

2005 Equal Justice Conference

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**What You Don't Know
Can Hurt You**

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Andrew M. Grumet Select Publications and Teaching

Publications

- ? “Prop. Regs. Fail to Ease GST Exemption Allocation Concerns” 73 Practical Tax Strategies 324, (December 2004)
- ? “Choosing the Best Charitable Lead Trust to Meet a Client’s Needs,” 30 Estate Planning 86 (February 2003), *reprinted* Charitable Giving and Solicitation (May 20, 2003)
- ? “Review Grantor Trust Planning Points and Tax Return Tips” 70 Practical Tax Strategies 68 (February 2003), *reprinted* in Tax Ideas at ¶ 425 (March 2003)
- ? “Correcting Failures to Elect Out of Automatic GST Allocations” , ___ Tax Notes ___ (electronic edition December 30, 2002, print edition January 6, 2003)
- ? Life Insurance Answer Book, 3rd Edition, Chapter 52 entitled “Family Limited Partnerships and the Untrust,” edited by Gary Lesser and Lawrence Starr, (December 16, 2002)
- ? “Gains and Gaffes from Funding Charitable Trusts with FLP Interests,” 68 Practical Tax Strategies 332 (June 2002), *reprinted* in Tax Ideas at ¶ 428 (July 24, 2002)
- ? “New Requirement to File Gift Tax Returns,” The CPA Journal p. 65 (June 2002)
- ? “I Used My Entire GST Exemption? – How?,” 94 Tax Notes 1219 (March 4, 2002)
- ? co-author, “A Positive Space. The wash-sale rule depends on waiting between your selling and buying,” Angel Advisor mag. p. 73 (March/April 2001)
- ? co-author, “Final Regulations Issued to End the ‘Vulture’ Trust: Has the Vulture Really Been Buried?,” 90 Tax Notes 1227 (February 26, 2001)
- ? co-author, “Vulture Trust Regulations: Hold the Valedictory?,” 87 Tax Notes 1641 (June 19, 2000), *reprinted* 29 Exempt Org. Tax Rev. 51 (July 2000)
- ? co-author, “Forward Planning for 2000 and Beyond: Net GRATs, GRUTs, CLATs and CLUTs,” 139 Trusts & Estates 30 (May 2000)

Upcoming Lectures and Teaching

- October 24, 2005, *Current Legal Issues in Philanthropy*, 2005 Conference on Philanthropy, sponsored by Blackbaud, Charleston, South Carolina
- August 12, 2005, *US Tax Reform: What May Be Coming and How It May Affect Your Organization*, 2005 International Conference, sponsored by the Association of Professional Researchers for Advancement, San Diego, California
- June 16, 2005, *Writing Policies To Protect Yourself and Your Organization*, Support Center for Nonprofit Management, New York, New York

- May 23, 2005, *Making the Ask*, 2005 Regional Conference, sponsored by Mid-Atlantic Association Healthcare Philanthropy, Baltimore, Maryland

Past Lectures and Teaching

- May 5, 2005, *What You Don't Know Can Hurt You*, 2005 Equal Justice Conference, sponsored by the American Bar Association and National Legal Aid and Defender Association, Austin, Texas
- April 26, 2005, *How to Protect Assets During Life and Avoid Estate Tax at Death in New Jersey*, sponsored by National Business Institute, Saddle Brook, New Jersey
- February 16, 2005, *A Roadmap for Board Responsibility*, Support Center for Nonprofit Management, New York, New York
- December 8, 2004, *A Holistic Approach to Gift Strategies*, Teleconference sponsored by CharityUniversity
- November 12, 2004, *A Toolbox to Answer the Grant-Maker's "Accountability" Questions*, 6th Annual National Conference, sponsored by the American Association of Grant Professionals, Boston, Massachusetts
- November 11, 2004, *Choice of Entity for Consultants*, 6th Annual National Conference, sponsored by the American Association of Grant Professionals, Boston, Massachusetts
- November 4, 2004, *Legal Issues in Charitable Giving*, 24th Annual Conference on Philanthropy, sponsored by Association of Fundraising Professionals of New Jersey, Whippany, New Jersey
- November 2004, *Tax Efficient Funding of Large Life Insurance Policies*, 2004 - 2005 Continuing Education Series, College for Financial Planning, audio presentation
- September 22, 2004, *Duties and Responsibilities of Board Members*, Tax-Exempt Organizations Leadership Forum, Edison, New Jersey
- May 2004, *Getting the Most Out of Your IRA Using a Family Limited Partnership*, 2003 - 2004 Continuing Education Series, College for Financial Planning, audio presentation
- April 15, 2004, *Gift Strategies - A Holistic Approach*, The CharityChannel Summit 2004, sponsored by The CharityChannel, Anaheim, California
- October 25, 2003, *Designing and Implementing Charitable Lead Trusts In Today's Changing Environment*, 16th National Conference on Planned Giving, National Committee on Planned Giving, Cincinnati, Ohio
- April 24, 2003, *Designing and Implementing Charitable Lead Trusts In Today's Changing Environment*, 8th Annual Conference, Gift Planning Council of New Jersey, Plainsboro, New Jersey
- January 2003, *Using Charitable Trusts for Clients Who May Not Be So Charitable*, 2002 - 2003 Continuing Education Series, College for Financial Planning, audio presentation

- April 18, 2001, co-presenter, *Cutting Edge Strategies for Charitable Remainder Trusts in the New Millennium*, 6th Annual Conference, Gift Planning Council of New Jersey, Plainsboro, New Jersey
- March 29, 2001, *Creative Strategies for Charitable Remainder Trusts in the New Millennium*, Not-for-Profit Accounting, Tax and Business Issues, Advance Training Course, Arthur Anderson Metro New York, New York, New York
- 1998 - 2000, co-presenter, *Tax and Accounting Issues*, Deener, Feingold & Stern, P.C., Continuing Professional Education Series for Certified Public Accountants

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I. INTRODUCTION

Nonprofits operate in accordance with a complex set of federal and state laws which are often very different from the laws applicable to for-profit enterprises. Unless you have extensive experience representing nonprofits and have received specific training on matters affecting nonprofits, it is unlikely you would even be aware of many of the rules that a nonprofit must comply with. Add the fact that federal and state laws affecting nonprofit organizations are changing at an alarming rate and you have an area of law that is wrought with opportunities to make an error.

For many people with a vested interest in nonprofit organizations, the events of September 11, 2001 were a wake-up call for change and education. Scandals emanating from nonprofit organizations that the public has long trusted have received a great deal of media attention. Even today, new scandals continue to be exposed by the media. This media attention has resulted in a heightened public awareness of the potential for inappropriate action among nonprofits. The collapse of companies such as Enron, Worldcom, Tyco and others, have also fueled the public's mistrust for large organizations. While such events have shed light on many of the things that could, and have, gone wrong with nonprofit organizations, we, as concerned citizens, continue to offer our time and efforts by volunteering as directors to thousands of nonprofits that provide valuable benefits to our communities. Now, with the United States Senate having held hearings to begin formulating a plan to revise many of the laws that apply to nonprofits, everyone is on "red-alert" for changes to come.

It comes as no surprise to professionals who give advice to nonprofits that many individuals and organizations are either unaware, or simply lackadaisical when it comes to implementing appropriate procedures in connection with the management and operations of nonprofits. We hear countless stories of the wonderful plans that a group of individuals have for making society a better place by providing financial support for those in need and implementing programs to help the less fortunate. However, despite good intentions, sometimes things go awry.

Due, in part, to the increased public awareness of poor practices (and in some cases, misconduct) among nonprofits, charity watchdog groups have begun to receive greater attention. Groups such as BBB Wise Giving Alliance (an affiliate of the Council on Better Business Bureaus), Guidestar, Charity Navigator and the American Institute of Philanthropy provide information to the general public regarding the activities of nonprofits. Recently, many of these organizations have, independently, begun to establish model standards of accountability which, if not adhered to, could cause a nonprofit organization to receive a less than favorable report. For organizations seeking to raise funds from the public, a less than favorable report may hinder the organization's fundraising campaign.

Although professionals who advise nonprofits have long been lecturing about the need to establish a "best practices" method of doing business, it appears that some individuals and organizations are finally taking this advice to heart. Whether this new attitude is the result of years of advice, or the recent publicity of legislative and administrative action that has been implemented to curb poor practices among nonprofit organizations, individuals who serve on nonprofit boards are beginning to see the light, or are at least beginning to ask questions. Despite increased board member concern over the activities of the nonprofit organizations they serve, it is not uncommon for members of a board to be uncertain about what it is they need to be concerned with and what it is that they need to be doing.

These questions, and many others, are very common among individuals who establish a nonprofit organization. Although one or more individuals can establish an organization to do charitable work, only organizations that comply with federal and state laws will be permitted to retain the status of a tax-exempt entity and as a nonprofit. Thus, it is critical for new organizations to have, at the very least, a working knowledge of the requirements imposed upon them. For organizations that have been operating for some time, a refresher of these requirements is always in your best interest.

This workshop is designed to educate anyone who represents nonprofit organizations to better understand the hierarchy of laws applicable to nonprofits, the corporate and fiduciary duties of its participants, the different filing requirements, what

changes are taking place at the federal and state level and how to react to these changes and many other matters that arise in everyday practice.

II. THE INTERSECTION OF FEDERAL AND STATE LAW

A. What is a Nonprofit?

Charitable organizations are defined by two bodies of law, federal and state law. While state law governs the legal existence of the organization (i.e., whether an organization is a not-for-profit corporation, a trust, or some other entity), federal law governs the federal tax status of the organization. This distinction is important and can best be illustrated by the following statement: an entity may be established as a not-for-profit corporation pursuant to the laws of a particular state and yet fail to be treated as a charity exempt from federal income tax if certain specific requirements set forth in the Internal Revenue Code (the "Code") are not satisfied. In other words, the fact that an organization established as a not-for-profit corporation or as a trust which purports to be charitable in nature, does not necessarily mean that the organization or entity will be treated as a tax-exempt charity for federal income tax purposes.

1. State law definition

The type of activities in which the charitable organization will engage will usually dictate the selection of the form of business entity for a charitable organization. This section describes the different forms of charitable organizations that are traditionally used.

(a) Not-for-Profit (or Nonprofit) Corporation

A charitable organization may normally be formed in accordance with the not-for-profit corporation law of any state. If a state other than the state in which the organization will conduct its activities is selected for incorporation, it is usually necessary to qualify in the state in which activities will be conducted. Qualification is normally a simple process.

Generally, not-for-profit corporation laws are similar to business corporation laws in that the organization is governed by a board of directors.

Officers are elected/appointed on an annual basis to carry-out the decisions of the board and to supervise employees and volunteers. The primary difference between not-for-profit corporations and business corporations is the lack of stockholders and the lack of distributions for purposes primarily other than the organization's exempt purpose (i.e., nonprofits do not declare dividends).

The laws of most states provide that a not-for-profit corporation may be formed as a membership organization or a non-membership organization. The primary difference between the two types of organizations is where control of the organization is held. In a membership organization, the members are similar to stockholders in that the members are the individuals/entities that elect the board of directors, adopt, amend and repeal the by-laws and decide whether to dissolve and/or merge with another organization. Membership organizations may have a large membership that is open to the general public, or a limited membership with substantial restrictions for admission.

Non-membership organizations are typically designed in a manner that will permit the board of directors to be self-perpetuating (i.e., the directors periodically re-elect themselves).

State law will typically provide that membership in a charitable organization is non-transferable and will terminate upon the death of a member. An organization may include various provisions in its by-laws to restrict membership to particular individuals.

(b) Trusts

Forming a charitable organization as a trust pursuant to a trust agreement is essentially no different than establishing any other trust, except that the beneficiaries of the trust are those individuals and/or organizations who fit within a charitable class. When a trust is utilized, each individual responsible for administering the organization is usually referred to as a Trustee. Typically, a trust will not have officers, though some states permit such designations. Trustees of a charitable trust are typically held to the same fiduciary responsibilities as trustees of a non-charitable trust (e.g., prudent investor rules).

There are three primary differences between a charitable trust and a not-for-profit corporation. The first difference pertains to the formalities applicable to charitable trusts and a not-for-profit corporations. Generally charitable trusts do not require a great deal of formal documentation, when compared with a not-for-profit corporation, which generally requires regular meetings, notices, corporate minutes, etc.

The second significant difference pertains to the standard of care applicable to trustees.¹ Generally, the strict standards that apply to trustees of private trusts apply to trustees of charitable trusts. These standards are generally higher than the standards imposed upon a director of a not-for-profit corporation

In addition, Trustees are required to administer a charitable trust in accordance with the terms of the trust. Unlike a not-for-profit corporation, trustees of a charitable trust may not alter the terms of the trust agreement without the authorization of a court unless the trust agreement specifically grants such a power, which is not normally done. For this reason, a charitable trust is less flexible than a not-for-profit corporation.

2. Who are the “players”
 - (a) Board of Directors
 - (b) Members
 - (c) Officers
 - (d) Employees
 - (e) Volunteers
 - (f) Secretary of State
 - (g) State Attorney General

B. What does it mean to be “Tax-Exempt”

To be exempt from federal income tax, an organization must be an

¹ A detailed explanation of the liability issues is set forth in Section IX.

organization that is described in Section 501(c)(3) of the Code. In order for an organization to be described by Section 501(c)(3) of the Code, the organization must meet two tests: the “Organizational Test” and “Operational Test”. The Organizational Test requires that the organization’s articles of organization limit the purposes of the organization to one or more exempt purposes, and do not expressly empower the organization to engage, other than as an insubstantial part of its activities, in activities which in themselves are not in the furtherance of one or more exempt purposes. The Organizational Test also requires that upon the dissolution of the organization the assets of the organization must be distributed, by reason of a provision in the organization's articles or by operation of law, for one or more exempt purposes, or to the federal, state or local government for a public purpose.

The Operational Test is met if: (i) the organization engages primarily in activities which accomplish one or more of the exempt purposes specified in section 501(c)(3) of the Code, (ii) no part of the net earnings inure to the benefit of any private shareholder or individual, (iii) no substantial part of the activities of the organization consist of carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in Section 501(h)), and (iv) the organization does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

If both the Organizational Test and the Operational Test are satisfied, an organization will be treated as an organization described in Section 501(c)(3) of the Code. As a result, by reason of Section 501(a) of the Code, such organization will be exempt from federal income tax.

Although many organizations may be exempt from federal income tax by reason of being described by Section 501(c)(3) of the Code, there are basically five sub-classifications under Section 501(c)(3) in which an organization could be classified. All organizations are classified into one of these categories. The first two categories are generically referred to as public charities, the third category is generally referred to as a quasi-public charity or a supporting organization, the fourth category are organizations that conduct testing for public safety and the fifth category is referred to as a “private

charity”, “private foundation”, “family foundation” or simply as a “foundation”.²

With certain exceptions, public charities are organizations such as schools, hospitals, synagogues and organizations that receive a substantial portion of their revenue from the general public.³ Private charities, on the other hand, typically receive most, if not all, of their revenue from a small number of sources.

The importance of the differentiation between public charities and private foundations is essentially two-fold. First, unlike public charities, private foundations are subject to substantial rules and regulations with respect to: (i) with whom they may conduct transactions, (ii) the type of investments that may be made and/or owned by the organization (including assets that are gifted to the organization), and (iii) the type of expenditures/distributions that can be made. In addition, certain private foundations are subject to an excise tax on their income.

The second major difference between public charities and private foundations is the income tax deductions that a donor may receive as a result of contributions to the organization. For example, while a contribution of cash to a public charity may be utilized to offset up to 50% of the donor’s adjusted gross income for the year, the same contribution to a private foundation will be limited to 30%. Similarly, contributions of appreciated capital gain property, such as marketable securities, to a public charity will be subject to a 30% limitation, while the same gift to a private foundation will be subject to a 20% limitation.

Due to the operational restrictions imposed upon private foundations, as well as the income tax limitations, it is usually preferable for a nonprofit to qualify as a public charity. However, due to the technical requirements applicable to public charities, qualification as such may be difficult to achieve if broad public financial support cannot be achieved.

² Reference to quasi-public public charities and organizations that conduct testing for public safety are made only to recognize the existence of these types of entities. However, because these types of entities are less commonly used, particularly organizations that conduct testing for public safety, the discussion in this outline is not focused on these types of entities.

³ Organizations such as schools, hospitals and synagogues maybe considered de facto public charities since their qualification as a public charity is based upon the activities they perform.

III. PUBLIC CHARITIES

With the exception of certain de facto charitable organizations (e.g., schools, hospitals and synagogues), there are two categories of public charities, both of which are referred to as “publicly supported organizations”. Publicly supported organizations “normally” receive a substantial portion of their support from the general public. The difference, however, between the two categories is the method of determining whether the organization received a substantial portion of its support from the general public. An explanation of both types of publicly supported organizations is set forth below.

A. Section 509(a)(1) Organizations

The first category of publicly supported organizations is defined in Section 509(a)(1) of the Code and is often referred to as an “A1 organization”. A1 organizations are organizations that “normally” receive a substantial portion of their support from the general public. The Regulations generally define “normally” as deriving more than one-third ($1/3$) of the organization’s support from direct and indirect contributions from the general public. This test is often referred to as the “ $33\frac{1}{3}$ percent-of-support test”. Determining whether the $33\frac{1}{3}$ percent-of-support test is met is mechanical and complex.

1. The $33\frac{1}{3}$ Percent-of-Support Test

To satisfy the $33\frac{1}{3}$ percent-of-support test, an organization must establish that during the prior four (4) years (referred to as the “Testing Period”), more than one-third ($1/3$) of the organization’s support was derived, directly or indirectly, from the general public. In computing the percentage of support an organization receives from the public, a fraction is utilized. The numerator is comprised of a portion (as described below) of all direct and indirect contributions made to the organization, including gifts, bequests and grants, and the denominator is generally comprised of the total of all direct and indirect contributions made to the organization, including gifts, bequests and grants and most other income of the organization.⁴

The following rules apply when computing the portion of all gifts,

⁴ The calculation for determining the public support fraction is actually much more complicated than is explained in this presentation. However, the generalization made herein is sufficient for our purposes.

bequests and grants to be included in the numerator:

(a) Each donor's contribution is aggregated with the contributions made from each "Related Party" so that any contributions made by a donor and all Related Parties are treated as if made by one donor.

(b) Once the total of all contributions made by a donor and all Related Parties are determined, to the extent such amount exceeds two (2%) percent of the total contributions made to the organization during the Testing Period and certain other income, such excess is excluded from the numerator of the fraction.

A "Related Party" is any: (i) owner of more than twenty (20%) percent of: (a) the total combined voting power of a corporation, (b) the profits interest in a partnership, and (c) the beneficial interests of a trust or unincorporated enterprise, which is a substantial contributor⁵, (ii) family member of any substantial contributors, foundation managers, or the individuals described in clause (i) (a member of the family includes the person's spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of children, grandchildren and great grandchildren), (iii) corporation in which more than thirty-five (35%) percent of the voting power is owned by substantial contributors, foundation managers, or the individuals described in clauses (i) and (ii), (iv) partnership in which more than thirty-five (35%) percent of the profit interests are owned by substantial contributors, foundation managers, or the individuals described in clauses (i) and (ii), and (v) a trust or estate in which more than thirty-five (35%) percent of the beneficial interest is held by substantial contributors, foundation managers, or the individuals described in clauses (i) and (ii).

The $33\frac{1}{3}$ percent-of-support test may be illustrated by the following example:

⁵ A "substantial contributor" is a contributor who contributes more than \$5,000 in any year in which such contribution constitutes more than 2% of the total of all contributions made during such year. Once a person is classified as a substantial contributor, he or she will, generally, remain a substantial contributor for all subsequent periods.

Assume that Husband make a gift to a charity in the amount of \$500,000 during the year 2000, Spouse makes a gift to the same charity in the amount of \$1,000 during the year 2001 and one hundred fifty other individuals each make a contribution of \$1,500 to the same charity during the years 2000 through 2003.

Since Husband's gift exceeds \$5,000 and is in excess of the 2% limitation for the year 2000, Husband is treated as a substantial contributor. Since Spouse is Husband's wife, Spouse's gift is attributed to Husband, resulting in their gifts being aggregated for purposes of the 33¹/₃ percent-of-support test. In this case, the support fractions would be computed as follows:

From unrelated individuals:	\$225,000
Husband & Spouse (limited):	<u>\$ 14,520</u> (2% of \$726,000)
	\$239,520
 Total of All Contributions:	 \$726,000

	\$239,520
Fraction =	----- = 32.99%
	\$726,000

Under these facts, the charity fails the 33¹/₃ percent-of-support test.

2. Alternative Test

A1 organizations that fail to meet the 33¹/₃ percent-of-support test are not automatically disqualified from public charity status. One of the primary differences between A1 and A2 organizations is that A1 organizations are permitted to apply an alternative test (the "Alternative Test") to determine whether the organization "normally" receives a substantial portion of its support from the general public. The Alternative Test is based upon a consideration of various factors. There are no bright line rules to determine whether the test has been met.

Pursuant to the Alternative Test, an A1 organization will be treated

as “normally” receiving a substantial portion of its support from the general public if: (i) the amount of direct and indirect contributions to the organization during the Testing Period is at least ten (10%) percent of the total support received, and, (ii) it is organized and operated in a manner that will attract new and additional public or governmental support on a continuous basis. Although the rules for determining whether the organization has met the ten (10%) percent test are objectively applied, the requirements set forth in clause (ii) are subjective. In determining whether clause (ii) has been met, the Regulations set forth five (5) factors which are used to determine whether these requirements have been met. Furthermore, the Regulations provide that no one factor is determinative. Each factor is to be considered in light of the nature and purpose of the organization and the length of time it has been in existence.

The five factors set forth in the Regulations are as follows:

(a) Percentage of Financial Support. When considering the facts and circumstances test, the higher the percentage of public support (i.e., the closer to the $33\frac{1}{3}$ support), the stronger the case for meeting the Alternative Test.

(b) Sources of Support. The greater the number of sources for support, the more likely the organization will qualify under the Alternative Test.

(c) Representative Governing Body. The greater the diversity in the members of the organization’s governing body, the more likely the organization will qualify under the Alternative Test.

(d) Availability of Public Facilities or Services; Public Participation in Programs and Policies. Another factor is whether the organization is actively engaged in providing programs and/or services to the general public. One example given by the Regulations is that of a museum that is open to the general public. Another example is a conservation organization that provides educational services to the public by distributing educational materials to the general public.

(e) Additional Factors Applicable to Membership Organizations.

If the organization is established as a membership organization, consideration is also given as to whether membership is sought from a broad cross-section of the general public or if membership is designed to be limited (e.g., to a few wealthy individuals).

B. Section 509(a)(2) Organizations

The second category of publicly supported organizations is defined in Section 509(a)(2) of the Code and is referred to as an “A2 organization”. Similar to A1 organizations, A2 organizations are organizations that “normally” receive a substantial portion of their support from the general public. For purposes of determining “normally” for an A2 organization, the Regulations define “normally” as deriving more than one-third of the organization’s support from direct and indirect contributions from the general public. This test is similar to the 33¹/₃ percent-of-support test applicable to A1 organizations, with several important modifications.

When calculating the numerator of the support fraction, A2 organizations do **not** include any portion of contributions made by Related Parties. In addition, any revenue earned by the organization from programs that further the organization’s exempt purpose are included in the numerator.

The second important difference between A1 organizations and A2 organizations is that A2 organizations may not receive more than one-third (1/3) of their revenue from investment income. There is no alternative test for qualification as an A2 organization

IV. PRIVATE FOUNDATIONS

The terms “private charity”, “private foundation”, “family foundation” and “foundation” have no precise meaning, but imply a charitable organization that achieves its goals primarily by making grants to public charities, which grants are then ultimately used by the grantees for charitable purposes. Under the Tax Reform Act of 1969 (“TRA 69”), the term private foundation was used to describe a category of charitable

organizations described in Section 501(c)(3) of the Code which do not meet the definition of a public or quasi public charity.

Congress' effort to stop certain abuses with family foundations in TRA 69 included: (i) limiting the percentage of a taxpayer's adjusted gross income (as specially computed) which can be deducted on account of charitable gifts to private foundations as compared to public charities, (ii) limiting the amount of the deduction for certain gifts to foundations based upon basis, instead of value, and (iii) imposing certain excise taxes (which are embodied in Chapter 42 of the Code) upon private foundations and/or the individuals who control them in the event certain acts are committed by the private foundation and/or the individuals who control them.⁶ The Chapter 42 excise taxes are as follows:

1. Section 4940 imposes a two (2%) percent (or, in some cases, one (1%) percent) excise tax on net investment income of the foundation.
2. Section 4941 imposes an excise tax on acts of self-dealing.
3. Section 4942 imposes an excise tax on a foundation's failure to make distributions equal to five (5%) percent of the foundation's assets that are not used in the direct performance of the foundation's exempt functions.
4. Section 4943 imposes an excise tax on the foundation's excess business holdings.
5. Section 4944 imposes an excise tax on investments which jeopardize the foundation's charitable purposes.
6. Section 4945 imposes an excise tax on "taxable expenditures", including: (i) grants for lobbying, (ii) grants to influence elections or conduct voter education campaigns, (iii) grants to individuals, except as specially permitted, (iv) grants to organizations other than public charities, unless the foundation monitors the grantee's

⁶ In order for an organization that is classified as a private foundation to satisfy the Organizational Test of Section 501(c)(3) of the Code, the organization's governing instrument must also include (either expressly or by operation of state statute) that the organization will not engage in activities which would give rise to liability under the Chapter 42 excise taxes (other than those imposed by Section 4940).

use of the funds and complies with certain other rules, and (vi) grants for non-charitable purposes.

A. Chapter 42 Prohibitions and Excise Taxes

Code Sections 4940 through 4945 follow the same basic structure. Subsection (a) of each section imposes an initial excise tax, which is often referred to as the “first-tier” tax, at a relatively low rate, which continues accrue until such time as the prohibited act is corrected. In the event the act is not corrected, subsection (b) of each section will generally provide for what is referred to as a “second-tier” or additional excise tax at a very high rate (i.e., 200 percent of the amount involved). In addition, though not included in Chapter 42, in cases where there are willful repeated acts, or one willful and flagrant act, in violation of the restrictions imposed by Chapter 42, Code Section 507 will require a private foundation to repay all income, gift and estate tax benefits that the private foundation or its substantial contributors received since the year 1913. This final tax is often referred to as the “third-tier” tax. The system of imposing a first, second and third-tier tax was Congress’ attempt to eliminate abuses it perceived with respect to the creators of private foundations and their substantial contributors.

1. Excise Tax on Net Investment Income

Section 4940 of the Code imposes an excise tax on the investment income of a private foundation. The tax is applied at the rate of two (2%) percent of net investment income, but a reduced rate of one (1%) percent can be obtained provided that the private foundation distributes a sufficient portion of its assets each year (as determined by a statutory formula). However, all private foundations will be taxed at the rate of two (2%) percent in the first year of operation. The excise tax on investment income is the only excise tax that may be imposed upon a private foundation without jeopardizing the organization’s tax exempt status.

2. Excise Tax on Acts of Self-Dealing

Probably the most onerous of the Chapter 42 excise tax provisions is Section 4941, which imposes a tax on acts of self-dealing involving a "disqualified

person".⁷ The tax is imposed upon the "self dealer" (i.e., the disqualified person involved), and upon each foundation manager who "knowingly" engages in the act of self-dealing. It is not imposed upon the private foundation. The initial tax on the self-dealer is five (5%) percent of the amount at issue, per year, until the act is "corrected". If not corrected as prescribed, the excise tax, as a general rule, is equal to 200% of the amount involved.

Virtually every economic transaction, including a sale or exchange between a disqualified person (including the spouse and the descendants and spouses of the descendants of the person who creates the private foundation) and a private foundation will constitute an act of self-dealing. Unless a specific exception is set forth in the Code and/or the Regulations, the determination of whether an act of self-dealing has occurred is an objective determination. The excise tax is imposed not only on direct acts of self-dealing but indirect acts as well.

Acts of self-dealing include:

(a) Sales of property between a private foundation and a disqualified person.

(b) Leases between a private foundation and a disqualified person.

(c) Loans between a private foundation and a disqualified person.

(d) Excessive compensation between a private foundation and a disqualified person. However, since a private foundation is expected to pay its ordinary costs and expenses, a private foundation can pay a salary for services received provided the salary is reasonable.

⁷ A "disqualified person" is the same as any person who is a Related Party.

3. Excise Tax on Failure to Distribute the "Minimum Return"

Section 4942 of the Code imposes an excise tax, to the extent that a private foundation (and certain other entities) fails to distribute its "distributable amount". As a general rule, the distributable amount is five (5%) percent of the private foundation's net worth each year (computed using a method of averaging the fair market value of the private foundation's assets throughout the year).

In computing the distributable amount, a private foundation is permitted to exclude from the foundation's net worth any property held by the foundation to accomplish the private foundation's exempt purpose. For example, ABC Foundation holds \$500,000 in stocks and a \$1 million townhouse used as an art museum that is open to the general the public. The private foundation's exempt purpose is the ownership and operation of a museum. In computing the distributable amount, only five (5%) percent of the average value of the stock portfolio must be distributed.

If a violation of the minimum distribution rule occurs, the Code imposes a fifteen (15%) percent excise tax on the amount which should have been distributed until the amount is actually distributed by the private foundation, and, if the required distribution is not made before the end of the taxable year, a one-hundred (100%) percent tax of the amount remaining undistributed is imposed.

4. Excise Tax on Excess Business Holdings

Section 4943 of the Code imposes an excise tax on the excess business holdings of a private foundation. Excess business holdings are ownership interests in business enterprises which exceed certain percentages. Generally, a private foundation may hold no more than 20% of the interests in any business (including a corporation or partnership) reduced by the percentage held by disqualified persons. The general policy being advanced by this rule is that a private foundation should not be investing in an entity, such as a closely held business venture that is owned by a substantial contributor, a foundation manager or his/her family, nor should a private foundation be engaged in an active trade or business.

The excise tax for having excess business holdings, for each

taxable year, is equal to five (5%) percent of the total value of all of the private foundation's excess business holdings. To the extent that there continues to be excess business holdings at the end of the "taxable period" (as defined in the Code), an additional tax equal to two-hundred (200%) percent of the value of the excess business holdings is imposed.

5. Excise Tax on Jeopardy Investments

Section 4944 of the Code imposes an excise tax on a private foundation and each foundation manager who make a jeopardy investment in the amount of five (5%) percent of the amount invested. A jeopardy investment will have been made if the investment jeopardizes the ability of the private foundation to carry out its exempt purposes. The standard which must be met in connection with each investment made by the private foundation is that of the "prudent trustee". While no category of investments will be a per se violation of prohibition against jeopardy investments, the Regulations state that trading on margin, trading in commodity futures, investing in working interests of oil and gas wells, purchasing puts, calls, straddles and warrants, and selling short will all trigger "close scrutiny" by the Internal Revenue Service.

6. Excise Tax on "Taxable Expenditures"

Section 4945 of the Code imposes an excise tax on a private foundation for any amounts paid or incurred by the foundation: (i) to carry out propaganda, or otherwise attempt to influence a legislature, (ii) to influence the outcome of any specific public election, or to carry on, directly or indirectly, any vote or registration drive, unless certain conditions are met, (iii) as a grant to an individual for travel, study, or other similar purposes, unless the grant meets certain requirements, (iv) as a grant to an organization other than a "public" charity, unless the granting foundation exercises "expenditure responsibility", and (v) for any purpose other than one specified in Section 170(c)(2)(B) of the Code.

If a there is a violation of the prohibition against taxable expenditures, an excise tax of ten (10%) percent of the expenditure will be imposed upon the private foundation as an initial tax. In addition, an excise tax in an amount

equal to two (2½%) percent of the amount of the expenditure will be imposed on any foundation manager who participated in the distribution if such person willfully, knowingly or reasonably caused the taxable expenditure. If the taxable expenditure is not “corrected”, a second level excise tax equal to hundred (100%) percent of the amount of the expenditure will be assessed to the foundation and an additional tax of fifty (50%) percent of the taxable expenditure will be imposed upon the foundation manager who does not agree to correct the taxable expenditure.

B. Termination of Private Foundation Status

Once an organization is classified as a private foundation, it may incur a confiscatory tax if it abandons its status as such. The amount of the tax is equal to the lesser of: (i) all the net assets of the private foundation, or (ii) all tax benefits accruing to all parties (e.g., the organization and its contributors) since formation as a result of the organization's tax exemption.

An organization may avoid this onerous termination tax in several ways. If it continues in existence, it may apply to IRS to be reclassified as a public charity and operate as such for a five-year period. Alternatively, it may dissolve and give all of its net assets to any public charity with a five-year operating history.

V. FEDERAL RECOGNITION OF TAX EXEMPTION

Generally, in order for an organization to be treated as exempt from federal income tax under Section 501(a) of the Code as an organization described in Section 501(c)(3), the organization must make a formal request to the Internal Revenue Service for exemption.⁸ The request is made by filing Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code. The application is generally filed within 15 months of the end of the month in which the organization was organized or incorporated.⁹

⁸ Religious organizations such as churches, synagogues and mosques are not required to file a formal request to the Internal Revenue Service. These organizations are automatically treated as being exempt from federal income tax under 501(a) of the Code.

⁹ However, if an organization fails to meet this requirement, an automatic extension is automatically granted if the organization files within one year of the expiration of the fifteen month period. If an

Although all public charities and private foundations use Form 1023 to request recognition of exemption, the process for obtaining the recognition of exemption is different. An overview of these differences is set forth below.

A. Private Foundations

When a private foundation files a Form 1023, one of two things will usually occur. The first possibility is that IRS will issue a “Determination Letter” to the organization, usually within four (4) to six (6) months.¹⁰ Alternatively, IRS may send a letter requesting additional information to supplement one or more of the responses on the Form 1023. If this should occur, which is not unusual, a response is prepared and submitted to the IRS agent assigned to review the application. Assuming that the private foundation’s response satisfies the agent’s questions, a Determination Letter will then be issued.

Once a Determination Letter is issued, a private foundation is officially treated as being exempt from federal income tax. If the original application was timely, the private foundation’s tax-exempt status will be retroactive to the date in which the organization was formed.

B. Public Charities

Since public charities which qualify as such by reason of being publicly supported (e.g., A1 and A2 organizations), these organizations are usually unable to obtain a Determination Letter when the Form 1023 is filed. This is due to the fact that the organization will lack a sufficient history of public support to establish that the organization qualifies under the applicable test. Thus, A1 and A2 organizations typically file a request for an “Advance Ruling”.

An Advance Ruling may be thought of as a provisional or probationary grant of public charity status. If granted, an Advance Ruling will usually be valid for a period of five (5) years, thus giving the organization sufficient time to establish its ability to meet the applicable public support test. When a request for an Advance Ruling is

organization fails to file during the automatic extension period, the organization may still file, but unless certain conditions are met, exemption will only be effective as of the date the request is filed.

¹⁰ A “Determination Letter” is the name of the document that IRS issues formally recognizing an organization’s tax-exempt status.

made, it is critical to establish the factual basis for concluding that the organization can reasonably be expected to meet the applicable public support test. If sufficient facts are not set forth in the application, the request for an Advance Ruling may be denied. If the request is denied, the organization will usually be classified as a private foundation.

In the event that the request for an Advance Ruling is denied, the organization may appeal the decision or, accept the classification as a private foundation. If the organization accepts the classification as a private foundation, the organization may re-apply for a Determination Letter once the organization has been in existence for a sufficient period of time to establish that it qualifies under the applicable public support test.

If the Advance Ruling is granted, within ninety (90) days of the expiration of the Advance Ruling period (i.e., after 5 years) the organization will be required to make an additional filing in order to obtain a Determination Letter. The additional filing is a short form which sets forth the sources of the organization's support during the Advance Ruling period so as to establish that the organization has met the applicable public support test.

VI. GRANTMAKING

The term "grantmaking" has multiple meanings. Generally, the term means that a charitable organization is making distributions to one or more individuals and/or organizations. Beneficiaries of a grant need not be charitable organizations (e.g., described in Section 501(c)(3)). The manner in which a grant may be made, however, will depend upon the tax classification of the grantmaking organization and the identity of the grantee.¹¹

A. Public Charities

Very few restrictions are imposed upon public charities in connection with their grantmaking. So long as the organization utilizes its assets in accordance with the Operational Test (discussed in Section II.B.), a grant made by a public charity will

¹¹ Due to the complex rules and issues applicable to making grants to foreign individuals and organizations, this presentation does not address those types of grants.

usually be proper. However, despite the wide range of latitude held by public charities, most advisors to public charities generally recommend that public charities follow procedures similar to those followed by private foundations (which are discussed below). This course of action is advisable since it will provide a record for the directors of the organization to rely upon in the event a government agency, such as the Internal Revenue Service, questions the appropriateness of the grant.

B. Private Foundations

One of the excise taxes which applies to a private foundation are based upon “taxable expenditures”. Private foundations that make grants must strictly comply with certain rules, which are explained below, to avoid the imposition of an excise tax under Section 4945 of the Code and/or loss of tax-exemption.

1. Grants to Individuals

A private foundation may make grants to individuals in one of several ways without causing the private foundation to be subject to the excise tax for making a taxable expenditure. For example, grants may be made that: (i) are made on an “objective and non-discriminatory” basis, (ii) are made pursuant to a procedure approved in advance by IRS, (iii) are either a scholarship or fellowship (which will be excluded from the recipients gross income under Code Section 117(a)), (iv) are utilized for study at a qualified educational institution, or, constitute a prize or award which is excludable from gross income under Code Section 74(b), and (v) select recipients from the “general public”, or, have the purpose of achieving a specific objective, producing a report or other similar product, or improving or enhancing a literary, artistic, musical, scientific, teaching, or similar competency, skill, or talent to the grantee.

Private foundations may also make grants to recipients provided that the award of the grant does not require future activities. These grants would, for example, include a grant for past literary achievement, a grant to a winner of a student competition at a craft school, or a grant to a local science fair prize winner. A grant may also be made to an organization which then pays the funds to an individual, provided that the granting private foundation does not “earmark” the use of the grant for the named individual and there is no agreement permitting the private foundation to control

the selection of the individual for whom the grant will ultimately be made. For example, a grant made to a organization providing college scholarships to high school students is permissible provided that the granting private foundation does not retain the ability to control the selection of the candidate.

A grant may be given to public charities for use in a project under the control of a named individual, provided that the grant is made for a project supervised by the public charity and where the public charity controls the selection of the individual who will be running the project. Grants may also be made to a government agency which are earmarked for use by a named individual if the government agency's grant program is approved by the Internal Revenue Service.

(a) Selection of Grant Recipient

A private foundation must establish that a grant made to an individual is made on an "objective and non-discriminatory basis" and is awarded through a program consistent with:

- (i) The existence of the private foundation's exempt status;
- (ii) The allowance of a charitable income tax deduction to individuals for contributions to the granting private foundation; and
- (iii) A procedure which states specific rules covering the applicants, the selection criteria and the persons making the selections.

(b) Potential Grantees

The group of potential grantees of a private foundation's grant program may be broad or narrow, provided that the number of potential grantees is large enough to satisfy the private foundation's exempt purpose (i.e., a private foundation may not be formed for the sole purpose of providing funds exclusively for a specific person).

(c) Selection Criteria

A private foundation's criteria for awarding grants should be related to the grant's purpose. For example, scholarship grants should require potential candidates to prove the recipient's ability to succeed in an academic program.

(d) Grant Selection Process

The person who selects the grant recipients may not receive, either directly or indirectly, any benefit from the grants.

(e) Grant programs aimed at race and/or ethnicity

While grants must be on a "objective and non-discriminatory basis", grant programs may be skewed to recipients of a particular racial or ethnic background provided that certain requirements are met. The rules for such a program are technical and should be addressed if such a plan is being considered.

(f) Supervision of Scholarship and Fellowship Grants

A private foundation that awards scholarship or fellowship grants must receive a "verified" report from the educational institution, at least annually. If a grant recipient is not enrolled in a traditional course of study, the private foundation must receive progress reports, approved by faculty members supervising the grantee or by another appropriate official. Upon completion of the course of study, a final report of the grantee's work must be obtained. The private foundation has a continuing obligation to investigate "jeopardized" grants. (See subparagraph (g) below). A private foundation may be relieved of its investigatory duties if:

(i) The scholarship and/or fellowship is excluded from the recipient's gross income under Section 117(a) of the Code and the grant funds are to be used for study at a qualified educational institution;

(ii) The private foundation pays the grant directly to the educational institution, and not to the recipient; and

(iii) The educational institution agrees to use or apply the grant funds to defray the grantee's expenses, only if the grant recipient is enrolled at the

institution and the grantee's standing at the institution is consistent with the purposes and conditions of the grant.

(g) Investigating "Jeopardized" or "Diverted" Grants

A private foundation has a continuing obligation to ensure that its grants are used to accomplish the private foundation's exempt purposes. A private foundation's failure to investigate the use of its funds will subject the private foundation to an excise tax for making a "taxable expenditure". Where the private foundation receives reports from the grantee, or receives information from another source indicating that funds were not used for permissible purposes, the private foundation has a "duty to investigate". While an investigation is pending, the private foundation must withhold any further payments to the grantee until certain conditions are met.

Where the grantee has not previously misused grant funds, the private foundation must:

(i) Take all reasonable and appropriate steps to either (i) recover the grant funds, or (ii) ensure restoration of the diverted funds, and assure the dedication of other grant funds held by the grant recipient to the original grant purposes; and

(ii) Withhold further payments to the grantee after the private foundation discovers that a diversion may have occurred until it receives assurances from the grantee that further diversions will not occur and that the grant recipient has taken "extraordinary precautions" to prevent further diversions from occurring.

Where the grantee has previously diverted funds, the private foundation must, in addition to the rules which apply in the case of a first offense, withhold further grant payments until the funds which were diverted have been recovered or restored.

(h) Recordkeeping

A private foundation must retain records of all grants made to individuals. These records include:

- (i) All information that the private foundation used or possesses to evaluate the qualifications of potential grantees;
- (ii) Identification of grantees, including information pertaining to the grantees and his or her relationship to the private foundation;
- (iii) The amount and purpose of each grant; and
- (iv) Any follow-up information that the private foundation obtains in complying with the requirements of obtaining reports and investigating jeopardized grants.

2. Grants to Organizations

A private foundation may make grants to public charities. Such grants do not necessitate the extensive recordkeeping requirements applicable when a private foundation makes grant to an individual. This is the type of activity that is most common among private foundations. However, grants made to other types of organizations generally require the private foundation to exercise “expenditure responsibility”.

The status of an organization as a public charity is critical to whether or not the private foundation is subject to the “expenditure responsibility” rules. A private foundation is normally permitted to rely upon a Determination Letter from the Internal Revenue Service in order to ascertain whether an organization is a public charity. However, such reliance is predicated upon the private foundation not being “responsible for, or aware of, a substantial and material change” “or acquired knowledge that the Internal Revenue Service had given notice to such organization” that it would lose its classification as “public charity”. If a private foundation lacks knowledge of the organization’s change in status as a “public charity”, the private foundation may avoid the application of the taxable expenditure rules if: (i) the private foundation is not deemed responsible for “the substantial material change” in the organization’s support, (ii) the grant qualifies as an “unusual grant” which does not

cause a “substantial and material change” in the organization’s support, or (iii) the private foundation exercises “expenditure responsibility”.

A private foundation will cause a substantial and material change “in an organization’s support” if the private foundation and/or certain other individuals related to the private foundation, contribute an amount to a public charity in a particular year in excess of twenty-five (25%) percent of the total support given to the organization during the preceding four (4) taxable years.

Grants made by a private foundation to another organization which then makes a grant to a specific individual requires that the rules described in Paragraph 3, below, be applied.

3. Expenditure Responsibility

Unless an exception applies, expenditure responsibility is required any time a private foundation makes a grant to a person or entity that is not treated as a public or quasi public charity. To exercise “expenditure responsibility” a private foundation must make all reasonable efforts to establish adequate precautions to: (i) see that the grant is spent solely for the purposes for which it was made, (ii) obtain full and complete reports from the grant recipients on how the funds are being spent, and (iii) make full and detailed reports with respect to such expenditures to the Commissioner of the Internal Revenue Service.

(a) Pre-grant Inquiry

Before a private foundation makes an grant to an organization, the private foundation must conduct a “limited” inquiry to ascertain that the grant recipient will use the grant for proper purposes. This inquiry should focus on the identity, prior history and experience of the grant recipient and its managers, as well as any knowledge that the private foundation has, or other information which is readily available, concerning the management, activities and practices of the grant recipient.

(b) Grant Agreement.

Once a grant recipient has been approved during the pre-grant inquiry, a written grant agreement must be entered into between the private

foundation and the grant recipient. For a conventional grant, the agreement must provide that the grant recipient will repay any portion of the grant not used for grant purposes; that full and complete annual reports will be provided to the private foundation detailing how the funds have been spent and the progress made in accomplishing the purposes of the grant; that records of receipts and expenditures will be maintained and that such records will be made available for inspection by the private foundation at reasonable times; and, that the funds will not be used for any purposes which would constitute a “taxable expenditure”.

If the private foundation is making a grant to another organization for a “program-related investment”, the agreement must specify the purpose of the investment and must include an agreement that all funds provided by the private foundation will be used only for purposes of the investment; to repay any portion not used for such purposes; that the private foundation will be furnished with, at least annually, a report which will set forth a complete financial report of the type “ordinarily required by commercial investors under similar circumstances”; a statement that it has complied with the terms of the investment; and that the recipient will maintain books and records adequate to provide information ordinarily required by commercial investors under similar circumstances and to make such books and records available for inspection by the private foundation at reasonable times. There must also be an agreement not to use any portion of the funds from the private foundation for purposes which would constitute a “taxable expenditure”.

(c) Reports and Recordkeeping

(i) Reports from Grantees. Each year, a grant recipient must report to the private foundation concerning the use of the grant funds; compliance with the terms of the grant; the progress made toward achieving the grant purposes until the grant funds are completed utilized. Additionally, a grant recipient must make a final report on all expenditures made from the grant funds.

(ii) Capital Endowment Grants. A private foundation must require reports reflecting the use of the principal and any income derived from grant funds provided to another private foundation for the purpose of: (a) increasing the

grant recipient's endowment, (b) purchasing capital equipment, or (c) some other capital purpose. Such reports must be received by the granting private foundation in the year of the grant, as well as the two (2) succeeding taxable years.

(iii) Reports from Re-granting Private Foundations. A granting private foundation may rely upon the reports of the grantee foundation (in the case of grants from one private foundation to another), provided that the report contains the following information:

(A) The name and address of the ultimate grant recipient;

(B) The date and amount of the grant;

(C) The purpose of the grant;

(D) The amount spent by the grantee;

(E) Whether the grantee has diverted any portion of the funds from the purposes of the grant;

(F) The dates of any reports received from the grantee; and

(G) The audit results of any verification of the grantee's reports undertaken by the grant recipient foundation or by any other party.

(iv) Reports to Internal Revenue Service. A private foundation must include on its Form 990-PF, with respect to each grant made during the taxable year, all of the information listed in clause (iii) above. This requirement can be made by attaching a copy of each report received by the private foundation to its Form 990-PF.

(v) Additional Requirements. A private foundation must make available to the Internal Revenue Service, at the private foundation's principal office, a copy of all agreements covering grants for which it assumes "expenditure responsibility", a copy of each report received, and a copy of each report made by the private foundation's personnel or independent auditors of any audit or other

investigation made by the private foundation with respect to any grants made for which “expenditure responsibility” applies.

VII. FIDUCIARY DUTIES

A “fiduciary” may be defined as: “one often in a position of authority who obligates himself or herself to act on behalf of another (as in managing money or property) and assumes a duty to act in good faith and with care, candor, and loyalty in fulfilling the obligation : one (as an agent) having a fiduciary duty to another”. Merriam-Webster Dictionary of Law, © 1996 Merriam-Webster, Inc.

A “duty” may be defined as: “An act or a course of action that is required of one by position, social custom, law, or religion”. The American Heritage® Dictionary of the English Language, Fourth Edition.

A. Duty of Care

This duty requires directors to discharge their duties in good faith and with the degree of diligence, care and skill that an ordinary prudent person would exercise under similar circumstances. While this obligation may sound almost cryptic, it all boils down to three things; that is to say, each director must: (a) pay attention to what is going on, (b) make informed decisions, and (c) act accordingly.

In order for a director to give a not-for-profit corporation his/her proper attention, a director must regularly attend meetings, review corporate documents, such as the certificate of incorporation, bylaws, mission statement, minutes of meetings, management reports and reports of third-parties prepared for the organization (e.g., tax returns, financial statements, advice of counsel, etc.). Making informed decisions, on the other hand, is simply that, making decisions on matters affecting the organization based upon the information that one would ordinarily expect to rely. For example, a director makes an informed decision on the proper salary for an executive director by reviewing the candidate’s qualifications, considering the duties he or she is expected to assume and reviewing recommendations of experts as to the appropriate salary and consideration of salaries offered by other organizations similarly situated. On the other hand, if a director merely acts as a “rubber stamp” in approving information set before

him or her, such director will fail to make an informed decision.

In exercising a director's duty of care, state law will often permit a director to delegate certain of his or her duties to others.¹² When state law permits a director to delegate his or her responsibilities, the ability to delegate is usually subject to certain limitations. For example, if a director is permitted to delegate the responsibility of preparing the organization's tax returns to an accountant, the director may do so if the director determines that the accountant selected possesses the requisite degree of knowledge and expertise to prepare such returns. In any case where a director delegates his or her duties to another person, such delegation is always subject to the limitation that the director has acted in good faith.

One of the duties that is often delegated by directors is the management of the organization's investments. When delegating this responsibility, directors are generally required, by state law, to consider the long and short term needs of the organization in accomplishing its purpose, its present and anticipated financial requirements, expected total return on its investments, price level trends and general economic conditions. If investment authority is delegated, the directors of an organization may be protected from liability resulting from a failure of investment performance if the board of directors has acted in accordance with its duty of care in selecting the delegate, defining the scope of the delegate's authority and supervising the delegate's actions.

Despite the extensive set of duties imposed on directors of a not-for-profit corporation, a director is often protected from liability under a doctrine referred to as the business judgment rule. In short, the business judgment rule provides that a director who has exercised his or her duties will not be held liable for adverse consequences resulting from the exercise of his or her discretion. This doctrine is based upon the notion that a director should not be held accountable for results that, though not intended, occur despite the director's exercise of his or her duties. In other words, a director will not be held liable for failures that result from their decisions if, when the

¹² Trustees of charitable trusts, however, are usually only permitted to delegate certain investment authority.

decision was made, the director acted in good faith. For example, a director who votes in favor of investing in a parcel of real estate for an organization and later discovers that the real estate is subject to an environmental contamination will not be held liable for the decision if the director acted in accordance with his or her duties when making the decision (i.e., acted upon the advice of qualified counsel, retained the services of a qualified real estate inspector who performed a phase I investigation, etc.).¹³

In addition to the duty of care imposed by state law, federal law imposes certain requirements upon not-for-profit corporations and their directors consistent with state law duties. These requirements include an obligation to file certain returns. For example, not-for-profit corporations must, unless certain limited exceptions apply, file an information return (e.g., Form 990 or Form 990-PF) each year. Directors who fail to comply with a demand of the Internal Revenue Service for such information returns may be held liable for such failures unless reasonable cause can be established. These rules also apply to information returns which are filed in an incomplete or incorrect manner.

Directors may also be held accountable for a not-for-profit corporation that fails to file returns and make payments with respect to FICA taxes in connection with the organization's employees. Although a director of a nonprofit organization who serves as a volunteer is granted a limited immunity from these penalties, such immunity will only apply if the director serves solely in an honorary capacity, does not participate in the day-to-day operations of the organization, does not participate in the financial operations of the organization, does not have actual knowledge of the failure in which the penalty is based, and the grant of immunity to the director will not result in no person being responsible for the penalty.

State law registration requirements also impose obligations upon directors of a nonprofit in a manner that is similar to the responsibilities imposed by federal law in connection with the filing of annual information returns. Most states require nonprofits to register with the attorney general's office of the state in which they are located, as well as each of the states in which solicitations are made. When registration is required,

¹³ Trustees of a charitable trust are not permitted to rely on the business judgment rule.

not-for-profit corporations are usually required to file annual reports disclosing information in connection with the prior year's solicitations, as well as financial information that is typically included in the organization's annual information return filed with the Internal Revenue Service. If an organization fails to file these reports, state law often imposes financial penalties, along with the possible loss of authorization to conduct activities in the state. With respect to the financial penalties for failing to file, directors are often held personally liable for the penalty.

B. Duty of Loyalty

Directors are also charged with the duty of loyalty with respect to the organization in which he or she serves. This duty requires a director to refrain from using his or her position as a director to derive personal benefits which should otherwise inure to the organization. State laws which establish this duty are often found in the form of laws prohibiting and/or regulating conflicts of interest. Conflict of interest laws generally provide certain circumstances in which a nonprofit may void a contract or other agreement entered into by the organization with a director or some related party who has a material interest in the transaction. For an agreement to be fully enforceable, the interested director is usually required to disclose the material interest to the board of directors, and, upon the board's vote, there needs to be enough directors voting in favor of the agreement without the interested director's vote to approve the transaction. If either of these conditions are not met, a nonprofit can usually void the agreement unless it is proven that the agreement was fair at the time the agreement was approved.

In addition to state law, federal law includes several provisions which indirectly enforce a director's duty of loyalty. The first such provision is contained in the Operational Test required under the Regulations to Section 501(c)(3) of the Code and is referred to as inurement.

Section 501(c)(3) of the Code and Regulations promulgated thereunder prohibit any inurement of the net income of an organization to any private

shareholder or individual. When any inurement occurs, the organization will not qualify (or will cease to qualify) as an organization described in Section 501(c)(3) of the Code.¹⁴

In the context of insurement, a private shareholder or individual means any person or entity that has a personal and private interest in the activities of the organization; “insiders” to the organization (e.g., founders, trustees and executive management). Insiders are not to be confused with individuals who have an interest because they are members of the class of individuals who the organization’s work is intended to benefit.¹⁵ For example, a person who receives a free mammogram from an organization that provides such benefits to the general public as a part of its outreach has an interest in the organization, but unless that person has some relationship with the organization, such as being a trustee or an employee, the person will not fall within the definition of a “private shareholder” or “individual” for purposes of insurement analysis.¹⁶

Neither the Code, nor the Regulations provide a definition of “inurement”. Whether net earnings “inure” to someone’s benefit is considered an issue of fact, to be determined on a case-by-case basis. As a general rule, courts will look to see whether an insider is being unjustly enriched as a result of his or her insider relationship with an organization.¹⁷ In terms of compensation, inurement can occur when the salaries paid by the organization fail to be ordinary and necessary to the accomplishment of the organization’s purposes. In John Marshall Law School and John Marshal University v. United States, the Court of Claims, in reviewing a situation in which an unaccredited law school was operated by a single family, stated that:

[t]he term “net earnings”...has been construed to permit an organization to incur ordinary and necessary expenses in the course of its operations without losing its tax-exempt status...The issue, therefore, is whether or not the expenditures by JMLS paid to or on behalf

¹⁴ See Spokane Motorcycle Club v. U.S., 222 F.Supp. 151 (E.D. Wash 1963), wherein \$825 was used for refreshments, goods and services were furnished to members; see also, Founding Church of Scientology of Washington, D.C., 412 F.Supp. 1197 (Ct. Cl. 1969), *cert. den.* 397 U.S. 1009 (1970).

¹⁵ Treas. Reg. § 1.501(a)-1(c).

¹⁶ People of God Community v. Comm’r, 75 T.C. 127 (1980).

¹⁷ Id.

of the Fenster family were ordinary and necessary to JMLS operations.¹⁸

Although courts have taken differing, and in some cases what may be considered inconsistent, approaches in reviewing cases of inurement resulting from compensation,¹⁹ the IRS has stated that a particular compensation arrangement will cause inurement when: (1) the compensation is merely a device to distribute profits to one or more principals of the organization, or to create a joint venture, (2) there is a lack of arms-length bargaining, or (3) the compensation is unreasonable.²⁰ Each of the aforesaid issues are to be considered separately, but when taken as a whole, will determine whether a compensation arrangement will cause inurement.

Certain other federal laws also prohibit certain breaches of the duty of loyalty. These laws address excess benefits (which apply to public charities) and self-dealing (which apply to private foundations) between nonprofits and a “disqualified person”. Any economic benefit provided by a public charity to a disqualified person that exceeds the value of benefits provided to the organization by such disqualified person will be treated as an excess benefit transaction. When an excess benefit transaction occurs, a penalty tax is imposed on the disqualified person in an amount equal to 25% of the excess benefit and 10% (limited, however, to \$10,000) on the director, officer or trustee who knowingly acted on behalf of the organization. If an excess benefit transaction is not corrected within certain specific time limits, the penalty tax on the disqualified person is increased to 200% of the excess benefit. The excess benefit transaction rules, however, do not apply to private foundations. Instead, the rules against self-dealing apply.²¹

¹⁸ John Marshall Law School and John Marshall University v. U.S., 81-2 USTC 9514, 87,685 (Ct. Cl. 1981).

¹⁹ See Alive Fellowship of Harmonious Living v. Comm’r, T.C. Memo. 1984-87; Bubbling Well Church of Universal Love, Inc. v. Comm’r, 74 T.C. 531 (1980); People of God Community, *supra.*; Mabee Petroleum Corp. v. U.S., 203 F.2d 872 (5th Cir. 1953); Rev. Rul. 69-383, 1969-2 C.B. 113.

²⁰ General Counsel Memorandum 39670 (October 14, 1987).

²¹ These rules are similar, but more stringent than the rules imposed on public charities. See Section IV. and Section VIII.D.3.(b).

C. Duty of Obedience

Each director of a not-for-profit corporation is charged with the duty of obedience, which obligates each director to ensure that the mission of the organization is carried out. This duty also requires the directors to act in accordance with the governing documents of the organization, including its certificate of incorporation, as amended, its by-laws and policies. State laws generally prohibit a nonprofit from engaging in acts outside the authority of the organization's governing documents unless such action is approved by a court. When such action is taken, the attorney general may seek to dissolve the organization for such violation.

D. Duty of Oversight

Each director of a not-for-profit corporation is also charged with the duty of oversight. This duty imposes an affirmative obligation on each director to oversee the operations of the organization. For example, each director is obligated to see to it that assets held for investment are being actively managed and that an organization's facilities are being maintained in good repair. This duty does not necessarily mean that a director is obligated to make regular physical inspections of an organization's facilities, for example, but rather that each director actively determine whether these things are being done.²²

VIII. FIDUCIARY DUTIES IN THE REAL WORLD - WHAT NEEDS TO BE DONE

A. Corporate Formalities

Like any for-profit business, a nonprofit should be operated in accordance with its governing documents and with precision.

1. Corporate Documents

A nonprofit should implement, and abide by, its rules of governance as contained in its:

(a) Mission Statement

²² This duty is in stark contrast to that of trustees of a charitable trust, who generally, absent a specific provision in the trust agreement, are required to actively administer and oversee the trust's activities.

- (b) By-Laws
- (c) Minutes, Resolutions and Consents
- (d) Corporate Policies

2. Meetings

A nonprofit should hold regular meetings. Each meeting should be structured in a manner that will allow the board to accomplish its objectives and satisfy each board members' fiduciary duties.

B. Returns and Reports

1. Federal Returns - Form 990 and Form 990-PF

Members of the Board of Directors should ensure that the nonprofit prepares and files its Form 990 (or Form 990-PF, for private foundations) in a complete and timely manner. Board member should also ensure that they are familiar with the contents of these filings.

2. Other Federal Filings

In addition, members of the Board of Directors of a non-profit must also ensure that other tax filings and reports are addressed. These reports include the following:

(a) Social Security. Social Security (FICA) must be withheld from each employee's salary and paid over to IRS. Form 941 and Form 8109 must be filed with IRS quarterly.

(b) Unemployment Taxes. Organizations described in Section 501(c)(3) are exempt from paying unemployment taxes.

(c) Income Tax Withholding. If an organization described in Section 501(c)(3) does not withhold income taxes, the organization must file Form

941E, quarterly. If the organization withholds income tax, the organization must withhold and file such information on Form 941.

(d) If the organization is paying wages, each year the organization must supply all employees with a W-2 and Form W-2P (if applicable). The organization must also file a Form W-3 with IRS, with a copy to Social Security Administration Data Operations Center, on or before February 28th.

(e) An organization described in Section 501(c)(3) must issue a Form 1099-MISC to each individual who was paid \$600 or more in:

- (i) gross rents;
- (ii) gross royalties;
- (iii) commissions, fees or other compensation (as in non-employees);
- (iv) prizes or awards; or
- (v) other fixed or determinable income.

If either (i) or (ii) is required, then the organization must also file a Form 1096.

(f) Any new fiduciary, such as a Trustee, should file a Form 56.

(g) If an organization receives a contribution of property valued in excess of \$500 that it disposes within two (2) years of its receipt, then the organization must file a Form 8282 and provide a copy of the form to the original donor of such property.

3. Financial Report to Board

Whether required to do so, or not, management should always provide periodic reports to the Board of Directors detailing the financial condition

of the organization. These reports should detail the income, loss and expenses of the organization. Remember, management is generally responsible for the day-to-day activities of the organization. Board members are not in the office every day to see what is going on first-hand.

On the other hand, members of the Board of Directors have an obligation to ask questions to ensure that they are properly informed of the organization's activities. It is not sufficient for a Director to assume that the organization's assets are being used as the Board directs. Each Board member must take appropriate action to determine whether this is the case.

C. Financial

1. Policies

Each nonprofit should have corporate policies addressing matters that regularly arise in the course of the nonprofit's operations. For example, all nonprofits should have a policy for addressing conflicts of interest and banking matters. Nonprofits who seek contributions from the general public ought to have a policy on donor confidentiality.

Effective policies will state the purpose for the policy, the position of the nonprofit regarding such policy, as well as procedures for addressing circumstances in which the policy seeks to address. For example, a conflicts of interest policy should state the purpose of the policy and the manner in which conflicts should be addressed by the nonprofit.

2. Ledgers and Supporting Documentation

All nonprofits should maintain complete and accurate records of its revenues and expenses. These records are critical. Every nonprofit should have written procedures addressing the manner in which all revenue is utilized. These records should include when, where and how much is received by the nonprofit, and when where and how much is spent by the nonprofit, along with supporting documentation (e.g., invoices and paid receipts). These records should be open to inspection by all members of the Board of Directors. Regular reports of this information

should also be made to the Board.

3. Investment Responsibility and Stewardship

Any nonprofit that maintains funds for future use should have a specific policy in place which addresses the manner in which such funds shall be invested. An investment policy that is adhered to can ensure that a nonprofit's assets are invested in a manner that is consistent with its present and long-term goals. These policies can also further a nonprofit's stewardship responsibilities by evidencing the nonprofit's commitment to fiscal responsibility. For nonprofits that accept gifts for restricted purposes, investment and stewardship policies can provide donors with additional assurances that the nonprofit will use and manage such funds in accordance with the restrictions that the gift was made subject to.

4. Receipt of Contributions

All charitable organizations must provide each donor who has: (i) contributed cash or other property in excess of \$75, and (ii) received property or services from the charitable organization, with a statement which sets forth for the following information:

(a) That the amount which is deductible is limited to the amount received by the charity over the fair market value of the property or services received by the donor; and

(b) A good faith estimate of the value of the goods or services received by the donor.

Failure to provide this information could result in a penalty of \$10 per contribution received by the charity, but is limited to a \$5,000 penalty.

In addition to the aforesaid disclosure, each donor who makes a contribution in excess of \$250 in any calendar year will be required to obtain from the charitable organization a written acknowledgement of the contribution. Each

acknowledgement must set forth: (i) the name of the organization, (ii) the amount of any cash contribution, (iii) a description of any non-cash contribution, and (iv) a statement that no goods or services were provided, or, if goods or services were provided, a statement estimating the fair market value. If a donor fails to obtain the written acknowledgement by the due date for filing his or her income tax return, plus any extensions (e.g., by April 15th of the year following the year the contribution is made), the donor is not permitted to claim a charitable deduction for the gift.

D. Transactions

Anytime a person who directly or indirectly has a financial interest in a non-profit enters into a transaction with a non-profit, a problem may arise. The type of problem that may arise would largely be dependent upon whether the organization is a public charity or a private foundation. As previously discussed, all organizations must avoid violating the rules of inurement. While private foundations and disqualified persons are subject to the rules of self-dealing, public charities are subject to the intermediate sanction rules.

Intermediate sanction rules were added to the Code in the form of Section 4958 in 1996.²³ Final Regulations were made effective January 23, 2002 and apply as of that date.²⁴ These sanctions are penalty taxes due if a public charity pays (or transfers) an "excess benefit" to any disqualified person. These sanctions were labeled "intermediate sanctions" because they represent a compromise between inaction and revocation of the exempt organization's tax exemption (e.g., when violations of inurement exist). The imposition of intermediate sanctions is designed to penalize disqualified persons who are unjustly enriched by the transaction as well as the officers and directors who condoned it, rather than the organization itself. The need for intermediate sanctions arose because of a widespread perception that the penalty of

²³ Section 1311 of the Taxpayer Bill of Rights 2, P.L. 104-168, 110 Stat. 1452, enacted July 30, 1996. The section 4958 excise taxes generally apply to excess benefit transactions occurring on or after September 14, 1995. The Report from the Committee on Ways and Means on the Taxpayer Bill of Rights 2, H.R. 2337, was submitted March 28, 1996. H. Rep. No. 506, 104th Cong., 2d Sess. (1996) 53.

²⁴ Proposed regulations were published in the Federal Register August 4, 1998, 63F.R. 41486. The proposed regulations were replaced by temporary regulations that were published in the Federal Register January 10, 2001, 66 F.R. 2173. The temporary regulations were replaced by final regulations that were published in the Federal Register January 23, 2002, 67F.R. 3076.

revocation of an organization's tax exempt status often exceeded the severity of the offense and was therefore seldom used. However, the Regulations state that a transaction that is not subject to the intermediate sanctions rules may nonetheless jeopardize a charity's tax-exempt status, for example, by providing a prohibited private benefit.

Although intermediate sanctions (as described below) are intended to be the Service's primary enforcement tool against self-dealing transactions in public charities (i.e., those transactions which are prohibited by the inurement and private benefit doctrine) involving Section 501(c)(3) organizations, it has been clear since the issuance of proposed regulations that the IRS and Treasury Department will still entertain revocation of an organization's tax exempt status as an option in egregious cases. The Preamble to the 1998 Proposed Regulations recited four factors that would be considered in determining whether to revoke an organization's exemption:

1. Whether the organization had been involved in repeated excess benefit transactions.
2. The size and scope of the excess benefit transaction.
3. Whether, after concluding that it had been party to an excess benefit transaction, the organization implemented safeguards to prevent future recurrences (such as a conflict of interest policy).
4. Whether the organization complied with other applicable laws.

The Temporary Regulations did not repeat these factors but stated in the Preamble that the IRS and Treasury would publish guidance regarding the factors they would consider in enforcing Sections 4958²⁵ and 501(c)(3) as they gained more experience in administering Section 4958. While the IRS and Treasury Department continue to entertain suggested additions and revisions to their list, they have not yet issued Regulations enumerating these factors. As a result, some practitioners believe that the IRS will apply its usual "facts and circumstances" standard to revocation

²⁵ The Section that imposes the intermediate sanctions.

decisions.²⁶

Intermediate sanctions provide for an initial penalty tax equal to 25% of the “excess benefit” amount (as described below). This tax is payable by the disqualified person. Section 4958(b) of the Code provides that where an initial tax is imposed, but the excess benefit involved in such transaction is not corrected within the taxable period, a tax equal to 200 percent of the excess benefit involved is imposed and must be paid by any disqualified person with respect to such transaction. The 200% tax will be abated, however, if corrected within 90 days after the mailing of a deficiency notice by the Internal Revenue Service.²⁷

In addition, a penalty tax equal to 10% of the excess benefit amount may be imposed on any organization manager who knowingly participates in the excess benefit transaction.²⁸ This organizational manager tax is subject to a cap of \$ 10,000 per excess benefit transaction. The liability for this tax is joint and several on any appropriate organization managers.

Section 4958(c) of the Code defines “excess benefit transaction” as any transaction in which an economic benefit is provided by an “applicable tax-exempt organization” directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit. Regulation Section 53.4958-1(e)(1) provides that an excess benefit transaction occurs on the date the disqualified person receives the economic benefit.²⁹

The Regulations state that certain benefits received as a result of a deductible charitable contribution are disregarded as an excess benefit transaction if (i)

²⁶ See Kaufman, “The Intermediate Sanctions Regulations Are Final -- No More Excuses,” 96 J. Tax'n 240 (April 2002).

²⁷ Treas. Reg. § 53.4958-1(c)(2) and 53.4961.

²⁸ The Regulations define the term “organization manager” as any officer, director, or trustee or any individual having powers or responsibilities similar to those persons. The regulations add that a person who regularly exercises general authority to make administrative or policy decisions (as opposed to those who have the ability to recommend action but not to implement actions without the approval of a supervisor) on behalf of the organization (but not an attorney or accountant that performs services solely in that capacity) is an organization manager. Treas. Reg. §53.4958-1(d)(2).

²⁹ Unreasonable compensation and below market sales are the two primary areas that the Regulations focus on in its discussion of excess benefit transactions.

any non-disqualified person making a comparable charitable contribution to the organization is given the option of receiving the same benefit and (ii) a number of people actually make payment of that amount.³⁰

Pursuant to Section 4958(e), an organization exempt from federal income tax pursuant to Section 501(c)(3) (other than a private foundation) is an "applicable tax-exempt organization" and therefore subject to the intermediate sanction rules.

Section 4958(f)(1) and Regulation Section 53.4958-3(a)(1) define a "disqualified person" as (A) any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization, (B) a member of the family (including a spouse) of a disqualified person, and (C) a 35% percent controlled entity.

In general, whether a person is in a position to exercise substantial influence over a public charity is determined by the person's actual powers and responsibilities, not merely by the person's title.³¹ However certain categories of persons are specifically slated as disqualified.

Regulation Sections 53.4958-3(b) & (c) provide three categories of persons who are automatically deemed to have substantial influence over a charity:

1. Voting members of the charity's governing body; the president, chief executive officer, or chief operating officer of the charity; the treasurer or chief financial officer of the charity; anyone holding any of the powers or responsibilities of these persons, regardless of title; and persons with a material financial interest in a provider-sponsored organization.

2. Family members--i.e., spouses, brothers or sisters, spouses of brothers or sisters, ancestors, descendants, and spouses of descendants of persons described in the first category.

3. Any entity in which 35% or more of the combined voting power (in the case of a corporation), profits interest (in the case of a partnership), or beneficial

³⁰ Treas. Reg. §53.4958-4(a)(4)(iv).

³¹ Treas. Reg. §53.4958-3(a).

interest (in the case of a trust) is owned by persons described in the first and second categories.

While the Regulations deem certain persons to be in a position to exercise substantial influence, they also deem certain persons not to have such power.³² One such person is another Section 501(c)(3) organization. Thus, a transaction between two Section 501(c)(3) organizations is not subject to the intermediate sanction rules. Employees receiving economic benefits of less than a specified amount are deemed not to have substantial influence so long as they are not (1) automatically deemed to be disqualified persons under the rules discussed above or (2) substantial contributors to the charity.

According to Regulation Section 53.4958-3(e), in all other circumstances, whether a person exercises substantial influence and is therefore a disqualified person depends on all relevant facts and circumstances. Certain factors tending to show that a person has substantial influence over a charity include whether or not the person:

- is a founder of the organization;
- is a substantial contributor to the organization;
- has the authority to control or determine a significant portion of the charity's capital expenditures, operating budget, or employee compensation;
- manages a discrete segment of the organization that represents a substantial portion of the activities of the organization; or
- owns a controlling interest in an entity that is a disqualified person.

The Regulations also provide factors tending to show that a person does not have substantial influence. These factors include whether or not the person:

- is a contractor--such as an attorney, accountant, or an investment manager or advisor--whose sole relationship to the charity is providing professional advice with respect to transactions from which the contractor will not economically benefit (aside from fees for the advice rendered).

³² Treas. Reg. §53.4958-3(d).

- has a director or supervisor who is not a disqualified person.
- does not participate in any management decisions affecting the charity as a whole or a discrete segment that represents a substantial portion of the charity.
- received any preferential treatment as a donor that was based on the amount of his or her contribution, which treatment was offered to all other donors making comparable donations.

The Regulations provide an example of the application of the disqualified person rules. Regulation 53.4958-3(g) examples 8 & 9 provide that a dean of a law school that is a substantial source of revenue and contributions for a university may be a disqualified person with respect to the university because the dean manages a discrete segment of the university that represents a substantial portion of the university's income. The chair of a small academic department at the same university, however, may not be a disqualified person with respect to the university because the chair does not manage a discrete segment of the university that represents a substantial portion of its activities, income, or expenses.

As stated above, if an excess benefit transaction is not corrected, a 200% tax is imposed on the disqualified person. The excess benefit may be corrected by a cash payment, a return of property to the charity, or a combination of the two. According to Regulation Section 53.4958-7, the cash or property paid must be equal to the excess benefit amount plus interest at the applicable federal rate.

The statute of limitations on excess benefit transactions for purposes of the intermediate sanction rules may extend up to 7 years from the taxable year of the charity during which the transaction occurred.³³

1. Conflicts of Interest

All nonprofits should avoid entering into transactions with related parties. However, it should be anticipated that such circumstances will arise and it may be in the best interests of the nonprofit, nevertheless, to enter into such a transaction. A nonprofit should have a detailed policy for addressing situations in which such

³³ Treas. Reg. §53.4958-1(e)(3); I.R.C. §§ 6501(e)(3) and 6501(l).

transactions arise. An organization should also be mindful that many states have absolute prohibitions against certain conflicts.

2. Best Interests of the Corporation

Just because a transaction may take place with a related party, does not necessarily mean that the transaction should not be consummated. Assuming that the law will not prevent the transaction from being consummated, the primary consideration for a nonprofit should be whether or not a particular transaction is in the best interests of the nonprofit.

3. Compensation

When determining the appropriateness of an executive's compensation, three concepts must be understood in order to appreciate the potential problems that could arise in the event that compensation paid by an organization is improper. The relevant concepts are: (i) inurement,³⁴ (ii) private benefit, and (iii) self-dealing. In the case of inurement or private benefit, the result is disqualification of the organization, while self-dealing will usually only result in excise taxes on the individuals deemed to be involved. Each of these concepts is discussed below, followed by a series of guidelines and suggestions that may be used to avoid and/or mitigate allegations of impropriety.

(a) Private Benefit

In order for an organization to obtain and maintain its tax-exempt status, the organization must be organized and operated exclusively for an exempt purpose. An organization is organized and operated exclusively for an exempt purpose if it serves a public rather than a private interest.³⁵ The organizational and operational requirements are often referred to as the "Organizational Test" and the "Operational Test".³⁶

An organization must establish that it meets the Organizational Test and the Operational Test, both at the time the organization is

³⁴ See Section VII.B.

³⁵ Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii).

³⁶ See Section II.B.

formed and at all times thereafter. If either of these tests are not satisfied at the time of formation, the organization will not receive a determination letter from IRS granting the organization its tax exempt status. If subsequent to the organization's formation the organization fails to meet either of these tests, the organization's determination letter will be revoked. This may occur if IRS determines that the organization's activities benefit private individuals or classes of individuals in more than an insubstantial manner (this is referred to the "Private Benefit Doctrine"). Although this is similar to the rule prohibiting inurement, the Private Benefit Doctrine is broader in its application because there is no requirement that the party being benefited be an insider.

An example of the application of the Private Benefit Doctrine is described in the Tax Court decision of American Campaign Academy.³⁷ In that case, a school was organized to train its students to work in political campaigns. However, since the purpose of the school was to train people to work solely for Republican campaigns, the Tax Court found that the school provided more than an insubstantial benefit to the Republican party. Thus, the school was denied tax-exempt status based on this private benefit.

For the purpose of determining if only an insubstantial amount of the organization's activities furthers a non-exempt and private purpose, both quantitative and qualitative analyses are applied. If a private party receives a benefit that is quantitatively and qualitatively incidental, then the organization's activities that are not in the furtherance of its exempt purpose will be treated as insubstantial. In that case, the organization will have satisfied the Operational Test.

With respect to the quantitative analysis, the Tax Court stated in American Campaign Academy, the "private benefit must be insubstantial, measured in the context of the overall tax-exempt benefit conferred by the activity." Under the qualitative analysis, a determination must be made if the organization's exempt purpose can be accomplished without benefiting a private person. If it cannot, exempt status should be granted.³⁸

³⁷ American Campaign Academy, 92 T.C. 1053 (1989)

³⁸ Id.; Rev. Rul. 70-186, 1970-1 C.B. 129.

(b) Self Dealing

One of the most common situations in which an act of self-dealing may occur is in the case of compensation paid to disqualified persons. Despite the general prohibition against the payment of compensation by a private foundation to a disqualified person, if the compensation is: (i) for personal services that are reasonable, and (ii) not excessive, the payment of compensation will not be an act of self-dealing.³⁹ For a compensation package to be reasonable, the compensation must be both ordinary and necessary for the private foundation to carry out its exempt purpose.⁴⁰ In determining what is ordinary and necessary, one will generally look to what is reasonable under all of the circumstances, which may be determined by comparison to the amount in which another private foundation would pay for like services under similar circumstances.⁴¹ In determining whether compensation is excessive, the Regulations require the application of the same standards imposed on for-profit businesses.⁴²

When the excise tax for an act of self-dealing is imposed, the tax is not assessed upon the private foundation. Instead, the tax is assessed upon the “self dealer” (i.e., the disqualified person involved), and upon each foundation manager (i.e., directors and trustees) who “knowingly” engage in the act of self-dealing. The initial tax on the self-dealer is five (5%) percent of the amount at issue, per year, until the act is “corrected”. If the act is not corrected as prescribed, the excise tax, as a general rule, is equal to 200% of the amount involved. This tax is imposed regardless of whether or not the disqualified person knew there was an act of self-dealing; the disqualified person is strictly liable.⁴³

Foundation managers who “participate” in the act of self-dealing, in their capacity as a foundation manager, will be assessed an initial tax of two and one-half (2 ½%) percent of the amount involved for each year, or portion thereof,

³⁹ Reg. § 53.4941(d)-3(c).

⁴⁰ Reg. § 1.162-7(a).

⁴¹ Reg. § 1.162-7(b)(3).

⁴² For-profit businesses are subject to the limitations imposed under Section 162 of the Code and Treasury Regulation section 1.162-7.

⁴³ Treas. Reg. § 53.4941(a)-1(a)(1).

for which the act is not corrected.⁴⁴ The liability imposed upon foundation managers is joint and several among all of the foundation managers who participate in an act of self-dealing. However, the liability of all foundation managers with respect to the initial tax (imposed on each act) shall not exceed \$10,000 in the aggregate, nor shall the liability of all foundation managers with respect to the additional tax (imposed by reason of each act) exceed \$10,000 in the aggregate. Thus, foundation managers can never be subject to more than \$20,000 of liability for each act of self-dealing. In determining the number of acts of self-dealing, an act conducted by more than one person is generally treated as a single act unless the acts of each person, independently, would give rise to an act of self-dealing. In the event that a foundation manager acts both in his or her capacity as a foundation manager and as the self-dealer, then the foundation manager will be liable for both the five (5%) percent tax and the two and one-half (2 ½%) percent tax.⁴⁵

A foundation manager to be treated as having “participated” in an act of self-dealing by either directly participating in the act, or, by failing to act against an act of self-dealing when he or she had a duty to speak (e.g., by not objecting to a compensation package in which the foundation manager knows to be excessive).⁴⁶ Despite a foundation manager’s participation in an act of self-dealing, the excise tax will only be imposed if: (i) a tax is imposed upon the self-dealer, (ii) the foundation manager “knows” that the act is an act of self-dealing and (iii) the participation of the foundation manager was “willful” and not due to “reasonable cause”.⁴⁷

For purposes of Code Section 4941, a person charged with knowledge must have: (i) had actual knowledge of sufficient facts such that those facts alone would be sufficient to establish that an act of self-dealing had occurred, (ii) been aware that an act under such circumstances may violate the federal tax law governing self-dealing and (iii) negligently failed to make reasonable attempts to ascertain whether such act was an act of self-dealing unless such person already knows that the act is

⁴⁴ I.R.C. § 4941(a)(2).

⁴⁵ Treas. Reg. § 53.4941(a)-1(a)(1).

⁴⁶ Treas. Reg. § 53.4941(a)-1(b)(2).

⁴⁷ Treas. Reg. § 53.4941(a)-1(b)(1).

self-dealing.⁴⁸ In determining whether the knowledge requirement is met, the Tax Court has been inconsistent in determining what will constitute “knowledge”. In 1995 the Tax Court, in Shearn Moody v. Commissioner, held that a foundation manager must not only have knowledge that the expenditure was being made, but that the expenditure was an act of self-dealing. On the other hand, in 1997, the Tax Court took a narrow approach in Madden v. Commissioner, and held that the knowledge requirement will be satisfied by the presence of the foundation manager’s knowledge of the expenditure, and not whether the expenditure is improper.⁴⁹ It is possible, however, to reconcile these opinions by looking to the underlying facts of each case. In Shearn Moody, the court specifically indicated that the foundation manager charged with an act of self-dealing was unsophisticated and was not acting in a manner which would suggest any intent to do wrongdoing. On the other hand, in Madden, the foundation manager was a sophisticated individual who possessed a great deal of knowledge with respect to prohibited transactions between private foundations and disqualified persons. In fact, the foundation manager in Madden conceded that the acts constituted self-dealing.

Although an act will be deemed to have been “willful” where the act is voluntary, conscious and intentional, an act is not willful if the person does not know that the act constitutes self-dealing.⁵⁰ Even if a finding is made that a foundation manager has acted willfully and with knowledge, a foundation manager may still be immune from the excise tax on self-dealing if the foundation manager can establish that he has acted with “reasonable cause”. “Reasonable cause” will be found where a foundation manager has exercised his responsibilities as a foundation manager with ordinary business care and prudence.⁵¹ The Tax Court has suggested that such care and prudence would require seeking the advice of counsel.⁵²

An alternative basis for a foundation manager to obtain immunity from liability for acts of self-dealing is based upon the advice of counsel.⁵³ A foundation manager may rely on an opinion of counsel if the foundation manager

⁴⁸ Treas. Reg. § 53.4941(a)-1(b)(3).

⁴⁹ Shearn Moody v. Comm’r, T.C. Memo 1995-195; Madden v. Comm’r, T.C. Memo 1997-395.

⁵⁰ Reg. § 53.4941(a)-1(b)(4); see also Shearn Moody, *supra*.

⁵¹ Reg. § 53.4941(a)-1(b)(5).

⁵² Madden v. Comm’r, *supra*.

⁵³ Reg. § 53.4941(a)-1(b)(6).

obtains a written legal opinion from counsel which sets forth all of the facts and circumstances known to the foundation manager along with a reasoned analysis of those facts and such counsel's conclusion. When a foundation manager obtains such an opinion, a foundation manager's participation in an act of self-dealing will be deemed not to have been "willful" or "knowing" and actions on the part of the foundation manager will be treated as having been based upon "reasonable cause". Thus, no liability will be imposed on the foundation manager.

(c) Application of Rules

Of the three issues that could apply in compensation cases, the most difficult issue to avoid is inurement.⁵⁴ As explained above, the position of IRS (and that of most courts) is that an organization should be able to prove that: (1) the compensation is not merely a device to distribute profits to one or more principals of the organization, or intended to create a joint venture, (2) the compensation package was the result of arms-length bargaining, and (3) the compensation is not unreasonable. Although the inability to prove one or more of these factors is not determinative, these factors, when taken as a whole, will be utilized by IRS and the courts to determine whether a particular compensation arrangement causes inurement. Each of these factors are addressed below.

(i) The compensation is not merely a device to distribute profits to one or more principals of the organization, or to create a joint venture

This issue pertains to an organization distributing revenue to an insider in a manner that suggests a sharing of profits. Though an organization is not prohibited from issuing bonuses and other nontraditional forms of compensation, there must be a clear and consistent process for compensating

⁵⁴ Although inurement issues are the most difficult to address, many court cases have mistakenly referred to violations of the Private Benefit Doctrine when the improper act should have been identified as inurement. If inurement can be avoided, then so should the application of the Private Benefit Doctrine and self-dealing.

employees. For example, courts have been skeptical of compensation arrangements that do not include a limit on the amount that an employee may be paid.⁵⁵

(ii) Arms-length Bargaining

The IRS has repeatedly stated that the most important factor to consider in determining the appropriateness of an executive's salary is whether the compensation package is the result of an arms-length negotiation between the parties.⁵⁶ This is not to say, however, that a lack of arms-length negotiation will be fatal. In 1956 the Tax Court considered a case where the issue of control over an organization was used by IRS to allege the existence of inurement. In that case the Court specifically looked at whether control of the organization was being utilized to "channel net earnings" of the organization to insiders.⁵⁷ Neither the Tax Court, nor several other courts that had the occasion to consider this issue had a problem permitting the compensation when evidence could be produced to establish that the power and control was not being used to the benefit the person in question.

Measures that an organization can undertake to address this potential problem could include:

(A) forming a standing compensation committee comprised of members of the board of directors to establish and negotiate the related party's compensation; and/or

(B) retaining the services of a qualified firm to perform a compensation survey. When a compensation survey is undertaken, the following factors should be considered to determine the reliability of the survey: (i)

⁵⁵ See People of God Community, *supra*. (holding that a minister who received a percentage of the organization's revenue with no limitation on the total amount that he could receive was found to constitute inurement); see also, Gemological Institute of America v. Comm'r, 17 T.C. 1604 (1952).

⁵⁶ See General Counsel Memorandum 39670 (October 14, 1987); Exempt Organizations Continuing Professional Education Technical Instruction Program for 1993, 1987 and 1983; see also, Kafka, 390-2¹⁰ T.M., Reasonable Compensation at A-5, stating "virtually all challenges by IRS to the deductibility of compensation have occurred in the context of salary arrangements between related parties...There does not appear to be any case which holds that compensation paid in a truly arm's length situation was unreasonable."

⁵⁷ St. Germain Found. v. Comm'r, 26 T.C. 648, 660 (1956); see also, World Family Corp. v. Comm'r, 81 T.C. 985 (1983); The Church of the Visible Intelligence that Governs the Universe v. U.S., 4 Cl. Ct. 55 (Cl. Ct. 1983); Bubbling Well Church of Universal Love, Inc. v. Comm'r, 74 T.C. 531 (1980).

whether the compensation survey is performed by a reputable firm, (ii) whether the firm has knowledge and expertise in the same industry as that of the organization, (iii) whether the firm is independent with respect to both the organization and the employee in question, (iv) whether the organizations included in the compensation survey are similarly situated, (v) whether the positions considered in the surveys were functionally comparable to the position of the employee in question, and (vi) the number of compensation surveys and the number of different organizations included in the survey.

(iii) Reasonableness of Compensation

The Regulations to Section 162 of the Code provide a litany of factors to consider in determining whether compensation is reasonable. Among the factors to be considered are:

- (A) the nature of the employee's duties;
- (B) the employee's background and experience⁵⁸;
- (C) the employee's knowledge of the organization's activities;
- (D) the size of the organization⁵⁹;
- (E) the employee's contribution to the organization's success;
- (F) the time devoted by the employee to the organization;
- (G) the economic conditions in general and locally;
- (H) the character and amount of responsibility of the employee;
- (I) the amount paid by other organizations of a similar size in the same area to equally qualified employees for similar services,⁶⁰ and

⁵⁸ See Home Oil Mill v. Willingham, 68 F.Supp. 525 (D.C. Ala. 1945) *aff'd* 181 F.2d 9 (5th Cir. 1950), *cert. den.* 340 U.S. 852.

⁵⁹ See Home Oil Mill, *supra*.

(J) the prior history of the employee's salary.⁶¹

E. Employees

1. Written Policies

Employment disputes are one of the leading areas for litigation in any enterprise, whether for-profit, or not-for-profit. As a result, every nonprofit that employs one or more individuals should have an employee manual which addresses the terms and conditions of an employee's services. This manual should be prepared by, or along with the advice of, an attorney who is knowledgeable in employment matters and should be reviewed regularly.

2. Salaries and Withholding

One of the most common areas for noncompliance with the tax laws pertains to employment taxes. Nonprofits need to be careful about employing individuals and making the proper withholding in accordance with state and federal law.

3. Oversight

As in the case of any for-profit business, nonprofits should actively supervise the actions of its employees. Employees are generally considered to be agents of the organization, and as such, may cause liabilities for a nonprofit even if the nonprofit is unaware of the actions of the employee.

F. Fundraising

1. State Registration and Renewals

With the exception of New Hampshire, Indiana, Iowa, South Dakota, Montana, Idaho, Wyoming, Nevada, Texas and Hawaii, every state requires an organization that is engaged in business in a particular state to register as a charity (which registration is usually made with the Attorney General). In many states, an additional registration is also required in the event that a charitable organization solicits

⁶⁰ See *Mabee, supra.*, see also *Kermit Fischer Found. v. Comm'r*, T.C. Memo 1990-300, holding that payment of compensation to a foundation manager that was disproportionate to the services provided was an act of self-dealing.

⁶¹ See *Lefkowitz v. Comm'r*, 46 T.C.M. (CCH) 485 (1983).

to receive contributions from donors.⁶²

Each year a charitable organization is generally required to provide renewal registrations to each state in which solicitations are made. Renewal registrations usually require one or two state specific forms to be filed, along with a copy of the organization's Form 990 (or Form 990-PF) and a filing. In the event that the organization receives substantial revenue from a particular state, it is common for the State to require either an audited or a reviewed financial statement.

Members of the Board of Directors should ensure that the nonprofit for which they serve complies with the state registration laws of each state in which the nonprofit solicits contributions.

2. Professional Fundraisers and Fundraising Counsel

In addition to individual state registration requirements with respect to charitable solicitations, most states also require charitable organizations to provide detailed information with respect to their relationships with paid fundraisers. These rules generally exempt individuals who are bona fide employees of the organization, as well as accountants, attorneys, volunteers and Board members.

(a) Fee Arrangements

In most states, a charitable organization may negotiate any financial arrangement with a paid fundraiser. The substance of a financial arrangement with a paid fundraiser is an issue that has prompted heated debates. On one hand, many professional organizations specifically prohibit (within their code of professional ethics) any fee arrangement based upon a percentage of funds raised. On the other hand, such financial arrangements are regularly utilized throughout the country. Regardless of your particular point of view, the one important point to keep in mind is that most fee arrangements are or will become a matter of public record. As a result, anyone can usually find out what your financial arrangement is.

(b) Written Contracts

⁶² The second registration is usually included with the original registration.

While it goes without saying, that any charitable organization should always enter into a written contract when it hires a paid fundraiser, indeed, many states specifically require that a written contract be executed by the parties and a copy of such contract be filed with the Attorney General's Office of the particular state. Any states, such as New York, also have certain terms and provisions that must be included in any contract with a paid fundraiser. Failure to include such provisions is typically grounds for rejection of the filing.

(c) Federal Disclosures

Pursuant to the Federal Trade Commission's (FTC) Telemarketing Sales Rule, telemarketers hired to conduct inter-state solicitations of charitable contributions by phone, must:

- (i) be made within the hours of 8 a.m. and 9 p.m.;
 - (ii) promptly identify the organization they represent and that the purpose of the call is to ask for a contribution;
 - (iii) not make misleading statements during their pitch to induce a donation; and
 - (iv) honor any request to be placed on a "do not call" list.
- Any further calls to that person may subject the telemarketer to a fine of up to \$11,000.

In order to comply with clause (ii) above, the telemarketer must state the name of the charitable organization on whose behalf a charitable contribution is sought. The identity of the telemarketer, or person making the call, however, need not be disclosed. In addition, if the charitable organization commonly uses a fictitious name that is registered with appropriate state authorities, that name may be disclosed instead of the charitable organization's legal name.

Compliance with clause (ii) also requires that in disclosing the purpose of the call, the telemarketer must make the disclosure promptly. The manner in which the purpose of the call is described or explained is up to the telemarketer, provided that the description or explanation is not likely to be misleading.

In the case of telemarketers that are employed to both fundraise and sell items on behalf of the organization, other than items of nominal value, the telemarketer must comply with sales disclosures applicable to all telemarketing sales (i.e., the rules applicable to telemarketing for a for-profit enterprise).

Examples provided by the FTC are as follows:

(i) “I am calling on behalf of [name of non-profit organization] to offer you a subscription to the organization’s newsletter, which [description of newsletter] and to ask for a donation to help support the work of [name of non-profit organization].”

(ii) “I am calling for [name of non-profit organization] to seek your support. For a donation of \$25 or more, [name of non-profit organization] will extend to you a one-year membership, which entitles you to [description of the membership]. Your donation will help us to continue the [non-profit organization’s] important work . . .”

In order to comply with clause (iii) above (pertaining to misrepresentations), a telemarketer is prohibited from making any misrepresentation pertaining to the following:

(i) The Nature, Purpose, or Mission of the Entity on Whose Behalf the Solicitation is Made. Telemarketers are prohibited from misrepresenting the nature, purpose, or mission of any entity on whose behalf a charitable contribution is being solicited.

(ii) Tax Deductibility. Telemarketers are prohibited from misrepresenting, either expressly or by implication, that any charitable contribution is partly or fully tax deductible, or falsely implying that an organization on whose behalf a contribution is solicited is “tax exempt.”

(iii) Purpose of a Contribution. Telemarketers are prohibited from misrepresenting how the requested contribution will be used. This prohibition includes statements pertaining to how a donation will be spent, and the locality where the donation will be utilized.

(iv) Percentage or Amount of Contribution that Goes to the Charitable Organization or Program. Although telemarketers are not required to affirmatively disclose the amount of a contribution that will ultimately go to the charity, if asked by a donor, or a potential donor, Telemarketers are prohibited from misrepresenting the percentage or amount of the contribution that will go to a charitable organization or program.

3. State Disclosures

In addition to federal requirements, most states require certain disclosures to be made in written solicitations for contributions. Generally, a disclosure is required **any** time a solicitation is made. Often, the only exception is for donated airtime (radio or tv) or advertisement space (for print media).

The following is a list of some of the disclosures required:

(a) **Florida:** A COPY OF THE OFFICIAL REGISTRATION AND FINANCIAL INFORMATION MAY BE OBTAINED FROM THE DIVISION OF CONSUMER SERVICE BY CALLING 1-800-435-7352, TOLL-FREE WITHIN THE STATE. REGISTRATION DOES NOT IMPLY ENDORSEMENT, APPROVAL, OR RECOMMENDATION BY THE STATE⁶³

(b) **Maryland:** A copy of the current financial statement is available on request, by sending written requests to _____ [INSERT THE NAME AND ADDRESS OF THE ORG.], or by calling _____ [INSERT THE TELEPHONE NUMBER OF THE ORG.]. The cost of copies and postage, documents and information submitted under this title are available from the Secretary of State.⁶⁴

⁶³ Florida Statutes § 496.411.

⁶⁴ Section 6-101g of the Maryland Charitable Solicitations Act.

(c) **New Jersey:** Information filed with the Attorney General concerning this charitable solicitation may be obtained from the Attorney General of the State of New Jersey by calling (973) 504-6215. Registration with the Attorney General does not imply endorsement.⁶⁵

(d) **New York:** A COPY OF THE LATEST ANNUAL REPORT MAY BE OBTAINED, UPON REQUEST, FROM _____ [INSERT THE NAME AND ADDRESS OF THE ORG.], OR FROM THE NEW YORK ATTORNEY GENERAL'S CHARITIES BUREAU, ATTN: FOIL OFFICER, 120 BROADWAY, NEW YORK, NEW YORK 10271.⁶⁶

(e) **Pennsylvania:** A copy of the official registration and financial information of _____ [INSERT THE NAME OF THE ORG.] may be obtained from the Pennsylvania Department of State by calling toll free, within Pennsylvania, 1 (800)-732-0999. Registration does not imply endorsement.⁶⁷

(f) **Virginia:** A financial statement is available from the State Division of Consumer Affairs in the Department of Agriculture and Consumer Services upon request.⁶⁸

(g) **Washington:** You may obtain additional financial disclosure information by contacting the Secretary of State at 1-800-332-GIVE.⁶⁹

In addition to the standard disclosures described above, some states also require additional disclosures in the event that the organization uses funds it receives to provide grants to other organizations. For example, New York law requires, that an organization that makes contributions to another organization which is not its

⁶⁵ N.J.S.A. 45:17A-21.

⁶⁶ New York Executive Law, Section 174-b.

⁶⁷ Act 202, Section 13 of the Pennsylvania Law

⁶⁸ Section 57-55.3 of the Virginia Code.

⁶⁹ Revised Code of Washington § 19.09.100.

affiliate shall include in its solicitations a statement that such contributions have been made (to such other organization(s)) and that a list of all organizations which have received contributions during the past twelve months from the soliciting organization may be obtained from that organization.

4. Fundraising on the Internet

At present, no state explicitly addresses fundraising using the internet. Some states, however, will define a “solicitation” by including any request for support using “any medium”. Such language leaves the internet (i.e., whether registration in every state is required) issue open for interpretation. At present, no single point of view seems to be controlling.

The prevailing point of view is embodied in something called the Charleston Principles. The Charleston Principles were written by the National Association of State Charity Officials, an association generally comprised of representatives from State Attorney General offices from around the country. Generally speaking, the Charleston Principles provide that any organization domiciled within a state must register with the state that it is domiciled. In addition, organizations will be required to register in other states where internet solicitations yield contributions on an “on-going” basis or where there are “substantial” contributions received from a particular state. The Charleston Principles, however, do not provide definitions for what will constitute on-going or substantial. Those terms are left to each state to define. The Charleston Principles also provide that registration of a non-domicilliary shall be required where the charitable organization specifically targets individuals in a particular state through it’s internet fundraising activities.

5. Do-Not-Call Lists

While many states, such as the State of New York, specifically exempt charitable organizations from statewide “Do Not Call” statutes, federal law does not provide a complete exemption. With the passage of the USA Patriot Act in 2001, charitable organizations became subject to the federal “No Not Call” laws if the charity employs for-profit telemarketers to conduct fundraising activities on their behalf. These rules may be found in the Telemarketing Sales Rule (the “TSR”).

Pursuant to the TSR, telemarketers must:

- (a) make certain prompt disclosures in every outbound call (See Paragraph 2(c) above);
- (b) get express verifiable authorization if accepting payment by methods other than credit or debit card;
- (c) maintain records for 24 months; and
- (d) comply with the entity-specific Do Not Call requirements, but are exempt from the National Do Not Call Registry provision.⁷⁰

Telemarketers are also prohibited from:

- (a) making a false or misleading statement to induce a charitable contribution;
- (b) making any of several specific prohibited misrepresentations;
- (c) engaging in credit card laundering;
- (d) engaging in acts defined as abusive under the TSR, such as calling before 8 a.m. or after 9 p.m., disclosing or receiving consumers' unencrypted account information, and denying or interfering with a consumer's right to be placed on a Do Not Call list.

6. Collection of Sales Tax on Charitable Fundraisers

As a general rule, each state imposes a tax on sales made within its state. Although the internet has caused a great deal of confusion over whether or not a sale has taken place within a particular state, less confusion exists in connection with the applicability of sales taxes when a charitable organization conducts a fundraising event, such as the sale of merchandise.

⁷⁰ Individuals may register for the federal "Do Not Call" registry online at www.donotcall.gov or by calling toll-free, 1-888-382-1222 (TTY 1-866-290-4236), from the number you wish to register. Registration is free of charge.

Each state has its own set of laws defining when a charitable organization is required to collect sales tax on revenue received from a fundraiser. These laws vary dramatically from state-to-state. Some states give a complete exemption to all charitable organizations, while others will only exempt certain specific types of organizations (e.g., elementary schools) and/or certain specific types of charitable fundraisers. Before any organization sells a product, professional advice should be obtained regarding the obligation to collect sales tax.

IX. LIABILITIES

The potential liabilities of a director, officer or trustee may be classified into two distinct categories; liabilities which could result from claims asserted by individuals and the general public, and liabilities which could result from claims asserted by state and federal agencies (e.g., the Internal Revenue Service and/or a State Attorney General).

Claims that may arise from members of the general public are similar to the types of claims which could accrue in the case of any for-profit business enterprise. These claims may include: (i) torts/negligence (e.g., slip and fall on the charity's property), (ii) contract claims, and (iii) employment claims (e.g., discriminatory hiring, wrongful termination, breach of contract and employee benefits claims). In addition, charities are often sued by members of the public in connection with claims of discrimination (e.g., resulting from the manner in which scholarships are awarded, hiring practices, etc.) and for the release of information (e.g., failing to comply with a request for public inspection from the general public and/or or a request from members of the charity).

The Volunteer Protection Act of 1997 (the "VPA") provides a conditional immunity for volunteers, including officers, directors and trustees, who perform services for a nonprofit organization and who do not receive compensation from the organization in excess of \$500 per year.⁷¹ Immunity under the VPA protects volunteers against personal liability for harm they cause while acting within the scope of their responsibilities on behalf of the organization, so long as the harm is not caused by: (i) willful misconduct, (ii) gross negligence, (iii) reckless misconduct, (iv) operating a motor

⁷¹ While the VPA protects volunteers of a nonprofit organization, it does not limit the liability of the nonprofit organization whose volunteer caused the harm.

vehicle, vessel or aircraft for which a license or insurance is required, or (v) a conscious, flagrant indifference to the rights or safety of the person harmed. Although the VPA provides a defense to liability for volunteers who meet certain criteria, it does not prohibit lawsuits from being filed.

Many states have also enacted statutes providing officers, directors and others with immunity from claims if the individual serves as a volunteer.⁷² This immunity, however, is not absolute and is usually only available if the individual did not act in a manner that would constitute gross negligence, or in a manner that was intended to cause harm. In addition, neither state immunity statutes nor the VPA provide immunity from claims brought by a State's attorney general, IRS, or a specific beneficiary of such organization.

As in the case with most potential liabilities, an organization may obtain insurance to provide a financial source of protection in the event of a potential liability. Insurance may be obtained for general liability, directors and officer's protection, fiduciary protection, discrimination protection, sexual harassment protection, business interruption protection and many other areas common to for-profit enterprises. There are several critical issues that should be considered when determining whether or not insurance should be obtained by an organization. First, of course, cost should be considered. The amount of premium is always a significant issue. Careful consideration must also be made as to the likelihood of a claim for which the insurance would provide protection from. Lastly, and potentially most importantly, insurance may not be obtained which will provide reimbursement in the case of excise tax imposed for violation of the intermediate sanctions or Chapter 42 of the Code.

X. STAYING ON TRACK

A. Board Orientation

1. Board Books

Each new member to the board of directors should be provided with

⁷² The VPA preempts state law, unless a particular state law provides additional liability protection for volunteers.

what is commonly referred to as a “board book”. A board book contains basic information about the organization that every director would need to have in order to carry-out his or her fiduciary responsibilities. A typical board book may contain the following items:

- (a) Mission Statement
- (b) Certificate of Incorporation
- (c) By-Laws
- (d) Board Policies
- (e) IRS Determination Letter
- (f) Current Strategic Plan
- (g) Most Recent IRS Form 990 & State Filings
- (h) Most Recent Budget
- (i) Board Minutes and Resolutions for Past Year
- (j) List of Board Members and Contact Information
- (k) List of Officers and Contact Information
- (l) List of Management and Contact Information
- (m) Calendar of Events
- (n) Organization Structural Flow-Chart

2. Initial Orientation

In addition to the board book, each time a new member is elected to the board of directors, he or she should undergo a brief orientation. At this orientation the new board member should be presented with a copy the board book and a detailed review of its contents should be made. Going through this exercise helps ensure that the presentation of the board book is not a mere exercise in the exchange of paper, but will be a meaningful exchange of information.

3. Continuing Education

Like most things in life, the organizational structure and documents of a nonprofit will change over time. While an initial orientation will educate board members regarding the organizational structure and documents at the time he or she joins the board, in time, individuals will forget many of the things that were initially discussed. Thus, a refresher of what was originally explained, as well as the items that have changed is advisable.

B. Keeping Accurate Records

Accurate records are critical to the long-term success of any organization. For example, these records should include all Board minutes and consents from the first day that the organization is formed. Copies of all written policies, as well as governing documents, such as by-laws and articles of organization, with all amendments, should be readily accessible and maintained with the organization's records. Non-profit organizations, like any other business enterprise, will frequently have substantial turnover through the years. Thus, unless accurate records are maintained on a daily basis, it may be difficult for an organization to function properly.

C. Seeking Professional Advice

Just as for-profit business enterprises are constantly concerned with the "bottom line", non-profit organizations must always be mindful of their finances. As a result, many non-profit organizations will seek professional advice, first, from those who will provide such services free of charge. As a result, the best services are not always obtained. Non-profits can help themselves by doing some of their own work in-house and only calling professionals when necessary. The key is to find competent professional advice and balance the use of such resources with those functions that can be handled within the organization.