



MINNESOTA COUNCIL
ON FOUNDATIONS

a community of grantmakers

WHAT
EVERY
GRANTMAKER
SHOULD
KNOW

**2009
UPDATE**

philanthropy

public trust

FREQUENTLY
ASKED
LEGAL
QUESTIONS

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What Every Grantmaker Should Know



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PLEASE NOTE:

None of the material in this publication should be construed as offering legal advice. Seeking legal counsel is recommended before acting on any matter described in this publication.

Frequently Asked Legal Questions



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Northwest Area Foundation identifies, shares and advocates "what's working" to reduce poverty for the long term, partnering with select communities in Minnesota, Iowa, North Dakota, South Dakota, Montana, Idaho, Washington and Oregon.

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The Council also thanks the Forum of Regional Associations of Grantmakers for underwriting the distribution of this publication and *Principles for Grantmakers & Practice Options for Philanthropic Organizations* to all 1,300 grantmakers in the state of Minnesota.

GRANT (\$5,000)



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Philanthropy & Public Trust Series: What Every Grantmaker Should Know & Frequently Asked Legal Questions

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Printed in the United States of America.

This publication and subsequent updates are available online at www.mcf.org/publictrust.

Foreword

Prior to a reprinting in December 2009, this publication was reviewed and updated to reflect changes in law since its first printing in 2007. As always, we encourage grantmakers to seek legal counsel before acting on any matter described in this publication.

DEAR COLLEAGUES AND FRIENDS:

As part of our continuing efforts to help foundations maintain and improve the effectiveness of their work, the Minnesota Council on Foundations has prepared this comprehensive resource to help private, corporate and community/public foundations understand their legal requirements and obligations. This publication and its companion piece, *Principles for Grantmakers & Practice Options for Philanthropic Organizations*, are key publications in MCF's Philanthropy & Public Trust series.

Since its founding in 1969, the Council has offered numerous seminars and publications, drawing on the expertise of member law firms and other interested and informed members. MCF also has fielded frequent legal-related questions from its foundation members every year. This guidebook comprises two specific Council efforts:

- Information around key foundation topics, which are important for every grantmaking organization to know, was developed in seven 2004-2005 issues of *MCF Notes* newsletter in its previous print format.
- Answers to the most common legal questions that the Council had received over the years were originally presented online in 2003 as "Answers to Frequently Asked Questions on Foundation Law."

The information in this combined publication has been expanded and updated, reflecting changes in law and specific provisions of the Pension Protection Act of 2006. These documents will continue to be updated as legal requirements change. Look for the most up-to-date versions on www.mcf.org/publictrust.

We have many individuals to thank. An MCF task force originally laid out the scope of Legal FAQs project. A majority of the work presented here derives from four of Minnesota's top foundation legal experts: Hazen Graves, Gina Kastel, Mary Probst and Claire Topp. We also laud the singular contribution of former MCF vice president David Biemesderfer in drafting the original "What Every Grantmaker Should Know" series. He is now a consultant working with grantmakers and grantmaker associations around the country.

We would be remiss if we did not call attention to the generous contributions of three member foundations in supporting our Philanthropy & Public Trust work. Northwest Area Foundation, among the Council's charter members, has been the major financial supporter of the public trust work, together with Cargill and Duluth Superior Area Community Foundation. Finally, the Forum of Regional Associations of Grantmakers provided a grant that has allowed us to send these two publications to every grantmaker in the state of Minnesota.

We commend this work to you and wish you well in all your efforts to embrace public trust.

philanthropy  public trust 

Sincerely,





William R. King
President
Minnesota Council on Foundations

PREAMBLE

Principles for Grantmakers

The desire to give is a defining human characteristic. As members of the Minnesota Council on Foundations, we honor diverse charitable expressions across the wide economic, racial, ethnic and social spectrum. We celebrate new and traditional forms of giving that respond to human needs, build community, increase knowledge and promote creative expression. We acknowledge the fundamental roles and responsibilities of engaged individuals and the public, private and nonprofit sectors in a just and equitable society.

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PRINCIPLES

As a community of grantmakers, we embrace philanthropy's role in a civil society. We are leading advocates for public policy to sustain robust philanthropy. We work strategically through grantmaking and other means to improve the vitality and health of our communities, to educate our members and the field, and to achieve our collective mission of strengthening and expanding philanthropy. We express a shared commitment to excellence by formally subscribing to the Principles for Grantmakers.

- 1. Ethics and Law Principle**
To sustain public trust by adhering to the highest ethical principles and practices and abiding by all state and federal laws that govern philanthropy.
- 2. Effective Governance Principle**
To achieve effective governance by ensuring performance in the areas of stewardship of assets, donor intent, fiduciary responsibility and sound decision-making.
- 3. Mission and Goals Principle**
To be purposeful in our philanthropy by having a clearly stated mission and explicit goals.
- 4. Engaged Learning Principle**
To foster continuous learning and reflection by engaging board members, staff, grantees and donors in thoughtful dialogue and education.
- 5. Respectful Relationships Principle**
To build constructive relationships with applicants, grantees and donors by ensuring mutual respect, candor, confidentiality and understanding.
- 6. Transparency Principle**
To achieve transparency in our relationships with the public, applicants, grantees and donors by being clear, consistent and timely in our communications with them.
- 7. Diversity Principle**
To reflect and engage the diversity of the communities we serve in our varying roles as grantmakers, boards and employers, economic entities and civic participants.
- 8. Self-Assessment & Commitment Principle**
To uphold the highest standards by regularly assessing ourselves against these principles and committing to implement them.

*Adopted by the MCF Board of Directors in 2006;
developed from the original 1996 version.*

WHAT
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WHAT EVERY GRANTMAKER SHOULD KNOW:

Board Fiduciary Duties

Becoming a foundation board member, whether for a community, private or corporate foundation, brings with it legal and ethical duties and responsibilities. Foundation board members and officers must fully understand their duties and always uphold the public trust in their role as stewards of the foundation. Here are things all grantmakers should know about board fiduciary duties.

Basic Fiduciary Duties

Foundations can be organized as either trusts or corporations, and the fiduciary standards applicable to trusts and corporations have developed somewhat separately under state law. Essentially, however, directors, trustees and officers of a foundation owe three fiduciary duties to the foundation:

- **Duty of Care**, which requires the individual to discharge duties in good faith, in a manner one reasonably believes to be in the best interests of the organization, and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. The individual must devote the time, attention and resources necessary to understand and prudently oversee the affairs of the foundation.
- **Duty of Loyalty**, which requires the individual, when making a decision or acting on behalf of the foundation, to set aside personal or conflicting interests and act solely in the best interest of the foundation.
- **Duty of Obedience**, which requires the individual to obey all laws pertaining to foundations and act in furtherance of the foundation's charitable purposes.

Board members must always uphold the public trust in their role as stewards of the foundation.

Meeting Fiduciary Duties

The following steps can be taken to help ensure compliance with fiduciary duties.

DUTY OF CARE

Active Participation: Board members should actively participate in the management of the organization, including attending board meetings, evaluating reports, reading minutes and reviewing, if applicable, the executive director's performance and compensation.

Committees: The board should ensure committees operate under the direction and control of the board. Board members are responsible for committees and should regularly receive committee reports and scrutinize their work.

Board Actions: Directors should understand that for purposes of determining whether a director met the duty of care, a board member who is present at a meeting when an action is approved is presumed to have agreed to the action unless (a) he or she objects to the meeting because it was not lawfully called or convened and does not participate in the meeting, (b) he or she votes against the action, or (c) he or she is prohibited from voting on the action due to a conflict of interest.

Minutes of Meetings: Written minutes should be taken at every board meeting. The minutes should accurately reflect board discussions as well as actions taken at meetings. Minutes should be distributed to board members and formally approved at a subsequent board meeting.

Books and Records: Board members should have access to, and general knowledge of, the organization's books and records (articles, bylaws, accounting records, tax returns, voting agreements, minutes, etc.).

Accurate Recordkeeping: Board members should not only be familiar with the content of the books and records, but also should make sure that the organization's records and accounts are accurate. This may require independent audits and/or the implementation of appropriate internal controls.

Trust Property: Board members should protect, preserve, invest and manage the foundation's property, and do so consistent with donor restrictions and legal requirements.

Investigations: Allegations of misconduct should be investigated and addressed.

DUTY OF LOYALTY

Generally: Board members should avoid using their positions or the organization's assets in a way that would result in inappropriate financial gain for themselves or any member of their family.

Conflicts of Interest: Board members should ensure that conflicts of interest are appropriately addressed and the organization's conflicts of interest policy are followed (see *Conflicts of Interest, page 12*).

Loans: A director of a Minnesota nonprofit corporation should not permit loans to directors and officers unless the loan may reasonably be expected, in the judgment of the entire board, to benefit the foundation.

DUTY OF OBEDIENCE

State and Federal Statutes: Board members should be generally aware of state and federal statutes and laws relating to nonprofit corporations or trusts, tax-exempt status, charitable solicitations, sales and use taxes and employment matters and ensure the organization follows them.

Filing Requirements: The board must ensure that the organization complies with deadlines for tax and financial reporting, including filings with the Secretary of State, Attorney General and IRS.

Governing Documents: Board members should be familiar with their foundation's governing documents and should follow the provisions of those documents.

Outside Help: When appropriate, board members should obtain opinions of legal counsel, accountants, appraisers or other professionals.

Board Member Liability

In general, only a corporation's or trust's own assets are at risk for actions taken by or on behalf of the corporation or trust. Nevertheless, the act or failure to act by a board member or officer of a foundation may sometimes result in personal liability. Actions or omissions that constitute a breach of fiduciary duty or breach of a personal contractual obligation, or that cause physical injury or death, may cause personal liability. Actions or omissions that are considered reckless or criminal may also give rise to personal liability. Individual directors and officers may also be held personally liable for a foundation's failure to withhold and pay certain federal taxes.

Both federal law and Minnesota state law afford some protection against personal liability to individuals serving as unpaid officers and directors of charitable organizations, including foundations. Under Minnesota law, such a person generally is not liable under civil law for acts taken in good faith, within the scope of the person's responsibilities, and which do not constitute willful or reckless misconduct. Federal law provides volunteers with somewhat duplicative immunity from both federal and state civil liability.

For More Information

See also *Frequently Asked Legal Questions: Board Fiduciary Duties, pages 41-42*.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Private Foundation Self-Dealing

Foundation abuses that reach public notice are often related to apparent violations of federal self-dealing laws by foundation officials. Because self-dealing transactions involve individuals with influence over a foundation using charitable assets for personal gain, they can erode public trust in the field. Self-dealing transactions can also carry serious tax penalties.

Here are things all grantmakers should know about the self-dealing prohibition, which applies to private foundations (most corporate foundations, family foundations and independent foundations). For a description of tax laws barring similar transactions involving community foundations and other public charities, see *Excess Benefit Transactions*, page 6.

Self-Dealing Defined

Self-dealing laws prohibit financial transactions between a private foundation and its “disqualified persons.” The definition of a disqualified person includes the foundation’s officers, directors, trustees, key employees, substantial contributors, their family members, corporations, partnerships, trusts or estates in which any of the foregoing has more than 35 percent of the voting power, profits or beneficial interest, and any owner of more than 20 percent of a corporation, partnership or trust that is a substantial contributor.

The definition of self-dealing is broad and includes the following transactions involving foundations and their disqualified persons: (a) sales, exchanges or leases of property; (b) loans; (c) the provision of goods, services or facilities; and (d) transfers of foundation assets. In addition, most payments to government officials — regardless of their relationship to the foundation — are considered self-dealing.

Self-dealing laws prohibit these transactions even though they may be fair to the foundation. It is therefore important for foundation managers to know who the foundation’s disqualified persons are and carefully evaluate every transaction between the foundation and a disqualified person.

Self-Dealing Exceptions

There are exceptions to the definition of self-dealing, which include the following:

Gifts to the Foundation: A disqualified person may transfer or furnish goods, services or facilities to a private foundation without charge.

Reasonable Compensation: A private foundation may pay reasonable compensation to a disqualified person for providing necessary professional services to the foundation. The compensation for such services must be reasonable in amount. For example, a foundation can pay an accountant who serves on the foundation’s board of directors reasonable fees for accounting services provided to the foundation.

Meals and Lodging: A private foundation may provide transportation, meals and lodging (or reimbursement for such expenses) to a disqualified person to the extent the expenses are reasonable and necessary for the foundation to conduct business.

Self-dealing can carry serious tax penalties.

Comparable to Public Availability: A private foundation may furnish goods or facilities to a disqualified person on terms that are no more favorable than those on which it makes the goods or services available to the general public. For example, a disqualified person may enjoy a museum operated by the foundation on the same terms as the public.

Incidental Benefits: Self-dealing does not include “incidental and tenuous benefits” derived by a disqualified person from a private foundation’s use of its income or assets. For example, public recognition or goodwill afforded to the disqualified person as a result of a foundation grant will normally be considered an incidental or tenuous benefit.

Penalties for Self-Dealing Violations

The Internal Revenue Service may impose substantial excise (penalty) taxes on disqualified persons who engage in self-dealing transactions under a two-tier tax system. The first-tier taxes are imposed on disqualified persons who engage in the self-dealing transaction with the private foundation. The amount of the first-tier tax on disqualified persons is 10 percent of the amount involved.

In addition, a foundation manager is subject to first-tier taxes if he or she participated in a self-dealing transaction knowing that it was self-dealing, unless the participation was not willful and was due to reasonable cause. The amount of the first-tier tax for a foundation manager is 5 percent of the amount involved.

If a self-dealing transaction is not undone or “corrected” within a certain period of time, the IRS may impose confiscatory second-tier taxes of 200 percent of the amount involved on the disqualified person, and 50 percent of the amount involved on a foundation manager who refused part or all of the correction.

Self-Dealing Pitfalls to Avoid

Private foundations that violate the self-dealing rules often do so unknowingly. Here are some common self-dealing pitfalls to avoid:

Paying for Spouse Travel: Generally, travel expenses incurred by the spouse or family member of a foundation employee or board member are not “reasonable and necessary” expenses incurred in connection with the foundation’s charitable activities. Thus, payment of such

expenses by the foundation will constitute self-dealing (and may also be a taxable expenditure), unless (a) the spouse independently performs necessary services on behalf of the foundation, or (b) the payment is treated as compensation for services to the board member or employee, and the total compensation paid to that individual is reasonable.

Fulfilling Personal Charitable Pledges: A foundation cannot satisfy a legally binding personal charitable pledge of a disqualified person. A pledge is treated like any other legal obligation of the disqualified person and therefore cannot be paid by the foundation.

Buying Tickets to Fundraising Events: A private foundation cannot purchase tickets to a charitable fundraising event and then provide the tickets to disqualified persons or to third parties if doing so benefits a disqualified person. There is an exception that permits foundation managers to use the tickets if attending the event furthers their duties for the foundation. This issue arises most frequently with corporate foundations, which may wish to make tickets available to the corporation’s employees or customers. Such uses of the tickets are barred by the self-dealing rules. Tickets for fundraisers should be purchased by the corporation or the individual attendees.

Using Credit Cards: If a disqualified person uses a foundation credit card for personal expenses and later reimburses the foundation for the expenses, this is considered a loan and a form of self-dealing, even if the person reimburses the full amount within a month of the transaction.

Paying Rent: If a foundation pays any type of rent to a disqualified person, even at below-market rates, this is considered self-dealing.

Related Matters

Even if a transaction is acceptable under the self-dealing rules, it may present a conflict of interest. See *Conflicts of Interest*, page 12.

See also *Frequently Asked Legal Questions: Private Foundation Self-Dealing*, pages 37-40.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Excess Benefit Transactions

The federal self-dealing rules apply only to private foundations; however, community foundations and other public charities are subject to similar rules prohibiting excess benefit transactions with disqualified persons. These rules are sometimes referred to as the “intermediate sanctions” law. Here are things all grantmakers that are public charities should know about excess benefit transactions.

Excess Benefit Transactions Defined

The excess benefit transactions rules provide for a penalty tax on “disqualified persons” who receive an “excess benefit” from a public charity. Generally, an excess benefit transaction is a transaction in which a public charity provides an economic benefit to a disqualified person and receives less than the value of the benefit in return.

The definition of “disqualified persons” under the excess benefit transactions rules is different from the one used for private foundations under the self-dealing rules. In this context, a disqualified person is anyone who, during the five years preceding a transaction, was in a position to exercise substantial influence over the affairs of the organization. The term includes directors and high-level officers. With respect to community foundations or other organizations that sponsor donor-advised funds, the term also includes investment advisors, their family members and entities for which they control 35 percent of voting power, profits or beneficial interest.

Excess benefit transactions may include unreasonable compensation arrangements, leases, loans and sales between an exempt organization and a disqualified person. Excess benefit transactions can also arise indirectly through intermediary entities such as an exempt organization’s taxable subsidiary.

The penalties for violations of the intermediate sanctions rules can be greater than for violations of the self-dealing rules. Disqualified persons who receive excess benefits must pay a tax equal to 25 percent of the amount of the excess benefit. If the transaction is not corrected, an additional penalty of 200 percent of the excess benefit is assessed.

Managers who knowingly approve an excess benefit transaction are also subject to an excise tax unless their participation in the transaction was not “willful” and was due to “reasonable cause.” Managers are subject to a tax equal to 10 percent of the value of the excess benefit.

Public charities are subject to rules prohibiting excess benefit transactions with disqualified persons.

Rebuttable Presumption Procedure

The intermediate sanctions rules include a procedure by which the charity may establish a “rebuttable presumption of reasonableness” for a transaction involving a disqualified person. A charity’s appropriate use of the procedure shifts the burden to the IRS to prove that the charity’s transactions with a disqualified person are not reasonable. Under the regulations implementing the intermediate sanction rules, three conditions must be satisfied to take advantage of the rebuttable presumption rules:

Approval by Disinterested Governing Board: The transaction must be approved in advance (before any payment) by the governing body or a committee of the organization composed entirely of individuals who do not have a conflict of interest with respect to the arrangement.

Reliance on Comparable Data: The board must obtain and rely on appropriate comparability data prior to making its determination. Relevant information for compensation arrangements includes, but is not limited to, current compensation surveys compiled by independent firms, compensation levels paid by similarly situated organizations for functionally comparable positions, and written offers from similar institutions competing for the services of the person under consideration. Most foundations rely heavily on salary and compensation surveys to guide them in finding a reasonable level of compensation. Commonly used surveys include the national Council on Foundations’ annual grantmaker salary survey. It is common for foundations to compare compensation levels with specific foundations of similar size, operations and geographic location. It is not necessary to look only at nonprofit data. Data from comparable for-profit organizations may also be used.

For sales or leases, independent appraisals may be used.

Concurrent Documentation: The board must document the basis for its determination concurrently with making that determination (within 60 days of the decision or the date of the next meeting of the board, whichever is later). To qualify as concurrent documentation, written or electronic records of the board (such as meeting minutes) must note:

- The terms of the transaction and the date it was approved.
- The board members who were present during the debate and those who voted on it.
- The comparability data used and how the data were obtained.
- Any actions taken with respect to consideration of the transaction by anyone who is a board member but who had a conflict of interest with respect to the transaction.

WHAT EVERY GRANTMAKER . . .

Excess Benefit Transactions (continued)

Special Rules for Donor-Advised Funds and Supporting Organizations

With respect to a donor-advised fund, the definition of an excess benefit transaction includes any grant, loan, compensation or similar payment from the donor-advised fund to the fund's donors, persons appointed by the donor as fund advisors, and entities in which such persons control 35 percent or more of the voting power, profits interest or beneficial interest. The amount of the excess benefit equals the *entire* payment, not only the amount that exceeds fair market value.

With respect to supporting organizations, excess benefit transactions include (a) any grant, loan, compensation or similar payment provided by the organization to a substantial contributor, family member of a substantial contributor, or a 35 percent controlled entity; and (b) any loan provided by the organization to a disqualified person. The excess benefit transaction is equal to the entire payment or loan amount, not merely any portion that exceeds fair market value.

Grantmakers should note that the rebuttable presumption procedure may not be used for transactions involving supporting organizations and donor-advised funds as described in this section. The transaction will be treated as an excess benefit even if it is fair and reasonable.

For More Information

See "Determining Reasonable Compensation for Foundation Directors and Trustees" and "Recommended Best Practices in Determining Reasonable Executive Compensation" at www.mcf.org/publictrust.

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Related Matters

In addition to considering the tax implications, public charities should keep in mind applicable conflicts of interest laws and their own internal policies and procedures regarding conflicts of interest when considering transactions involving a disqualified person (see *Conflicts of Interest*, page 12).

WHAT EVERY GRANTMAKER SHOULD KNOW:

Board Compensation

The Facts

Three-quarters of grantmakers do not compensate board members, according to a 2007 national Council on Foundations (COF) survey. Board compensation is most common for independent foundations, of which 60 percent provide compensation to some or all board members, compared to 28 percent of family foundations, 12 percent of public foundations and just 1 percent of community foundations.

Board compensation is more common for larger organizations, especially for family and independent foundations. Ninety-two percent of independent foundations with assets of \$500 million or more compensate some or all board members, compared to 43 percent of those with assets under \$5 million, according to the COF survey. Half of family foundations with assets of \$500 million or more provide some board compensation, compared to 16 percent of those with assets under \$10 million.

The Law

Federal self-dealing rules allow a private foundation to pay its board members reasonable compensation for their personal service on the board. For community and other public foundations, there is a similar requirement for reasonable compensation under the intermediate sanctions regulations.

Board compensation must not be excessive, and should be evaluated for reasonableness based on the functions or services required and actually performed by board members; the level of skill and experience necessary for board members to fulfill their duties; and the amount of time spent by board members in fulfilling their duties. The payment of excessive or unreasonable compensation can result in IRS-imposed excise taxes against a foundation's participating board members.

Federal law requires that all board compensation be reported on the IRS form 990 or 990-PF. Foundations should also note that payment of compensation to board members may cause them to lose immunity from liability under Minnesota and federal volunteer protection statutes.

What Is Reasonable?

Current law leaves open to interpretation what is considered reasonable compensation for a foundation's board members. A foundation may want to use the rebuttable presumption procedure described in the excess benefit transaction rules when setting board compensation. Although doing this will not give a private foundation the benefit of a rebuttable presumption, it will provide good evidence that the board took appropriate steps to ensure the compensation is reasonable (see *Excess Benefit Transactions*, page 6).

philanthropy & public trust

*Board compensation
cannot be excessive.*

WHAT EVERY GRANTMAKER . . .

Board Compensation (continued)

Procedures

Of those grantmakers that provide board compensation, 60 percent compensate all their board members and 40 percent compensate just some members, according to the COF survey. For grantmakers that compensate selected board members, the most common people to be compensated are the board chair/president (23 percent), non-family members (20 percent) and staff members who are also board members (20 percent).

Most foundations that compensate their directors use some combination of set fees, including per meeting or annual fees. COF advises against the practice of compensating board members by providing a fee based on a percentage of assets or income, utilized by a few foundations, because that practice provides much greater potential for excessive compensation.

Reimbursement and Fees for Service

Aside from compensating board members for their service on the board, some grantmakers pay board members for professional services they provide to the organization, such as accounting, investment, legal and public relations. However, the COF survey shows that many grantmakers (59 percent) receive such services from board members on a pro bono basis. If a foundation pays its board members for professional services, this is another situation in which it will be advisable to follow the rebuttable presumption procedures that are applicable to community foundations and other public charities (see *Excess Benefit Transactions*, page 3).

Although most grantmakers do not compensate their board members, a larger number have determined that it is appropriate to reimburse board members for certain expenses. According to the COF survey, more than half of grantmakers (53 percent) reimburse board members for expenses tied to foundation business activities such as site visits, and 40 percent reimburse for expenses incurred to attend board meetings.

Developing a Policy

Foundations that compensate and/or reimburse board members should consider developing a compensation and reimbursement policy. Although having such a policy does not guarantee that the reasonable compensation requirement is met, a policy will provide clear documentation of how the organization handles such matters, and can help bring clarity to the issue for the board.

A compensation and reimbursement policy may include the following components:

- A brief rationale for the policy.
- Position descriptions for board members and staff.
- A detailed explanation of how compensation will be determined.
- Details on which expenses will and will not be reimbursed, and limits on reimbursed expenses.
- Identification of the decision-makers for compensation matters.

Alternatives to Compensation

As an alternative to board compensation, some grantmakers use one or more of the following options to honor and encourage their board members' service:

Discretionary Grants: Foundations may permit board members to make a small number of discretionary grants to nonprofits of their choice, within stated guidelines, or provide a small discretionary grants budget to each board member. One-fourth of all grantmakers (and nearly half of family foundations) allow discretionary grants for board members, according to a COF survey.

Matching Grants: Some grantmakers make matching grants in recognition of a board member's personal gift to a nonprofit, up to a certain amount each year. Matching grants are more common for larger organizations. A COF survey shows that about half of grantmakers with assets of \$500 million or more provide board matching grants, compared to 10 percent of organizations with assets under \$5 million.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Staff Compensation

The Law

As described in the sections of this booklet on self-dealing and excess benefit transactions, the Internal Revenue Code imposes excise tax penalties when unreasonable or excessive compensation is paid to high-level employees of charitable organizations. Examples of excessive staff compensation that get the most attention by elected officials and the media tend to involve compensation paid to the president or CEO.

What Is Reasonable?

Generally, reasonable staff compensation is defined as what similar persons in similar positions with similar duties at similar organizations are paid.

Both private foundations and public charities may determine appropriate staff compensation, particularly for senior-level positions, using the guidance provided by the rebuttable presumption procedure described in the excess benefit transaction rules. Although these rules only apply to community foundations and other public charities, the rules offer useful guidance for all foundations on best practices to follow for compensation decisions.

Although private foundations may wish to use the rebuttable presumption procedure as a matter of good governance, it is important to note that only public charities currently get the benefit of the rebuttable presumption.

*Reasonable staff
compensation is what
similar positions at similar
organizations are paid.*

Conflicts of Interest

Conflicts of interest are a matter of both legal and ethical concern for foundations and other grantmakers. A strong conflict of interest policy not only helps promote compliance with the law, but also helps a grantmaker develop a consistent approach to actual and perceived conflicts of interest. Here are things all grantmakers should know about conflicts of interest.

Conflicts of Interest Defined

For foundations, a conflict of interest arises when a board member or officer has a personal interest in a transaction that conflicts, or may conflict, with the best interests of the foundation. Under fiduciary standards, the duty of loyalty (see page 3) requires the director or officer to set aside personal or conflicting interests and act solely in the best interest of the foundation when making a decision or acting on behalf of the foundation.

Transactions where conflicts may arise include the sale or purchase of goods, services or rights; the provision or receipt of a grant or loan; or the establishment of any other type of financial relationship with the foundation.

Conflicts of interest may arise *directly* in a transaction between the foundation and a director or officer, or *indirectly* in transactions between the foundation and family members of directors or officers, or entities in which these individuals have a material financial interest or a management or oversight role. Although the Minnesota statute does not define a “material financial interest,” this term generally includes a financial interest that an ordinarily prudent person in a similar position would reasonably conclude could affect one’s judgment in making decisions about a transaction with that entity. The definition of a family member varies by law. For purposes of the Minnesota Nonprofit Corporation Act, a family member includes a spouse, parent, child, sibling, or spouse of a child or sibling.

For grantmakers organized as nonprofit corporations, the law generally requires that a conflicting interest transaction be fair and reasonable to the grantmaker at the time it occurs. Fair and reasonable transactions generally are not void or voidable. The individual with the conflict of interest has the burden to prove the fairness of the transaction.

Minnesota law also provides a “safe harbor” for approval of conflicting interest transactions. Under the safe harbor, a transaction in which a nonprofit director has a conflict of interest is not void or voidable if the director’s interest is fully disclosed to the board, and the transaction is approved by a majority of the disinterested directors, without counting the vote the interested director might otherwise have, and without counting the interested director in determining the presence of a quorum. It is advisable to use this procedure whenever possible.

More stringent conflict of interest standards may apply to grantmakers organized as trusts. These requirements will vary from state to state.

Conflicts of interest are a matter of both legal and ethical concern.

Managing Conflicts

Although the law does not require a grantmaker to adopt a conflict of interest policy, doing so can help the organization ensure that it handles conflicts of interest appropriately. (IRS Form 990, which is filed by public charities but not private foundations, asks whether the organization has a conflict of interest policy, leading many organizations to believe that a policy is required under the tax laws. It is not.) Having a policy is also advisable in the event that transactions are scrutinized by the IRS, the State Attorney General or the media. Of course, a conflict of interest policy is useful only if a grantmaker follows the policy consistently.

A good policy should address conflicts involving directors, officers and staff, and should provide a process for these individuals to disclose potential conflicts of interest. It is common to require annual written disclosures of business and financial interests, in addition to requiring disclosures as potential conflicts arise in the course of business.

The policy should also provide a process for the board (or in the case of staff conflicts, the president or chief executive officer) to address conflicts of interest. Common mechanisms include requiring full disclosure of the conflict, prohibiting the interested individual from participating in discussion and voting on the affected transaction, requiring documentation in the minutes of all votes concerning the transaction, and giving the chair of the meeting the power to ask the interested individual to leave the room during discussion and voting.

Other provisions that some grantmakers choose to include in their conflicts of interest policies:

- Requirements that alternatives to the conflicted transaction be explored.
- Requirements that the rebuttable presumption procedure for excess benefit transactions be used where applicable.
- Procedures for acceptance or offering of gifts or gratuities.
- Procedures to address outside activities, such as consulting, speaking or service as a director on other boards.

Sample Policies

If your foundation needs to prepare a conflict of interest policy, or is interested in reviewing or revamping your policy, several examples and templates of conflicts of interest policies are available. Find more information and sample policies at www.mcf.org/publictrust.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Reporting and Disclosure

Foundations focus on annual reporting not just for tax requirements but also for the purpose of community relations, transparency and accountability. Here are things all grantmakers should know about reporting and disclosure.

Annual Reporting

INTERNAL REVENUE SERVICE

All private foundations, regardless of income or asset size, are required to annually file IRS Form 990-PF. Public charities, including community foundations, are generally required to file IRS Form 990 if their annual gross receipts are normally more than \$25,000; however, some organizations may file the simpler Form 990-EZ. For tax year 2009, public charities with gross receipts of less than \$500,000 and assets of less than \$1.25 million are eligible to file Form 990-EZ. For subsequent tax years, the ceilings are reduced to \$200,000 and \$500,000, respectively.

Forms 990-PF, 990 and 990-EZ must be filed by the 15th day of the fifth month after the end of an organization's fiscal year. For example, a private foundation with a fiscal year ending Dec. 31 must file its Form 990-PF by May 15 of the following year. Form 8868 may be used to request an automatic three-month extension.

Public charities with gross receipts normally \$25,000 or less must file an annual report with the IRS that provides basic information about the organization, such as its name, address, web address, principal officer and evidence of its continuing eligibility for exemption from Form 990 filing requirements.

STATE CORPORATE FILINGS

Foundations organized as nonprofit corporations generally must file annually with the Secretary of State in their state of incorporation and other states where they are qualified to do business. Minnesota nonprofit corporations are required to file a Nonprofit Corporation Renewal form with the Minnesota Secretary of State by Dec. 31 of each year. Failure to file the form results in dissolution of the corporation without further notice.

Annual reporting is done not just for tax requirements but also for community relations, transparency and accountability.

CHARITABLE SOLICITATION FILINGS

Most states require charitable organizations that solicit funds to register with the appropriate state regulatory agency. For instance, charitable organizations that solicit contributions from the public in Minnesota must register and report annually to the Minnesota Attorney General's Office. The initial Charitable Organization Registration Statement for such organizations must be filed with the appropriate attachments and \$25 fee within 30 days after the organization's total contributions exceed \$25,000. In each subsequent year, soliciting organizations must file a Charitable Organization Annual Report with the appropriate attachments and \$25 fee by the 15th day of the seventh month following the close of its fiscal year.

Certain charitable organizations are exempt from the state's registration and reporting requirements. For example, organizations are exempt if they receive less than \$25,000 in annual contributions and do not use paid staff members or professional fundraisers.

Private foundations and other Minnesota charities that do not solicit contributions from the public (and have gross assets of \$25,000 or more at any time during the year) must file with the Minnesota Attorney General's Office a Charitable Trust Registration Statement, with the appropriate attachments and \$25 fee within three months after the organization receives assets. Such organizations are not required to submit annual reports; however, they must submit copies of their Forms 990, 990-EZ or 990-PF each year.

Disclosures

DISCLOSURES REQUIRED BY THE IRS

Federal law requires public charities and private foundations to make available for public inspection, without charge, copies of their original and amended annual tax returns (Forms 990, 990-EZ or 990-PF) for the last three years. Public charities are not required to publicly disclose the portions of the returns that include the names and addresses of contributors to the organization, but private foundations are required to publicly disclose this information. Form 990-T, on which charities report unrelated business taxable income, must also be made available to the public.

Charities also must make available for public inspection, without charge, copies of their exemption applications, along with the accompanying attachments and amendments, and any documents issued by the IRS concerning the application. The organization may request that certain proprietary information, such as trade secrets, be withheld from public inspection.

Foundations and public charities must make their annual returns and exemption application materials available at their principal, regional and district offices during regular business hours. If the organization does not maintain a permanent office, it must make the information available for inspection at a reasonable location of its choice or mail the information. Requested copies must be made available on a same-day basis for walk-in requests, and within 30 days for mail-in requests. An organization may set reasonable costs for copying these materials, including staff time and actual costs.

WHAT EVERY GRANTMAKER . . .

Reporting and Disclosure (continued)

A foundation or public charity is exempt from the requirement to provide copies of its tax returns and exemption materials if it makes them “widely available” by posting these materials on a website and directing requestors to the appropriate web page, provided that the online forms are exact images of the originals and can be downloaded free of charge.

GuideStar (www.guidestar.org) and the Foundation Center (www.foundationcenter.org) post the 990 and 990-PF forms for thousands of public charities and foundations in the easily downloadable PDF format. There is some disagreement among legal analysts as to whether posting a tax form on either site will satisfy a foundation’s federal disclosure requirement, since both sites block out some or all signatures on the online forms due to privacy concerns. Some analysts have expressed concerns because the regulations require the posting of exact duplicates of returns on the websites and do not expressly permit the removal of signatures. But other analysts believe that a publicly available and otherwise unrevised return meets the spirit of the law.

PROACTIVE PUBLIC COMMUNICATIONS

Forms 990-PF and 990: Grantmakers have traditionally treated the 990-PF and 990 tax forms solely as vehicles for reporting their financial information to the IRS, but mandatory reporting and the greater accessibility of 990s through the Internet have made the 990 forms an important means of communication with a much broader audience. Anyone with a computer and Internet connection has easy access to the tax returns of most foundations free of charge.

This newfound transparency means that grantseekers, reporters, colleagues and researchers alike will look to a foundation’s 990-PF or 990 as one more tool in researching and evaluating the organization. The foundation’s accountant and CEO should not be the only people who pay much attention to the 990-PF or 990. The board, program and communications staff should also be familiar with the return and may be helpful in adding more detailed information that adds context to the form.

Annual Report: The annual report is another common vehicle grantmakers use to report their financial information and grantmaking accomplishments. Grantmakers are not required by law to produce an annual report, but the grantmaking field has encouraged funders to distribute annual reports as a way to improve the sector’s openness and accountability.

Annual reports can include an organization’s financial highlights, a complete list of grants for the previous year, and funding highlights and grantee accomplishments. Grantmakers can also consider including grant guidelines and application procedures in the report.

Traditionally, grantmakers' annual reports have been printed documents, but with the advent of the Internet, a growing number of grantmakers are making the information in their annual reports available on their website. This can limit printing and mailing costs, and makes the report accessible to people when and where they want it.

For a corporate grantmaker, the only legal reporting requirements are for the portion of giving from the company's foundation (if it has a foundation), and it must follow the same reporting requirements as any other 501(c)(3) organization. However, many companies issue annual reports on their full contributions program, including contributions made directly by the company, which is a proactive approach that helps build community relations and can help minimize calls for greater reporting and oversight.

Other Reporting Options: Aside from 990s and annual reports, other common reporting vehicles for grantmakers include grant application and guidelines brochures, newsletters and general websites.

The Minnesota Council on Foundations also provides several communications vehicles that can help members be open and accountable about their giving:

- MCF's Minnesota Grantmakers Online (www.mcf.org/mngrants), the largest online database of Minnesota grantmakers and grants, allows foundations to provide a profile (which can be updated online anytime) with basic information about the organization's programs, application procedures, recent grants, staff, directors/trustees and more. A similar profile is published in MCF's annual *Guide to Minnesota Grantmakers* print directory.
- MCF also broadly communicates members' recent grants, notable accomplishments, changes in guidelines or programs, staff/trustee news and more through *Giving Forum*, a free quarterly newspaper distributed to more than 15,000 readers in Minnesota's nonprofit and philanthropy community, and *MCF Giving Memo* (public) and *MCF Notes* (member), free e-newsletters with about 3,000 subscribers (www.mcf.org/enews). And mcf.org features links to grantmaker websites, a grantmaker deadlines calendar, the latest grantmaker news and much more.

For More Information

990s Online:

The Foundation Center's 990-PF Search: www.foundationcenter.org/findfunders/990finder. For information about posting your 990-PF on the site, go to www.foundationcenter.org/grantmakers/990pf.html.

GuideStar: www.guidestar.org. To learn more about linking from your website to your 990-PF image on GuideStar, contact customerservice@guidestar.org.

"Making the Most of Your Form 990-PF" tip sheet at www.mcf.org/publictrust.

Other:

See also *Frequently Asked Legal Questions: Annual Reporting and Public Disclosure*, pages 50-51.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Investments

Although a foundation's grantmaking activity typically attracts the most attention, its investment activity is, in many ways, the true heart of its operations. The more successful a foundation's investment returns, the more charitable funds it will have available to fulfill the organization's mission. A foundation, therefore, needs sound, effective investment policies and practices to maximize its effectiveness as a grantmaker.

Here are things all grantmakers should know about investments.

What the Law Requires

FIDUCIARY DUTIES OF THE BOARD

The overall responsibility for a foundation's investments rests with its board of directors or trustees. The governing board of a foundation has a legal obligation to manage the foundation's assets and income prudently. If a foundation is not a "pass-through" foundation but instead holds assets that it invests to produce income for grantmaking and operational purposes, its board members have a fiduciary obligation to establish and monitor prudent investment policies and oversight functions.

The board can rely either on internal board or staff expertise, or it can obtain outside expert advice, depending on the foundation's size, complexity and internal resources. A board member is entitled to rely upon information, opinions and reports from staff, board committees and outside professionals and experts the board member reasonably believes to be reliable and competent. Even if a board uses outside investment help, board members need to be familiar with the foundation's investment results and insist that investment managers provide them with the necessary information to ensure that they are properly fulfilling their legal fiduciary responsibility to the foundation.

A foundation's investment activity is, in many ways, the true heart of its operations.

LAWS REGULATING INVESTMENT STRATEGY

Most states have adopted laws governing the investment of charitable assets, including the Uniform Prudent Investor Act (UPIA). This law embraces the concept of modern portfolio theory, under which prudent investment policy is based on diversification of assets, long-term performance benchmarks and the importance of a portfolio's total return on investment. No particular category of investments is barred. Rather, an investment is viewed in the context of the entire portfolio, and investment managers are expected to balance risk and return in making investment decisions.

Most states have also adopted the Uniform Prudent Management of Institutional Funds Act (UPMIFA), which, among other things, makes many of the concepts in the UPIA applicable to the investment of institutional funds, including endowment funds, held by a charity for its own use. UPMIFA also addresses spending from those funds.

JEOPARDIZING INVESTMENT RULES

In addition to state corporate or trust law, UPMIFA, and UPIA, private foundations are subject to the federal excise tax rules that bar "jeopardizing investments." Jeopardizing investments are those that show a lack of reasonable business care and prudence in providing for the long- and short-term financial needs of the foundation. Although no category of investment is considered inherently too risky, certain types of investments receive particular scrutiny, including trading in securities on margin; trading in commodities futures; investments in working interests in oil and gas wells; purchase of puts, calls and straddles; warrants; selling short; investments in junk bonds; risk arbitrage; hedge funds; derivatives; distressed real estate; and international equities in third-world countries.

Jeopardizing investments should be distinguished from "program-related investments," which may take the form of a financial investment but are made primarily for charitable rather than investment purposes. Examples of program-related investments include buying shares of a small business in an economically depressed area, micro-lending programs and providing seed money to capitalize a community development loan fund. Even though they may be risky, program-related investments do not violate the jeopardizing investment rules. In order to qualify as a program-related investment, three conditions must be met:

- The primary purpose of the investment must be to accomplish the foundation's charitable purposes.
- Production of income cannot be a significant purpose of the investment.
- The investment cannot involve lobbying or political campaign activity.

OTHER

Foundation board members should also be aware of other legal issues that may arise in the investment context, such as the prohibition against excess business holdings, which generally prevents a private foundation from holding a substantial interest in a single company or business enterprise (although there is a five-year period for disposing of excess business holdings acquired by gift or bequest). There are also legal and investment issues to be considered when a foundation receives contributions of specific assets subject to donor restrictions on use or sale, or assets that the donor or the board wishes to put to use in furtherance of the foundation's charitable purposes. In these situations, professional advice is particularly important.

Investment Committees

Many boards delegate investment responsibilities to an investment committee. The majority of the committee is usually comprised of board members, although sometimes a foundation will also invite non-board members with particular investment skills and expertise to serve on the committee.

The main role of the investment committee is to recommend investment policies and guidelines that protect the foundation's investment assets. The committee should develop an investment strategy and continuously monitor the foundation's investment portfolio through comprehensive analysis and review of the performance of the investments and managers. Typical duties and responsibilities of a foundation's investment committee include the following:

- Formulate and amend, as required, the foundation's investment and spending policy statements for recommendation to the board.
- Develop and maintain an investment strategy to accomplish the foundation's goals.
- Adopt and revise investment management agreements as needed with consultants, managers and custodians for approval by the board.
- Meet periodically (at least annually is recommended) with the investment consultants to review and assess the investment strategy.

- Review the asset allocation, individual manager and combined portfolio performance on a regularly scheduled basis (at least quarterly is recommended), and make any course corrections necessary.
- Meet with each investment manager on a regular basis to review style, performance, guidelines and objectives to ensure compliance and a clear understanding of the foundation's position and goals.
- Recommend the addition, deletion and replacement of investment managers as appropriate, consistent with the goals and objectives of the foundation's investment policy.
- Manage investment assets not managed by professional investment managers.
- Report on a timely basis all committee findings, activities and recommendations to the board.

A foundation should have a written description of the roles and responsibilities of its investment committee. Sample investment committee descriptions can be found at www.mcf.org/publictrust.

The Investment Policy

A foundation should have in place a sound, effective investment policy to guide its investing activities. A foundation investment policy may include the following elements:

Definition of the Investment Duties: The policy should spell out the roles and responsibilities of the board, investment committee, staff and consultants in managing investments.

Spending Policy: A spending policy describes the processes and procedures the foundation will follow to calculate the percentage of its endowment or unendowed assets available for grants and operating expenses each year. In establishing a spending policy, a foundation should consider such important issues as whether it wants to meet or exceed the minimum 5 percent payout requirement (if it is a private foundation) and whether it wants to grow its endowment or maintain the endowment at current levels (inflation-adjusted).

Performance Objectives: The policy may include a statement of long-term investment performance objectives, including a goal for the minimum annual total return the foundation hopes to achieve over a specific period of time. The return objective for most foundations is the amount needed to maintain the value of the endowment while also meeting the foundation's spending objectives and the expected rate of inflation.

Strategic Statement: The policy may include a statement of the foundation's philosophy regarding the use of fixed-income and equity securities.

Allocation Formula: The policy may provide an asset allocation formula, including target percentages of total investments in fixed-income versus equity securities, and target percentages in various types of equity holdings.

Manager Guidelines: The policy may include guidelines on how much managers can invest in a single stock, maximum percentage of a company they can own, minimum number of positions they can have in a portfolio, maximum percentage any one company can have in the manager's total portfolio, and areas determined off-limits (commodities, art objects, real estate, gold, etc.). Equity managers also may be told when they can invest in fixed-income securities, how much they can have in cash, and the minimum investments quality levels (AA or A bonds, no junk bonds, no derivatives, etc.).

WHAT EVERY GRANTMAKER . . .

Investments (continued)

Mission-Related Investing

Some foundations are exploring the concept of “mission-related investing,” sometimes known as “socially responsible investing.” The Foundation Partnership on Corporate Responsibility defines mission-related investing as an integration of the relationships among a foundation’s asset management and charitable purpose. Mission-related investing could include:

Portfolio Screening: A foundation may screen portfolios to include best-in-class corporations or avoid corporations that have poor records on social issues, environmental issues or other issues of interest to the foundation.

Proxy Voting: Shareholder activity may include voting proxies on a company’s proxy statement, or developing a set of proxy voting guidelines covering issues of concern to the foundation. These activities could also include engaging corporations in dialogues on issues of concern, and filing and co-filing shareholder resolutions.

Early Investment: Mission-related venture capital uses the foundation’s assets for early-stage investment in companies that are seeking solutions to the problems that the foundation is seeking to solve through its grantmaking.

Community Investing: Community investing assists underserved communities in meeting their development needs. There is disagreement in the foundation field about the use of mission-related investing. Some would argue that the board’s primary fiduciary responsibility is to ensure the maximum return on the foundation’s investment assets, so that the foundation has the largest amount of financial resources possible to fulfill its mission. Others would argue that in order to fulfill its fiduciary responsibilities, a board has a duty to consider whether the foundation’s investment decisions will further its charitable purposes — or at least not run counter to them.

For More Information

See also *Frequently Asked Legal Questions: Investments*, page 43.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Grantmaking

Grantmaking is the most visible activity foundations undertake. It is therefore critical to comply with applicable legal requirements and to develop consistent practices to maintain the public's trust. Here are things all grantmakers should know about the process of making grants.

Private Foundations

Private foundations are required each year to make "qualifying distributions" in an amount approximately equal to 5 percent of their investment assets. Grants and administrative expenses (other than investment expenses) count toward this payout requirement. When making grants and other distributions, private foundations must take care to avoid prohibited payments known as "taxable expenditures." Private foundations that make a taxable expenditure must pay an excise tax on the expenditure and correct the transaction.

Taxable expenditures include amounts paid or incurred (a) to carry on propaganda or otherwise attempt to influence legislation; (b) to influence the outcome of public elections or carry on voter registration drives; (c) to individuals for travel or study (unless requirements described below are met); (d) to organizations other than public charities; or (e) for purposes that are not charitable.

Grants to individuals and organizations are discussed in more detail in the following paragraphs. For additional information about lobbying and public policy activities, see *Public Policy Engagement*, page 27.

Grants to Individuals: Grants to individuals are generally permissible, as long as they serve a charitable purpose. If the grant is made for travel or study, including scholarship and fellowship grants, a private foundation may make the grant to the individual only pursuant to a program that has been approved in advance by the IRS. As an alternative, the foundation may make the grant to a school or college and allow the school to choose the scholarship recipient. Such a grant will be treated as having been made to the school, rather than the individual.

If the grantee is not a public charity, the foundation must exercise "expenditure responsibility."

Grants to Organizations: Private foundations generally may make grants to organizations that qualify under IRS requirements as section 501(c)(3) public charities if the grant is made for a charitable purpose. If the grantee organization is not a public charity, the foundation must exercise “expenditure responsibility.” A private foundation must also exercise expenditure responsibility if the grantee is a public charity that is classified as a supporting organization described in section 509(a)(3) of the Internal Revenue Code, and is considered a “Type III” supporting organization that is not “functionally integrated.” The process for determining the status of a public charity is discussed in more detail below.

Expenditure responsibility requires:

- *Pre-grant inquiry:* Prior to making the grant, the foundation must conduct an inquiry that is complete enough to give a reasonable person assurance that the grant will be used for proper purposes. If the grantee has a good track record with the foundation, no pre-grant inquiry is ordinarily required.
- *Written grant agreement:* The agreement must state the purposes of the grant, and require the grantee to return funds not used for grant purposes, submit annual reports, maintain financial records, not use the funds for inappropriate purposes, and hold the funds in a separate account.
- *Grantee reports:* The grantee must submit annual reports describing the use of funds, compliance with the terms of the grant, and progress toward achieving the objectives of the grant. The grantee must also submit a final report identifying all expenditures of grant funds.
- *Report to IRS:* The foundation must include information about the grant on its 990-PF.
- *Recordkeeping:* The foundation must maintain certain records concerning the grant and take remedial steps if it discovers the grantee has diverted the funds.

Determining Public Charity Status: Private foundations have always had to undertake due diligence to confirm that organizational grantees are section 501(c)(3) public charities. Typically, that due diligence includes obtaining a copy of the grantee’s IRS determination letter, obtaining confirmation from the grantee that its public charity status has not been revoked, and perhaps reviewing IRS Publication 78, which lists recognized 501(c)(3) organizations.

Because private foundations are required to exercise expenditure responsibility with respect to grants made to certain supporting organizations, the due diligence process for grants to supporting organizations is somewhat complex. Private foundations must ensure that any supporting organization they fund qualifies as a “Type I,” “Type II” or “functionally integrated Type III” organization. The IRS has published Notice 2006-109, which describes, among other things, procedures to determine the classification of a supporting organization. As of the date of this publication, Notice 2006-109 is available at www.irs.gov/eo. If a foundation determines that a supporting organization is a non-functionally integrated Type III supporting organization, it should consider carefully whether to make the grant. Grants to such organizations require the exercise of expenditure responsibility and, unlike all other grants made for charitable purposes, do not count toward the 5-percent payout requirement.

Foreign Organizations: Foreign charities usually do not have determinations from the IRS as to their 501(c)(3) and private foundation status. A U.S. private foundation therefore cannot easily determine whether grants to the foreign organization will require the exercise of expenditure responsibility. The foundation is allowed to rely on its own good-faith determination as to the grantee's status if it obtains an affidavit from the grantee (or an opinion from the foundation's or the grantee's legal counsel) setting forth sufficient facts about the grantee's operations and support that would allow the IRS to determine that the grantee would qualify as a public charity. Alternatively, the foundation can choose to exercise expenditure responsibility. Use of this approach was reaffirmed in an April 18, 2001, IRS letter to the Council on Foundations. Under certain circumstances, a U.S. intermediary organization (fiscal agent) can be used to avoid expenditure responsibility or the affidavit process. The use of fiscal agents must be carefully managed, however, to avoid making a taxable expenditure.

Program-Related Investments: Although program-related investments often take the form of loans, they are treated as grants for purposes of the taxable expenditure rules. If the entity in which the foundation invests is not a public charity, the foundation generally will have to exercise expenditure responsibility with respect to the investment. For example, if a foundation makes a loan to a small business in a distressed neighborhood, it must exercise expenditure responsibility with respect to the loan.

Public Charities

Public charities are free from many of the procedural restrictions imposed on private foundations under the taxable expenditure rules. Like private foundations, however, community foundations and other public charities must ensure that their grants are made solely for charitable purposes. In addition, certain distributions made from donor-advised funds maintained by public charities are treated as "taxable distributions" that are subject to excise taxes similar to those that apply to private foundations.

It is important to consider the definition of a donor-advised fund when analyzing whether a proposed grant is permissible. A donor-advised fund is a fund or account that (a) is separately identified by reference to contributions of a donor or donors; (b) is owned and controlled by a sponsoring organization (such as a community foundation); and (c) affords advisory rights to the donor or his or her appointee with respect to distribution or investment of amounts held in the fund.

The definition of a donor-advised fund excludes (a) funds that make distributions only to a single identified organization, and (b) funds with respect to which a donor or person designated by a donor makes recommendations concerning grants for travel or study, but only if the individual makes recommendations as part of a committee appointed by the sponsoring organization, donors and their designees do not control the committee, and the grants are awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the board of directors of the sponsoring organization.

A taxable distribution from a donor-advised fund includes:

- Any distribution made to an individual.
- Any distribution made for non-charitable purposes.
- Any distribution to an organization that is not a public charity (unless the organization that sponsors the donor-advised fund exercises expenditure responsibility).
- Any distribution to a non-functionally integrated Type III supporting organization (unless the organization exercises expenditure responsibility).
- Any distribution to a supporting organization that is controlled by the donor or a donor-advisor of the fund (unless the organization exercises expenditure responsibility).

The prohibition against distributions to individuals bars the payment of scholarships and similar grants from donor-advised funds, and also prohibits such funds from reimbursing individuals for expenses incurred for fundraising or similar events.

Donor-advised funds are also subject to excise taxes for distributions that result in more than an incidental benefits to donors, donor advisors and certain related parties.

Avoiding Financing Terrorist Activities

Both private foundations and public charities must take care to ensure their grants do not support terrorists or terrorist activities. The U.S. Department of Treasury has issued *Anti-Terrorist Financing Guidelines: Voluntary Best Practices for U.S.-Based Charities*. These guidelines recommend, in some detail, various practices that charities and foundations can undertake when providing assistance to other organizations (domestic and foreign) to minimize the risk that charitable resources will be inadvertently diverted to support terrorism. The guidelines are voluntary and cover both grantmaking practices and corporate governance practices.

While the guidelines are quite detailed and in some cases perhaps overly burdensome and costly, they do acknowledge that charities and foundations may adopt a “risk-based approach” to investigating possible ties between recipient organizations and terrorism. The guidelines emphasize that not every practice identified in the guidelines will be appropriate for every organization in every circumstance, and that there may be exigent circumstances (such as catastrophic disasters) that make application of the guidelines impracticable. The Treasury recommends, in those cases, that organizations take “all prudent and reasonable measures that are feasible under the circumstances.”

For More Information

See also *Frequently Asked Legal Questions: Grantmaking*, pages 47-49.

WHAT EVERY GRANTMAKER SHOULD KNOW:

Public Policy Engagement

Many grantmakers historically shied away from involvement in lobbying, advocacy or public policy work, prompted in large part by strict federal laws; however, the tide appears to be changing, as a growing number of foundations in Minnesota and across the country have become more engaged in elevating the public dialogue on issues integral to their missions. Here are things all grantmakers should know about advocacy and public policy.

Terms Defined

Public Policy: There is no single definition of “public policy.” In this document, public policy refers to the principles guiding any level of government or its representatives on a given topic, as expressed in laws, administrative practices, regulations, funding priorities and executive or judicial orders.

Lobbying: Lobbying is one specific form of public policy engagement that is often a key strategy for making and changing laws. Lobbying is defined by federal tax law as any attempt to influence specific legislation. More specifically, lobbying is any attempt to influence public officials in support of, or in opposition to, any legislation that has been introduced, or any legislation that may be introduced, in any legislative body, such as a city council, state legislature or Congress. Lobbying includes communicating with legislators and their staff directly, and encouraging others to contact their legislators.

Direct Lobbying: Direct lobbying is a communication with a member or employee of a legislative body (or certain other government officials) that both (a) refers to specific legislation, and (b) reflects a view on the legislation.

Grassroots Lobbying: Grassroots lobbying is any attempt to influence the opinions of the general public about specific legislation. In order to be grassroots lobbying, a communication must (a) refer to specific legislation, (b) reflect a view on the legislation, and (c) encourage the recipient to take action, such as contacting his or her legislator.

Advocacy: The term “advocacy” covers a much broader range of activities to push for changes in public policy, and these activities may or may not include lobbying. One way of differentiating between lobbying and advocacy is to understand that lobbying always involves advocacy, but advocacy does not necessarily involve lobbying.

The term “advocacy” covers a broad range of activities to push for changes in public policy.

Private Foundation Rules

Private foundations are prohibited from expending funds “to carry on propaganda, or otherwise attempt to influence legislation.” This rule prohibits both direct lobbying activities by the foundation and grantmaking to support lobbying.

Notwithstanding the restrictions on lobbying that apply to private foundations, there are many ways private foundations can participate in public policy and advocacy. First, they can participate in or make grants to support the activities described in this section that do not constitute lobbying. Here are other examples:

Project Support Grants: Private foundations may also make grants for a project that involves some lobbying activity as long as the amount of that grant, together with all other grants by the same foundation for the same project for the same year, does not exceed the amount budgeted by the grantee for project activities other than lobbying. In making this determination, the foundation can rely in good faith on the grantee’s budget for the project. If, however, the foundation has reason to doubt the grantee’s information or reasonably should doubt the grantee’s information, then the foundation may not rely on the information.

General Support Grants: Another option is to make a general support grant to an organization that lobbies, as long as the grant is not earmarked to be used for lobbying. (A grant is earmarked if the grantee is required to use it for a specific purpose or recipient, or if the grantor has the right to impose such a requirement.) A private foundation may make a general support grant to a public charity even if the charity is known to engage in some lobbying activities and is likely to use some of the grant for that purpose. Unlike specific project grants, the regulations do not require a private foundation to seek information about a charity’s lobbying budget when the charity applies for a general support grant.

Jointly Funded Programs: A narrow exception to the lobbying definition allows private foundations (but not their grantees) to present information to government officials about a program that is, or may be, funded by both the foundation and the government, provided that the communications are limited to the program.

Exceptions to Definition of Lobbying

Foundations that are interested in public policy and advocacy should keep in mind the following activities, which for tax purposes are not considered to be lobbying:

Nonpartisan Analysis, Study or Research: Certain educational or research activities are expressly excluded from the legal definition of lobbying. Nonpartisan analysis, study or research on a particular topic is not considered lobbying even if the research or report advocates a particular viewpoint, so long as there is a sufficiently complete and balanced discussion to enable members of the public to form their own opinions or conclusions on the issue. The nonpartisan analysis, study or research must be made widely available and cannot be distributed selectively to persons on only one side of the issue.

Discussions of Broad Social Problems: A related exception pertains to “examinations and discussions of broad social, economic and similar problems.” Examinations and discussions of such problems do not constitute lobbying even if the problems are of a type with which government would be expected to deal ultimately, and even if the communications are made to legislators, so long as the discussions do not address the merits of a specific legislative proposal and do not directly encourage recipients to take action with respect to legislation.

Legislative Testimony and Technical Assistance: Providing testimony or other technical assistance to governmental bodies or committees is not lobbying if done in response to a written request by the body or committee and if the testimony or assistance is available to every member of the requesting body or committee.

“Self-Defense” Lobbying: Communications with legislative bodies about proposed legislation that would affect the existence of a charity, its powers and duties, its tax-exempt status or the deductibility of contributions is not considered lobbying.

Membership Communications: Communications by a public charity to its members that refer to legislation or reflect a view of direct interest to the organization and its members, but do not encourage the reader to lobby, are not treated as lobbying.

Public Charity Requirements

Public charities, such as community foundations, operate under lobbying laws and regulations that are somewhat less restrictive than those for private foundations. Public charities are allowed to lobby as long as “no substantial part” of the charity’s activities consists of lobbying.

“No Substantial Part” Test: The IRS and the courts have consistently declined to provide a clear rule about how much lobbying constitutes a “substantial part” of a public charity’s activities. Also, the “no substantial part” rule fails to define clearly what activities are considered to be lobbying or how much money a charity may spend on lobbying.

501(h) Election: If a public charity (other than a church) chooses, it may avoid the uncertainties of the “no substantial part” test altogether by making a section 501(h) election. Section 501(h) of the Internal Revenue Code sets financial limits for lobbying activities and also defines, in considerable detail, the activities that count against those limits. In general terms, total direct lobbying expenses for a given year may not exceed 20 percent of the first \$500,000 of an organization’s expenses, plus 15 percent of the second \$500,000, plus 10 percent of the third \$500,000, plus 5 percent of the remainder, subject to an overall \$1 million limit. In addition, grassroots lobbying expenditures may not exceed 25 percent of the overall lobbying limit.

Advantages of 501(h) Election: The 501(h) election has a number of advantages. First, only expenditures are considered when analyzing whether an organization is in compliance with section 501(h). This means that activities undertaken by volunteers will not count toward the 501(h) limits, nor generally will the amount of time spent on the lobbying activities be considered. Second, the regulations are clear in defining what is and is not lobbying. Third, the expenditure limits are fairly generous. Fourth, the section 501(h) election is very easy to make. The organization files a simple one-page form (IRS Form 5768) with the IRS. Regardless of the date of filing, the election is effective as of the first day of the tax year during which the organization makes the election. The election continues in effect until the beginning of the year in which it is revoked. Finally, it is easy to revoke the section 501(h) election. The election may be revoked at any time by filing a second Form 5768.

Election-Related Activities

Private foundations and public charities are prohibited by law from funding or engaging in activities that support or oppose candidates for public office. As 501(c)(3) organizations, foundations may not make campaign contributions, make expenditures on behalf of candidates, endorse candidates for public office, make resources such as space or office equipment available to candidates, or communicate anything that explicitly or implicitly favors or opposes a candidate.

Election-related activities foundations may support include:

- Public education and training sessions about participation in the political process.
- Candidate education on public interest issues.
- Certain candidate debates and forums.
- Nonpartisan get-out-the-vote drives.
- Nonpartisan voter registration drives (with certain restrictions for private foundations).
- Canvassing the public on issues.
- Ballot measure work through specific project grants.

Foundation officials and employees acting in their individual capacities may also work on political campaigns outside of work hours or using their available leave, but they may not use foundation facilities, equipment, personnel or other resources to provide support to, or oppose, a candidate or campaign.

For More Information

For a variety of resources about the federal tax and other lobbying rules, see the Center for Lobbying in the Public Interest at www.clpi.org or the Alliance For Justice at www.afj.org.

For information about the Minnesota campaign finance requirements, see www.cfboard.state.mn.us.

See also *Frequently Asked Legal Questions: Lobbying*, pages 31-32.



philanthropy public trust

FREQUENTLY
ASKED
LEGAL
QUESTIONS

FREQUENTLY ASKED LEGAL QUESTIONS:

Lobbying

Q1

Are private foundations allowed to lobby?

No, with a few exceptions. Foundations that engage in prohibited lobbying are subject to financial penalties imposed by the Internal Revenue Service. Certain nonpartisan research and discussions of broad social problems are not treated as lobbying even though they reflect a particular viewpoint. Under certain conditions, foundations may also provide legislative testimony and engage in so-called “self-defense” lobbying.

The four exceptions to lobbying restrictions for private foundations:

Nonpartisan Research: Certain educational or research activities are expressly excluded from the definition of lobbying. A private foundation may fund or present an independent and objective report on a chosen subject, even if the report advocates a particular viewpoint on proposed legislation, so long as there is a sufficiently complete and balanced discussion to enable members of the public to form their own opinions or conclusions on the issue. This “nonpartisan analysis, study or research” must be made widely available and cannot be distributed selectively to persons on only one side of the issue.

Discussions of Broad Social Problems: A related exception pertains to “examinations and discussions of broad social, economic and similar problems.” Examinations and discussions of such problems do not constitute lobbying even if the problems are of a type with which government would be expected to deal ultimately, and even if the communications are made to legislators, so long as the discussion does not address itself to the merits of a specific legislative proposal and does not directly encourage recipients to take action with respect to legislation.

Legislative Testimony and Technical Assistance:

The private foundation lobbying rules also permit foundation representatives to provide testimony or other technical assistance to governmental bodies or committees if the foundation is doing so in response to a written request by the body or committee, and if the testimony or assistance is available to every member of the requesting body or committee.

“Self-defense” Lobbying: A fairly narrow exception permits lobbying when proposed legislation would affect existence of the private foundation, its powers and duties, tax-exempt status, or the deductibility of foundation contributions.

Q2

Does lobbying include all activities that have to do with legislation?

No. For these purposes, an activity that has to do with legislation is prohibited lobbying only if it constitutes “direct” or “grassroots” lobbying. The technical definitions of these terms are quite extensive.

Generally speaking, “direct” lobbying is a communication with a member or employee of a legislative body (or certain other government officials) that both (a) refers to specific legislation, and (b) reflects a view on the legislation.

“Grassroots” lobbying is attempting to influence the opinions of the general public about specific legislation. In order to be grassroots lobbying, a communication must (a) refer to specific legislation, (b) reflect a view on the legislation, and (c) encourage the recipient to take action, such as contacting his or her legislator.

Legislation-related communications that do not fall within one of these two definitions are not prohibited by the lobbying rules that apply to private foundations.

Q3

May a private foundation make a general support grant to an organization that lobbies?

Yes, as long as the grant is not earmarked to be used for lobbying.

Lobbying by a public charity is not prohibited. In fact, the needs and issues addressed by public charities are often well-served by the lobbying and advocacy efforts of those organizations, to the extent allowed by law. A private foundation may make a general support grant to a public charity even if the public charity is known to engage in some lobbying activities and is likely to use some of the grant for that purpose.

FREQUENTLY ASKED...

Lobbying (continued)

Q4 **May a private foundation make a grant for a project that will involve lobbying?**

Yes, as long as the grant doesn't exceed the budgeted non-lobbying expenses of the project.

When a grant is designated for a particular project, and the project involves some lobbying activity, the grant will not violate the private foundation lobbying prohibition as long as the amount of that grant, together with all other grants by the same foundation for the same project for the same year, does not exceed the amount budgeted by the grantee for project activities *other than* lobbying. In making this determination, the foundation is entitled to rely in good faith on the grantee's budget for the project.

Q5 **Are public charities, including community foundations, allowed to lobby?**

Yes, within limits. "No substantial part" of a public charity's activities may consist of lobbying (*see next question*).

Q6 **How much lobbying is permitted for public charities?**

As a general rule, "no substantial part" of the activities of a public charity may consist of lobbying. The IRS and the courts have consistently declined to provide a clear rule about what constitutes a "substantial part." To take advantage of some more objective rules on this point, public charities (other than churches and certain church-related organizations) may choose to be governed by Section 501(h) of the Internal Revenue Code, which allows the organization to expend a specified portion of its budget for lobbying. In general terms, total lobbying expenses for a given year may not exceed 20 percent of the first \$500,000 of an organization's expenses, plus 15 percent of the second \$500,000, plus 10 percent of the third \$500,000, plus 5 percent of the remainder, subject to an overall \$1 million limit.

In addition, grassroots lobbying expenditures may not exceed 25 percent of the overall lobbying limit. These rules apply only if the public charity has filed Form 5768 — the half-page 501(h) election form — with the IRS.

Q7 **Is an organization that lobbies required to register as a lobbyist?**

An organization that employs an in-house lobbyist for federal lobbying must register under the federal Lobbying Disclosure Act if it expects to incur, or does incur, lobbying expenses that exceed \$24,500 in a semiannual period.

A "lobbyist" is a person who is compensated for multiple lobbying contacts and whose lobbying activities constitute at least 20 percent of his or her services for the organization during any six-month period. Registered organizations must file semiannual reports with the Secretary of the Senate and the Clerk of the House of Representatives. Separate requirements apply to lobbying firms and self-employed lobbyists.

Minnesota lobbying rules require the individual lobbyist to register, not the organization. However, organizations that pay lobbyists are required to file certain reports with the Minnesota Campaign Finance and Public Disclosure Board.

For More Information

See also *What Every Grantmaker Should Know: Public Policy Engagement*, pages 27-29.

FREQUENTLY ASKED LEGAL QUESTIONS:

Endowment Funds

Q1 ***What is an endowment fund?***

An endowment fund is a fund held by a charitable organization in which the donor has imposed a restriction that prohibits some or all of the fund from being spent currently. This would include, for example, a gift that is to be held “in perpetuity,” or one that must be held for 25 years before it can be spent.

Q2 ***How is an endowment fund created?***

An endowment fund may be created by virtually any means that indicates that the donor intended to create an endowment fund. Such means include a direct instruction from the donor, a donor’s gift designated for an existing endowment fund, or an otherwise undesignated gift that is received in response to a request for an endowment gift.

Q3 ***How must an endowment fund be invested?***

In general, the board members of a foundation must perform their duties, including their investment duties, with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

Various laws governing the investment of charitable assets — including the Uniform Prudent Management of Institutional Funds Act (UPMIFA), the Uniform Prudent Investor Act (UPIA), and the Third Restatement of Trusts — all embrace the concept of modern portfolio theory. Under modern portfolio theory, prudent investment policy is based on diversification of assets, long-term performance benchmarks and the importance of a portfolio’s total return on investment.

Q4 ***How much may be spent from an endowment?***

Unless the donor specifies a particular percentage or dollar amount that is to be spent periodically from the endowment, the governing body of the foundation is responsible for determining the amount that may be spent currently from an endowment. In doing so, the board must act reasonably, and must take into account the duration and preservation of the endowment fund, the purposes of the institution and the endowment fund, general economic conditions, the possible effect of inflation or deflation, the expected total return from income and the appreciation of investments, other resources of the institution and the investment policy of the institution.

Q5 ***What happens if the current value of an endowment is below its original value?***

Unless expressly provided for by the donor, there is no absolute requirement that the value of an endowment fund must never fall below its original value. The board is given considerable discretion in determining spending from an endowment, but it must always act prudently, taking into account the considerations listed in Q4 above. Over the long term, it is generally expected that a perpetual endowment fund should maintain its value, adjusted for inflation, but short-term deviations from this objective may sometimes be justified as “prudent,” depending on the particular circumstances. It is important to keep in mind that private foundations must always comply with the 5-percent payout requirement imposed by federal tax law, even if distributions at that level would cause the endowment fund to fall below its target level.

FREQUENTLY ASKED...

Endowment Funds (continued)

Q6

How does the endowment spending policy relate to the 5-percent payout requirement for private foundations?

A private foundation must meet the 5-percent payout requirement that is imposed by federal tax law even if distributions at that level would cause the endowment fund to lose value or not meet its target value. Note: The 5-percent payout requirement applies only to organizations that are private foundations.

Q7

How do “board-restricted” endowment funds differ from “donor-restricted” endowment funds?

If, at the time a contribution is made to a foundation, the donor restricts the type or manner of investing the assets of the gift, or restricts the time or manner of making distributions of earnings from the gift, such restrictions normally can be modified or eliminated only with the written consent of a living donor or pursuant to a court proceeding. This includes restrictions establishing the contribution as part of the permanent endowment funds of the foundation. Restrictions placed on assets of the foundation by its governing board, however, such as designating a portion of the foundation’s assets as permanent or endowment funds, may usually be released or modified by resolution of the board acting alone.

Q8

Can the amount available for spending be determined by looking at the “unrestricted funds” column on a foundation’s financial statement?

Generally, no. In many cases, there can be significant differences between the meaning of “unrestricted” under the financial accounting standards and its meaning under the legal standards.

Q9

Can endowment principal be used as a last resort if the foundation becomes insolvent?

Generally, no. Insolvency does not excuse a foundation from its obligation to maintain an endowment fund as such. As a general rule, the portion of an endowment fund that is not available for current spending is not available to creditors unless a court authorizes the expenditure based on certain extraordinary circumstances.

Q10

What responsibilities does the board have with respect to the endowment?

The governing board of a foundation is ultimately responsible for all aspects of the administration of an endowment fund, including its investment and determination of how much can be spent from year to year. In making these decisions, each board member must act in a manner he or she reasonably believes to be in the best interests of the foundation, and with the care of an ordinarily prudent person in a similar position under similar circumstances.

FREQUENTLY ASKED LEGAL QUESTIONS:

Community Foundations

Q1

What is a community foundation?

Community foundations come in many forms, but in general terms, they are collections of charitable funds administered by a single board that is representative of the general public. Most, but not all, community foundations focus on a particular geographic area. Community foundations are both fundraising and grantmaking organizations, and they avoid private foundation status by virtue of the fact that they receive broad public support. Each fund of a community foundation generally must be subject to a “variance power,” which allows the governing board to modify fund restrictions under certain circumstances.

Q2

What is the “variance power”?

Most community foundations require that each fund be subject to a power of the governing board (usually found in the articles of incorporation or bylaws of the foundation) to modify any restriction that limits the fund to a particular purpose or for a particular organization if, in the sole judgment of the governing board, the restriction becomes unnecessary, incapable of fulfillment or inconsistent with the charitable needs of the community or area served. Donors should be made aware of this power, and it must be exercised judiciously.

Q3

How does a community foundation differ from a private foundation?

Because it is not classified as a private foundation, a community foundation is not subject to the tax on investment income that applies to private foundations, nor to the rules that apply to private foundations regarding self-dealing, required distributions, excess business holdings, risky investments or taxable expenditures.

Community foundations are permitted to engage in a limited amount of lobbying (*see Lobbying Q6, page 32*). Contributions to community foundations under certain circumstances receive more favorable tax deduction treatment than contributions to private foundations.

Q4

What is a “material restriction”?

A fund intended to be part of a community foundation may instead be treated as a separate entity (and therefore classified as a private foundation that must obtain its own tax-exempt status and file its own tax return) if it is subject to a “material restriction.” A material restriction is a restriction imposed by the donor that allows the donor to have some continuing control over the fund.

Examples of material restrictions are the donor’s right to designate the recipients of grants from the fund, to direct the investment of the fund assets, or to change the purposes of the fund. The donor’s irrevocable designation of a particular beneficiary or purpose for the fund, however, is not a material restriction if it is done at the time of the gift.

Q5

What are the different kinds of funds that community foundations offer?

Most community foundations maintain both endowment and non-endowment funds. One very popular type of fund is the donor-advised fund, in which the donor or another designated person has the right to make recommendations to the community foundation regarding grants from the fund. These recommendations are not binding on the community foundation (if they were, the fund would be subject to a material restriction), but allow the donor to maintain involvement with the fund after his or her gift.

Other common fund types include funds that are designated for particular beneficiary organizations or particular charitable purposes, and so-called “agency funds,” which are established when a charitable organization hands over its own assets to the community foundation, to be administered for the benefit of the organization.

FREQUENTLY ASKED...

Community Foundations (continued)

Q6

Are donor-advised funds required to pay out a certain amount each year?

No, not at the time of publication of these Frequently Asked Questions; however, the Pension Protection Act of 2006 directs the Treasury Department to study this issue and make recommendations about a mandatory distribution requirement. From time to time, proposals have been circulated to amend the law to require a certain minimum distribution annually from donor-advised funds, but no such legal requirement currently exists. Some community foundations have voluntarily adopted a policy of distributing a specified percentage of a fund's assets each year.

Q7

Are there any special limits on grants or other payments from donor-advised funds?

Yes. Donor-advised funds are not permitted to make grants to individuals. Grants to private foundations and non-charitable organizations require "expenditure responsibility" (see *Grantmaking Q7, page 48*), as do grants to certain kinds of "supporting organizations" (see *Private Foundations vs. Public Charities Q1, page 44*).

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Donor-advised funds also must not make grants that result in a benefit to the donor or a related party (such as a "thank-you gift") that is more than "incidental." Payment of compensation or loans to a donor or related party is prohibited.

Not all funds that involve an ongoing role for donors are "donor-advised funds" for purposes of these restrictions. For example, certain funds with multiple donors or a single beneficiary are excluded.

FREQUENTLY ASKED LEGAL QUESTIONS:

Private Foundation Self-Dealing

Q1 **What common activities constitute self-dealing when undertaken between a private foundation and a disqualified person?**

The definition of self-dealing covers a wide range of transactions that are prohibited even though they may be fair to the foundation and advantageous to all parties to the transaction. It is therefore important for private foundation managers to know who the foundation's disqualified persons are and carefully evaluate every transaction between the foundation and a disqualified person (*see next question*).

Common activities that a private foundation might undertake that are generally covered by the definition of self-dealing include sales, exchanges or leases of property (both real estate and personal property) between a foundation and a disqualified person, most loans, and the provision of goods, services or facilities between a disqualified person and a private foundation. These categories of activities are generally self-dealing regardless of whether the foundation is the provider or receiver in the transaction. Compensation paid to, or reimbursement expenses of, a disqualified person by a private foundation; the transfer or use of the foundation's assets or income by a disqualified person; and certain transactions with government officials also fall within the definition of self-dealing.

Q2 **Who is considered a "disqualified person"?**

A disqualified person is defined as:

- An officer, director or trustee of the foundation (or an individual having powers or responsibilities similar to those of officers, directors or trustees of the foundation).
- A substantial contributor to the foundation. A "substantial contributor" is defined as any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the private foundation, if such amount is more than 2 percent of the total contributions and bequests received by the foundation before the close of the taxable year in which the contribution or bequest is received by the foundation from such person. In the case of a trust, the term "substantial contributor" also means the creator of the trust.
- Family members of any disqualified person. This includes spouses, ancestors, children, grandchildren, great-grandchildren and the spouses of children, grandchildren and great-grandchildren.
- A corporation of which a disqualified person owns more than 35 percent of the total combined voting power.
- A partnership in which a disqualified person owns more than 35 percent of the profits interest.
- A trust or estate in which a disqualified person holds more than 35 percent of the beneficial interest.

It is important to note that this definition of "disqualified person" differs from the definition used for purposes of the "intermediate sanctions" rules that apply to public charities.

FREQUENTLY ASKED...

Private Foundation Self-Dealing (continued)

Q3

What are some frequently used exceptions to the definition of self-dealing?

A disqualified person (*see previous question*) may transfer or furnish goods, services or facilities to a private foundation without charge. Thus, a foundation can share space or office equipment with its corporate sponsor or family members or business as long as the foundation does not pay the disqualified person rent or other fees.

A foundation may also pay reasonable compensation to a disqualified person for personal services to the foundation, including reimbursement of expenses associated with the personal services. For example, a foundation can pay an accountant who serves on the foundation's board of directors for accounting services provided to the foundation.

Another exception to the self-dealing rules is that a foundation may furnish goods or facilities to a disqualified person on a basis at least as favorable as it makes the goods or services available to the general public. For example, a disqualified person may enjoy a park or museum operated by the foundation on the same basis as these facilities are available to the public.

Q4

What are the consequences if a person doesn't know that an activity he or she engages in is prohibited under the self-dealing rules?

The Internal Revenue Service may impose penalty taxes ("excise taxes") on disqualified persons who engage in self-dealing transactions, under a two-tier tax system.

First-tier taxes are imposed on disqualified persons (other than foundation managers acting only as such) who engage in the self-dealing transaction with the private foundation, whether or not they knew the activity constituted self-dealing. The amount of the first-tier tax on disqualified persons is generally 10 percent of the amount involved. By contrast, a foundation manager is subject to first-tier taxes only if he or she participated in the transaction knowing that it was self-dealing and the participation was willful and not due to reasonable cause. The amount of the first-tier tax for a foundation manager is 5 percent of the amount involved. It is worth noting that, unlike other private foundation excise taxes, the tax on self-dealing cannot be abated at the discretion of the Internal Revenue Service.

If the self-dealing act is not undone or "corrected" within a certain period of time, the IRS may impose confiscatory second-tier taxes. However, the disqualified persons will have an opportunity to correct the transaction and obtain court review of the issue before the second-tier taxes are imposed.

Q5**Can a private foundation pay its board members?**

Yes, a private foundation can pay its board members reasonable compensation for their personal service as board members. A foundation can also pay board members' reasonable and necessary expenses associated with their services to the foundation.

Board compensation cannot be excessive, and should be evaluated for reasonableness based on the functions or services required and actually performed by board members; the level of skill and experience necessary for board members to fulfill their duties; and the amount of time spent by board members in fulfilling their duties. Payment of compensation to board members may cause them to lose immunity from liability under Minnesota and federal volunteer protection statutes.

For guidance on compensation for board directors and trustees, and for executives, consult the following guidance memoranda from the board of directors of the national Council on Foundations, which can be found at www.mcf.org/publictrust: "Determining Reasonable Compensation for Foundation Directors and Trustees" and "Recommended Best Practices in Determining Reasonable Executive Compensation."

Q6**Can a private foundation pay for spouse travel?**

Generally, travel expenses incurred by the spouse of a foundation employee or board member are not "reasonable and necessary" expenses incurred in connection with the foundation's charitable activities. Thus, payment of such expenses by the foundation will usually constitute self-dealing (and may also be a taxable expenditure), unless the spouse is also a foundation manager or employee or independently performs necessary services on behalf of the foundation.

Under some circumstances, reimbursement of spousal travel expenses may be permissible if it is treated as compensation to the board member rather than the spouse and if it is reasonable in amount when combined with all other compensation provided to the board member.

Q7**Can a foundation satisfy a personal charitable pledge of a family member who is a disqualified person?**

No. A charitable pledge is usually a binding legal obligation of the person making the pledge, and it is considered self-dealing for a foundation to make a grant or other payment to satisfy the legal obligation of a disqualified person.

Q8**Is it self-dealing for a foundation to make a grant to a charity where a family member or other disqualified person serves on the board?**

Unless the grant is made by the foundation in satisfaction of an obligation of the disqualified person to the grantee, as discussed in the question above, such a grant does not constitute self-dealing. There is an exception to the definition of self-dealing for "incidental and tenuous benefits" derived by a disqualified person from a private foundation's use of its income or assets. Any public recognition or goodwill afforded to the disqualified person as a result of the foundation grant will normally be considered an incidental or tenuous benefit. However, any such grant must be made in accordance with the foundation's conflicts of interest policy and procedures.

FREQUENTLY ASKED...

Private Foundation Self-Dealing (continued)

Q9

Under what circumstances can a corporation provide office space, equipment and staff services to its corporate foundation?

A corporation can provide facilities or services to its foundation without charge. The corporation and the foundation may also share employees under a time-sharing arrangement in which each pays for its respective share of the employees' time. Finally, the corporation and its foundation may share staff services, facilities or equipment provided by a third party, whom they each pay for their respective share of the services, facilities or equipment.

Q10

Is it self-dealing for a foundation to buy tickets to a charitable fundraising event and provide them to corporate officers or staff?

Normally it is considered self-dealing for a corporate foundation to purchase tickets to an event and then provide the tickets to corporate directors or personnel to attend the event. The corporation, as a disqualified person, is clearly prohibited from receiving a tangible economic benefit, such as tickets to the event, from the foundation. It is unclear whether all managers and employees of the corporation are also disqualified persons, but the better approach would be to have the corporation itself or the individual attendees purchase the tickets.

For More Information

See also What Every Grantmaker Should Know: Private Foundation Self-Dealing, pages 4-5.

FREQUENTLY ASKED LEGAL QUESTIONS:

Board Fiduciary Duties

Q1

What are the basic fiduciary duties of a foundation board member?

Foundations can be organized either as trusts or corporations, and the fiduciary standards for governing members of trusts and corporations have developed somewhat separately under state law. Essentially, however, a board member of a foundation owes two fiduciary duties to the foundation: a duty of loyalty and a duty of care. A third duty is sometimes mentioned, the duty of obedience.

The **Duty of Loyalty** requires the board member, when making a decision or acting on behalf of the foundation, to set aside personal or conflicting interests and act solely in the best interest of the foundation. The **Duty of Care** requires a board member to devote the time, attention and resources necessary to understand and prudently oversee the affairs of the foundation. The **Duty of Obedience** requires the board member to obey all laws pertaining to the foundation and act in furtherance of the foundation's charitable purposes.

Q2

How is a conflict of interest defined for a foundation's board?

A conflict of interest arises when a board member has a personal or other interest in a transaction that conflicts, or may conflict, with the best interests or opportunities of the foundation, and thus poses a challenge to the board member's duty of loyalty to the foundation. Essentially, a conflict of interest arises when the board member has a competing interest in a transaction with the foundation either individually, through another organization, or through a member of the director's family or other personal relationship.

Q3

Should a foundation have a written conflict of interest policy for its board?

While there is no general legal requirement that grantmakers have a written conflict of interest policy, it is generally recommended (including by the IRS) so that all board members are sensitive to their fiduciary obligations to the foundation and have standardized procedures in place to disclose and handle conflicts of interest as they arise. A written conflict of interest policy demonstrates good organizational fiduciary practice and can provide legal protection both to the foundation and individual board members. State law requirements provide a good starting place for a written conflict of interest policy.

The Minnesota Attorney General has published a recommended conflict of interest policy for nonprofit corporations that can be viewed and downloaded at www.ag.state.mn.us.

The Internal Revenue Service has published a sample conflict of interest policy for charitable organizations including foundations, as part of the Instructions to Form 1023. It can be viewed and downloaded at www.irs.gov/formspubs.

Foundations should consider whether any modifications are appropriate for their particular circumstances before adopting either of these policies.

FREQUENTLY ASKED...

Board Fiduciary Duties (continued)

Q4

In what circumstances might a foundation board member or officer be subject to personal liability for actions taken in connection with the foundation?

Any action or failure to act that is determined to be outside the scope of the board member's or officer's official responsibilities and capacity may create personal liability for the board member or officer. Actions or omissions that constitute a breach of fiduciary duty, a breach of a contractual obligation, or cause physical injury or death may create claims of personal liability. Actions or omissions that are considered negligent, reckless or criminal also are likely to raise issues of personal liability. Individual directors and officers may also be held personally liable for a foundation's failure to withhold and pay federal taxes.

Q5

What special protections against personal liability are available for a foundation's volunteer board members and officers?

Both federal and Minnesota state law afford some protection against personal liability to individuals serving as officers and directors of charitable organizations, including foundations, on a volunteer or unpaid basis. Under Minnesota law, such a person generally is not liable under civil law for acts taken in good faith, within the scope of the person's responsibilities, and which do not constitute willful or reckless misconduct, subject to certain exceptions. Federal law provides volunteers with somewhat duplicative immunity from both federal and state civil liability.

For More Information

See also What Every Grantmaker Should Know: Board Fiduciary Duties, pages 1-3.

FREQUENTLY ASKED LEGAL QUESTIONS:

Investments

Q1 **When should a foundation's board seek expert advice regarding investment decisions and payout policies?**

The governing board of a foundation has a legal obligation to manage the assets and income of the foundation prudently. If a foundation is not a "pass-through" foundation but instead holds assets that it invests to produce income for grantmaking or operational purposes, the board members have a fiduciary obligation to establish and monitor prudent investment policies and oversight functions. The board can rely either on internal board or staff expertise, or it can obtain outside expert advice, depending on the foundation's size, complexity and internal resources. A board member is entitled to rely upon information, opinions and reports from staff, board committees, and outside professionals and experts the board member reasonably believes to be reliable and competent.

Q2 **What is the legal standard by which a foundation's investment decisions are judged?**

In general, the board members of a foundation must perform their duties, including their investment duties, with the care an ordinarily prudent person in a similar position would exercise under similar circumstances. Various laws governing the investment of charitable assets — including the Uniform Prudent Management of Institutional Funds Act (UPMIFA), the Uniform Prudent Investor Act (UPIA) and the Third Restatement of Trusts — all embrace the concept of modern portfolio theory. Under modern portfolio theory, prudent investment policy is based on diversification of assets, long-term performance benchmarks and the importance of a portfolio's total return on investment.

Q3 **What special rules apply to investments by a private foundation?**

In addition to state corporate or trust law, and UPMIFA or UPIA, private foundation investments are also subject to federal tax law regulations.

Federal tax law provides that certain risky investments or investment strategies may constitute "jeopardizing investments" that subject the foundation to private foundation excise taxes. The "prudent trustee" standard under federal tax law emphasizes the need to consider the current and future needs of the foundation, investment risks and the importance of diversification. The regulations also list several categories of investments that will be subject to "close scrutiny" by the IRS, including trading in securities on margin; trading in commodities futures; investments in working interests in oil and gas wells; purchase of puts, calls and straddles; warrants; selling short; junk bonds; risk arbitrage; hedge funds; derivatives; distressed real estate; and international equities in developing countries.

Private foundations are also subject to "excess business holdings" rules that limit the percentage interest a foundation, together with all its "disqualified persons" (see *Private Foundation Self-Dealing Q2, page 37*), holds in a given business enterprise.

Q4 **What special rules apply to donor-advised fund investments?**

Donor-advised funds are subject to the same rules that apply to private foundations (see *Endowment Funds Q8, page 34*).

For More Information

See also *What Every Grantmaker Should Know: Investments, pages 18-22*.

FREQUENTLY ASKED LEGAL QUESTIONS:

Private Foundations vs. Public Charities

Q1 What is the difference between a private foundation and a public charity?

All organizations that are described in Section 501(c)(3) of the Internal Revenue Code are either private foundations or public charities. The Internal Revenue Service classifies an organization described in Section 501(c)(3) of the Code as a private foundation unless the organization can demonstrate that it qualifies as a public charity. Because there are different rules that apply to public charities and private foundations, it is important to be able to identify whether an organization is a public charity or a private foundation.

Unlike private foundations, which normally receive substantially all of their contributions from relatively few sources and often rely on investment earnings as their source of ongoing support, a public charity is either “publicly supported” (i.e. derives a substantial portion of its financial support from the public) or functions to “support” one or more organizations that are public charities. Specifically, an organization may qualify as a “publicly supported” organization because it does one of the following:

- Carries on specific activities identified by statute (e.g. activities carried on by churches, educational organizations, colleges and universities, hospitals and medical research organizations and governmental units).
- Is supported substantially by financial support from government agencies and the general public.
- Is supported substantially by certain permitted contributions and gross receipts from its exempt activities and does not receive more than one-third of its support from investment income.
- Is organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified publicly supported organizations. Organizations described in this paragraph are called “supporting organizations” and are classified as a Type I, Type II, Type III functionally integrated or Type III non-functionally integrated supporting organization.

Because the private funding and private control of a private foundation increase the likelihood that the foundation will improperly benefit those who control the foundation, the Code subjects a private foundation to certain requirements and restrictions that are not applicable to public charities. For example, private foundations are subject to a 2-percent tax on net investment income that can be reduced to 1 percent if the private foundation makes sufficient qualifying distributions for charitable purposes. In addition, private foundations are subject to excise taxes for failing to take certain required actions or for taking certain prohibited actions; under Minnesota law, they are prohibited from engaging in conduct that would result in excise taxes being imposed.

Most notably, private foundations are required to make annual distributions equal to 5 percent of the aggregate fair market value of all investment assets of the organization (see *5% Payout Rule*, page 46) and are prohibited from the following:

- Engaging in acts of “self-dealing” with certain persons (see *Private Foundation Self-Dealing*, pages 37-38).
- Having “excess business holdings” (see *Investments Q3*, page 43).
- Making jeopardizing investments (see *Investments Q3*).
- Making certain prohibited non-U.S. expenditures (see *Grantmaking Q4*, page 47).

Finally, the deductibility for federal income tax purposes of contributions to a private foundation is subject to certain limitations that do not apply to contributions to public charities. For example, the amount of contributions to private foundations that may be deducted for any year generally may not exceed 30 percent of an individual’s adjusted gross income for the year. There also are special limitations with respect to the amount of deduction that may be claimed in connection with the contribution of appreciated property to the foundation.

Q2

How do I know if a foundation is a public charity or a private foundation?

The Internal Revenue Service indicates whether an organization is a public charity or a private foundation in the organization's determination letter. The organization is required to provide you with a copy of its determination letter upon request.

In lieu of reviewing an organization's determination letter, you can determine whether an organization views itself as a public charity or a private foundation based on its annual information return filed with the IRS. All private foundations are required to file a Form 990-PF, while a public charity files a Form 990 or Form 990-EZ (assuming it has significant enough revenues to trigger the filing requirement). If an organization files a Form 990 or 990-PF, such forms are generally available at www.guidestar.org.

Note: Often the links to such forms are labeled "Form 990" even if an organization files a Form 990-PF, so make sure to follow the link and view an organization's tax forms in order to verify whether an organization is a public charity or private foundation.

Q3

How does a private foundation determine whether a grantee is a supporting organization?

It is sometimes important to determine not only whether an organization is a public charity, but also what kind of public charity it is. Specifically, the law distinguishes among four types of supporting organizations (see Q1, page 44), and provides that private foundations must exercise expenditure responsibility over grants to certain types of supporting organizations (see *Grantmaking Q1, page 47*) and may not count such grants toward meeting the 5% minimum payout requirement (see *5% Payout Rule Q3, page 46*).

The IRS Section 501(c)(3) determination letter for a supporting organization will indicate that the organization is classified under Section 509(a)(3) of the Internal Revenue Code of 1986. In contrast, other public charities are classified under Section 509(a)(1) or Section 509(a)(2) of the Code. If you do not have a copy of the determination letter, review the grantee's Form 990 on www.guidestar.org.

Although you can determine whether a grantee is a supporting organization, it is more difficult to determine the organization's "type." Determination letters historically have not identified an organization's type, and organizations completing the Form 990 are not always sure which type they are, even though the annual information return now requires supporting organizations to identify their type on Schedule A, Part I, Line 11. To address this concern, the IRS has published special procedures for funders to determine a supporting organization's type. As of the date of this publication, these can be found in Notice 2006-109, available at www.irs.gov/eo.

FREQUENTLY ASKED LEGAL QUESTIONS:

5% Payout Rule

Q1 **What is the 5% payout rule?**

The federal tax laws require that private foundations distribute a certain amount each year for charitable and administrative purposes. That amount is equal to 5 percent of the value of the foundation's net investment assets.

Q2 **5% of what?**

The assets against which the 5 percent is measured include the foundation's investment assets, but not program-related investments or other assets that are used directly in carrying out the foundation's charitable mission. For example, if the foundation owns the building that houses its offices, the value of the building is excluded from the 5 percent calculation to the extent the building is used directly for charitable activities and related administrative functions. The tax regulations contain instructions for valuation of the investment assets. For example, a foundation must use the average of the monthly values of publicly traded securities held during the year.

Q3 **What distributions count toward the 5%?**

Any amount, including most grants and program-related investments, that the foundation distributes for its charitable purposes counts toward the 5 percent. In addition, reasonable and necessary administrative expenses that relate to charitable activities count. The tax that foundations pay on their investment income does count, but expenses relating to management of investments do *not* count. A grant or program-related investment paid to a Type III non-functionally integrated supporting organization, to a Type I or Type II donor-controlled supporting organization, or to another private foundation or to an organization that is controlled by the foundation, generally does not count. Special rules apply to payments to foreign organizations. With the approval of the IRS, amounts set aside for use in a future year will, under certain limited circumstances, count as distributions in the year of the set-aside.

Q4 **What is the deadline for making the required distributions each year?**

A foundation must make the required distributions by the end of the year following the year on which the 5 percent calculation is based. For example, a foundation with \$1 million in assets in 2009 must make at least \$50,000 of qualifying distributions by the end of 2010.

Q5 **Can extra distributions be applied to other years?**

Excess distributions may be carried *forward* for up to five years to meet future distribution requirements. Excess distributions may not be carried back to satisfy distribution for previous years.

Q6 **What are the consequences of failing to meet the payout requirement?**

If a foundation does not distribute the required amount by the deadline, it is subject to an initial penalty equal to 30 percent of the shortfall. It must also distribute the shortfall or be subject to a penalty equal to 200 percent of the shortfall.

Q7 **What about operating foundations?**

Certain private foundations that actively conduct charitable activities (as opposed to making grants) may qualify as "private operating foundations," which are subject to somewhat different distribution requirements. Operating foundations receive some of the benefits of public charity status, including some favorable tax deduction rules for contributions they receive.

FREQUENTLY ASKED LEGAL QUESTIONS:

Grantmaking

Q1

Does a grantee's tax status affect a foundation's ability to make a grant to that organization?

Public charities and private foundations are required to ensure that any grants they make are used to further their exempt purposes. In general, grants to other Section 501(c)(3) public charities and private foundations further a public charity's exempt purposes, so a public charity can make a grant without any restriction; however, special rules apply to grants from donor-advised funds (see *Community Foundations Q7, page 36*), and grants to and from supporting organizations (see *Private Foundations vs. Public Charities Q1, page 44*).

Subject to the exceptions noted above, a public charity can make a grant to an organization that is *not* described in Section 501(c)(3) of the Internal Revenue Code (e.g., a for-profit corporation, a trade association, a social welfare organization or a foreign charity) to perform activities that further the public charity's exempt purposes, but the public charity should enter into a grant restriction agreement pursuant to which the recipient agrees to use the funds in furtherance of the grantor public charity's exempt purposes.

Additionally, private foundations must exercise "expenditure responsibility" for grants to any organization that is not described in Section 501(c)(3) and to Type III non-functionally integrated supporting organizations and to Type I and Type II "controlled" supporting organizations. To exercise expenditure responsibility, the private foundation must establish monitoring procedures to ensure that the grant funds are used solely for the purpose for which the grant was made, which includes, but is not limited to, obtaining full and complete reports from the grantee on how the funds are spent (see *Grantmaking Q7, page 48*).

Q2

May a foundation make a grant to a private foundation?

In general, a public charity, as opposed to a donor-advised fund, may make a grant to a private foundation without any restrictions. In contrast, a private foundation may make a grant to another private foundation only when the granting private foundation exercises "expenditure responsibility" over the grantee's use of the grant (see *Grantmaking Q7, page 48*).

Q3

May a foundation make a grant to a tax-exempt organization that is not tax-exempt under Section 501(c)(3) of the Code (e.g. Section 501(c)(4) or 501(c)(6))?

Most public charities may make a grant to an organization that is exempt from federal income tax under another section of the Code (e.g. Section 501(c)(4) social welfare organization or Section 501(c)(6) trade association) provided the public charity enters into a grant restriction agreement pursuant to which the recipient agrees to use the funds in furtherance of the grantor public charity's exempt purposes. If such a grant is made by a donor-advised fund or a private foundation, the grantor must exercise "expenditure responsibility" over the grantee's use of the grant (see *Grantmaking Q7, page 48*).

Q4

May a foundation make a grant to a foreign charity that is not exempt under Section 501(c)(3) of the Code?

A public charity, as opposed to a donor-advised fund, may make a grant to a foreign charity provided the public charity enters into a grant restriction agreement pursuant to which the recipient agrees to use the funds in furtherance of the grantor public charity's exempt purposes.

In contrast, a private foundation may make a grant to a foreign charity provided it *either* (a) makes a good faith determination that the foreign entity could be recognized under Section 501(c)(3) as a public charity, even if it has not obtained an exemption determination; or (b) exercises "expenditure responsibility" over the grantee's use of the grant (see *Grantmaking Q7, page 48*). A donor-advised fund usually must exercise expenditure responsibility to make a grant to a foreign charity.

FREQUENTLY ASKED...

Grantmaking (continued)

Q5 **May a foundation make a grant to a for-profit corporation?**

A public charity, as opposed to a donor-advised fund, may make a grant to a for-profit corporation, provided the public charity enters into a grant restriction agreement with the grantee pursuant to which the grantee agrees to use the grant for the public charity's exempt purposes. If a private foundation or a donor-advised fund makes such a grant, the private foundation must exercise "expenditure responsibility" over the grantee's use of the grant (see *expenditure responsibility*, Q7).

Q6 **May a foundation make a grant to a public charity serving as the fiscal agent for another entity?**

Customarily, an organization that has not yet incorporated and/or has not yet obtained recognition as a tax-exempt organization under Section 501(c)(3) of the Internal Revenue Code may make an arrangement with an established public charity to serve as its fiscal agent.

A public charity serving as fiscal agent may receive individual donations and grants intended for the other entity. However, the donor will only receive a tax deduction if the public charity with section 501(c)(3) status has control over the final decision to use the funds to support the other entity. Although the donor can indicate a preference that the donation support the other entity, donors should be careful not to earmark their contributions for distribution to the intended entity. As fiscal agent, the public charity manages the funds.

A public charity may make a grant to a public charity that serves as a fiscal agent for another entity without restriction provided the public charity, in its capacity as fiscal agent, ensures that such funds are being used for exempt purposes. Further, as a result of the fiscal agent arrangement, private foundations making a charitable contribution to the fiscal agent need not exercise "expenditure responsibility" because the grant is given to the public charity (rather than the entity awaiting tax-exempt status).

Q7 **What is "expenditure responsibility"?**

Private foundations must exercise "expenditure responsibility" for grants to any organization that is not described in Section 501(c)(3) and to Type III non-functionally integrated supporting organizations, and Type I and Type II "controlled" supporting organizations are prohibited from making a grant to an organization that is not a public charity. To exercise expenditure responsibility, the private foundation must establish monitoring procedures to ensure that the grant funds are used solely for the purpose for which the grant was made, which includes, but is not limited to, obtaining full and complete reports from the grantee on how the funds are spent. In addition, a private foundation is required to summarize the status of each grant over which it exercises expenditure responsibility on its IRS Form 990-PF that is filed annually with the Internal Revenue Service. (Preparation of this return may require the assistance of an attorney or accountant.)

Given the additional documentation and reporting requirements associated with the exercise of expenditure responsibility, many private foundations have voluntarily chosen to award grants only to public charities; however, such a limitation is not legally required.

Q8 **Can a foundation make a grant for any purpose?**

Public charities and private foundations are required to ensure that any grants they make are used to further their exempt purposes. In addition, private foundations are prohibited from directly or indirectly making grants for the following purposes:

- To carry on propaganda, or otherwise to attempt to influence legislation.
- To influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive, with certain very limited exceptions.
- To an individual for travel, study or other similar purposes, unless certain requirements are satisfied, including the obtaining of advance approval from the IRS.

Q9
May a foundation make a grant to an organization or otherwise engage in activities to influence legislation?

See *Lobbying Q3 and Q4, pages 31-32.*

Q10
May a foundation make a grant to a group that lobbies?

See *Lobbying Q3, page 31.*

Q11
May a foundation make a grant to influence the outcome of a specific election or a voter registration drive?

As organizations described in Section 501(c)(3), public charities and private foundations are prohibited from participating in, or intervening in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office. Consequently, a public charity or private foundation is strictly prohibited from making a grant to another entity in order to support that entity's attempt to influence the outcome of an election.

Public charities and private foundations may provide support for voter education or voter registration drives; however, it is impermissible to fund such activities if they are overtly or implicitly partisan in the persons targeted or the messages conveyed. Voter education or voter registration activities may be considered nonpartisan if they are carefully designed and implemented to ensure that a) the activities are not targeted to a particular group based on the way that group tends to vote, and b) there is no express or implied support for (or opposition to) a candidate or political party or positions associated with a candidate or political party. For example, it is not permissible to fund a voter registration drive that encourages votes for "pro-life" candidates.

Private foundations considering providing support for voter education or voter registration activities must be aware that there are very specific additional legal restrictions applicable to private foundations that impose onerous requirements on nonpartisan voter education or voter registration activities (e.g. that the activities must be carried on in five or more states). Due to the complex requirements imposed by these laws, private foundations should seek legal advice before providing any such support.

Q12
May a foundation make a grant to an individual for travel, study or similar purpose?

A public charity, as opposed to a donor-advised fund, may make a grant to an individual provided the public charity enters into a grant restriction agreement pursuant to which the recipient agrees to use the funds in furtherance of the public charity's exempt purposes.

In contrast, a private foundation is prohibited from making a grant to an individual for travel, study or similar purposes, unless the grant satisfies numerous criteria, including that the grant is made pursuant to a procedure approved in advance by the IRS and is used to undertake activities that are consistent with the private foundation's exempt purpose. A grant to an individual for purposes other than travel, study or similar purposes is not a taxable expenditure but must otherwise qualify as a charitable grant (e.g., a grant to an indigent individual to meet basic needs).

A private foundation also must follow specific record retention requirements for grants to individuals. These requirements do not apply to other types of grants (see *Annual Reporting and Public Disclosure Q4, page 51*).

For More Information

See also *What Every Grantmaker Should Know: Grantmaking, pages 23-26.*

FREQUENTLY ASKED LEGAL QUESTIONS:

Annual Reporting and Public Disclosure

Q1 **What annual reporting requirements apply to a foundation?**

Federal Requirements: All private foundations are required to annually file federal income tax Form 990-PF, even if the organization's annual gross receipts are less than \$25,000.

Public charities, including community foundations, are generally required to file IRS Form 990 if their annual gross receipts are normally more than \$25,000; however, some organizations may file the simpler Form 990-EZ. For tax year 2009, public charities with gross receipts of less than \$500,000 and assets of less than \$1.25 million are eligible to file Form 990-EZ. For subsequent tax years, the ceilings are reduced to \$200,000 and \$500,000, respectively.

Forms 990-PF, 990 and 990-EZ must be filed by the 15th day of the fifth month after the end of an organization's accounting period. For example, a private foundation with an accounting period ending Dec. 31 must file its Form 990-PF by May 15 of the following year. Form 8868 may be used to request an automatic three-month extension.

Public charities with gross receipts normally \$25,000 or less must file an annual report with the IRS that provides basic information about the organization, such as its name, address, web address, principal officer and evidence of its continuing eligibility for exemption from Form 990 filing requirements.

Minnesota Requirements: All Minnesota nonprofit corporations are required to file an Annual Business Renewal with the Minnesota Secretary of State by December 31 of each year. The filing is free and can be done online. Failure to file will result in dissolution of the corporation without further notice. During an organization's first year of existence, the organization itself needs to obtain the form.

Most charitable organizations that solicit contributions from the public in Minnesota are obligated to register and report annually to the Minnesota Attorney General's Office. Organizations must file a Charitable Organization Registration Statement with the appropriate attachments and \$25 fee within 30 days after the organization's total contributions exceed \$25,000. In each subsequent year, organizations must file a Charitable Organization Annual Report with the appropriate attachments and \$25 fee by the 15th day of the seventh month following the close of its fiscal year. Certain charitable organizations are exempt from the registration and reporting requirements. For example, organizations are exempt if they a) do not receive, and do not expect to receive, more than \$25,000 in contributions in any year, and b) do not have paid staff members or employ a professional fundraiser.

Charitable organizations that do not solicit contributions from the public (if they have gross assets of \$25,000 or more at any time during the year) are obligated to file a Charitable Trust Registration Statement, including the appropriate attachments and a \$25 fee, with the Minnesota Attorney General's Office within three months after the organization receives assets. Such organizations are not required to subsequently submit an annual form and fee; however, such organizations are required to annually submit copies of their Forms 990, 990-EZ or 990-PF. The reports must be filed by the 15th day of the fifth month following the close of the organization's fiscal year.

Q2**What information is a foundation required to share with the general public?**

Upon request, a public charity or private foundation must make available for public inspection, without charge, a copy of its annual returns (Forms 990, 990-EZ or 990-PF and 990-T, if any) for three years after filing. Public charities are not required to publicly disclose the portions of the annual returns that include the names and addresses of contributors to the organization (whereas private foundations are required to publicly disclose such information).

A foundation also must make available for public inspection, without charge, a copy of its exemption application, along with the accompanying attachments and amendments, and any documents issued by the Internal Revenue Service concerning the application. However, the foundation may request that certain information be withheld from public inspection on the grounds that it constitutes a trade secret or some other form of intellectual property.

Q3**What satisfies a foundation's public information requirements?**

Foundations and public charities must make their annual returns and exemption application materials available for inspection, without charge, at their principal, regional and district offices during regular business hours. If the organization does not maintain a permanent office, it must make the information available for inspection at a reasonable location of its choice; it may also mail the information.

Organizations must provide copies of their annual returns and exemption applications to anyone who requests a copy either in person or in writing. The organization may charge a reasonable amount for copying these materials, including staff time and actual costs. As an alternative to providing copies, an organization can make its information widely available by posting the information on a web page and directing requestors to such page.

Q4**What information must a foundation retain regarding its grants?**

Private foundations that make grants to an individual for travel, study or similar purposes are required to retain the following information regarding the grant: (a) all information the foundation secures to evaluate the qualification of potential grantees, (b) identification of grantees (including information regarding whether grantee is a disqualified person), (c) specification of the amount and purpose of each grant, and (d) the follow-up information that the foundation obtains in complying with these record retention requirements. Internal Revenue Service regulations broadly require that organizations retain records "so long as the contents thereof may become material in the administration of any internal revenue law." However, the Treasury regulations do address the issue of how long a grant recipient must keep records: four years after completion of the use of grant funds.

Q5**How long must a foundation retain its records?**

An annual return is required to be available until three years have passed from the date the return was required to be filed (including any extensions) or was filed, whichever is later.

Exemption applications (and related documents) are required to be available indefinitely. However, applications are not required to be available if they were filed before July 15, 1987, and if the organization did not have a copy of the application on July 15, 1987.

The Internal Revenue Service does not specify exact time periods for which exempt organizations shall maintain general records. Rather, the Treasury Regulations broadly require that organizations retain records "so long as the contents thereof may become material in the administration of any internal revenue law." Therefore, organizations should take a best-practices approach regarding records retention and should retain as much information as is reasonable for a reasonable period of time. Organizations should consult with their attorneys regarding this issue, but it is commonly recommended that organizations retain information for a period of seven years.

FREQUENTLY ASKED LEGAL QUESTIONS:

Financial Audits

Q1

When is a foundation required by law to have its financial statements audited?

An organization that is registered with the Minnesota Attorney General because it solicits charitable contributions is required to include audited financial statements with its annual report to the Attorney General if its total revenue for the year exceeded \$750,000. Currently, there is no federal tax law audit requirement.

Q2

Under what other circumstances might a financial audit be recommended or required?

Financial audits are sometimes required under a foundation's organizational documents. In other cases, contributors, the federal government for certain contracts, or other program partners may require a foundation to have audited financial statements. Other states have more stringent audit requirements for foundations conducting activities or organized in those states. A number of proposals have been made that would impose a federal audit requirement on many charitable organizations, including foundations. The trend is toward more stringent requirements for financial audits of charitable organizations.

The preparation of audited financial statements by an independent auditor generally improves the quality of financial information available, and can help foundation board members fulfill their fiduciary duties to the foundation. An independent examination permits a competent and objective review of the organization's financial affairs. It can be time-consuming for staff and expensive for smaller foundations, however, and therefore most requirements and recommendations for independent financial audits attempt to balance the size and complexity of the foundation with the expense and time required to prepare audited financial statements.

Q3

What is the process for authorizing and approving a financial audit?

Financial audits and independent auditors are normally authorized and selected by the foundation's board, which may have a separate audit committee for this purpose. The auditors work with the foundation's audit committee or board and staff to conduct the audit, and normally report their results to the audit committee or board.

Although some sources recommend periodic rotation of audit firms or lead auditors, this is not required by law. The foundation's board or audit committee is responsible for engaging the auditor and defining the scope of the engagement, reviewing the audit, responding to recommendations for changes, and addressing any significant issues that may be brought to light as a result of the audit.

Accountability Self-Assessment Tool for Private Foundations

MORE ACCOUNTABILITY TOOLS

In addition to this document and the *Principles for Grantmakers & Practice Options for Philanthropic Organizations*, the Minnesota Council on Foundations also offers private foundations — family, independent and corporate — additional tools comprising an Accountability Self-Assessment. This tool was developed with the Forum of Regional Associations of Grantmakers, the national association of 32 regional associations like the Minnesota Council on Foundations that are working collaboratively to strengthen philanthropy throughout the country.

MCF has made the self-assessments and related tools available for all grantmakers to use. Included among these useful tools:

Accountability Self-Assessment Questionnaire

The Accountability Self-Assessment Questionnaire helps assess a foundation's compliance with legal issues and other accountability issues. The questionnaire comes in versions for unstaffed and staffed private foundations.

Accountability Self-Assessment Worksheet

The Accountability Self-Assessment Questionnaire is accompanied by a Microsoft Excel spreadsheet to help tabulate responses. The worksheet comes in versions for unstaffed and staffed private foundations.

Legal Compliance Checklist

The Legal Compliance Checklist contains all legal requirements tracked in the Accountability Self-Assessment Questionnaire, to ensure compliance with federal law. The checklist comes in versions for unstaffed and staffed private foundations.

Note: The Accountability Self-Assessment Tool for Private Foundations has been developed for grantmakers around the nation, and is not tailored specifically to Minnesota laws governing foundations. The Practice Options for Philanthropic Organizations do cover key Minnesota laws, as well as federal laws. Find the specific Minnesota-related requirements in the Practice Options section of this booklet.

Additional Resources

Additional resources include a Glossary of terms used in the self-assessment tool and an extensive Accountability Resource List, which provides more information on the topics and issues covered in the tool.

Find these tools at www.mcf.org/publictrust.

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About the Minnesota Council on Foundations

Founded in 1969, the Minnesota Council on Foundations is a regional membership association of grantmakers working to improve the health and vitality of our communities. The Council's membership includes family and other private foundations, community and other public foundations, and corporate foundations and business giving programs.

The Council provides service to Minnesota philanthropy in:

- Educating the field
- Providing access to the field
- Communicating with and on behalf of the field
- Providing research and information about the field
- Protecting the field
- Expanding and leading the field

For additional information about the Council, go to www.mcf.org. For membership information, please contact the Council at 612.338.1989.



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