Ridgeway PHILANTHROPY

Handbook for Directors and Trustees of Private Foundations

Ridgeway Philanthropy offers this paper for clients who may serve as directors and trustees of private foundations. The information contained in this paper is intended to be a limited discussion of issues which might affect private foundations in general, and clients should consult with us concerning issues specific to a particular foundation.

General Information

What is a Private Foundation? A private foundation is a charitable organization that generally receives its funding from the members of one family or one business, and uses its funds to make grants to other organizations that actively conduct charitable programs. Some private foundations also directly operate charitable programs in addition to (or instead of) granting funds.

A private foundation is usually created as either a corporation controlled by directors or a trust controlled by trustees. In either case, the charitable purposes set forth in the corporate bylaws or the trust instrument will guide the directors and trustees on what kinds of grants and activities the foundation may sponsor. The governing documents are also the primary source for every director and trustee to learn of his or her responsibilities and any limitations on his or her liability. The governing documents should be read carefully by every director and trustee.

What Does it Mean to be a Tax-Exempt Organization? All charitable organizations including private foundations must apply for tax-exempt status from the Internal Revenue Service, and the IRS determines whether the organization's governing documents and proposed activities properly ensure that it is sufficiently educational, religious, scientific, literary or otherwise charitable to deserve a tax exemption under Section 501(c)(3) of the Internal Revenue Code. Once determined to be tax-exempt, a charitable organization may receive tax-deductible donations and generally will not have to pay income tax on its donations or earnings, although private foundations must still pay an excise tax of two percent on net investment income. Tax-exempt organizations are prohibited from participating in political campaigns for or against any candidate for public office, and generally (although there are some narrow exceptions) may not attempt to influence any legislation. Tax-exempt organizations may not have shareholders and may not privately benefit any individual except as part of their charitable purposes.

How Does a Private Foundation Differ From a Public Charity? All tax-exempt organizations are further classified by the IRS as a tax-exempt private foundation or a tax-exempt public charity. The tax code makes a distinction between the two because private foundations are considered somewhat less deserving of deductible contributions and somewhat more in need of supervision, as described below. To be a public charity, an organization must generally show that it receives at least one-third of its annual support from the "general public", defined to include any individual or corporate donor except to the extent that donations from the donor (when aggregated with donations from related parties) exceed two percent of the organization's support. For example, if an organization has $100,000 of support, generally at least $33,333 must come from a group of donors who do not (when aggregated with their family members) give more than $2,000. If an organization can not satisfy this public support test, then it will generally be classified as a private foundation.

Responsibilities of Directors and Trustees

Directors and trustees are responsible for overseeing the accomplishment of a foundation's charitable purposes. To do this task well and to minimize exposure to liability, a director or trustee must understand the required duties of care and loyalty, duties concerning investments, and the special federal rules imposed on private foundations.

- **Duty of Care**

State law requires directors and trustees of foundations to perform their duties "in good faith, and in a manner which they reasonably believe to be in the best interests of the organization, and with such care as an ordinarily prudent person in a like position in a similar charitable organization would use under similar circumstances".

What does this mean? The American Bar Association has offered a helpful interpretation:

> [The law] allows directors of nonprofit corporations to exercise their judgment with due regard to the nature, operations, finances, and objectives of their organizations. The "ordinarily prudent person" concept . . . applies to directors who balance potential risks and rewards in exercising their duties as directors. It is intended to protect directors who innovate and take informed risks to carry out the [organization's] goals and objectives. The directors need not be right, but they must act with common sense and informed judgment. The duty of care recognizes that directors are not guarantors of the success of investments, activities, programs or grants. It allows leeway and discretion in exercising judgment.

ABA Business Law Section, Report of Subcommittee on Model Nonprofit Corporation Law (1988), comments 2 and 7 to §8.30.

A key to a director or trustee performing his or her duties is that decisions be made on informed judgment. This requires the director or trustee to:

- attend regular meetings and review information sufficient to remain alert to the foundation's activities, the investment of its assets, and the distribution of its funds for both administrative purposes and charitable purposes; and

- evaluate the foundation's executive director or any other employee or agent as to their reliability and competence in the matters delegated to them.

- **Duty of Loyalty**

Directors and trustees must base their decisions on what they believe to be in the best interests of the foundation. Where an activity or transaction is likely to personally benefit a director or trustee or the donor, or any of their family members, then all directors and trustees must remain diligent in protecting the interests of the foundation. To accomplish this, a director or trustee must:

- disclose fully and timely the existence of any conflict of interest, and consider withdrawal from any discussion and voting on such matter; and

- independently evaluate the fairness to the foundation of any activity or transaction that might involve a conflict of interest between the foundation and others.

The duty of loyalty also requires directors and trustees to respect the confidential nature of all discussions and distributed materials.

- **Duties Concerning Investments**

The donor who creates a private foundation may place limitations on certain types of investments or otherwise prescribe certain standards of care in the governing document, and directors and trustees must be familiar with these provisions.

To the extent not inconsistent with specific investment rules in the governing documents, the Prudent Investor Act serves to guide directors and trustees on investment issues. The Prudent Investor Act provides that a trustee must consider the following circumstances in investing and managing assets:

- general economic conditions;

- the possible effect of inflation or deflation;

- the role that each investment or course of action plays within the overall trust portfolio; and

- the expected total return from income and the appreciation of capital.

In general, the Act encourages reasonable diversification of assets, and diligence in reviewing the portfolio and implementing decisions designed to bring the portfolio into compliance with the Act. Trustees are permitted to delegate their investment function if prudent to do so, as long as reasonable care is taken in selecting the agent, establishing the scope of the delegation, and periodically reviewing the agent's actions. Fees paid to a trustee must be reasonable in relation to the assets, to the charitable purpose of the trust, and the skills of the trustee. If the investment function is delegated to an agent who is compensated, the trustee will likely receive a lower fee than if the trustee retains the investment function.

- **Duties Imposed by Federal Rules Concerning Private Foundations**

Congress has enacted special rules that apply to private foundations:

- Minimum Distribution Requirement. Private foundations must annually distribute a minimum amount to accomplish one or more charitable purposes. The annual minimum distribution amount is 5% of the net fair market value of the foundation's assets, other than any assets used by the foundation in directly conducting its charitable purpose. This amount may be reduced by the amount of any excise tax on investment income. The value of the foundation's assets is determined based on average monthly balances of cash and marketable securities, and an annually-updated appraisal of other assets. The minimum distribution amount computed for a tax year must actually be distributed for charitable purposes by the end of the following tax year.

- Prohibitions on Self-Dealing. Self-dealing is described as virtually any transaction, direct or indirect, between a private foundation and a disqualified person. Disqualified persons generally include substantial contributors and any person or entity related to a substantial contributor. Prohibited transactions specifically listed include selling, leasing (except a rent-free lease to the foundation), lending (except an interest-free loan to the foundation), furnishing of goods or services (except the donation of goods or services to the foundation) and payment of compensation (except reasonable, "not excessive," compensation).

- Prohibition on Excess Business Holdings. A private foundation is generally not permitted to control, together with disqualified persons, more than 20% of certain active businesses.

- Limitations on High-Risk Investment of Foundation Assets. A private foundation must not invest its assets in such a manner which jeopardizes the carrying out of its exempt purpose. An investment is considered to jeopardize the carrying out of exempt purposes if the foundation manager, in making the investment, has failed to exercise ordinary business care and prudence, under the facts and circumstances then prevailing.

  A program-related investment which furthers a private foundation's exempt purpose is not a jeopardizing investment. An investment is program-related if (i) its primary purpose is to accomplish one or more religious, charitable, educational or other related purposes, (ii) no significant purpose of the investment is the production of income or the appreciation of property, and (iii) no purpose of the investment is attempting to influence legislation or intervening in any political campaign. For example, a foundation committed to combat inner-city deterioration could invest in a company located in a distressed area that provides jobs and training to economically disadvantaged people.

  Taxable Expenditures. A private foundation must avoid certain "taxable expenditures." Taxable expenditures are amounts paid by a private foundation (i) for influencing legislation or public elections, (ii) for other non-charitable purposes, (iii) as travel or study grants to individuals (but certain scholarships or awards are not taxable expenditures if they are awarded on an objective and non-discriminatory basis in accordance with procedures approved in advance by the IRS), or (iv) as grants to any other organization that is not an approved public charity, unless the grant-making private foundation exercises *expenditure responsibility*. Expenditure responsibility requires the foundation to exert all reasonable efforts and establish adequate procedures: (1) to see that the grant is spent solely for the purpose for which it was made; (2) to obtain full and complete reports from the grantee on how the funds are spent, and (3) to make full and detailed reports on the expenditures to the IRS.

Liability Protection Available to Directors and Trustees

The various responsibilities faced by foundation directors and trustees could give rise to liability in the following manners:

- Any alleged breach of a director or trustee's duties to the foundation may generally be prosecuted by the foundation through a civil suit.

- The Division of Public Charities at the office of the State Attorney General is charged with enforcing the proper application of charitable funds for both public charities and private foundations, and is authorized to bring civil claims against private foundations and their directors and trustees for breaches of duty or other wrongful conduct.

- Directors and trustees of charitable organizations that operate public activities, whether for fundraising purposes or in the course of directly fulfilling their charitable purpose, must be concerned with civil claims for bodily injury, property damage, and even defamation of character. If a charitable organization has any paid employees, claims arising out of the employment relationship are often a concern.

- The Internal Revenue Service is authorized to assess substantial penalties against both foundations and their directors and trustees for violations of the special federal rules governing private foundations.

As an initial protection against these liabilities, the governing instruments of most foundations explicitly release directors and trustees from any liability for breaches of duty or investment losses due to mere negligence, so there would only be recourse by the foundation against a director or trustee whose actions were willful and committed in bad faith.

In addition, some state laws (Massachusetts, for example) offer a director or trustee of a charitable organization protection from liability relating to the performance of his or her duties, but often only if the director or trustee serves without compensation and only if his or her acts or omissions did not intentionally cause harm and were not grossly negligent; generally, the protection does not apply to injuries resulting from the operation of an automobile. A separate limitation on liability for certain injuries may apply to charitable organizations but not to the directors and trustees personally (in Massachusetts such law is known as the "charitable immunity doctrine").

To cover possible situations where directors and trustees may still be subject to liability, foundations often adopt provisions in their governing documents requiring the foundation to indemnify (to the extent of the foundation’s assets) directors and trustees against any liabilities relating to the performance of their duties. The indemnification may also cover a director or trustee’s costs incurred in defending against such liability. However, indemnification will not be available in situations where a director or trustee has been adjudicated to have acted in bad faith or with no reasonable belief that his or her action was in the best interests of the foundation.

While the limited statutory protection against liability and the foundation’s indemnification provisions should be sufficient to protect directors and trustees of most foundations, there may be specific situations that warrant the foundation’s purchase of directors and officers liability insurance.

Annual Reporting Requirements of a Private Foundation

A private foundation must file information returns with the IRS (Form 990PF) and a Charities Division of a State Attorney General (Form PC in Massachusetts). The forms are similar to each other, requiring full disclosure of the foundation’s financial matters and activities. These filings are open to public inspection. In addition, if the foundation has any “unrelated business taxable income” (e.g., income from regularly operating a commercial business, advertising revenue, or income from certain debt-financed property), income tax must be paid to the IRS with Form 990-T (and in Massachusetts to the Department of Revenue with Form 2 or 3M). Further, if the foundation is a corporation, an annual report listing the current directors and officers must be filed with the State Secretary of State’s Office. In general, a foundation should keep its records on hand for several years in order to be able to comply with any additional requests for information by the state or federal regulatory authorities or the public.