myself and my family?
- Do I understand the "ground rules" well enough to know that I can be comfortable operating within them?
- Have I created a system of checks and balances to ensure that the foundation fulfills its charitable mission and remains in compliance with applicable laws?

Affirmative answers to these questions should result in a solid legal framework for your foundation — an enduring structure that will enable you and your family to accomplish the objectives that inspired your philanthropy in the first place.

fig 16

Funding Outside the Box II: Program-Related Investments

On one of her frequent visits to Mexico, Phyllis Landers meets a woman in Oaxaca, Juana Lopez, who is trying to revive the local silk-making industry. Juana explains that there was an indigenous silk-making craft in southern Mexico prior to the Spanish Conquest. However, the industry was suppressed in the 16th Century when the Spanish, from their base in the Philippines, began to ship silk from the Far East to Mexico and Spain. Juana is cultivating silk worms on mulberry trees on her farm, but she says that too little silk is being produced for a viable industry to be established. Fifteen to 20 local women, most without jobs or any education, are being trained to cultivate the silk, harvest it, and make cloth. Juana sells the cloth in local shops, mainly to tourists. Juana says that she sees the potential to hire more people and perhaps eventually operate a profitable business.

At a foundation board meeting, Phyllis proposes that the foundation make a grant in support of Juana's silk-making activities. Several trustees express the view that a grant would not be appropriate, because Juana appears to be operating a business with a profit motive. Phyllis argues that Juana's business probably will never make a profit, or at least not a significant one, and that the real objective of the activity is to restore a craft tradition that died out nearly 500 years ago and to provide job training and jobs in an impoverished region.

One trustee asks whether the idea of a "PRI" might be appropriate. The trustee explains that "PRI is foundation lingo for program-related investment — an investment no one would ever make except to do good in the world." On consultation with the foundation's counsel, the board learns that the PRI must be for a purpose that is genuinely charitable and consistent with the foundation's governing instrument. The production of income or gain cannot be a significant motive of a PRI. After a review of the relevant documents and the law, the lawyer concludes that the foundation may make the investment as a charitable undertaking.

After some debate about whether to lend money to the project, in exchange for a promissory note, or to invest in the project, in exchange for a share of the equity, the board selects the second option. The foundation will seek, in exchange, a seat on the board of directors of the new business. The trustees conclude that a seat on the board will enable the foundation to provide ongoing business advice intended to ensure the survival of the new company and will prevent the company from abandoning its initial mandate. Protecting the foundation's investment, the trustees conclude, is not a significant objective of taking a seat on the board.

Although the foundation will own more than 20 percent of the stock in the new business, counsel to the foundation advises the trustees that there should not be any problem with "excess business holdings" so long as the foundation can show that an investment in the business is substantially related to the foundation's performance of its charitable purposes.