Top 10 Ways Family Foundations Get Into Trouble

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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

<table>
<thead>
<tr>
<th>Asset Group (in millions)</th>
<th>Salary</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Median</td>
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<tr>
<td>$10 to $24.9</td>
<td>$101,363</td>
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Chief Executive Officer/President of a Family Foundation (2012)
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
• **Legally binding** 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

• Foundation can only pay disqualified person for “personal” services
• Payments to third parties is ok
• 0% 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

“Don’t be silly – lots of men share the same briefcase.”
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 non-discriminatory 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](www.cof.org/legal)
  Resources from the Council on legal issues
- [www.learnfoundatoinlaw.org](www.learnfoundatoinlaw.org)
  Collaborative project of the Packard, Gates, Hewlett and Moore Foundations including training modules on advocacy rules and expenditure responsibility rules