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10 Rules Every Foundation Should Know About Compliance

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Running a private charitable foundation can be one of life's most rewarding experiences – a chance not only to make a real difference in the community – but to practice philanthropy with the personal signature and control that only a private foundation can offer. Yet, it can also be a daunting task. For too many founders and directors, what begins as a positive endeavor focused on giving, can often wind up as a time-consuming chore. Regulations, paperwork and IRS filings leave the well-intentioned donor frustrated and wondering why. Fortunately, many of these problems can be easily avoided through a basic understanding of the rules that govern private foundations. This article summarizes 10 common issues and pitfalls we encounter in the daily administration of hundreds of private foundations, ranging in size from large to small. For professional advisors, this article is provided as a quick reference. For founders and directors, this information is provided to make you more aware of some of the factors that govern private foundations. It is not intended as a substitute for legal, tax or investment advice. Nor should it be construed as a comprehensive guide to foundation rules.

REGULATIONS, PAPERWORK AND IRS FILINGS LEAVE THE WELL-INTENTIONED DONOR FRUSTRATED AND WONDERING WHY

1. Scholarship Grants and IRS Approval

Since universities are 501(c)(3) public charities and grants made to public charities do not require the IRS's advance approval, many foundation personnel believe that they can fund a specific person's scholarship without advance approval from the IRS as long as the grant is paid directly to the university and not to the student. In fact, this is not true.

It is the foundation's act of choosing the scholarship recipient – instead of having the university make that choice – which triggers the need for the IRS's advance approval. This is the case regardless of whether the funds are paid to the individual or directly to the university. It is only when a foundation funds a university's existing scholarship program and does not involve itself in selecting the scholarship recipients that advance approval is not required.

If a foundation wishes to take an active role is selecting scholarship recipients, it must determine the group of individuals who are eligible to apply for a scholarship and develop an objective and nondiscriminatory plan for selecting the final recipients and then submit this to the IRS. If the IRS does not contact the foundation within 45 days of the foundation's submission of its scholarship plan and procedures, the foundation may begin making scholarship grants unless it hears from the IRS to the contrary.

2. Paying Off Pre-Existing Charitable Pledges to Religious Institutions That Are Incurred By Foundation Staff

A common problem arises when foundation insiders make a personal pledge to a church synagogue, mosque, etc., and the foundation satisfies that pledge. Since churches are public charities, many foundation personnel believe it is perfectly legitimate for the foundation to cover a charitable pledge made by a founder or other board member. This is an incorrect assumption. A foundation may make a charitable grant or pledge to a religious institution when that pledge was initiated by the foundation. However, there is a subtle distinction between making its own charitable grants and satisfying the personal obligation of a board member or other insider. Insiders are not allowed to obtain a personal benefit from their dealings with the foundation. To the extent that the foundation relieves that insider of such a financial obligation, that person is considered to have benefited.

3. Hosting Fundraising Events Such As Golf Tournament and "Bike-A-Thons"

Foundations hosting fundraising events such as golf tournaments and bike-a-thons seldom realize that they are required to ascribe a value to the benefits provided to attendees as well as provide a tax receipt for each attendee at year-end. This is so the attendee knows

what portion of the donation is actually tax-deductible.

For example, say an attendee pays $150 for a golf tournament hosted by the foundation, and the usual greens fees are $50. The foundation must provide a tax receipt letter to that attendee, stating that the value of goods and services provided was $50 (the value of the greens fees). The proper tax deduction for the attendee to claim is the ticket price minus the value of the greens fees, or $100. If the attendee does not obtain this tax receipt by the time he files his income tax return, the charitable deduction may be lost.

Sometimes foundations raise additional funds at these events by selling merchandise, such as T-shirts, sweatshirts or other accessories. Depending on where the event is held and where the foundation conducts its business, the foundation may be required to charge state and local sales taxes. Although the foundation itself may be exempt from paying sales tax, that doesn't necessarily mean that it does not have to charge a sales tax when it sells merchandise to others. The requirement to charge and remit sales tax varies from one locality to another. Some localities permit a foundation two or three days per year in which it may sell merchandise free of sales tax in connection with a fundraising event. Often, the best solution is to make an arrangement with a local merchant to charge, collect and remit sales tax to the appropriate taxing authority on behalf of the foundation.

If giving away free memorabilia or tokens to attendees of a fundraising event, such as coffee mugs, calendars, posters or T-shirts, the foundation would be well-advised to ensure that the total value of all such tokens is modest on a per-person basis. If the cost of these items is approximately $7 per person or less, adjusted annually, it will not count in calculating the total amount of the attendee's charitable deduction. For example, if the ticket price for a golf tournament is $150, the green fees are valued at $50, and each attendee is provided with a T-shirt that costs the foundation $5 per shirt, the attendee's charitable deduction would be unaffected and remain at $100. However, if each T-shirt costs the foundation $12, the charitable deduction would be reduced to $88.

A foundation must record the names and addresses of all attendees of an event, so that it may provide those who pay over $250 with tax receipts at the end of the year. Failure to provide a tax receipt to an attendee before she files her income tax return may cause the attendee to lose the charitable deduction.

Fundraising events can be an effective way to raise additional funds, but foundations commonly fail to develop a budget for the event. As a consequence, many foundations lose money, break even or raise much fewer funds than they had hoped. It's worth consulting with a professional event planner or advisor in advance to develop realistic financial projections.

4. Validating the Continuing Tax Status of Charities to Which Foundations Make Grants

Because a charity obtained a favorable determination letter from the IRS at one time does not mean that the letter remains in effect forever, especially when the charity is one that bases its public charity status upon broad-based public support. For example, if such a public charity does not continue to maintain its broad public support, the IRS removes its favored status, and it is considered to be a private foundation.

... ORGANIZATIONS MAY BE TAX-EXEMPT (FOR EXAMPLE, A 501(C)(4) OR (C)(6)) AND STILL NOT BE RECOGNIZED BY THE IRS AS A PUBLIC CHARITY, THEREBY REQUIRING THE FOUNDATION TO EXERCISE EXPENDITURE RESPONSIBILITY

In IRS Publication 78, issued on a quarterly basis, the IRS lists all exempt organizations. Foundations may make a grant to a public charity listed in this publication without exercising expenditure responsibility, provided that the charity's status has not been revoked in any Internal Revenue Bulletin issued between the date of the last publication and the date of the grant. If a private foundation makes a grant to an organization that is not considered to be a public charity and does not exercise expenditure responsibility, it may be subject to a penalty, and the grant will not count towards satisfying the foundation's annual distribution requirement.

Some organizations are considered to be public charities, even though they are not listed in Publication 78. For example, churches, synagogues and mosques and instrumentalities of the government such as the parks department or a municipality that is a political subdivision of a state fall into this category. However, a private foundation must undertake due diligence to ensure that a church not registered with the IRS as a public charity is genuine.

The personnel of many foundations often assume that certain types of organizations, such as fire departments, Rotary Clubs, libraries, veterans funds or policemen benevolence funds are public charities that do not require expenditure responsibility. However, such organizations may be tax-exempt (for example, a 501(c)(4) or (c)(6)) and still not be recognized by the IRS as a public charity, thereby requiring the foundation to exercise expenditure responsibility.

5. Self-Dealing When "Buying Tables" at Charity Events

Many private foundations support local charitable institutions that conduct fundraising events themselves. Persons attending or "buying tables" at such events typically receive food and entertainment. If a private foundation purchases tickets for such an event (or is given tickets), a question arises as to whether self-dealing results when a board member, or other insider, their relatives or friends, attend the event and parttake of the food and benefits provided.

As a basic rule, all direct and indirect financial transactions between a private foundation and those persons who control and fund it are prohibited. It is immaterial whether the transaction results in a benefit or a detriment to the foundation. However, the foundation is permitted to pay reasonable compensation to its insiders for services rendered and directly pay expenses of their participation in meetings and events on the foundation's behalf.

Some argue it is necessary and appropriate for foundation directors, trustees and staff to attend fundraising events and therefore, no self-dealing occurs when its insiders use the tickets. Logically, if a foundation's board member or officer attends the event to represent the foundation in an official capacity, there should be no private benefit, so long as the attendance is work-related and allows the foundation to effectively show support for the organization at a public function.

Impermissible self-dealing may arise, however, if the table seats are given to friends and family members. To remove any question of self-dealing, it is preferable for a private foundation to decline to accept tickets for persons other than board members, trustees, senior staff members and their spouses. A foundation could conceivably furnish the charity with a list of persons to whom tickets might be furnished but only with the clear stipulation that the charity must decide which individuals are awarded the tickets.

6. Calculating the Minimum Distribution Requirement

Generally, a private foundation is required to distribute 5% of the average value of its investment assets for the previous year. The IRS prescribes a specific method for averaging a foundation's securities and the balances in its savings and checking accounts on a monthly basis. The 12-month average allows for market fluctuations over the year. Special rules apply to the valuation of real estate and all other assets.

Grants to qualifying organizations and all reasonable administrative expenses necessary for conducting a foundation's charitable activities – other than investment fees – count as qualifying distributions toward satisfying the 5% pay-out requirement. Reasonable administrative expenses may include office supplies, telephone charges, consulting fees, certain legal and accounting fees, training and professional development, publication of the foundation's annual report and modest travel expenses associated with foundation business. These calculations can be complex. When performed incorrectly, as is too often the case, it can result in under- or over-payment, so special care must be taken when determining the 5% requirement.

7. Making Grants to Individuals for Hardship Assistance

It is commonly believed that a foundation may not make grants to an individual without advance approval from the IRS or the exercise of expenditure responsibility. However, grants made to relieve suffering may be made without advance approval under certain conditions, provided that the foundation makes the grant on an objective and nondiscriminatory basis, complies with basic recordkeeping requirements showing how and why a particular individual was selected for assistance and does not require the recipient to spend the grant funds in a particular way.

UNRELATED BUSINESS TAXABLE INCOME (UBTI) IS COMMONLY ASSOCIATED WITH REVENUE THAT A CHARITY GENERATES THROUGH AN ACTIVITY THAT HAS NO DIRECT CONNECTION WITH ITS CHARITABLE MISSION

The IRS divides such grants into two broad categories in Publication 3833: emergency and hardship assistance. Emergency assistance usually is provided after there has been a natural catastrophe, such as an earthquake, tornado, hurricane or flood. By contrast, hardship assistance is provided based upon established economic need and may, for example, be used to purchase food or cover health insurance premiums for a low-income family.

8. Appropriate Compensation

Board members and other insiders generally are not permitted to reap any economic benefit from their dealings with a foundation. An exception is made for compensation – provided the compensation is reasonable. The reasonableness of compensation is judged on a list of factors, including qualifications, experience, job responsibility, duties and the time dedicated (part- or full-time) by the insider to his position. Additional factors can include the size of the foundation, the local labor market, the cost of living in the area and the salary paid by similarly situated charitable organizations for similar positions. It is common to have an attorney draft an opinion letter on the reasonableness of compensation, in order to insulate the foundation and its insiders from penalties and other repercussions.

9. How to Treat Unrelated Business Taxable Income (UBTI)

Unrelated business taxable income (UBTI) is commonly associated with revenue that a charity generates through an activity that has no direct connection with its charitable mission. To the extent that a foundation has UBTI, it must be taxed as if it were a for-profit organization. The UBTI rules were enacted to ensure that non-profit, charitable organizations do not compete with for-profit companies, gaining an unfair competitive advantage. Foundation staff often don't realize that if a foundation borrows money (for example, on margin) to purchase an investment asset (not related to performing its charitable activities), any income flowing from that asset usually will be deemed UBTI.

In addition to paying taxes at a for-profit tax rate, a private foundation with significant UBTI also must file an additional tax return, Form 990-T, along with its 990-PF. Many professional advisors counsel their foundation clients to avoid engaging in activities that would generate UBTI, unless the potential for profit is considerable.

10. Making a Grant to a Second Foundation – Crediting the 5% Annual Pay-Out Requirement

Grantmakers are often unaware that one private foundation may make a grant to another private foundation, as long as the granting foundation exercises expenditure responsibility. This may be desirable when the grantee foundation runs its own special programs (for example, for a scholarship program approved by the IRS). When one foundation makes a grant to another foundation and the recipient foundation (grantee) follows by disbursing those grant funds, the IRS will allow only one of those foundations to count those funds toward satisfying the annual 5% pay-out requirement. Unless the foundations otherwise agree, the grantee will be the foundation that will count the disbursement of the funds toward its 5% pay-out requirement.

In order for the granting foundation to count the grant proceeds toward its own 5% pay-out requirement, the grantee foundation must agree to (1) make a special election on its annual return not to count the disbursement of the proceeds toward its 5% pay-out requirement, and (2) disburse all of the granted proceeds by the end of its fiscal year following the year in which the funds were received.

Conclusion

Practicing philanthropy through a private foundation can be one of the most satisfying rewards of a successful life; and while there are many rules and regulations governing a foundation's actions, there are also many resources available to help you pursue your philanthropic mission while staying in compliance. ■

About the Author

In his capacity as senior vice president and general counsel of Foundation Source, Jeffrey Haskell is responsible for product architecture and legal issues around the foundations the company creates. Prior to joining Foundation Source, Jeff was an associate at the law firm of Kronish Leib Weiner & Hellman LLP and Olshan Grundman Frome Rosenzweig & Wolosky, in the Tax and Trusts and Estates departments. Jeff has extensive experience in the non-profit sector, preparing applications for recognition of federal tax exempt status on behalf of private foundations. Prior to joining Olshan Grundman, Mr. Haskell worked at Coopers & Lybrand for several years in the Business Tax Planning Group.

Foundation Source is a philanthropic services company that provides the back-office infrastructure and support services to power private charitable foundations. For more information, visit their web site at www.foundationsource.com or call 800-839-0054.

Notes

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