

Private Foundation

Risk Management Primer

The purpose of the risk management primer is to help you become aware of common pitfalls with managing a private foundation.

Success in philanthropy comes from doing the very most that you can, given the limits of your available resources, to make the world a better place. Your desire to establish or manage a private foundation undoubtedly comes from a deeply-felt motivation to make a meaningful impact. However, managing a foundation is not without its risks that could result in severe penalties to the foundation and those entrusted with its management.

This primer covers the following topics:

- 1) Self-dealing
- 2) Personal Pledges
- 3) Attending Fundraising Events or Galas
- 4) Hiring Family Members & Compensation
- 5) Travel Expenses for Family Members
- 6) Grants to Individuals (e.g., Scholarships)
- 7) Disaster or Emergency Hardship Relief
- 8) Grants to Foreign Organizations or Non-charities
- 9) Charitable Solicitation or Fundraising

Please note that many of the risks listed here have exceptions that must be considered on a case-by-case basis. Professional services and counsel should be consulted when assessing specific foundation management issues.

1. Self-dealing

The IRS expects nonprofits to operate for *the good of the public* and not for the benefit of a specific person(s). As such, the IRS has defined unacceptable practices by tax-exempt organizations that could result in tax penalties or even loss of tax-exempt status. Although we highlight 'self-dealing' as it is specific to private foundations, you may also hear the related terms "*private benefit*" and "*private inurement*" when it comes to this common nonprofit risk.

To understand self-dealing, you must first understand who the IRS considers a **disqualified person** when it comes to private foundations. A disqualified person can include the following:

- Foundation officers, directors, or trustees
- A substantial contributor, *person or company*, to the foundation
- Companies or partnerships substantially owned by disqualified persons
- Spouses and relatives of the above including grandparents, spouses of children, and grandchildren
- Certain government officials

What to look for:	Examples of prohibited activities:	Questions to ask:
<p>Any type of transaction between the foundation and a disqualified person(s), whether direct or indirect, and financial or otherwise.</p>	<p>The following transactions are generally considered acts of self-dealing between a private foundation and a disqualified person. However, there are many exceptions that would permit the below transactions with conditions:</p> <ul style="list-style-type: none"> • Providing goods, services, or facilities (including renting office space from a family member) • Sale, exchange, or leasing of property (including office supplies, services, or insurance) • Lending money or other extensions of credit • Paying compensation or reimbursing expenses to a disqualified person (See #4 for allowable exceptions) • Transferring foundation income or assets to, or for the use or benefit of, a disqualified person • Certain agreements to make payments of money or property to government officials 	<ul style="list-style-type: none"> • Does the transaction deal with an insider or disqualified person (directly or indirectly)? • Does the transaction deal with a business or entity associated with an insider or disqualified person (directly or indirectly)? • Is the transaction dealing with a person who contributed more than \$5,000 or over 2% of the foundation’s contributions? • Is a disqualified person or entity gaining any tangible or intangible benefit? • Is it clear to an outsider how the transaction or activity is furthering the foundation’s charitable purpose? • Do the transactions directly benefit the general public or a charitable purpose?

Note: Penalties for self-dealing include taxes of 10% of the amount involved on the self-dealer and 5% on the foundation manager, initially. An additional 200% and 50%, respectively, is incurred if not corrected within the taxable period. Continued self-dealing can result in loss of tax-exempt status.

2. Personal Pledges

Some donors may see the foundation as an extension of their personal assets and may fall into a common pitfall of fulfilling personal pledges or commitments through the foundation. Personal pledges are legally binding promises of gifts, whether made verbally or written, that can be enforced in a state court. Since a personal pledge is considered a personal debt and legal obligation, a disqualified person cannot use foundation assets to fulfill a personal pledge or other personal obligations such as membership fees and dues; otherwise, that person is personally benefiting and it is considered self-dealing.

What to look for:	Examples of prohibited activities:	Questions to ask:
<p>A foundation makes a payment or satisfies a personal pledge or any other legal obligation on behalf of a disqualified person.</p>	<ul style="list-style-type: none"> • The founder of a private foundation makes a personal commitment to a public charity and sends payment from the foundation. The public charity submits a donation acknowledgement letter indicating the foundation payment fulfilled the founder’s personal pledge. • At a university alma mater fundraiser, a 	<ul style="list-style-type: none"> • Was the personal pledge made by a disqualified person? • Are there tangible or intangible benefits for disqualified persons related to the pledge? • Are the terms of the pledge clear and unambiguous?

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	<p>family member commits to a personal pledge of several payments over the next five years. The family foundation submits a payment indicating it fulfills the personal pledge of the family member.</p>	<ul style="list-style-type: none"> • Was the pledge accepted by the donee? • Did the charity or donee act in reliance of the pledge or promise? • Did the commitment or pledge bypass the foundation board's review and approval? • Is there a lack of documentation of the approval in board meeting minutes?
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3. Attending Fundraising Events or Galas

Charities, hospitals, universities, and art institutions often sell tickets to fundraising events where dinner or entertainment is provided. As noted in self-dealing, the exchange of goods or services between a foundation and a disqualified person is considered self-dealing. Therefore, a foundation should not pay for a disqualified person to attend fundraising events unless the person is carrying out their duties for the foundation (e.g., grantee oversight, program evaluation, etc.), which is rarely feasible at a fundraising event or gala.

What to look for:	Examples of prohibited activities:	Questions to ask:
<p>A foundation pays for a ticket for a disqualified person to attend a fundraising event who has no oversight responsibility or relation to grant evaluation activities.</p>	<ul style="list-style-type: none"> • A foundation pays for a board member's ticket to a charity's annual gala where dinner and entertainment will be provided. • An executive director of a foundation attended a fundraising dinner as part of his oversight responsibilities of the grantee. He brought his wife as a guest and used foundation funds to pay for her ticket as well. 	<ul style="list-style-type: none"> • For whom is the ticket? • Who paid for the event ticket? • Is the event attendee a disqualified person or the family member of a disqualified person? • Is the attendee participating in the event in an official foundation capacity?

Note: Bifurcating (e.g., a disqualified person personally paying for their dinner but having the foundation pay for the charitable donation of the ticket) is still self-dealing and is not allowed by the IRS.

4. Hiring Family Members & Compensation

The ability to hire and compensate family members to help manage the family foundation is a significant and attractive benefit of private foundations. Oftentimes, one or a few members of the family take on the preponderance of the foundation management responsibilities and for some, it can be a full time occupation. As such, many foundations offer compensation to family members in these positions.

Recall that compensating or reimbursing expenses to disqualified persons (family members are typically disqualified persons) is considered self-dealing, **but there are exceptions.** *The exceptions allow compensation and reimbursement to disqualified persons for personal services if reasonable, necessary, and in support of the foundation's charitable purpose.*

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Although not defined, it is generally understood that personal services are professional and managerial in nature, such as legal, accounting, tax, and investment management services. Defining “reasonable” is more difficult, but past rulings by the IRS suggest that compensation is reasonable if it is similar to the amount paid at similar foundations in comparable situations; in other words, it’s not excessive in comparison. Because compensation can be in the form of a salary, fees, bonuses, benefits, and fringe benefits, it is critical to look at the sum total of compensation and all benefits when assessing if it is reasonable and necessary.

As a best practice, we recommend private foundations have board approved policies in place that document the employee management practices including establishment of compensation.

We also strongly recommend consulting an outside party, such as Sterling, to independently assess compensation against a benchmark of related characteristics including the person’s role and responsibilities, the size of the foundation, the charitable focus of the foundation, the complexity of operations, the location, etc.

What to look for:	Examples of prohibited activities:	Questions to ask:
<p>Generally, family members can be hired as foundation staff and provided compensation as long as services are:</p> <ul style="list-style-type: none"> • Reasonably compensated • Necessary and “personal” • Support the foundation’s charitable purposes 	<ul style="list-style-type: none"> • A founder of a family foundation hires his daughter to manage the foundation and provides a total compensation package that is twice as high as comparable foundations. • A private foundation is hosting a large gala event and hires an event planning company owned by a board member for a significant fee. No other quotes were sought from other vendors. 	<ul style="list-style-type: none"> • What do the foundation governance policies say on hiring and compensation? • What are the state laws related to hiring and compensation? • Is there documentation of the hired person’s responsibilities? • Are the services necessary to carry out the exempt purposes of the foundation? • Are the services “personal” (e.g., Legal, Accounting, Banking, etc.), or non-personal (e.g., Real estate management, Janitor services, etc.)? • Was compensation benchmarked against reliable data? • Would an outside party consider it excessive?

Note: Any compensation paid by the foundation should be reported as income and is subject to federal income tax.

5. Travel Expenses for Family Members

A foundation’s board members, directors, or officers will often need to travel for foundation related business such as attending an annual board meeting or visiting a charity to evaluate the outcome of a grant. They may choose to bring along their spouse or children who do not serve or support the foundation; therefore, their presence is not necessary to carrying out the foundation’s charitable purpose. As the spouse and children are disqualified persons, payment of their travel expenses by the foundation would be considered self-dealing.

An exception exists where the spouse and children’s travel expenses can be paid by the foundation – if

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the payment is considered part of the board member’s reasonable compensation. In this case, payment of family travel and expenses should be reported as income via Form 1099 or W-2.

What to look for:	Examples of prohibited activities	Questions to ask:
<p>Foundation funds used to pay for family members’ travel and other expenses who are not board members, officers, or employees.</p> <p>As mentioned above, family members of disqualified persons are disqualified persons too and cannot receive tangible economic benefit from foundation assets (unless they work for or serve the foundation).</p>	<ul style="list-style-type: none"> • An Executive Director has the foundation reimburse the travel expenses for her and her spouse to meet with an out-of-town grantee. • A board member must attend a conference and brings his family. The foundation covers the cost for his children to visit a theme park while he attends conference sessions. 	<ul style="list-style-type: none"> • Is the family member a disqualified person? • Is the family member carrying out legitimate foundation duties or responsibilities? • Are the expenses to be reimbursed part of the family member’s reasonable compensation?

6. Grants to Individuals (e.g., Scholarships)

Providing grants to individuals is a popular form of grant making. As with many aspects of a private foundation, there are specific requirements and exceptions to follow.

Any grants given by a private foundation to an individual for “travel, study, or other similar purposes” are considered taxable expenditures unless approval has been given by the IRS in advance. For example, if your foundation plans on giving scholarships to students to go toward tuition, or providing grants to scholars to conduct research, or giving prizes to artists for a specific purpose, then you need to first obtain IRS approval.

To obtain IRS approval, the foundation’s grant procedures must be submitted and show they are objective and nondiscriminatory. The procedures should reflect the following IRS guidelines¹:

- The pool of grantees is large enough to constitute a charitable class
- Criteria for grantee selection is related to the purpose of the grant
- Persons selecting grantees do not derive private benefit directly or indirectly
- The foundation must check that grantees used the grants per intended activities and take action if not used per intended activities

As an example, if a foundation wants to operate a scholarship program, it needs to demonstrate how scholarships will be awarded on an objective and nondiscriminatory basis. The applicant pool should not be so small that it could appear to be benefiting pre-selected individuals. However, a smaller candidate pool can be justified if it’s aligned to the foundation’s mission which itself has a narrow focus.

Let’s say a foundation has a mission to fight a rare medical condition and provides scholarships to medical students in that field of study. The foundation should also ensure that the selection committee² or persons who select the scholarship or grant recipients do not profit or benefit in any way; nor should disqualified persons such as family members be recipients of the foundation’s scholarships.

¹ The following list is not all inclusive of IRS requirements and exceptions to obtain approval for grants to individuals. A professional should be consulted for all considerations and requirements.

² Corporate foundations or foundations affiliated with a business entity are subject to additional regulations regarding scholarships.

What to look for:	Examples of prohibited activities:	Questions to ask:
<p>A foundation providing grants or funding directly to individuals. Exceptions allowed where specific rules are adhered to:</p> <ul style="list-style-type: none"> • Grant must be for a charitable purpose and cannot go to a disqualified person • IRS preapproval is required if the foundation is selecting recipients • The selection must be objective and nondiscriminatory • Potential grantees must be broad enough to be a “charitable class” 	<ul style="list-style-type: none"> • A foundation has a charitable purpose to eradicate pediatric cancer. A board member’s niece is in medical school studying pediatric oncology. The foundation gives her a grant to use for tuition costs. • A foundation provides a grant to a university for a scholarship program for underprivileged students. The foundation stipulates they will review applicants and select the scholarship recipients. 	<ul style="list-style-type: none"> • Is the grant for charitable purposes? • Is the scholarship going to a family member of a disqualified person? • Who is selecting the fellowship recipient? • Has the IRS approved the selection process before grants are awarded? • Are grants to disaster victims or hardship cases potentially benefiting a charitable class?

Exceptions:

Grants to individuals for purposes besides “travel, study, or a similar purpose” are not taxable expenditures and do not require advance approval from the IRS. Grants related to disaster or hardship relief are a common example of this and will be addressed in the following section.

Another example, although less common, is when a private foundation provides prizes or awards to individuals in recognition of past achievements. Let’s say a foundation has a charitable mission to support the arts and decides to award prizes to individual artists in recognition of their past achievements in writing, music, or painting. In a situation like this the foundation should not impose any conditions on the use of the funds and should not require or expect any future actions by the award recipient. As IRS advance approval is not required, the foundation should take extra precautions in order to meet the IRS guidelines and avoid self-dealing in its selection or distribution of awards.

7. Disaster or Emergency Hardship Relief

Many private foundations are interested in providing relief efforts in the wake of natural disasters or to those affected by other hardships. Disaster or emergency relief is typically seen as providing help to victims of large-scale events such as floods, fires, earthquakes, hurricanes, etc. Hardship relief is seen as providing assistance to those affected by illness, death, an accident, crime, or other personal events. Because these types of needs are usually urgent, it is best to understand the rules upfront or have policies already established.

Providing grants to suitable, existing charities within the U.S. such as a community fund, church, or relief organization is the simplest and least complicated method to provide disaster or hardship relief. As with all grants, private foundations should conduct proper due diligence³ on the charity, in addition to ensuring they have the experience, processes, and capability to identify persons who are in need and/or distressed. Although funds can be designated for certain programs or relief efforts, a private foundation cannot earmark funds to the charitable organization to give to specific people.

³ Grants to foreign organizations and non-charities require additional due diligence.

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Due to the urgency of relief efforts after a disaster or emergency, the IRS does allow private foundations to make grants to individuals in distress without advance approval⁴. Private foundations can provide assistance to disaster or emergency hardship victims in need of basic necessities such as food, clothing, housing or housing repairs, transportation, and medical assistance. Similar to the regulations stated in the previous section on grants to individuals, the private foundation needs to show that recipients qualify as a “charitable class;” in other words, qualified recipients represent a group large enough or open-ended enough that giving aid to that charitable class benefits the community as a whole. As such, private foundations should be cautious not to provide relief assistance to particular, pre-selected individuals or to disqualified persons.

Typically, less documentation is needed when providing short-term emergency assistance right after a major disaster, such as giving grants to victims affected by large-scale fires or floods. These individuals tend to need immediate access to basic necessities irrespective of their financial needs. Private foundations that give grants for longer-term relief assistance should show additional documentation such as the objective criteria used to assess the need and the process by which recipients were selected.

What to look for:	Examples of prohibited activities:	Questions to ask:
<ul style="list-style-type: none"> Relief grants to individuals in the form of funds, goods, or services. Exceptions are allowed if it can be shown that recipients qualify as a charitable class and the grant benefits the community as a whole. 	<ul style="list-style-type: none"> A wildfire destroyed homes and businesses in a local community including relatives of board members of a foundation. The foundation provides grants to only the board members’ relatives to help recover from the wildfire destruction. 	<ul style="list-style-type: none"> Are recipients only people that the board knows? How were the applicants identified? How were the applicant’s needs assessed? Is the grant amount justified by the needs assessed? Are grants given with no strings attached?

8. Grants to Foreign Organizations or Non-Charities

Grants to Foreign Organizations. Not surprisingly, donors are increasingly aware of and invested in global causes and issues. Technology has not only made it easier to access news and events happening across the globe, but it has also helped raise awareness of the charitable needs across borders. Before a private foundation considers giving internationally, it should be aware of the regulations and additional due diligence required for international grants or risk potential penalties.

Grants to Non-Charities. Although we most often think of grants to non-charities as grants to foreign organizations, there are situations where a private foundation may want to make a grant to a U.S. based organization that is not recognized as a public charity. This can include grants to for-profit companies for research or a program-related investment, or even a grant to another private foundation. Similar to making a grant to a foreign organization, private foundations can make grants to non-charities as long as the grant is for charitable purposes and the grantor foundation exercises additional due diligence;

⁴ Employer-controlled private foundations are subject to special considerations for gifts to individuals affected by natural disasters and are not discussed here. In particular, employer-controlled private foundations need to be aware of grants to individuals that could be perceived as private inurement for the employer.

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otherwise, the grant will result in a taxable expenditure.

Private foundations considering a grant to a foreign organization or other non-charity must conduct equivalency determination or expenditure responsibility:

Equivalency Determination (ED)

The IRS requires specific documents to be collected from the foreign organization and that a good faith determination be made via affidavit that the organization is the equivalent of an IRS 501(c)(3) public charity. In addition to getting the appropriate documentation, which can be difficult if there is a language barrier, all documentation and the affidavit must be translated into English. ED can be a very time and resource intensive effort due to the numerous and specific IRS evidence requirements that must be gathered, reviewed, and assessed; therefore, it is recommended to seek a professional with ED experience to avoid potential non-compliance and tax penalties.

An advantage of conducting ED is that the onerous due diligence is primarily conducted once before executing any grants. Once the equivalency determination has been made and documented in good faith, the foreign organization is not required to submit ongoing reports nor does the private foundation have to provide additional information on its annual 990-PF tax return. ED may be a good option for private foundations looking to establish a long-term relationship with a foreign organization or looking to provide multiple grants to the same foreign organization.

Expenditure responsibility (ER)

ER is another option for private foundations wanting to give international grants. With ER, the private foundation assumes full legal responsibility under U.S. tax laws for ensuring that the grant is used for its intended charitable purpose. ER is comprised of several guidelines that must be followed including getting documentation from the foreign organization very similar to the ED process. With ER, the private foundation assumes all responsibility in its assessment of the foreign organization to handle and use the donated funds for the agreed upon charitable purpose.

Once the grant has been received, the foreign organization must submit annual reports that indicate how the grant funds were used in accordance with the grant agreement until all funds are disbursed or the grant is terminated. The private foundation has an important role in reviewing the annual reports and confirming the donated funds are still being used for the agreed upon charitable purpose which must also be reported by the private foundation on the annual 990-PF tax return.

ER may be a more cost-effective or viable option when working with newly formed or smaller foreign organizations that may not be able to provide all the documentation required for ED. However, the private foundation should ensure grantees can comply with the annual reporting requirements associated with ER. Always consult an experienced professional when deciding between the use of ER versus ED.

What to look for:	Examples of Prohibited Activities:	Questions to ask:
<p>A foundation providing grants to foreign organizations (such as a foreign NGO) or any organization not recognized by the IRS as a 501(c)(3) public charity.</p> <p>Equivalency Determination International grants can be made if the foundation first makes a good faith determination that the grantee is the</p>	<ul style="list-style-type: none"> A private foundation provides a grant directly to a foreign organization that supports initiatives to educate young girls in underdeveloped countries. The foreign organization is recognized as a charity overseas and collaborates with well-known NGOs but is not recognized by the IRS as 	<ul style="list-style-type: none"> Is the grant aligned to the foundation’s charitable purpose? Is the grantee capable of carrying out the charitable intent or activity being funded? How was this determined?

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<p>foreign equivalent of a public charity or which consists of:</p> <ul style="list-style-type: none"> • A written opinion of a qualified practitioner that the proposed grantee is a public charity, or • Grantee affidavit and other evidence, affirming and providing supporting factual evidence that the proposed grantee is a public charity <p>Expenditure Responsibility International grants can be made if the foundation assumes full responsibility that funds will be used for charitable purposes and must abide by ER rules:</p> <ul style="list-style-type: none"> • Pre-grant inquiry, to confirm the grantee is capable of performing the charitable activity • Written commitment, specifically stating the charitable activities, requirements, and limitations of the grant • A separate account, established by the grantee for the non-charitable grant money • Regular reports from the grantee of expenditures and progress in fulfilling the grant’s purpose • Full and detailed reporting to the IRS of each non-charity grant 	<p>a 501(c)(3) public charity. The private foundation included the grant as a qualified charitable distribution.</p> <ul style="list-style-type: none"> • A private foundation is soliciting donations to fund a program aimed at alleviating homelessness in the community. A donor in the community gives a donation through his private family foundation. 	<ul style="list-style-type: none"> • Has the grantee provided a written commitment to meet the expenditure responsibility requirements? • Is the grantee agreement signed by an appropriate officer, director, or trustee of the grantee organization? • Has the grantee provided complete reports on how the grant funds were spent and progress? • Has the foundation submitted full and detailed reports to the IRS on the expenditures?
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9. Charitable Solicitation or Fundraising

Many private foundations are funded by one or a few donors and do not actively solicit for donations like public charities. However, private foundations are allowed to raise funds and accept donations – but they must abide by individual state charitable solicitation requirements.

Generally, any active or passive effort to obtain a donation—no matter the type of channel—is considered solicitation. The requirements to register for charitable solicitation differ state by state. To complicate matters further, each state has different processes, fees, and renewal requirements which make multiple state solicitation registrations burdensome and difficult. States also have requirements if foundations use fundraising professionals or have co-venture fundraising efforts.

What to look for:	Examples of prohibited activities:	Questions to ask:
<p>A foundation conducts a fundraising campaign, sends direct mail with a request for a donation, or builds a website</p>	<ul style="list-style-type: none"> • A foundation decides to host a gala event to raise funds for its charitable purpose. The foundation sends invitations to a large number of people 	<ul style="list-style-type: none"> • Is the foundation accepting donations or soliciting for donations locally, statewide, or nationally?

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with a "Donate Now" button.	in the community where ticket sales will be considered a donation to the foundation.	<ul style="list-style-type: none">• Is the foundation registered to solicit for charitable donations in applicable states?• Is the foundation using a professional fundraiser or fundraising firm?
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Contact Us

We are not able to cover every potential area of risk in managing a private foundation in this primer. If you have any questions or concerns regarding the management of your foundation, please contact us.

With over twenty years of charitable expertise and experience managing nonprofits, Sterling is uniquely qualified to assist you in successfully managing your foundation. Visit our website at www.sterlingfoundations.com.

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