

Legal Concepts Every Foundation Manager Should Know

Edie, John. "Legal Concepts Every Foundation Manager Should Know," *Family Foundations and the Law*. Washington, D.C.; Council on Foundations, 1999. p. 7-12. Reprinted from *Family Foundations and the Law* by permission of the Council of Foundations. For copies of this publication please visit www.cof.org.

LEGAL CONCEPTS EVERY FOUNDATION MANAGER SHOULD KNOW

The term "foundation manager" used throughout this [article] includes any family foundation officer, director, trustee or employee (if the employee has authority similar to that of an officer or director). Any person who takes on the fiduciary responsibilities of operating a private foundation should - at a minimum - be familiar with the basic legal concepts set forth in this section.

What is a Tax-Exempt Organization?

At the Federal level, the term "tax exempt" usually applies to a legal entity formed at the state level (normally a trust or nonprofit corporation) that has applied to, and received from, the IRS a determination letter certifying that it is exempt from Federal income tax. Not all organizations that are exempt from income tax are charitable (e.g., labor unions, trade associations, fraternal orders or chambers of commerce). Charitable organizations are only one type of tax-exempt entity. In addition, there are many other types of taxation for which tax exemption may or may not apply, such as sales taxes, real estate taxes and excise taxes. Many of these other taxes are set by state or local taxing authorities and the rules governing them vary widely.

What Dose "Charitable" Mean?

The definition of "charitable" is not finite or static but is constantly evolving, as a function of social change, statutory or regulatory revision or, occasionally, court interpretation. "Charitable" purposes are defined in Section 501(c)(3) of the Internal Revenue Code to be "religious, charitable, scientific, testing for public safety, literary, or educational, or to foster national or international sports cooperation (but only if no part of [the] activities involve the provision of athletic facilities or equipment) or for the

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prevention of cruelty to animals." Although there is no single totally inclusive list of every activity that is charitable, the income tax regulations also mention some specific activities: relief of the poor and distressed or of the underprivileged, erection or maintenance of public buildings, lessening of the burdens of government, lessening neighborhood tensions, eliminating prejudice and discrimination, defending human and civil rights secured by law, and combating community deterioration and juvenile delinquency. The regulations also make clear that the charitable purposes included in Section 501(c)(3) permit an organization, in carrying out its charitable purposes, to advocate social or civic changes or present opinions on controversial issues with the intention of molding public opinion or swaying the public to accept its views.

What is a Section 501(C)(3) Organization?

Section 501(c) of the Internal Revenue Code provides a long list of different types of organizations that are exempt from federal income tax. The third part of Section 501(c), namely Section 501(c)(3), is specifically designed for all charitable organizations. All public charities and all private foundations qualify as tax exempt under this section of the Code. To qualify, an organization must be formally structured and currently operating exclusively for charitable purposes. In addition, none of its funding or activities may involve participating in election campaigns to support or oppose candidates for public office. Limited funding for lobbying is permitted for public charities, but private foundations (with limited exceptions) may not lobby.

Finally, Section 501(c)(3) strictly forbids the organization from privately enriching any individual person. Reasonable compensation for services provided does not constitute private enrichment. Gifts and contributions to organizations classified under this section are eligible for an income tax, estate tax and gift tax charitable deduction.

How Does an Organization Obtain 501(C)(3) Status?

After forming a legal entity under state law (usually a trust or nonprofit corporation), the organization files Form 1023 with the IRS asking for recognition of tax-exempt status. So long as the application is submitted within 15 months (with a possible 12-month extension) of the date that the organization was created, its status as a 501(c)(3) organization - once approved - will be retroactive to the date of the organization's formation at the state level. Grants or gifts made by a corporation or an individual taxpayer to the entity after creation but prior to receipt of its tax letter will be protected

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as deductible. However, if the application is filed after the 15-month period + 12-month extension (or 27 months), tax-exempt status will begin on the date of the IRS approval, and only gifts made after that date are deductible.

What is an IRS Tax Determination Letter?

After an organization has submitted its Form 1023 and been approved by the IRS, it will receive a letter that states that the IRS has "determined" that the organization qualifies under Section 501(c)(3) as a charitable entity. The letter should note that deductions to the organization will be deductible for purposes of income (Section 170), estate (Sections 2055 and 2106) and gift taxes (Section 2522). The letter will also state whether or not the organization is considered to be a private foundation. Obtaining Section 501(c)(3) status from the IRS normally takes four to six months from the date of submission.

What is the Concept of Private Versus Public?

The most important and basic concept in this area is the difference between a private foundation and a public charity. The legal definitions here permeate the regulations that private foundations must live by and the amount of a gift that is deductible.

Understanding the differences between public charities and private foundations is essential to understanding the legal limitations on family foundations. "Private" suggests very limited public involvement, whereas "public" connotes widespread contributions from many sources and/or heavy involvement by the public sector in the operations of an institution (a congregation with its church, a student body and faculty with a university, doctors and patients with a hospital). A Section 501(c)(3) charity must have enough "publicness" if it is to avoid private foundation status and the relatively stricter rules associated with classification as a private foundation.

What is a Private Foundation?

The Tax Code's definition of a private foundation was first introduced in the Tax Reform Act of 1969. Strictly speaking, a private foundation is a separate legal entity formed as a trust or nonprofit corporation under state law that has obtained status as a tax-exempt Section 501(c)(3) charity from the IRS (see above). All private foundations are classified under Section 501(c)(3). But the IRS also assigns the private foundation label when the organization's funding sources are limited and there is not widespread involvement by the general public (as there would be with a school, church or medical

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institution). In the context of a family foundation, funding normally comes from one person, one couple or a limited number of family members. Often, once the endowment has been formed, the only source of funding may be investment income. Because such a charity does not have widespread financial support from the general public, it will be classified as a private foundation by the IRS. Once approved by the IRS, the foundation will be exempt from federal income tax, and contributions to it will qualify for income, estate and gift charitable deductions.

What is a Public Charity?

A public charity is any Section 501(c)(3) organization that is not a private foundation because it meets one of three Internal Revenue Code definitions: Sections 509(a)(1), 509(a)(2) or 509(a)(3). In other words, the Code's definition of a private foundation includes every Section 501(c)(3) organization unless it meets one of the following three definitions:

Section 509(a)(1) public charity. To qualify for Section 509(a)(1) status, an organization must satisfy the definition of a religious organization, an educational institution, a medical institution or a unit of government. If these definitions do not apply, it can meet a "public support test," which shows that a significant amount of the organization's ongoing support (normally one-third) is made up of gifts or contributions from a wide cross-section of the general public - not from one person, one company or one family. Admissions, sales, fees for services and other forms of gross receipt income do not count as public support.

Section 509(a)(2) public charity. A charity can also avoid private foundation status by meeting a different "public support test" under which gross receipt income does count as public support. A minimum of one-third of total support must be public support either in the form of gifts and contributions or gross receipts such as admissions, sales or fees for services. Under this test, investment income generated from any endowment or other investment may not exceed one-third of total support.

Section 509(a)(3) supporting organization. The final method to prevent private foundation classification is to qualify as a supporting organization under Section 509(a)(3). The rules for supporting organizations are complex, but generally such an organization must exclusively support, be very closely involved with or be controlled by another public charity (or charities). For example, a supporting organization could qualify if the

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charity it supports appointed a majority of the board members of the supporting organization. Note that a supporting organization, like a private foundation, may have limited sources of financial support. The supporting organization secures the "publicness" required for public charity status from its close ties to another public charity (the supported organization).

Following is a [listing] that summarizes the Section 509 definition of a private foundation. All Section 501(c)(3) organizations (as well as units of government) are poured in at the top. Those that fail to meet the definitions of a public charity fall to the bottom as private foundations. Note that the [listing] (and Section 509) also includes a fourth escape from private foundation definition, namely organizations operated exclusively for public safety. There are few of these organizations and they have little significance regarding the private foundation rules.

[LISTING OF] ALL SECTION 501(C)(3) ORGANIZATIONS AND GOVERNMENTAL UNITS:**1. Traditional 509(a)(1) Organizations** [also known as 170(b)(1)(A) groups]

- i. Churches
- ii. Schools
- iii. Hospitals
- iv. Support organizations to schools
- v. Governmental units
- vi. Publicly supported organizations (includes community foundations)

2. Gross Receipts 509(a)(2) Organizations (all publicly supported)

A. Normally receives more than 1/3 of support from:

- i. gifts, grants, fees and
- ii. gross receipts from admissions, sales, etc.

B. Normally receives not more than 1/3 of support from investment income

3. Supporting 509(a)(3) Organizations - Better known as "supporting organizations," these groups are not publicly supported but are controlled and closely associated with another public charity.

4. Public Safety 509(a)(4) Organizations - Operated exclusively for testing for public safety.

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Private Foundations – [do not fit into the above 4 categories]

What Official Organizational Documents Should Be Kept on File?

State law, not Federal law, governs the legal status of a family foundation. If incorporated under a state's nonprofit corporation code, the foundation should have the original articles of incorporation (plus any amendments) as approved by the appropriate state authority (usually the Attorney General or Secretary of State). The articles of incorporation name the foundation and set forth the purposes of the foundation. Once incorporated, the organization will be required to have bylaws, which are the basic procedural rules for operation - who constitutes the governing body, how members are selected and replaced, what officers will be appointed and their duties, how meetings will be called, how many governing body members must be present for a quorum and how the bylaws can be amended. In addition to the bylaws, copies of minutes should be kept, especially regarding any additional procedures or limitations approved by the governing board.

If the organization is created as a trust, an original copy of the trust document establishing the foundation (plus any amendments) should be kept on file. Trusts generally do not have bylaws, because the procedures for operation are normally set forth in the trust document, but trustees may choose to adopt such rules.

There should also be a separate file containing the application for Federal tax-exempt status (Form 1023), together with any attachments or correspondence regarding such status: the organization's determination letter from the IRS should be readily available (copies of all these documents must be made available to the public upon request).

Other documents that should be accessible include:

- ◆ Form SS-4, the application for the foundation's Employer Identification Number (EIN) and its approval.
- ◆ any other tax exemption certificates (such as exemption from state sales tax).
- ◆ copies of Federal tax returns.
- ◆ copies of state tax returns and/or other documents necessary to satisfy state reporting requirements.

What is Fiduciary Duty and the Legal Duty of Care?

The duties and responsibilities of a family foundation manager under Federal law are set forth below. At the state level, a foundation manager is required to exercise certain legal responsibilities, whether the foundation is in corporate or trust form. Under trust form, the duties may be stricter depending on the state on question.

Taking on the duties of a director, trustee or officer of a family foundation carries with it legal duties, sometimes called fiduciary duties. The funds or assets given to a family foundation no longer belong to the donor; they belong to the trust or the corporation. In most circumstances, the governing board of the foundation - including the donor or donors - must perform their duties in good faith, in the organization's best interests (not personal interests) and with the same degree of care that an ordinarily prudent person in a like position would use under similar circumstances. Failure to meet this standard of care or legal duty of care (such as squandering the assets) will be violation of fiduciary duty. In case of such a violation, most states empower the state attorney general to intervene.

In one particularly egregious case, the attorney general in one state successfully prosecuted a nonfamily board member for criminal fraud arising from misuse of assets for private benefit and excessive compensation. The family members of the board were replaced. The attorney general also brought a civil suit to recover the excess compensation from both family and nonfamily board members.

What Should Foundation Managers Know About State Laws?

This [article] concentrates primarily on Federal law, but you should also become familiar with those state laws that directly affect the existence and operations of a private foundation. Because state laws vary considerably, it is not practical to cover them here. The subject of state rules that affect your foundation should be an early question to your legal counsel. In addition to the state laws that govern the documents establishing the foundation as a legal entity, other local laws that may affect you are: (1) an annual reporting requirement to the state attorney general - sometimes including a fee, (2) sales tax exemption, (3) state income tax withholding, (4) unemployment insurance or (5) your state's version of the Uniform Management of Institutional Funds Act (UMIFA).