# Top 10 Ways Family Foundations Get Into Trouble



Kelly Shipp Simone
Vice President, Legal Affairs
Kelly.Simone@cof.org
703-879-0716

#### Key Issues

- Self-Dealing
- Hiring Family Members
- Conflicts of Interest
- Travel Expenses
- Attending Fundraisers
- Paying Pledges
- Sharing Resources
- Grants to Non-Charities
  - SO Grants
- Grants Outside the US
- Grants to Individuals



"Don't get caught."

# **Self-Dealing**

- No transactions with "disqualified persons"
  - Officers, directors, trustees
  - Substantial contributors
  - Family members of the above
    - spouse, ancestors, children, grandchildren, great grandchildren and spouses of same.
  - Businesses they control
- Penalties
  - Rectify the violation (pay it back)
  - 10% on self-dealer
  - 5 % on managers



## **Self-Dealing**

- Prohibited Transactions
  - Sale, exchange or leasing of property between foundation and disqualified person (in either direction!)
  - Lending money
  - Furnishing goods or service
- Permissible Benefits
  - Incidental and tenuous
  - Public recognition / goodwill
- Major Exception Compensation



# **Hiring Family Members**

- Personal Services:
  - Banking, legal, accounting, investments
  - Not interior decoration, janitorial
  - Query real estate management
  - Narrow interpretation by IRS
- Reasonable:
  - What similar people get paid for similar work in similar circumstances
  - Generally no percentage based compensation
- Necessary: Consistent with exempt purposes



# **Determining Compensation**

- Data use appropriate comparables
- Decision by disinterested governing board or committee
- Document, document, document

Chief Executive Officer/President of a Family Foundation (2012)

Asset Group (in millions)	Salary		
\$10 to \$24.9	Median	Mean	Range
	\$101,363	\$103,169	\$47,000 to \$185,000

#### **Conflicts of Interest**

- Definition any situation in which there are competing loyalties
- Some conflicts are illegal
- Others are matters of judgment and ethics
- Policies and procedures



#### **Travel Expenses**

- Spouses and children are disqualified persons
- Paying travel expenses for them is self-dealing
- Two Exceptions:
  - Family member has reasonable foundation duties
  - Treat reimbursement as taxable income to foundation director or staff person whose relative is reimbursed
- Expenses must be reasonable
- Training for future board service needs a robust program



## **Attending Fundraisers**

- Possibly self-dealing if used by a disqualified person
- Ticket may have some economic value
- Charitable dollars can't provide private benefit
- No violation if staff has duty to monitor and evaluate
- OK if value treated as income
- No bifurcation permitted



# **Paying Pledges**

- Assuming a debt of a disqualified person is self-dealing
- <u>Legally binding</u> pledges may not be paid by the foundation
- State law determines whether a pledge is legally binding
- Be careful in communicating with potential grantees



#### **Sharing Resources**



"Don't be silly – lots of men share the same briefcase."

- Foundation can only pay disqualified person for "personal" services
- Payments to third parties is ok
- O% loan to foundation ok
- Records must be meticulous
- Disqualified person can usually donate resources
  - No deduction for partial interests in property
  - No deduction for services



#### Jeopardy Investments

- Investments judged on relationship to portfolio
- No per se bad investments
- Fiduciary responsibilities under state law
  - In good faith and with care of ordinarily prudent person
    - Costs must be reasonable
    - Reasonable effort to verify facts
- May delegate but exercise prudence in
  - Selecting manager
  - Establishing scope and terms of delegation
  - Periodically reviewing manager's actions



## **Due Diligence**

- Investment policy
  - Asset allocation
  - Risk tolerance
  - Balancing
- Can you understand the investment strategy?
- What controls are in place?
- Social network references not enough
- Who's the auditor?



## **Due Diligence**

- Ongoing responsibility
  - -review reports
  - -obtain financial statements
  - -monitor portfolio
  - –compare transactions

#### **Grants to Non-Charities**

- You can make a grant to any organization as long as it is for charitable purposes
- Safest grants are to IRS recognized charities
- Otherwise "expenditure responsibility"
  - Pre-grant inquiry
  - Written agreement
  - Funds held separately by grantee
  - Regular reports from grantee
  - Summary status on Form 990-PF



## **Grants to Supporting Orgs.**

- Type matters
  - Type I parent-subsidiary (parent appoints majority of board)
  - Type II brother-sister (majority of board overlaps)
  - Type III minimal contact (some overlap + "responsiveness")
- Qualifying distributions
  - Grants to type I and II SO's generally count
  - Grants to type III only if "functionally integrated"
  - PF disqualified person can't control SO or org. it supports
- Taxable expenditures
  - Expenditure responsibility for type III unless "functionally integrated"



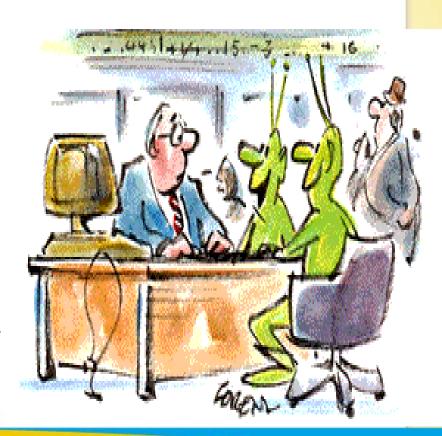
## **Determining SO Status**

- SO Status
  - IRS Business Master File (not IRS Publication 78)
  - Grantee's IRS determination letter
- Type
  - Written representation by grantee
  - PF collects and reviews governing documents
  - Written reps. From supported orgs. for type III
- Alternative -- Opinion of counsel



#### **Grants Outside the U.S.**

- Foundations can make grants anywhere in the world
- Three Options
  - Grantee is recognized by IRS
  - Expenditure Responsibility
  - Equivalency Determination
- Anti-terrorism concerns



# **Scholarships**

- Pursue education, achieve an objective, develop a skill
- Charitable class
- Objective and nondiscriminatory basis
- No disqualified persons
- IRS pre-approval required
- Special rules for employees or their dependents



"I know so much, I don't know where to begin."



#### Disaster Relief / Hardship

- Must benefit a charitable class
- Establish a process for determining who will receive assistance and permissible types of assistance
- Recordkeeping varies depending on type of assistance
- Tips
  - It helps to plan ahead
  - Intermediaries are often a good option



## **QUESTIONS**

#### Resources

- www.cof.org/legal
   Resources from the Council on legal issues
- www.learnfoundatoinlaw.org
   Collaborative project of the Packard, Gates, Hewlett and Moore Foundations including training modules on advocacy rules and expenditure responsibility rules