Governance of Nonprofit Organizations

Reference Outline

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Information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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I. INTRODUCTION

The broad purpose of this paper is to address the state and federal regulations that affect governance and operations of private foundations and public charities, with special emphasis on those regulations applicable to non-operating private foundations. Serving as an officer or director of a 501(c)(3) tax-exempt organization, or serving as a trustee of a charitable trust, involves inherent risk. As the gatekeepers of charitable funds, governing bodies of nonprofit organizations are held to strict state and federal standards in the conduct of their duties. While a nonprofit enterprise can take many forms (i.e. charitable trust, nonprofit corporation, nonprofit unincorporated association, or limited liability company), this paper focuses largely on the rules applicable to non-profit corporations (the most common organizational form for tax exempt nonprofits) organized and operated in the State of Texas. It should be noted, however, that the basic governance principles, both state and federal, discussed herein apply to managers of other nonprofit entities with certain variations.

More specifically, in light of recent financial scandals uncovered on Wall Street (which affected many nonprofit investors) and the tumultuous economy of the past few years, this paper also highlights the duties that officers and directors of nonprofit organizations (particularly non-operating private foundations) owe when managing and investing the organization's assets. The media attention has exposed numerous nonprofit investors to liability for breach of fiduciary duties ranging from failure to diversify to failure to exercise due diligence. Foundations that failed to diversify (and even those that did) now find themselves faced with a cash crunch as they try to meet their minimum distribution requirement with severely diminished asset values and all the while, donors are keeping their wallets closed in information will be sought by the Internal Revenue Service in the application process.

The corporation may also designate any one or more individuals to be ex-officio members of the Board of Directors. An ex-officio member of the Board of Directors is entitled to notice of all meetings and has the right to attend the meetings, but does not have the right to vote unless he or she is specifically given that right in

fear and uncertainty. There seems to be no relief on the horizon from the IRS. This paper addresses a few of the various scenarios played out on major news networks for the past several months. It also attempts to offer potential solutions to those challenges that have arisen in the boardrooms of Texas nonprofits, as they seek to adapt to a new economic climate while endeavoring to fulfill their charitable purpose.

II. STATE LAW DUTIES

Texas law defines a nonprofit corporation as a corporation whose income may not be distributed to its members, directors, or officers in the form of dividends or otherwise. *See* BOC § 22.001(5). Nonprofit corporations may be member organizations or non-member organizations (a decision largely related to control) but are generally governed by a board of directors with a minimum of three directors. The preceding sentence is conditional because Texas law provides that a nonprofit corporation may be governed by its members though such governance is rare outside of congregationally-led religious organizations. *See* BOC § 22.202. However, nothing in the Business Organizations Code prohibits a single member, member-managed nonprofit corporation.

The Business Organizations Code provides that a corporation may prescribe qualifications in its
governing documents (Articles of Incorporation or Certificate of Formation) that a person must meet in order to serve as a director. A director is not required to be a Texas resident, unless the governing documents provide otherwise. The corporation should establish and set forth in its governing documents the qualifications it desires a person to have to serve as a director, which may include certain educational or professional certifications or work experience. For organizations seeking tax-exempt status, this

the governing documents. If the ex-officio director is not given the right to vote, then neither will he or she have the duties or liabilities that are imposed by law on the other directors. In that event, the ex-officio director holds an honorary position. *See* BOC § 22.210. In other words, a person serving as an "honorary director" or in some sort of advisory capacity carrying no right to vote is not subject to the full panoply of duties identified in this paper. This can be a helpful solution to the need to include additional voices for fundraising or in another advisory capacity. Of course to the extent a person serves as an ex officio member of the board by virtue of being an officer of the corporation, the lack of a vote will not relieve that individual of his fiduciary obligations stemming from his role as officer.

A. Fiduciary Duties

1. Generally

As noted above, despite the difference in choice of form, all decision makers owe certain fiduciary duties to the organizations they serve. A fiduciary duty is simply a duty to act for someone else's benefit, while subordinating one's personal interests to that of the other person. *See* BLACK'S LAW DICTIONARY 625 (6th ed. 1990). Fiduciary duties are grounded in equity and influenced by the fact-specific and context-intensive flexibility of the law of equity. As such, different rules apply depending on the context, i.e. the relationship between the fiduciary and the beneficiary. Fiduciary law, including that applicable to directors and officers, has largely developed at common law with various aspects subsequently codified in the Business Organizations Code. Because the elements of a breach of fiduciary duty claim are (1) the existence of a duty; (2) breach of that duty; and (3) injury to the principal or benefit to the fiduciary, understanding what constitutes a breach is paramount. *See Burrow v. Arce*, 997 S.W.2d 229, 237 (Tex. 1999).

For example, while both trustees and corporate directors and officers owe fiduciary duties as a matter of law, because directors and officers are not trustees, the duties owed by directors differ from those owed by trustees. *See, e.g.*, BOC § 22.223. As such, a practicioner must be careful to distinguish case law based on the form of the entity in question.

Officers and directors of corporations in Texas owe a strict fiduciary obligation to the corporation as a matter of law. *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 576 (Tex. 1963); *Landon v. S&H Marketing Group, Inc.*, 82 S.W.3d 666, 672 (Tex. App.—Eastland 2002, no pet.); *General Dynamics v. Torres*, 915 S.W.2d 45, 49 (Tex. App.—El Paso 1995, writ denied). In the nonprofit context, officers and directors owe fiduciary duties to the corporation they serve and to the public in charity. While the same person may owe similar duties to other organizations (consider an individual who serves on the board of both a grantor and a grantee), when making decisions on as a director or officer, the person owes allegiance to the corporation being served. Of course this may at time present a conflict which will be discussed below.

Corporate fiduciaries stand in the unique position of being the keeper of the organization's assets and the guardian of the organization's mission. This unique role plays itself out in the duties of care, loyalty and obedience. Whereas directors are charged largely with making strategic decisions, evaluating, reviewing, overseeing and approving, officers are charged with implementing the decisions and policies established by the board. Nevertheless, the three primary duties remain the duty of care, duty of loyalty, and duty of obedience.

2. Duty of Care

a. Generally

Nonprofit managers are subject to the fiduciary duty of care. The duty of care most simplified is a duty to stay informed and exercise ordinary care and prudence in management of the organization. *See Holloway*, 368 S.W.2d at 576.

With respect to nonprofit corporate directors and officers, the duty of care under Texas law mandates that the decision maker act (1) in good faith, (2) with ordinary care, and (3) in a manner he or she reasonably believes to be in the best interest of the corporation. *See* BOC § 22.221(a).

(1) Good faith

Texas law does not define "good faith" in the context of fiduciaries. Broadly, the term describes "that state of mind denoting honesty of purpose, freedom from intention to defraud, and, generally speaking, means being faithful to one's duty or obligation." BLACK'S LAW DICTIONARY 693 (6th ed. 1990). In claims for legal malpractice, for example, "good faith" is a defense wherein the attorney can demonstrate that he made a decision that a reasonably prudent attorney could have made in the same or similar circumstances. *See Cosgrove v. Grimes*, 774 S.W.2d 662, 665 (Tex. 1989). Thus, at least in the context of legal malpractice (which bears many similarities to breach of fiduciary duty), good faith is measured objectively based on objective facts. "Good faith" can be contrasted with "bad faith". One court has stated that a fiduciary acts in bad faith when the fiduciary acts out of a motive of self-gain. *See Bohatch v. Butler & Binion*, 905 S.W.2d 597, 602 (Tex. App.—Houston [14th Dist.] 1995) *aff'd* 977 S.W.2d 543 (Tex. 1998). While this is helpful, it also tends to blur the lines between the duty of care and the duty of loyalty, a common feature of case law in this area.
concerning the corporation or another person that was prepared or presented by officers, employees, a committee of the board of which

(2) Ordinary care

"Ordinary care" requires the director to exercise the degree of care that a person of ordinary prudence would exercise in the same or similar circumstances. It should be noted that where the director has a special expertise (e.g., accounting expertise, legal expertise, etc.), ordinary care means that degree of care that a person with such expertise would exercise in the same or similar circumstances. A director may delegate decisions (including investment decisions) if she exercises reasonable care, skill, and caution in selecting the agent, establishing the agent's scope, and periodically reviewing the agent's actions to confirm conformance with the terms of the delegation. *See* BOC § 22.224. Put differently, while a director may delegate certain decisions or activities, she cannot delegate her oversight (i.e. governance) responsibility.

To satisfy her duty to use ordinary care, the director should be reasonably informed with respect to the decisions she is required to make. Specifically, the decision maker must understand the purposes of the organization as set forth in the organization's governing documents and make decisions comporting with those purposes and direction. Furthermore, the decision maker should be familiar with management of the organization, policies of the organization, and any financial data relevant to the decisions she is making. Such familiarity and knowledge requires that the director attend board meetings and actively seek the information necessary to make an informed and independent decision regarding which course of action is in the corporation's best interest. A director should be careful to personally weigh the benefits and detriments of the course of action to the corporation rather than simply voting with the majority.

In discharging the duty of care, a director may rely in good faith on information, opinions, reports, or statements, including financial statements or other financial data,
the director is not a member, or in the case of religious corporations, (1) a religious authority; or (2) a minister, priest, rabbi, or other person

whose position or duties in the corporation the director believes justify reliance and confidence and whom the director believes to be reliable and competent in the matters presented. *See* BOC § 3.102; BOC § 22.222 (the Business Organizations Code has split this provision into two separate sections with one section being generally applicable to all filing entities and one section being only applicable in the case of religious corporations). While a director may rely on the counsel of advisers, the director must nevertheless exercise her own independent judgment in making decisions as to what is in the corporation's best interests. As an aside, professionals serving as decision makers such as attorneys and CPAs should note that the ability to rely in good faith on others as referenced above will not apply where the professional/decision maker is the source of the information, opinion, report or statement.

(3) Best interest of the corporation

Finally, decision makers must make decisions they reasonably believe to be in the best interest of the organization. *See* BOC § 22.221. Reasonableness is based on the objective facts available to the decision maker. Determining whether a proposed action is in the best interest of the corporation requires weighing of many factors including the short-term interests, the long-term interests, the costs, the benefits, etc.

b. Business Judgment Rule

Texas law provides that decision makers of nonprofit corporations are not insurers and thus are not liable so long as those persons exercise their business judgment in making decisions on behalf of the organization. *See, e.g., Campbell v. Walker*, 2000 WL 19143 at * 10,11 (Tex. App.—Houston [14th Dist.] 2000, no writ) (citing *Cates v. Sparkman*, 11 S.W. 846, 849 (Tex. 1889); *Cleaver v. Cleaver*, 935 S.W.2d 491, 495-96 (Tex. App.—Tyler 1996, no writ). The parameters of the business judgment rule in Texas are not well-defined. The Business Organizations Code each provide that a decision maker will not be liable for errors or mistakes in judgment if the decision maker acted in good faith with reasonable skill and prudence in a manner the decision maker reasonably believed to be in the best interest of the corporation. *See* BOC § 22.221(a). Clearly this is merely a restatement of the duty of care. In addressing issues of a director's standard of care, negligent mismanagement of a business enterprise and the exercise of business judgment, case law provides that Texas courts will not impose liability upon a noninterested director absent a challenged action being ultra vires, tainted by fraud or grossly negligent. *See Gearhart Industries, Inc. v. Smith Int'l, Inc.*, 741 F.2d 707, 721 (5th Cir. 1984) (discussing and applying Texas law).

The business judgment rule rests on the concept that to allow a corporation to function effectively, "those having managerial responsibility must have the freedom to make in good faith the many necessary decisions quickly and finally without the impairment of facing liability for an honest error in judgment." *See* MARILYN E. PHELAN & ROBERT J. DESIDERIO, NONPROFIT ORGANIZATIONS LAW AND POLICY 109 (2003) (citing *Financial Industrial Fund, Inc. v. McDonnell Douglas Corp.*, 474 F.2d 514 (10th Cir. 1973). Because trusts are generally not operating entities in the sense of carrying on their own programs, the concept does not have the same relevance. *See, e.g., Stern v. Lucy Webb Hayes Nat'l School for Deaconesses and Missionaries*, 381 F. Supp. 1003, 1013 (D. D.C. 1974). While this reasoning may be faulty as trusts may, in fact, carry on their own programs, because the law imposes a higher standard of care on trustees, the business judgment rule does not apply to trustees of charitable trusts. While some have argued that directors of charitable nonprofit corporations should be held to the higher standard of trustees in that a charitable corporation is defined as a charitable trust under Texas law (*see* Chapter 123 of the Texas Property Code), the BOC makes clear that directors of nonprofit corporations are not trustees. *See, e.g.*, BOC § 22.223.

c. Development of a Gift Acceptance Policy

An example of discharging the duty of care (as well as the duty of loyalty which will be

discussed below) can be seen in the decision to develop a gift acceptance policy and the carrying out of such a policy. For nonprofit organizations engaging in fundraising, directors should develop and periodically review the corporation's gift acceptance policy. The corporation should exercise due diligence in establishing a relationship with potential donors to determine and evaluate the donor's motives for making a gift.

The corporation's staff and board members should not benefit personally from fees related to gifts received and should not participate in any activity which could be deemed a conflict of interest (both of which would implicate the duty of loyalty discussed below as well as potentially constituting prohibited conduct under the Internal Revenue Code and Treasury Regulations). Further, the corporation's staff and board members should not pay a finder's fee or other type of private benefit to anyone as a result of such person's involvement in acquiring gifts for the corporation. The corporation may consider advising all prospective donors to seek their own counsel in any and all aspects of their proposed gift and that if necessary, the corporation should assist donor to secure counsel. No gifts should be accepted that would be contrary to the corporation's gift acceptance policy.

The corporation's board should carefully consider which types of gift vehicles, if any, that it is willing to offer, which may include gifts via will or trust, charitable remainder trust, charitable gift annuity, charitable lead trust, remainder interest in home or farm, and outright lifetime gift. The board should consider what types of property it is willing to accept, which may include cash, securities, life insurance, individual retirement accounts or other retirement benefits, artwork, intangible property, various types of personal property, and real estate. The board should also determine whether or not it will accept restricted gifts. Additionally, the board should carefully consider and establish a policy for the acceptance of real estate and whether the acceptance of gifts of real estate will be conditioned upon an inspection and environmental evaluation.

Each of these decisions is significant in discharging the duty of care. Equally significant is the decision as to whether certain gifts will promote or hinder the corporation's mission. Does the gift have conditions that unacceptably tie up use of the property? Does acceptance of the gift create negative publicity for the organization? Each decision must be carefully weighed against the best interest of the corporation as a whole.

d. Checklist

Decision makers of nonprofit corporations that engage in ongoing operations should understand that their duty of care goes beyond financial or business decisions to reach all decisions made in the course and scope of their duties as directors.

The following checklist is provided to aid decision makers in satisfying the duty of care.

- All decision makers should know the following:
  - Legal form of the organization
  - Mission of the organization
  - Provisions of Articles of Incorporation/Certificate of Formation
  - Provisions of Bylaws
  - Any policies affecting decision makers (e.g. Conflict of Interest Policy)
  - Financial Picture (budget and financials)
  - Most recent 990
  - Existence/operations of related entities
  - Where the organization is conducting activities
  - Tax status and applicable legal requirements of the organization
  - Activities being conducted by the organization
  - Management structure
  - Key employees
  - Committee Structure
  - How directors and officers are selected

- A director should seek to do the following:
  - Familiarize herself with material aspects of the organization
  - Faithfully attend meetings
  - Read materials and prepare for meetings
  - Ask questions before, during and after meetings
  - Exercise independent judgment
  - Rely on appropriate sources of information
  - Review minutes of the board
  - Seek to stay informed as to legal obligations and good governance
  - With other members of the Board, develop schedules for review and approval of the strategic direction of the organization, executive compensation, legal compliance, and budget
  - Keep the following information accessible in a Board Book/Director's Notebook:

    - Articles of Incorporation/Certificate of Formation
    - Bylaws
    - Conflict of Interest Policy
    - Minutes for the previous year
    - Most recent audit/review
    - Budget and most recent financials

3. Duty of Loyalty

The second significant fiduciary duty owed by decision makers of nonprofit organizations under Texas law is the duty of loyalty. The duty of loyalty requires that the decision maker act for the benefit of the organization and not for her personal benefit, i.e. the duty of loyalty requires undivided loyalty to the organization. *See Landon*, 82 S.W.3d at 672.

As with the duty of care, corporate decision makers are subject to a less exacting application of the duty of loyalty in comparison to a trustee. For example, not all interested transactions are prohibited as will be discussed below. To satisfy her duty of loyalty, a corporate decision maker must look to the best interest of the organization rather than private gain. As the Texas Supreme Court has stated, the duty of loyalty requires an "extreme measure of candor, unselfishness, and good faith." *See International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567, 577 (Tex. 1963). The director must not usurp corporate opportunities for personal gain, must avoid engaging in interested transactions without board approval, and must maintain the organization's confidential information.

a. Corporate Opportunity

The corporate opportunity doctrine prohibits a corporate director from usurping corporate opportunities for personal gain. *See Holloway*, 368 S.W.2d at 577. Texas law defines such a breach as misappropriating a business opportunity that properly belongs to the corporation. *See Landon*, 82 S.W.3d at 681. An opportunity properly belongs to the corporation where the corporation has a "legitimate interest or expectancy in and the financial resources to take advantage of" the particular opportunity. *Id.* How the fiduciary learns of the opportunity can be an important factor in determining whether the opportunity properly belongs to the corporation. *See Scruggs Mgmt. Svcs., Inc. v. Hanson*, 2006 WL 3438243 (Tex. App.—Fort Worth 2006, no petition).

Where the opportunity properly belongs to the corporation, the fiduciary has an obligation to disclose the opportunity and offer the opportunity to the corporation. *See id.* The director or officer accused of usurping a corporate opportunity can raise three primary defenses (in addition to simply denying the factual basis of the claim): (1) the corporation lacked the financial resources to pursue the opportunity; (2) the corporation abandoned the opportunity; or (3) the opportunity constituted a different line of business than that pursued by the corporation. *See Landon*, 82 S.W.3d at 681. Importantly, the fiduciary bears the burden to show abandonment or lack of financial ability.

b. Interested Transactions

As referenced above, satisfying the duty of loyalty requires the officer or director to act in

good faith and not allow her personal interest to prevail over the interests of the corporation. *See Landon*, 82 S.W.3d at 672; *Torres*, 915 S.W.2d at 49. A common type of violation of the duty of loyalty is the interested director transaction, broadly characterized as a contract between the corporation and a director. An officer or director is "interested" if he or she (a) makes a personal profit from the transaction with the corporation; (2) buys or sells assets of the corporation; (3) transacts business in the officer's or director's capacity with a second corporation of which the officer or director has a significant financial interest; or (4) transacts corporate business in the officer's or director's capacity with a member of his or her family. *See Loy v. Harter*, 128 S.W.3d 397, 407 (Tex. App.—Texarkana 2004, pet. denied). Interested transactions between corporate fiduciaries and their corporations are presumed to be unfair on the part of the officer or director, fraudulent on the corporation and are thus generally voidable. *See Torres*, 915 S.W.2d at 49.

Texas law provides a safe harbor of sorts for interested transactions. Where the material facts are disclosed and a majority of the disinterested directors, in good faith and the exercise of ordinary care, authorize the transaction, the transaction is not void or voidable solely because of the director's interest or the director's participation in the meeting at which the transaction is voted on. *See* BOC § 22.230. Further, such a transaction will not be void or voidable if it is fair to the corporation when it is authorized, approved or ratified by the board. *See id.* However, a transaction from which a corporate fiduciary derives personal profit is "subject to the closest examination and the form of the transaction will give way to the substance of what actually has been brought about." *See Holloway*, 368 S.W.2d at 577. Significantly, if there has been no approval after full disclosure, the transaction is presumed unfair and the director bears the burden to show fairness. *See id.* Factors considered in evaluating the fairness of a transaction include "whether the fiduciary made a full disclosure, whether the consideration (if any) is adequate, and whether the beneficiary had the benefit of independent advice." *Miller v. Miller*, 700 S.W.2d 941, 947 (Tex. App.—Dallas 1985, writ ref'd n.r.e.). Of course there may be instances in which there can be no disinterested vote as in a situation with a family foundation and an all family board. In such situations it is advisable to document disclosure of the conflict, careful consideration of the transaction, and the methodology used to determine that the transaction would be fair to the corporation.

Because it is imperative that in the event an issue arises in which a decision maker has a personal interest the decision maker disclose the interest related to the decision being made and abstain from any vote, it is prudent for the organization, and beneficial to the decision makers, for the organization to adopt a conflict of interest policy requiring disclosure of material facts related to actions between the decision maker and the organization and abstention from voting by the interested decision makers. It is important to note that neither state law nor the Code require a nonprofit corporation exempt as a public charity under § 501(c)(3) to have a conflict of interest policy (with the exception of health care organizations). With that said, the Service is pushing organizations to adopt such policies and includes a question on Form 1023 as well as Form 990 inquiring whether an organization has adopted such a policy. Additionally, the Service has provided a suggested conflict of interest policy for charitable entities. Industry groups such as The Panel on the Nonprofit Sector convened by the Independent Sector suggest adoption of a conflict of interest policy as well. With the heightened scrutiny on governance practices of all corporations, including nonprofit corporations, wisdom dictates at least carefully considering the formal adoption of a conflict of interest policy.

If an organization chooses to adopt a policy, the policy should consider the following:

1. Identification of the class of individuals covered by the policy;

2. Definition of "actual" and "potential" conflicts of interest;

3. Articulation of the duty of disclosure of officers and directors;

4. Appropriate "trigger" mechanisms to help identify potential conflicts;

5. Annual, episodic disclosure obligations of individuals covered by the policy;

6. Written conflicts disclosure questionnaires;

7. A process for review of disclosed potential conflicts by a committee of disinterested directors with outside counsel's input;

8. The applicability of the corporate opportunity doctrine to the board;

9. Disclosure obligations regarding outside board service of officers and directors; and

10. Disclosure obligations regarding outside business activities of senior executive leadership.

As one commentator has described it, "[t]he key features that appear in most conflicts of interest policies can be reduced to a few simple (and alliterative) ideas: disclose, discuss, decide (by disinterested directors whenever possible) and document." Jane C. Nober, Conflicts of Interest, Part IV, Foundation News & Commentary, Jan/Feb 2005 Vol. 46, No. 1.

Certain interested transactions between directors and the nonprofit corporations which they serve are strictly prohibited under Texas law. For example, loans to directors are not allowed. *See* BOC § 22.225. Further, directors who vote for or assent to the making of such loans in violation of the statutory prohibition are jointly and severally liable to the corporation for the amount of such loan until the loan is fully repaid. *See id.*

c. Confidentiality

Finally, the duty of loyalty requires a decision maker to maintain confidentiality and therefore prohibits disclosure of information about the corporation's business to any third party, unless the information is public knowledge or the corporation gives permission to disclose it.

While breach of the duty of loyalty gives rise to a tort claim under state law, it may also implicate federal tax law as such breach often results in private inurement and may also constitute self-dealing or an excess benefit transaction, concepts which will be discussed more fully below.

4. Duty of Obedience

Along with the duties of care and loyalty, decision makers of nonprofit organizations owe the additional duty of obedience, the duty to remain faithful to and pursue the goals of the organization and avoid *ultra vires* acts. *See Gearhart*, 741 F.2d at 719. In practice, the duty of obedience requires the decision maker to follow the governing documents of the organization, laws applicable to the organization, and restrictions imposed by donors and ensure that the organization seeks to satisfy all reporting and regulatory requirements. The duty of obedience thus requires that directors see that the corporation's purposes are adhered to and that charitable assets are not diverted to non-charitable uses. It should be noted that "Texas courts have refused to impose personal liability on corporate directors for illegal or *ultra vires* acts of corporate agents unless the directors either participated in the act or had actual knowledge of the act." *Resolution Trust Corp. v. Norris*, 830 F.Supp. 351, 357 (S.D. Tex. 1993).

The duty of obedience is somewhat unique to the nonprofit context and particularly tax-exempt organizations. Because tax exemption rests in the first part on being organized for an appropriate tax-exempt purpose (be it charitable or social), these organizations more specifically identify their purposes in their governing documents compared to a for profit business which may be organized to conduct all lawful operations of whatever kind or nature. One court has noted the distinction stating that "[u]nlike business corporations, whose ultimate objective is to make money, nonprofit

corporations are defined by their specific objectives: perpetuation of particular activities are central to the raison d'etre of the organization." *Manhattan Eye, Ear & Throat Hosp. v. Spitzer*, 715 N.Y.S.2d 575, 595 (Sup. Ct. 1999). With the additional level of specificity as to purpose, the decision maker faces a more defined realm of permissible actions. That realm can be even more narrowly defined when funds are raised for specific purposes.

Because the duty of obedience requires pursuit of the mission of the organization and protection of charitable assets, it is clearly important to understand the purposes of the organization. In the context of a nonprofit corporation, the purpose is stated in the organization's governing documents (Articles of Incorporation/Certificate of Formation/Bylaws) and may be amplified by other documents such as testamentary documents directing the creation of the organization, the application for exempt status filed with the Internal Revenue Service or solicitations for contributions. Each of these sources should be consulted though the basic statement of purpose in the Articles of Incorporation/Certificate of Formation should be given primacy.

A Texas nonprofit corporation organized for charitable purposes is considered a "charitable entity". *See* TEX. PROP. CODE § 123.001(1)(2). Monies donated to a charitable entity are said to be impressed with a charitable trust for the benefit of the public, meaning the funds have to be used for the organization's stated purposes. *See Blocker v. State*, 718 S.W.2d 409, 415 (Tex. App. – Houston [1st Dist.] 1986, writ ref'd n.r.e.). As noted above, statutory law makes clear directors are themselves not held to the fiduciary standard of a trustee. *See, e.g.*, BOC § 22.223. To say the monies donated to the organization are impressed with a charitable trust for the benefit of the public, then, is simply to say those monies must be used for the organization's purposes thereby implicating a director's duty of obedience.

An important question is whether a future governing board may amend or alter the purposes of the organization to a different charitable purpose. Of course where the corporation has obtained recognition of its tax-exempt status, it has made certain representations to the Internal Revenue Service as to its purposes and operations. Nevertheless, it is possible to inform the Service of a change in purpose and continue operations. The larger question is how such action would implicate the duty of obedience under state law. May the board freely amend where there is no prohibition to same in the governing documents and the corporate form was intentionally chosen to provide latitude to the governing body? Must the approval of the Attorney General be sought? How broadly should the purpose be defined in making the determination of whether a deviation exists? May a board only change the purpose when such purpose has become impossible, illegal or impracticable (i.e. when the doctrine of cy pres would apply)? If the purposes are amended, must the assets of the corporation on hand at the time of the change be restricted to the former purposes absent court or AG approval? As one court has stated "those who give to a home for abandoned animals do not anticipate a future board amending the charity's purpose to become research vivisection" *See Attorney General v. Hahnemann Hospital*, 494 N.E. 2d 1011, 1021 n.18 (Mass. 1986). These questions, though important, remain largely unanswered by Texas case law (or the laws of other states) leaving room for advocacy on both sides. In any event, should a board contemplate deviating from the established purpose in its governing documents, particularly where the organization has been significantly funded with its current purposes, the duty of obedience should be carefully considered.

5. Standing to Bring a Complaint

While decision makers may be exposed to liability under a number of different theories and thereby exposed to claims from a number of different potential claimants, with respect to the fiduciary duties addressed above, standing to complain of wrongful conduct by the fiduciary is narrow.

With respect to nonprofit corporations, the organization (acting through its board of directors) may bring an action against a decision maker based on an alleged breach of the

decision maker's duties. Derivative suits may be brought by a director, member, or potentially an officer as well. Finally, the Office of the Attorney General ("OAG") has standing to bring such an action against the wrongdoing director.

The OAG's standing arises from that office's role as the representative of the public interest in charity. *See* TEX. PROP. CODE § 123.001, et. seq. The OAG is charged to ensure charitable assets are used for appropriate charitable purposes and has broad authority to carry out that duty emanating from the Texas Constitution, common law, and various statutes. Where the OAG brings suit alleging breach of one of the fiduciary duties outlined above, venue is in Travis County. *See* TEX. PROP. CODE § 123.005(a). In the event the OAG is successful in its claims of breach of fiduciary duty, the OAG is entitled to recover from the fiduciary actual costs incurred in bringing the suit and may recover reasonable attorney's fees. *See* TEX. PROP. CODE § 123.005(b).

While the public is the beneficiary of the work of charitable organizations and funds held by charitable organizations are said to be held in trust for the benefit of the public, a member of the public lacks standing on such basis to bring a claim against a decision maker. Rather, the OAG is the proper party to protect the public's interest. In very narrow circumstances, a donor may have standing to enforce the terms of his gift when the organization ignores or violates those terms. *See, e.g., Cornyn v. Fifty-Two Members of the Schoppa Family,* 70 S.W.3d 895 (Tex. App.—Amarillo 2001, no petition). Such standing requires that the donor have a *special interest* in the donated gift. *See id.* (holding donors had a special interest where donation was brain tissue for Alzheimer's research)*; see also* GEORGE G. BOGERT ET AL., THE LAW OF TRUSTS AND TRUSTEES § 411 (Rev. 2d ed. 1991). Generally, however, absent contractual standing created by way of a gift instrument a donor lacks standing to enforce the terms of a completed gift.

Common causes of action against fiduciaries include breach of fiduciary duty, fraud, negligence (though the parameters of this cause of action are narrowed by the business judgment rule), and conversion (along with defalcation and embezzlement). Remedies include removal from the fiduciary position, actual damages, disgorgement of benefits, imposition of a constructive trust, and in certain circumstances, exemplary damages. It should be noted that a decision maker is not responsible for actions taken prior to his/her taking office, unless the decision maker subsequently ratifies the previous action before beginning to serve.

B. Other Bases of Liability

Officers and directors have exposure to liability in other areas as well. Of course to the extent those individuals participate in operational activities of the organization they are exposed to liability in the performance of their duties including liability related to tort claims, employment decisions, defamation claims, etc. Exposure may also arise by virtue of the director making a defamatory statement (for example in providing a reference), agreeing to personally guarantee the debt of the corporation, personally engaging in discrimination or sexual harassment, or otherwise participating in wrongful conduct.

Directors who vote for or assent to distribution of corporate assets other than in payment of debts, when the corporation is insolvent or when such distribution would render the corporation insolvent, or during liquidation without payment and discharge or making adequate provision for payment and discharge for known debts, obligations and liabilities, are jointly and severally liable to the corporation for the value of the distributed assets to the extent that such debts, obligations and liabilities are not thereafter paid or discharged. *See* BOC § 22.226. Exceptions exist where the director relied in good faith and with ordinary care on information provided by appropriate persons such as officers, professional advisers, committees of the board on which the director does not serve, or the attorney for the corporation. *See id.*

In addition, directors and officers can face personal liability in the form of excise taxes for certain prohibited conduct under the Internal

Revenue Code as will be more fully discussed in Part III below.

C. A Note on Governance

The concept of "good governance" has received heightened attention in the past few years in the wake of various corporate scandals in both the for-profit and non-profit worlds. Although a thorough discussion is not permitted by time and length of this paper, the reader may wish to consider recent publications created by the Nonprofit Sector and the Internal Revenue Service. The Panel on the Nonprofit Sector's Advisory Committee on Self-Regulation of the Charitable Sector has developed 29 principles of effective practices for charitable organizations. The 29 principles can be broken into four broad categories: (1) Facilitating Legal Compliance; (2) Effective Governance; (3) Strong Financial Oversight; and (4) Responsible Fundraising. The Committee recommends all charities hold these principles as aspirational goals and that large public charities (those with annual revenues of at least $1M) and large private foundations (those with assets of at least $25M) implement the principles. It should be noted that despite the number of charities signing on to these principles, others reject full-scale adoption as a one-size fits all approach in a diverse field (see, for example, materials from the Philanthropy Roundtable). Although governance is largely based on state law, recognizing the interplay with federal law in the charitable sector, the IRS in 2007 released its Good Governance Practices for 501(c)(3) Organizations including nine draft recommendations to promote good governance. Recommendations 3 and 4 directly deal with the duty of care and duty of loyalty. While governance deals with much more than the duties of directors and officers, the concepts do intersect. Good governance can protect against liability. Practices such as having an audit committee, a code of ethics, and a conflict of interest policy are all aspects of good governance and each contributes to liability protection for board members. Investment policies are considered absolutely essential in light of recent investment fund scandals. The revised Form 990 reveals the importance the IRS places on whistleblower policies and document retention and destruction policies. Governance has evolved from regular meetings and recordkeeping into much more of a corporate practice, with corporate policies and procedures.

III. FEDERAL LAW: TYPES OF CHARITABLE ORGANIZATIONS

A. Foundations in General

The word "foundation" can be deceptive, as it may refer to any number of nonprofit organization types. I.R.C. § 509(a) defines a private foundation as any domestic or foreign organization described in I.R.C. § 501(c)(3) other than the following types of public charities:

1. Organizations that are, by definition or by activity, public charities I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i)-(v) ("traditional" public charities);

2. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. §509(a)(1); I.R.C. §170(b)(1)(A)(vi) ("publicly supported charities")

3. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(2) ("gross receipts" or "service provider" publicly supported charities);

4. Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations, I.R.C. § 509(a)(3) (Supporting Organizations); and;

5. Organizations organized and operated exclusively to test for public safety, I.R.C. § 509(a)(4) (beyond the scope of this outline).

In other words, an I.R.C. §501(c)(3) organization is presumed to be a private foundation unless it demonstrates that it fits one of the exceptions listed above. This outline

does not address public charities that are public charities by virtue of definition or by activities, referred to in 1. above as "traditional" public charities (see §170(b)(1)(A)(i)-(v)).

B. Private Nonoperating Foundation

The most common type of private foundation is the nonoperating foundation. It does not directly perform any charitable programs or services. It generally receives its funding from one primary source, such as an individual, a family or a corporation. It does not generally actively raise funds or seek grants. It is required to distribute approximately 5% of its assets annually to public charities. Donors' charitable income tax deductions are more limited than when made to a public charity.

C. Private Operating Foundation

The operating foundation has a stated charitable purpose and carries out its own programs. It generally seeks grants rather than awarding grants to other charitable organizations. The operating foundation must expend substantially all of its net investment income directly for the purposes of its own charitable activities. Although donors receive the more liberal public charity income tax deduction limitations, this type of foundation remains subject to the private foundation restrictions because its source of funding is generally from one individual, family or corporation.

D. Publicly Supported Organizations

1. I.R.C. §509(a)(1) Publicly Supported Organizations

Another type of organization is the publicly supported charity described in I.R.C. §509(a)(1) and I.R.C. §170(b)(1)(A)(vi), sometimes referred to as a "donative" publicly supported charity, because it does not typically provide services (as compared to §509(a)(2) organizations). It is not a private foundation; rather it is taxed as a public charity. It must meet a public support test and generally must demonstrate that it is organized to attract contributions from a broad range of donors.

2. I.R.C. §509(a)(2) Publicly Supported Organizations:

Another type of organization is the gross receipts, or publicly supported charity, which is described in I.R.C. §509(a)(2). It is not a private foundation; rather it is taxed as a public charity. It is generally established to attract contributions from a broad range of donors and must meet a public support test.

E. Community Foundation

Another type of foundation is the community foundation, which is described in I.R.C. §170(b)(1)(A)(vi). It is not a private foundation; rather it is taxed as a public charity. It does not perform any charitable programs or services. It is generally established to attract large contributions of capital or endowment for the benefit of a particular community or area. Its attractiveness is enhanced by the donor's ability to benefit multiple charities through the donor's gift to a single community foundation.

F. Supporting Organization

Another type of organization is the supporting organization, which is described in I.R.C. §509(a)(3). It is not a private foundation, but is a sub-category of public charity and is really only indirectly public, meaning that the public that monitors this organization's operations does so through an intervening public

charity. That intervening public charity is the entity to which the supporting organization must answer regarding organization and operation. Because of its "public charity" nature, its attractiveness to potential donors is enhanced because donations are allowed the more favorable tax deduction limitation of those made to public charity. However, a donor seeking control is not as likely to favor this organization as the choice for his or her donation because the organization cannot be controlled by the donor, the donor's family or other "disqualified persons" defined later in this outline. The Pension Protection Act of 2006 directs the Secretary of the Treasury to implement a study on the organization and operation of supporting organizations. The study must consider whether the income, gift and estate tax deductions for charitable contributions to supporting organizations are appropriate, considering the use of contributed assets and uses benefiting donors (or persons related to donors).

G. General Considerations

If a donor desires to have control of the organization's distributions and is not concerned about the reduced income tax percentage deduction limitations applicable to private foundations, the donor should consider classification as a private foundation. If an organization intends to have many sources of funding and have fundraising activities, it should consider classification as a public charity. If the organization intends to support a limited number of existing public charities, it should consider classification as a supporting organization. If a donor does not want the administrative burden of operating a private foundation, but would rather recommend grants from an endowment the donor has funded, the donor should consider creating a donor advised fund through a community foundation.

IV. TAX DEDUCTIBILITY OF CONTRIBUTIONS

A. Tax Treatment by Donors of Contributions:

1. Gifts of Cash and Non-Appreciated Property

Income tax deduction is limited to an amount equal to thirty percent (30%) of the donor's adjusted gross income in the taxable year (as opposed to 50% for gifts of cash and other non-appreciated property to public charities and to other foundations which qualify as public charities). Any excess can be carried forward for the next five years. However, the deduction may be zero if the donor has contributed capital gain property to public charities in excess of the 30% deduction limitation. Corporate contributions are limited to 10% of taxable income with a five year carry forward of excess contributions. See IRC § 170(b)(2) and § 170(d)(2)(A).

2. Gifts of Appreciated Property

Income tax deduction is limited to twenty percent (20%) of donor's adjusted gross income on gifts of appreciated property (as opposed to 30% for gifts of appreciated property to public charity.) Additionally, gifts of appreciated assets are limited to a deduction of only the donor's basis in the asset, unless the asset is publicly traded stock. Any excess can be carried forward for the next five years.

3. Deduction for gifts to certain Private Foundations - Pass Through Foundations

If a foundation meets the criteria of I.R.C. §170(b)(1)(A)(vii) and §170(b)(1)(E)(ii), the donor may receive a deduction as if the gift was made to a public charity (i.e. limited to 50% of the donor's adjusted gross income for gifts of cash and other non-appreciated property and 30% of the donor's adjusted gross income for gifts of appreciated property to a public charity) . Pass through foundations are described as any other foundation (as defined in section 509(a)), which makes qualifying distributions in an amount equal to 100% of the foundation's

contributions for the year, before the 15th day of the third month following the close of the foundation's taxable year. To substantiate the deduction, the taxpayer must obtain adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions. I.R.C. § 170(b)(1)(A)(vii) and §170(b)(1)(E)(ii). These types of distributions may be attractive to a founder who would be willing to make the required distributions from the foundation during his or her life in order to receive the 50% deduction, further funding the foundation with an endowment at his or her death.

B. Itemized Deduction Limitation

Subject to the limitations above, a donor's federal income tax deduction for a gift to a qualified charity (whether public charity or a private foundation) in any year is reduced by the lesser of 80% of the donor's itemized deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 1% of the amount by which the donor's adjusted gross income for that year exceeds that year's adjusted gross income threshold amount (2008 -$159,950 ($79,975 if married filing separately). Rev.Proc. 2007-66). Under the Economic Growth and Tax Relief Reconciliation Act of 2001, the 1% limitation applies for years 2008 and 2009. In year 2010 there is no limitation, but in year 2011, the Act sunsets, and the limit returns to the original 3%.

V. FEDERAL STANDARDS APPLICABLE TO NON-OPERATING PRIVATE FOUNDATIONS

A. Private Inurement Doctrine

1. Application

The private inurement doctrine applies to private foundations (and public charities). Implicit in the requirement that the organization be operated for an exempt purpose is the requirement that it not be operated for private benefit. Within the larger concept of the prohibition on private benefit is the private inurement doctrine, of particular import to the subject of federal standards of care for decision makers.

2. Definition

Included in the definition of an organization exempt under § 501(c)(3) is the requirement that no part of the net earnings of the organization inure to the benefit of any private shareholder or individual. This language constitutes an **absolute prohibition** on allowing the assets of the organization to be used for the benefit of a person having a personal and private interest in the affairs of the organization along with the ability to control the affairs of the organization.

3. Result

Private inurement can result in the revocation of tax-exempt status of private foundations.

B. Excise Taxes and Prohibited Transactions

Private foundations are organizations qualifying for exempt status under § 501(c)(3) other than traditional public charities, publicly supported public charities, supporting organizations, and public safety testing organizations. Sections 4940-4945 of the Code provide for excise taxes related to certain required actions and prohibited transactions. Included among the excise tax scheme are taxes against decision makers referred to as foundation managers. Foundations and in some cases, foundation managers are subject to imposition of excise taxes related to acts of self-dealing (§ 4941), excess business holdings (§4943) jeopardizing investments (§ 4944), and taxable expenditures (§ 4945). Foundations are also subject to an annual excise tax on net investment income (§4940).

C. Net Investment Excise Tax

The private foundation must pay an annual excise tax equal to 2% of the foundation's "net investment income." The net investment income equals gross income (interest, dividends, rents, royalties and realized capital gains), minus all

ordinary and necessary expenses paid or incurred for the production or collection of such income. It includes the gain on the sale of appreciated property because the foundation receives a carry-over basis from the donor. However, if the assets are gifted upon the death of a donor, the assets receive a step-up in basis as to the date of the donor's death. The ordinary and necessary expenses paid or incurred for the production and collection of such income and which are not subject to the excise tax include: brokerage fees, investment management fees and director fees applicable to managing the investments. This excise tax is reported on the foundation's annual Form 990-PF. These excise taxes must be paid on a quarterly estimated basis. The first quarterly payment being due 4 and ½ months after the beginning of the tax year (May 15 for calendar year filers), even though the tax return is not due to be filed until 4 and ½ months after the end of the tax year. I.R.C. § 6655.

1. Penalties

Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

2. Reduction of Excise Tax

The excise tax may be reduced from 2% to 1% provided that the foundation meets a "maintenance of effort" test. To meet such test, the foundation's total qualifying distributions that are paid out during the tax year must equal or exceed the sum of the following two calculations:

a. 5 Year Average Payout Times Current Year Assets

The foundation must calculate what its average payout percentage has been over the 5 years immediately preceding the year for which the return is being filed. If the foundation has been in existence for less than 5 years, then the calculation is based upon the number of years the foundation has been in existence. A newly organized foundation is not allowed the reduction in its first year of existence. The payout percentage is the amount of qualifying distributions for the year divided by the amount of noncharitable use assets for the year. In short, the percentage is determined by dividing the dollar value of the endowment into the amount of dollars that qualified in meeting the payout for that year. After the 5 year average payout is determined, this percentage is multiplied by the value of the net noncharitable use assets (or endowment) for the tax year for which the return is being filed, plus:

b. Tax Savings or 1% of Net Investment Income

After a final figure is calculated for the 5 year average payout described above, it must be added to 1% of the net investment income.

c. In summary, the foundation must demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the 5-year average payout times current years assets, plus (b) 1% of net investment income. If this test is met, the applicable tax is reduced to 1%.

3. Application in Estate Administration

Under Treas. Reg. § 53.4940-1(d)(2), a distribution from an estate does not retain its character for purposes of I.R.C. § 4940 when received by the distributee foundation. Thus, investment income earned by an estate will be treated as a contribution when received by the foundation beneficiary. See Rev. Rul. 80-118, 1980-1 C.B. 254, which provides that interest income on a bond not reported by an estate is taxable to the private foundation under I.R.C. § 4940.

D. Prohibition Against Self-Dealing

1. Self-dealing includes any direct or indirect:

a. sale or exchange or leasing of property between the private foundation and a Disqualified Person;

b. lending of money or extension of credit between a private foundation and a Disqualified Person;

c. furnishing of goods, services, or facilities between a private foundation and a Disqualified Person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the Disqualified Person, Treas. Reg. § 53.4941(d)(3)(b)(1);

d. payment of compensation (or payment or reimbursement of expenses) by a private foundation to a Disqualified Person, unless compensation is payment for personal services (narrowly defined by the Service), is reasonable, necessary and not excessive Treas. Reg. § 53.4941(d)(3)(c)(1);

e. transfer to, or use by or for the benefit of, a Disqualified Person of the income or assets of a private foundation; and,

f. agreement by a private foundation to make any payment of money or other property to a government official [as defined in I.R.C. § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. I.R.C. § 4941(d).

2. Disqualified Person

Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under I.R.C. § 4941(d) by certain Disqualified Persons of the foundation I.R.C. § 4946 defines the term "Disqualified Person." A Disqualified Person, with respect to a private foundation, is:

a. A substantial contributor to the foundation. Substantial contributor is defined in I.R.C. § 507(d)(2) as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution. Substantial contributor also includes:

(1) A family member of a substantial contributor (spouse, descendants and spouses of descendants), or any other person who would be a Disqualified Person by reason of his relationship to such person.

(2) Persons owning more than 20% of an entity which is a substantial contributor to the foundation. I.R.C. § 4946(a)(1)(C),

(3) Where the substantial contributor is a corporation, the term also includes any officer or director of such corporation.

b. A foundation manager,

c. A member of the family of anyone described in (a) or (b) above, and

d. A corporation in which persons described in (a),(b), and (c) above own more than 35% of the total combined voting power (more than 35% of profit interest of a partnership or more than 35% of beneficial interest of a trust)

3. Reimbursement for Expenses

Reimbursement to a director (Disqualified Person) for travel expenses causes the foundation and the director (i.e. a foundation manager) to be potentially liable for penalty taxes for self-dealing, for making noncharitable expenditures, or possibly both. (Additionally, a foundation can lose its exempt status if any of its net earnings inure to the benefit of a private person.)

a. Reasonable and Necessary.

Such reimbursement of expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the foundation and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is "reasonable and necessary." Treas. Reg. § 53.3941(d)-3(c)(1).

b. Business Expense Deductions.

Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. 1.162-2(a).

c. Not Excessive.

The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is "excessive." Under Treas. Reg. § 1.162-7, an amount spent on director's services will not be deemed "excessive" if it is only such as would be paid "for like services by like enterprises under like circumstances." Treas. Reg. 1.162-7 (i.e. as the organization would pay to someone independent of the foundation).

d. Cash Advances.

Additionally, a director cannot receive a cash advance for expenses in excess of $500 unless extraordinary expenses are included. Treas. Reg. 53.4941(d)-3(c)(1). Upon receipt of such a cash advance, the director must then account to the foundation under a periodic reimbursement program for actual expenses incurred. If this is done, then the cash advance, additional replenishment of the advance upon receipt of supporting vouchers, or the temporary addition to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of the assignment will be not considered to violate any act of self-dealing. Only a director or employee is entitled to a cash advance. Treas. Reg. 53.4941(d)-3(c).

4. Compensation

a. General Prohibition.

If a foundation pays compensation, including payment or reimbursement of expenses, to a disqualified person, generally such payment constitutes self-dealing. I.R.C. § 4941(d)(1)(D); Treas. Reg. 53.4941(d)-2(e). However, there are exceptions to this general rule.

b. Exception for Personal Services Reasonable and Necessary.

The payment of compensation by a private foundation to a disqualified person for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the private foundation shall not be an act of self-dealing if such compensation (or payment or reimbursement) is not excessive.

(1) Personal services includes services of a broker serving as agent for the private foundation, but not the services of a dealer who buys from the private foundation as principal and resells to third parties

(2) The test for whether compensation is excessive is the same test for whether a business expense is excessive under Treas. Reg. § 1.162-7. This requires the organization to obtain comparable data for compensation for the particular services.

c. The exception for payment of compensation for the performance of personal services which are reasonable and necessary to carry out the exempt purpose of the foundation shall apply regardless of whether the person receiving compensation is an individual.

5. Penalties: Excise Tax on Self-Dealing Transactions

a. Initial Penalty: Disqualified Person.

Any Disqualified Person who engages in an act of self-dealing is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected.

b. Initial Penalty: Foundation Managers.

Additionally, a foundation manager who willingly participates in the act knowing it is prohibited is subject to a tax of 5% of the amount involved (not to exceed $20,000 for

each such act) for each year that the transaction is uncorrected.

c. Additional Penalty: Disqualified Person.

If the transaction is not timely corrected and the 10% initially assessed was not timely paid, the Disqualified Person is subject to being assessed an additional tax of 200% of the amount involved.

d. Additional Penalty: Foundation Manager.

Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to $20,000 for each such act.)

e. Joint and Several Liability.

If more than one foundation manager is liable under this section, such persons are jointly and severally liable.

E. Minimum Distribution Requirements (Tax on Failure to Distribute Income)

A private foundation must generally distribute at least 5% of its assets on an annual basis in qualifying distributions. These assets are those not used in furtherance of the exempt purposes of the foundation, such as the building at which the foundation offices, capital equipment and fixtures are located, but are generally cash, stocks, bonds and other investment assets. This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes.

1. Time Period for Distribution

A foundation has 12 months after the close of the taxable year to satisfy the minimum payout requirement for that taxable year. Any foundation can retroactively satisfy last year's payout requirements with the current year's qualifying payment. If a foundation has a shortened first taxable year, then the foundation will have an additional 12 months to complete the prior year's minimum distribution requirement.

2. Qualifying Distributions

Generally, a private foundation's Qualifying Distributions will consist of grants to qualified charitable organizations (I.R.C. § 501(c)(3) organizations). Qualifying distributions also include grants to charities and non-charities for "charitable purposes," costs of all direct charitable activities (such as running a library or art gallery, providing technical assistance to grantees, maintaining a historical site, conducting a conference, etc.), amounts paid to acquire assets used directly in carrying out charitable purposes, set asides, program-related investments and all reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.

a. Grants to individuals.

Since a qualifying distribution may be made to a non-charity, it is possible for a grant to an individual to be a qualifying distribution, subject to the I.R.C. § 4945 restrictions on taxable expenditures for grants to individuals for travel, study or any similar purpose (see discussion below). Accordingly, grants, scholarships or other similar payments to individuals may be qualifying distributions, but only if the foundation maintains some "significant involvement" in the active programs in support of which the grants are made. Treas. Reg. § 53.4942(b)-1(b)(2). "Significant involvement" will be met if: 1) an exempt purpose of the foundation is the relief of poverty or human distress and the grants must be made or awarded without the assistance of an intervening organization or agency, Treas. Reg. § 53.4942(b)-1(b)(2)(ii)(A); or 2) the foundation has developed some specialized skills, expertise or involvement in the area to which the grant pertains and hires a staff to supervise and conduct the foundation's work in this area. The grants are then made to encourage involvement in the area. Treas. Reg. § 53.4942(b)-1(b)(2)(ii)(B). Whether or not a grant is made "directly" for the active conduct of the

foundation's exempt activities will be determined according to the facts and circumstances of the particular case. Treas. Reg. § 53.4942(b)-1(b)(2). If a foundation only selects, screens and investigates applicants for grants or scholarships and the grantees perform their work alone or under the supervision of some other organization, then the grants will not be treated as qualifying distributions; however, the administrative expenses incurred in screening may still be treated as qualifying distributions. Qualifying distributions in excess of the minimum payout may be carried forward for 5 years.

b. Administration Expenses

Administration expenses do not include investment expenses incurred in managing the endowment. Accordingly, investment management fees, brokerage fees, custodial fees, salaries, or board meeting expenses to oversee investments do not count toward meeting the minimum payout requirement. All other administration expenses that are necessary and reasonable can be taken into consideration. Administration expenses that do count toward the payout include salaries, benefits, trustees' fees, professional fees, travel expenses, general overhead, training, publications, office supplies, telephone, rent, preparation of tax returns, defending legal matters, obtaining rulings from the Service, state and federal filing requirements, costs to purchase newspaper ad announcements of the availability of the tax return for public inspection, cost of annual report and year-end audit. The amount of "grant" administrative expenses paid during any taxable year which may be taken into account as qualifying distributions cannot exceed the excess of (i) 65% of the sum of the foundation's net assets for such taxable year over, (ii) the aggregate amount of grant expenses paid during the two preceding taxable years which were taken into account as qualifying distributions. I.R.C. § 4942(g)(4). Furthermore, unreasonable expenditures for administrative expenses, including compensation and consultant fees will be taxable unless the foundation can prove that the expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses was consistent with ordinary business care and prudence. Treas. Reg. 53.4945-6(b)(2). Reasonableness is determined upon a case by case facts and circumstances determination. Treas. Reg. 53.4945-6(b)(2); Rev. Rul. 77-161. Expenses should be able to be validated by the foundation and somehow associated with the exempt purpose of the organization or the payment of the expenses may be construed to be "private inurement" and risk the exempt status of the organization.

c. Set-Asides

Set-asides are funds of the foundation which are applied for to the Internal Revenue Service in advance to set aside over a multiple year period, not exceeding 5 years, for a specific project. Such set-asides are treated as qualifying distributions. If the Internal Revenue Service approves such set-asides, the full amount of the multi-year grant may count toward payout in the first year.

3. Calculating the 5% Distribution Amount

a. 12 Month Average

The foundation first must calculate the 12 month average of its assets, which allows for fluctuation in investment markets. Any reasonable and consistently applied method can be chosen. In a short taxable year, the payout will be determined based upon the average of the numbers in the short year.

b. 1.5% Reduction of 12 Month Average

The 12 month average of the fair market value of the foundation's assets may be reduced by 1.5% of the "cash deemed held for charitable purposes." This takes into account that any foundation needs cash to conduct its ongoing business operations. Accordingly, cash given and held for the endowment is reduced by 1.5%.

c. Calculate 5% of net of (a) & (b)

Multiply the net of (a) & (b) by 5%.

d. Reduce the amount of (c) by taxes

The net figure obtained in (c) above is reduced by taxes paid by the foundation during the year. This is the "distributable amount" that the qualifying distributions must equal each year. Note Pertaining to Estates: Treas. Reg. § 53.4942(a)-2(c)(2)(ii) provides that the asset base for determining the minimum investment return of a private foundation does not include "the assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for federal income tax purposes pursuant to Treas. Reg. § 1.641(b)-3.

Private foundations may no longer count grants or payments to supporting organizations that are directly or indirectly controlled by persons who are disqualified persons of the foundation as part of their qualifying distributions.

4. Excise Tax on Failure to Distribute Income (I.R.C. §4942)

Minimum requirements for distribution of income: The foundation must make qualifying distributions in an amount equal to or greater than 5% of the aggregate fair market value of assets not used directly to carry out the foundation's exempt purposes for each taxable year. A qualifying distribution is one paid to accomplish one or more charitable purposes under I.R.C. § 4942(g). If such amount is not distributed by the close of the following taxable year, the foundation is assessed a penalty of 30% of the difference between the amount actually distributed and the amount which should have been distributed. An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made. I.R.C. § 4942. The penalties apply only to the foundation and not the foundation manager.

F. Excess Business Holdings

To prevent private foundations from having an advantage over other businesses which operate in the taxable income sector, Congress and the Internal Revenue Service have adopted restrictions on a private foundation's ability to engage in certain business activities.

1. Permitted holdings

The foundation may own 20% of the voting stock in a corporation, reduced by the percentage of voting stock held by all Disqualified Persons. If control of the entity can be shown to be held by Non-Disqualified Persons, the foundation and the Disqualified Persons may own 35% of the entity's voting interest. The foundation may hold a non-voting interest, but only if all Disqualified Persons together hold no more than 20% of the voting interest or no more than 35% of the voting interest if effective control is with a Non-Disqualified Person(s). The foundation may own a de minimis 2% of the voting stock or value.

2. 5 year period to dispose

A private foundation has 5 years to dispose of excess business holdings acquired by gift or bequest. The disposal must be to a non-Disqualified Person. Additionally, during the 5 year period, the excess business holdings will be treated as held by a Disqualified Person (rather than by the foundation).

In reducing excess business holdings, the foundation cannot impose on the transferee any material restrictions or conditions that prevent the transferee from freely or effectively using or disposing of the transferred interest (otherwise, the foundation will be treated as the owner of the interest until all restrictions or conditions are eliminated). In PLR 95551033, the IRS concluded that a transfer of stock to a designated fund at a community foundation was not subject to a material restriction. In PLR 8416033, a private foundation proposed to transfer stock to a newly created supporting organization. There were common board members to both the foundation and the supporting organization. Prior to the transfer, the business wanted to obtain from all shareholders (including the foundation) a right of first refusal if the stock were sold. The IRS ruled the right of first

refusal would not be a material restriction because it was imposed by the company on all shareholders, and did not restrict the right of the supporting organization to dispose of the stock freely and effectively.

A private foundation can dispose of excess business holdings by transferring stock to one or more public charities. Certain supporting organizations, however, are subject to excess business holdings restrictions (as are donor advised funds), including non-functionally integrated Type III supporting organizations and Type II supporting organizations if the donor(s) to the supporting organization control the supported organization. For more information on how excess business holdings rules apply to supporting organizations, see James P. Joseph and Andras Kosaras, "Advancing Philanthropic Goals While Divesting Excess Business Holdings", Taxation of Exempts, 3-11 (May/June 2009).

3. Unusual gifts and bequests

A private foundation may be granted an additional 5 year period to dispose of an excess business holding received by an unusually large gift or bequest, or holdings with complex business structures.

4. Business enterprise

The private foundation is not permitted to retain excess business holdings, as defined in I.R.C. §4943(c). For the entity in which an interest is held, to be considered a business holding, must be engaged in a business enterprise. An entity is not engaged in a business enterprise if 95% or more of gross income is from passive activity, I.R.C. § 4943(d)(3), or if the business is a functionally related business (i.e. to the foundation's charitable purpose) defined in I.R.C. § 4942(j)(4). Investment in such assets as passive rental real estate or marketable securities is not a business enterprise.

5. Excise Tax on Excess Business Holdings (I.R.C. §4943)

Restrictions on retention of excess business holdings. The foundation is taxed on its excess business holdings in the amount of 10% of the value of the excess business holding. A penalty of 200% is imposed on the foundation if the initial penalty is assessed and the excess business holding is not timely corrected. I.R.C. § 4943 (b). Although the private foundation has a 5 year time period to dispose of the excess business holding, the disposition of such holding is subject to the restrictions against acts of self-dealing. (See below discussion of Excess Business Holdings).

G. Jeopardizing Investments

A private foundation must not make investments which would jeopardize the carrying out of the exempt purpose as prohibited by I.R.C. § 4944. Although no investment is a per se violation, this rule requires close scrutiny of foundation managers' standard of care. Caution should be exercised in the consideration of speculative investments. This restriction applies to investment actions by the foundation managers and does not apply to assets received by a private foundation by gift or bequest.

1. Jeopardizing Investments

An investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes.

a. In the exercise of the requisite standard of care, the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio. The determination of whether the investment of

a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation's portfolio as a whole.

b. No category of investments shall be treated as a per se violation of section 4944. However, the following are examples of types or methods of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence:

(1) Trading in securities on margin

(2) Trading in commodity futures

(3) investments in working interests in oil and gas wells

(4) the purchase of "puts" and "calls" and "straddles"

(5) the purchase of warrants

(6) selling short

2. Exceptions to Jeopardizing Investments

a. Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation.

b. Section 4944 shall not apply to an investment which is acquired by a private foundation solely as a result of a corporate reorganization within the meaning of section 368(a).

3. Penalties: Excise Tax on Jeopardizing Investments

a. Initial Penalty: Foundation.

If a foundation makes jeopardizing investments, a tax is imposed on the foundation equal to 10% of the amount of the improperly invested assets.

b. Initial Penalty: Foundation Manager.

Additionally, each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed a tax of 10% of the amount of the improper investment (not to exceed $10,000 for each such act).

c. Additional Penalty: Foundation.

If the jeopardizing investment is not disposed of within the taxable period, the foundation is assessed an additional tax of 25% of the amount improperly invested.

d. Additional Penalty: Foundation Manager.

Each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed an additional tax of 10% of the amount of the improper investment (not to exceed $20,000 for each such act) if the jeopardizing investment is not disposed of within the taxable period.

e. Taxable Period.

The taxable period begins on the date of investment and ends the earlier of (i) the date of the mailing of a deficiency; (ii) the date on which the tax is assessed; or (iii) the date on which the investment is removed from jeopardy.

H. Guidance/Rulings from the IRS on jeopardizing investments

1. PLR 200621032

Trust left 1% working interest in oil and gas (usually a "high-scrutiny" type of investment) to private foundation. Private foundation would supply additional funds and capital as requested to participate in certain proposed operations. If the foundation accepted the contribution, it would intend to likewise participate in the proposed operations, and to supply additional capital and pay its proportionate share of costs and expenses, in the same manner as the donor (the trust) and other investors in the project. The projects historically have been highly profitable

(with little relative cost). Under the terms of the operative agreements and contracts, none of the expenses, costs or interest charges associated with exploration and development or the gathering system will be used to offset or encumber the foundation's existing diversified portfolio. The IRS said in this situation the mere receipt of the gift, without more, does not constitute a jeopardizing investment. The IRS cited the following facts in support of its position: that no consideration will be paid to the donor for the gift; the foundation pay elect to pay costs/expenses and may even be obligated to pay them in some circumstances, but that in no event can such costs/expenses become an encumbrance against the current portfolio or other non-project assets of the foundation.

NOTE: An investment received gratuitously is usually an exception to jeopardizing investments. However, sometimes investments require more than just receipt – they must be maintained. This is a situation where the IRS said it would not be jeopardizing to maintain the investment.

2. TAM 200218038

Private Foundation invested a significant amount of its assets in a limited partnership, the assets of which were traded in the futures and forward markets (an investment that warrants close scrutiny according to the IRS).

Private Foundation initially tried to get a ruling that the investment constituted a Program-Related Investment (PRI).

The agent concluded it was not a PRI, and WAS a jeopardizing investment (but that the tax should be abated because Private Foundation relied on legal advice).

The IRS took the position in the ruling that the investment was NOT a jeopardizing investment. The IRS rejected the argument that just because a private foundation may have received a better return with less risk in another investment vehicle, the investment was jeopardizing. It also said that the percentage of assets invested in one investment was not necessarily dispositive.

"Consideration must be given at the time the investment is made and merely because the end result is not as beneficial to the financial interests of a private foundation as another investment might have been is not grounds in itself for finding that a jeopardizing investment was made. Nor should the percent of assets invested in one investment area be a sole consideration."

3. PLR 9723045

Private Foundation had portfolio of US equities, US bonds/cash, international equities, real estate, and alternative investments. Consultants advised to expand asset portfolio to include a variety of alternative investments Private Foundation proposed to increase alternative investments by 10.5%. The amount Private Foundation would invest in each of six alternative investments would not be more than 2%. All of the proposed investments were limited liability investment vehicles. Investment 1 was a fund that invested in high technology partnerships and companies. Investment 2 was a fund that invested in hedge funds. Investment 3 was a fund that invested in the securities of companies that are being restructured or reorganized. Investment 4 was a fund that invested in equity and convertible instruments of companies in (certain geographic region/country). Investment 5 was a fund that acquired, managed and disposed of commercial forests. Investment 6 was a fund that invested in leveraged acquisitions.

IRS says NOT jeopardizing investments. Factors:

- Consulted outside advisors who are experts in portfolio management
- Outside advisors recommended these investments
- Foundation would not incur debt to invest in the alternative investments
- Aggregate amount of the Foundation's total assets invested in all alternative investments would not exceed 30%

- Each individual investment would not comprise more than 2% of the overall portfolio

4. PLR 9237035

Private Foundation's assets consisted of a diversified portfolio of common stock of major corporations. Private Foundation proposed to place 10% of its assets with a general partnership engaged in business as a futures commission merchant (FCM). One director of the Foundation owned 95.5% of the capital and profits interest of the general partnership, while another director owned a 1.5% capital and profits interest. The general partnership would manage the private foundation's investment of funds in commodities. The foundation also indicated the principal purpose of the transaction would be to reduce the risk of the foundation's investment portfolio by diversifying its investments.

The IRS recognized in the ruling that trading in commodity futures is a type or method of investment which will be closely scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence. The IRS recognized that these futures investments are intended to give the foundation's portfolio added diversity, since commodity futures have little or no correlation to the stock market, and this results in less risk for the foundation's overall investment portfolio.

The IRS ruled that the investment of 10% of the assets of the foundation in a managed commodities trading program managed by the partnership would NOT be considered a jeopardizing investment.

5. Thorne v. C.I.R., 99 T.C. 67 (1992)

Trustee of charitable trust transferred over $500k to Aruba Bonaire Curacao Trust Co., Ltd. (ABC), a Bahamian corporation, as a demand deposit. The trustee then deposited another $500k with ABC a few months later (in the form of two "time" deposits). These amounts constituted the entire corpus of the trust. The agreed annual rate of interest on the deposits was 5%. $194,000 was returned to the trust by ABC about 18 months later.

Trustee's attorney friend had advised Trustee to deposit with ABC. Several of the attorney's other clients had deposits with ABC. The attorney assured the Trustee that ABC was a good place to deposit money because it would pay a higher rate of interest than domestic banks and the funds would be available whenever needed.

The attorney did not provide a written legal opinion to the Trustee to this effect. Trustee did not make personal inquiries into ABC's integrity.

Thirteen years later, Trustee discovered that ABC's license had been revoked 15 years ago (prior to Trustee making any deposits with ABC) and its charter had been struck from the register of Bahamian companies that same year (15 years earlier). None of the other trustees voiced any objections to the Trustee with regard to the agreements with ABC. Nor did any of them request until 7 years later that Trustee agree to remove the Trust's funds from deposit with ABC.

The IRS, after audit, determined that the Trust's initial demand deposit with ABC WAS a jeopardizing investment because ABC's license had been revoked prior to the Trust's making the deposit, a lack of verification of ABC's assets, and irregular interest payments.

6. Additional rulings/guidance:

See also PLR 200637041; PLR 200318069; TAM 9627001; PLR 9451067; PLR 9210025; TAM 9205001; PLR 9001016;

7. Jeopardizing Investments in the News

A recent article in the Wall Street Journal reported that this fiscal year, most smaller endowments were poised to outperform Ivy League mega-endowments, due to greater allocation to fixed income versus alternative investments. The article highlights the trend that alternative investments have not been

performing to the level of their historical success. These larger endowments tend to be very heavily invested in alternatives – to the tune of 57% on average (Yale was at 70% in December 2008). Because alternatives are underperforming, and because the credit market is so tight, endowment-based institutions should be looking to make (or keep) their portfolios more liquid during these tough times. See Craig Karmin, "Ivy League Endowments Finally 'Dumb'," The Wall Street Journal, C1 (June 30, 2009).

In response to Wall Street scandals such as Madoff and Stanford, the IRS provided general guidance to taxpayers who invested in Ponzi schemes, but Rev. Rul. 2009-9 applied to individuals only and does not address the issues facing private foundations. The New York State Bar Association Tax Section issued a report, at the request of the IRS, in response to the government's request for assistance in identifying and addressing issues confronting private foundations invested in Ponzi schemes and other frauds. The NYSBA identified jeopardizing investments as the most critical issue, and said it was possible for private foundations to exercise the requisite due diligence and still be defrauded. The report to the IRS concluded with the recognition that there is not clear guidance from the IRS on the subject, and that such guidance would be helpful to foundation managers. One issue with these types of investments is removal from jeopardy once the fraud is uncovered. The report indicates that in the context of a Ponzi scheme, which is discovered and collapses on its own, it is unclear whether the foundation has disposed of a jeopardizing investment. See Bruce R. Hopkins, "Ponzi Schemes Guidance Requests: Report of NY Bar Tax Section", Bruce R. Hopkins' Nonprofit Counsel, 3-6 (July 2009).

Since several states have statutes regarding standards for fiduciary investing of nonprofit funds, theoretically these organizations could be exposed to state law liability as well. On April 6, the New York attorney general filed a suit against an investment manager, management company and offshore fund alleged to be a feeder fund of Bernard L. Madoff Investment Securities (New York v. Merkin). Over 10 percent of the assets in these funds were from nonprofit organizations, but the lawsuit does not include these organizations or their managers. See Bruce R. Hopkins' Nonprofit Counsel at 6.

The Bernard Madoff scandal ultimately led to the demise of 51 foundations (and 143 others took a serious hit). AT a Council on Foundations meeting in Atlanta, nonprofit experts recognized that relying on personal, religious and social connections and relationships and a sense of trust are no longer enough. One advisor says the new test is, "Can you fire the financial advisor comfortably?". Another advisor to a nonprofit that considered investing with Madoff, but decided against it, identified four "trouble" factors:

a. the returns looked too good to be true

b. Mr. Madoff's group did not welcome an office visit

c. The group would not disclose how the investments worked, and wouldn't answer the chief financial officer's questions

d. The auditors for the effort were "two guys at a strip mall"

See Council on Foundations, " 'Trust Deficit' Erupts After Madoff Investment Scandal", The Chronicle of Philanthropy News Updates (May 6, 2009) at http://philanthropy.com/news/conference/8133/trust-deficit-probed-in-wake-of-madoff-investment-scandal

I. Taxable Expenditures

A private foundation is prohibited from making taxable expenditures, I.R.C. § 4945, which are expenditures not in furtherance of the foundation's exempt purposes. Taxable expenditures include amounts paid or incurred by a private foundation to carry on propaganda or otherwise attempt to influence legislation or the outcome of any public election. Additionally, if the foundation makes a distribution to a for-profit entity, (i.e., including

an individual) it must monitor (i.e., exercise expenditure responsibility) the grant in order to avoid a penalty.

1. Expenditure Responsibility

Exercise of expenditure responsibility includes the conducting of a pre-grant inquiry concerning grantee's management and programs, obtaining a written agreement from the grantee prior to making the grant, obtaining regular written status reports from the grantee regarding its progress in using the grant, and filing reports regarding the grant's status with the private foundation's annual information return and checking the appropriate box. Review procedures should be adopted and records kept to document that a private foundation is not making taxable expenditures. These procedures should include:

a. Verification that a grantee is listed in Publication 78 – Cumulative List of Exempt Organizations (searchable online at www.irs.gov) or; investigate at www.guidestar.org.

b. Review of the grantee's determination letter granting grantee exempt status as a public charity;

c. Review of the grantee's current 990, Schedule A, Part IV to review its proof of non-private status and that is still classified as a public charity; and,

d. Filing reports regarding the grant's status with the private foundation's annual information return and checking the appropriate box pertaining to expenditure responsibility.

2. Awarding of Grants

Grants not awarded on an objective and nondiscriminatory basis are taxable expenditures. Treas. Reg. § 53.4945-4(a)(3)(ii)(a). To establish that grants are being made on these bases, the program with which they are associated must be consistent with the existence of the foundation's charitable purpose. Treas. Reg. § 53.4945- 4(b)(5)(b)(1)(i). No part of the program should benefit a private individual or attempt to influence legislation. I.R.C. § 501(c)(3). Also, the group from which the grantees are selected should be chosen on the basis of criteria related to the purposes of the grant and the group should be sufficiently broad so that grants to members will fulfill the foundation's charitable purpose (religious, charitable, scientific, public safety, literary or educational purposes or foster national or international amateur sports competition, or prevent cruelty to children or animals.) Treas. Reg. § 53.4945-4(b)(2). Selection from a group is not necessary, however, when the grantees are selected because they are exceptionally qualified to carry out the purposes of the grant, or it is sufficiently clear that the selection of the particular grantee is calculated to accomplish a charitable purpose rather than benefit a particular person or class of persons. Likewise, the person or group of persons who select recipients of grants should not be in a position to gain a personal benefit, directly or indirectly due to the choice of grantee. Treas. Reg. 53.4945-4(b)(4).

3. Grants to Individuals for Travel or Study:

If the foundation intends to make grants to individuals for study, travel or similar purposes, advanced written approval of the selection process must be received from the Internal Revenue Service or such grants will be subject to tax. I.R.C. § 4945(g). Grants to individuals for purposes other than study, travel or similar purposes do not require Internal Revenue Service approval but the foundation should exercise diligence to ensure these grants are used for charitable purposes. A request for approval of the grant selection process to individuals must contain the following[1]:

a. Statement describing the grantee selection process.

[1] Note that completing Schedule H of Form 1023 is the procedure for foundations seeking advance approval at the time of formation; otherwise, a private letter ruling should be requested.

b. Description of the terms and conditions under which the foundation ordinarily makes such grants, in sufficient detail to enable the Commissioner to determine whether the grants awarded would meet the foundation's exempt purposes (charitable, etc.).

c. Detailed description of the foundation's procedure for exercising supervision of scholarship and fellowship grants;

d. Description of the foundation's procedure for reviewing grantee reports and for investigating or correcting possible misuse of grant funds by the recipient; and

e. A user fee. Rev. Proc. 88-8, 1988-41 R.B. 22.

The foundation is not required to have a written agreement from the prospective grantee and does not have to have written approval of each grant program. The approval is to provide for an evaluation of the foundation's entire system of standards, procedures, and follow-up in order to evaluate if grants will meet required standards. Treas. Reg. 53.4945-4(d). As long as the foundation's procedures for selection are not altered, the approval will continue to apply. Treas. Reg. 53.4945-3(iii)(a), (b) and (c)

4. Criteria

Grants to individuals for study, travel or similar purposes are taxable expenditures unless specific requirements are met. I.R.C. § 4945(2)(6)(3). In order to obtain approval for grants to individuals for travel, study or other similar purpose, the following must be established to the Internal Revenue Service's satisfaction:

a. The grant must constitute a scholarship or fellowship grant which would be subject to the provisions of I.R.C. § 117(a). Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(1), (i.e., the grant would not be included as gross income by the grantee because it is received by an individual who is a candidate for a degree at an educational institution.) The grant must be used for tuition and fees for enrollment or attendance at the educational institution or for fees, books, supplies, and equipment required for courses of instruction at the educational institution. I.R.C. § 117(a); or,

b. The grant must constitute a prize or award, and the recipient of the prize or award must be selected from the general public. The prize or award must be such that it would be subject to the provisions of I.R.C. § 74(b). Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(2). I.R.C. § 74(b) requires prizes or awards to be made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. Furthermore, (i) the recipient must be selected without any action on his or her part to enter the contest or proceeding; (ii) the recipient must not be required to render substantial future services as a condition to receiving the prize or award; and (iii) the prize or award must be transferred by the payor to a governmental unit or organization pursuant to a designation made by the recipient; or,

c. The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance literary, artistic, musical, scientific, teaching, or other similar capacity, skill or talent of the grantee. Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(3). "Specific objective . . . or other similar product" is intended to encompass purposes which are sufficiently narrow and definite to ensure that grantees only be able to use funds in furtherance of charitable purposes. Rev. Rul. 77-434. Long-term, low-interest educational loans may fit into this category provided their use is sufficiently limited.

5. Supervision of Grants

Standards for supervision of scholarship and fellowship grants are set forth in the Treasury Regulations and provide that the foundation must arrange to receive a "verified" report from the appropriate educational institution at least once for each year in which the grantee takes courses and receives grades. If the grant involves research, projects, or other work not involving the taking of actual courses, the foundation manager must receive an annual

progress report approved by the faculty member supervising the grantee or by another appropriate university official. The foundation must receive a final report upon completion of the grantee's studies. Treas. Reg. § 53.4945-4(c)(2). The foundation must be able to insure that the grantees have not diverted funds away from the original purpose of the grant. If the foundation fails to investigate or correct grant misuse, the grant may become a taxable expenditure. Treas. Reg. § 53.4945-4(c)(4). The Treasury Regulations do provide an alternative to the above mentioned supervisory requirements for scholarship and fellowship grants. Treas. Reg. 53.4945-4(c)(5). The foundation need not receive reports or investigate grants which may be being misused if the following criteria are met:

a. The scholarship or fellowship grants are excludable from the recipient's gross income and are used for study at an educational institution described in I.R.C. § 151(e)(4); and,

b. The grantor pays funds directly to the educational institution and not to the individual grantee; and,

c. The educational institution agrees to use the grant funds directly to defray the recipient's expenses, or to pay the funds (or portion thereof) to the recipient only if the recipient is enrolled at the institution and his or her standing at the institution is considered with the purposes of the grant.

6. Recordkeeping

The private foundation must retain records pertaining to all grants to individuals for travel, study, or other similar purposes. Treas. Reg. § 53.4945-4(d). These records must include:

a. All information the foundation secures to evaluate the qualifications of potential grantees.

b. The identification of grantees. This should include any relationship of any grantee to, (i) members, officers, trustees of the organization, (ii)a grantor or substantial contributor to the organization or a member of the family of either, and (iii) a corporation controlled by a grantor or substantial contributor. Rev. Rul. 56-304.

c. Specification of the amount and purposes of each grant.

d. Any follow-up information which the foundation obtains regarding possible misuse of funds.

Even if all requirements and criteria in 3. through 6. are satisfied, a grant meeting all of the above may still constitute a taxable expenditure if, (i) the grant is to be used to attempt to influence legislation or affect the outcome of a public election, or (ii) there is an agreement between the fund and the grantee whereby the fund may cause the grantee to engage in and the grantee does engage in such an activity, or (iii) the grant is made for a purpose other than religious, charitable, scientific, public safety, literary, or educational purposes, fostering of national or international amateur sports competition, or prevention of cruelty to children or animals. Treas. Reg. § 53.4945-4(a)(5).

7. Distributions to Foreign Organizations or for Foreign Purposes

A foundation can make a contribution to a foreign organization and it not be deemed a taxable expenditure if the foreign organization has received a tax exempt determination letter from the Internal Revenue Service that it is a public charity or it qualifies as the equivalent of an I.R.C. § 501(c)(3) organization and a public charity under I.R.C. § 509(a)(1), (2) or (3); Treas. Reg. § 53.4945-6(c)(1), I.R.C. § 4945(d)(4)(A); or, if in the reasonable judgment of a foundation manager, it is determined that the foreign organization will be treated as the equivalent of an I.R.C. § 501(c)(3) organization and a public charity under I.R.C. § 509(a)(1), (2) or (3), Treas. Reg. § 53.4945-6(c)(2)(ii), and a good faith determination is made based upon an affidavit of the foreign organization or an opinion of counsel by either the foreign organization's or the foundation's counsel, setting forth sufficient facts concerning the operation and support of the organization to

enable the Internal Revenue Service on audit to determine that the grantee organization would likely qualify as a public charity under I.R.C. § 509(a)(1), (2) or (3). Treas. Reg. § 53.4945-5(a)(5). There is no requirement that the affidavit or opinion of counsel be attached to the donor foundation's annual information return. Treas. Reg. § 53-4942(a)-3(a)(6)(i). The foundation can make a grant to a foreign organization not meeting these requirements only if the foundation exercises expenditure authority as to the grant. If the contribution is made to a domestic organization which is to be used for a charitable activity in a foreign country, the domestic organization will be considered the recipient of the contribution and the contribution will be a qualifying distribution if the use of the contribution is subject to the domestic organization's discretion and control. Rev. Rul. 66-79, 1966-1 C.B. 48. However, the donating foundation must not earmark the contribution to the domestic organization directly for the use of the foreign organization. If they do, they will be deemed to have made a grant directly to the foreign organization and the foreign organization must meet the qualifications of a public charity in order for the distribution to be a qualifying distribution. As long as the donating foundation does not earmark the use of its grant for any named secondary donee, it will not be deemed to have made a contribution to the secondary donee. Treas. Reg. 53.49429(a)-3(c)(4). Care should be taken to comply with anti-terrorism measures to ensure funds are not diverted to terrorist purposes. That discussion is beyond the scope of this paper.

8. Excise Tax on Taxable Expenditures (I.R.C. §4945)

Restrictions on expenditures: The foundation is subject to a 20% tax on each taxable expenditure, and any foundation manager who willingly participates in making the distribution knowing it is a taxable expenditure, without reasonable cause, is subject to a 5% tax on such taxable expenditure. If the expenditure is not corrected within the taxable period, the foundation is subject to a tax of 100% of the amount of the taxable expenditure and the foundation manager is subject to a tax of 50% of the amount of the taxable expenditure, if the foundation manager refused to correct the transaction. The taxable period is the date starting when the expenditure is made and ending the earlier of the date (i) of mailing of a notice of deficiency; or (ii) the tax is assessed) Taxable expenditures include payments for noncharitable purposes or to non-qualifying recipients, including political campaigns and lobbying, and certain grants to individuals. (See below discussion of Taxable Expenditures.)

VI. OTHER CONSIDERATIONS FOR NON-OPERATING FOUNDATIONS:

A. The Board of Directors

The board of directors establishes policy of the foundation in accordance with its purposes as set forth in the entity's organizational documents. It also works with donors in acceptance of donations and using the foundation's assets in accordance with its exempt purpose.

B. Hiring Professional Management

Staff may be needed to administer the programs and handle operations. Directors of the private foundation usually delegate day-to-day management to an executive committee or an executive director. However, a small private foundation that makes grants only once per year generally operates without the necessity of a staff. Directors should, however, hire appropriate professional advisors as warranted.

See Section IX, E of this outline for more discussion on Delegation of Authority to Invest.

C. Developing Operating Procedures

Operating procedures should be adopted and strictly followed so as to avoid excise tax complications and avoid jeopardizing the private foundation's charitable status. These procedures include grant application guidelines, and should include, where necessary, review and compliance with procedures to be followed when making grants to foreign grantees,

individuals or non-charitable entities. A written statement about the foundation's guidelines, policies, programs of interest, any geographic limitations or other restrictions should be adopted by the board of directors.

D. Making Grants

Grants are distributions by the foundation to other organizations to perform charitable activities within their domain and under their control and such grants must be in an annual amount of at least 5% of the annual fair market value of foundation's assets not used directly to carry out the foundation's exempt purposes, after considering certain qualifying expenses. These grants may be to public charities (those which have received an IRS determination letter stating that the organization is an I.R.C. § 501(c)(3) organization and that it is not a private foundation because it is either classified under I.R.C. § 509(a)(1), 509(a)(2) or 509(a)(3)) or to a governmental unit such as a school board, fire department or public library (as long as the purpose for the grant is a charitable purpose) or to social welfare or civic action organization (under I.R.C. § 501(c)(4)), or trade associations and professional organizations (under I.R.C. § 501(c)(6), such as trade associations, chambers of commerce, real estate boards, boards of trade and similar professional organizations.) However, grants to such civic action organizations or social welfare organizations or trade associations and professional organizations require the foundation to conduct expenditure responsibility in order to avoid penalties. (See discussion regarding "expenditure responsibility.")

1. Grant Making Policy

The foundation should establish policies defining programs of interest and establishing objectives to be served. It should also establish its function and position as how to further its charitable purpose. Many private foundations designate a grant committee to review grant applications and make recommendations to board of directors.

2. Grant Application Guidelines

Processes for receiving, examining and deciding on grant applications should be established on a clear and logical basis and should be followed in a manner consistent with the organization's policies and purposes. The foundation's written statement about the foundation's guidelines, policies, programs of interest, any geographic limitations or other restrictions should be provided to applicants. Status reports to applicants should be given promptly.

3. Discretionary Grants

The board of directors may also establish a policy allowing each board member to designate grantees of grants of his or her own choosing up to a predetermined amount. An advantage to discretionary grants is that if each board member can designate a portion of the minimum distribution amount, then he or she would not be as self-motivated on discussing and deciding upon the distributions of the remaining minimum distribution amounts, but a conflict of interest may arise as to the director making decisions in favor of certain grantees.

4. Review of Applications

The directors may evaluate applications and put into written form their interests in certain applications. Foundation staff may further investigate potential grants.

5. Grant Agreement

The foundation should require each grantee to sign a Grant Agreement which binds the

grantee to use the grant funds for the purposes provided.

6. Reclaiming of Grant Funds

If the grantee fails to follow the Grant Agreement, the foundation can demand repayment of the grant funds.

7. Recordkeeping

The foundation should obtain and maintain documentation reflecting that distributed funds were used for charitable purposes. These records should include:

1) A copy of any Grant Agreement;

2) Reports regarding grant, if any;

3) Copy of grantee's IRS tax exempt determination letter and documentation that Publication 78 was consulted (a search of Publication 78 is available at www.irs.gov and the relevant portion can be printed for the file); and if the grantee is not a public charity, the foundation must keep complete documentation on its expenditure responsibility (see discussion above), or, in the case of a grantee that is a non-U.S. charity, equivalency determination documentation (see discussion above).

8. Tipping

Generally, a public charity must continually meet a public support test evidencing that a percent of its funding is obtained from a broad cross-section of donors of the general public, not from one foundation or one person. A large grant to a small public charity may cause the public charity to fail to meet its public support test and "tip" it into private foundation status. If the foundation's grant to the public charity tips the public charity, no penalty will be imposed upon the granting foundation if: 1) the grantee had an IRS tax exempt determination letter at the time of the grant, 2) the Service had not revoked the letter and the foundation was not aware of imminent action to do so by the IRS; and 3) the foundation did not control the grantee.

9. Grants to Entities of Which a Disqualified Person Serves on the Board of Directors

a. Self-Dealing

The foundation may make a distribution to an organization on which a Disqualified Person serves on the board of directors without violating the rules against self-dealing if the Disqualified Person only receives an incidental and tenuous benefit from the grant. See Treas. Reg. § 53.4941(d)-2(f)(2). See also Rev. Rul. 75-42, 1975-1 C.B. 359, where the Service determined that two individuals serving as trustees of both organizations did not violate rules against self-dealing because the benefit to Disqualified Persons was only incidental; and Rev. Rul. 82-136, 1982-2 C.B. 300, where the Service determined that a violation of rules against self-dealing did not occur where a bank served as trustee of two foundations where one was making a grant to the other and determined that any benefit received by the Disqualified Person (the bank) was incidental. Determinations should be made on a case by case basis as to whether any benefit is incidental or tenuous.

b. Qualifying Distribution

A distribution from the grantee organization is not a qualifying distribution if the donor organization is a "controlled organization".

(1) Controlled Organization: An organization is treated as controlled by the private foundation if one or more of its Disqualified Persons may by aggregating their votes or positions of authority, require the donee organization to make an expenditure or to prevent it from making an expenditure, regardless of the method by which the control is exercised or exercisable. Treas. Reg. § 53.4942(a)-3(a)(3). This is the case whether or not such control is actually exercised.

(2) However, even if the donee organization is a controlled organization, a grant from a foundation will still qualify as a qualifying

distribution if within the year in which the grant is made:

(i) The donee organization expends for charitable purposes described in I.R.C. § 170(c)(2)(B) an amount equal to the value of the grant not later than the end of the recipient's first taxable year after the taxable year in which the grant is received;

(ii) If the recipient is a private operating foundation, the redistribution is treated by the foundation as made out of corpus, as if the charity were a private nonoperating foundation; and,

(iii) The donor foundation obtains adequate records or other sufficient evidence reflecting that the redistribution has been made, the names and addresses of the recipients of the redistributed amount and the amount received by each, and that the redistribution would be treated as made from corpus as if the public charity were a private nonoperating foundation. I.R.C. § 4942(g)(3); Treas. Reg. § 53.4942(a)-3(c)(1).

E. Advisory Board

Often directors form an advisory board to advise them on policy matters. This advisory board is generally made up of professionals and other persons having expertise in differing areas that impact the foundation. This board lacks governing authority over the private foundation and cannot legally bind the private foundation.

F. Governance

The private foundation through its board of directors, committees and managers, should adopt policies as to governance and other related matters.

G. Compensation and Other Expenses

No part of the net earnings of a private foundation may inure to the benefit of any individual. Private inurement can cause the exempt organization to lose its tax exempt status. However, payments of compensation that are reasonable and necessary and not excessive may be paid to employees, consultants and others. Such compensation does not violate the restriction upon acts of self-dealing. Directors of private foundations often, however, serve without compensation. The private foundation may pay for the directors' liability insurance and reimburse the director for out-of-pocket expenses (subject to the restrictions upon acts of self-dealing). Federal law requires that the salaries and benefits of the private foundation's highest paid employees and all directors be disclosed to the public on the foundation's annual information return.

H. Outside Audit

Although not required, many foundations obtain outside audits to shield the directors from potential liability.

I. Insurance

Private foundations should and generally do purchase liability insurance and property insurance. Often, the insurance includes that for officers and directors ("D&O Insurance"). D&O Insurance protects the foundation and the directors from the costs of legal defense and the payment of certain losses where there is no bodily injury or property damage but is generally resulting from some wrongful act, including breach of duty, neglect, error, misstatement, misleading statement, omission, or other acts done or wrongfully attempted. Claims generally covered included those for wrongful termination, discrimination in employment, sexual harassment, breach of fiduciary duty, self-dealing violations and failure to timely file tax returns. The D&O policy generally is designed to pay attorney's fees and court costs.

J. Employment

The private foundation must comply with all federal, state and local employment laws, including withholding and other taxes applicable to private sector employers.

K. Documents Subject to Inspection

Applications for exempt status, annual returns (Form 990-PF) and unrelated business income tax returns (Form 990-T) must be made available for public inspection at the private foundation's office. Annual returns for many exempt organizations are available at www.guidestar.org.

VII. PUBLIC CHARITY EXCISE TAXES/INTERMEDIATE SANCTIONS:

Public charities are not subject to the excise taxes imposed on private foundations under I.R.C. §§ 4940-4945. (See discussion of excise taxes pertaining to private foundations above.) Rather, a public charity is subject to the intermediate sanctions rules under I.R.C. §4958 and the related Treasury Regulations (Treas. Reg. §§53.4958-1 through 53.4958-8). The final regulations pertaining to I.R.C. §4958, issued in January 2002, apply to excess benefit transactions between an applicable tax-exempt organization (public charity) and a Disqualified Person.

A. Tax Imposed

Any Disqualified Person who benefits from an excess benefit transaction with an applicable tax-exempt organization is liable for a tax of 25% of the excess benefit. The Disqualified Person is also liable for a tax of 200% of the excess benefit if the excess benefit is not corrected by a certain date. Additionally, organization managers (officer, director, or trustee) who knowingly participate in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause) are assessed a tax of 10% of the excess benefit transaction.

B. "Disqualified Person"

A Disqualified Person with respect to a public charity is defined as any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, a member of the family of that person, or an entity that is 35% controlled by a Disqualified Person. I.R.C. §4958(f). Note the difference between a Disqualified Person for private foundation purposes (I.R.C. §4946) and for intermediate sanctions purposes.

1. <u>The following persons are considered to have substantial influence</u>:

a. Presidents, chief executive officers, or chief operating officers,

b. Treasurers and chief financial officers,

c. Persons with a material financial interest in a provider-sponsored organization (generally, in the context of nonprofit hospitals)

2. <u>The following persons are deemed NOT to have substantial influence</u>:

a. Tax-exempt organizations described in I.R.C. §501(c)(3),

b. Certain I.R.C. §501(c)(4) organizations,

c. Employees receiving economic benefits of less than a specified amount in a taxable year

3. <u>Facts and circumstances govern in all other instances. Facts and circumstances tending to show substantial influence</u>:

a. The person founded the organization,

b. The person is a substantial contributor to the organization (within the meaning of I.R.C. §507(d)(2)(A),

c. The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls,

d. The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees,

e. The person manages a discrete segment or activity of the organization that represents a

substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole,

f. The person owns a controlling interest (in vote or in value) in a corporation, partnership, or trust that is a Disqualified Person,

g. The person is a non-stock organization controlled directly or indirectly by one or more Disqualified Persons.

4. Facts and circumstances showing no substantial influence:

a. The person is an independent contractor whose sole relationship to the organization is providing professional advice,

b. The person has taken a vow of poverty on behalf of a religious organization,

c. Any preferential treatment the person receives based on the size of the person's donation is also offered to others making comparable widely solicited donations,

d. The direct supervisor of the person is not a Disqualified Person,

e. The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole. Treas. Reg. §53.4958-3

C. Excess Benefit Transaction.

An excess benefit transaction means 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, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization for providing the benefit. An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a Disqualified Person, or in an exchange of property between a Disqualified Person and the exempt organization. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is its fair market value.

1. New Form 990.

The new Form 990 devotes an entire schedule (Schedule J) to reporting compensation information. Some of the highlights include:

a. Did the organization follow a written policy regarding payment or reimbursement or provision of expenses?

b. Did the organization require substantiation (documentation via receipts, etc.) prior to reimbursing or allowing expenses?

c. Methodology for setting executive compensation

d. Questions regarding compensation contingencies, if any

2. Rebuttable Presumption of Reasonableness

a. Compensation paid to a Disqualified Person is not excessive if it is reasonable. Reasonableness is determined under an I.R.C. §162 standard, which is the value that would ordinarily be paid by like enterprises under like circumstances

b. All items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation

c. There is a rebuttable presumption of reasonableness, and the payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the tax-exempt organization follows the following procedures:

(1) The transaction is approved by an authorized body of the organization (or an entity

it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction,

(2) Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services,

(3) The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:

i. The terms of the transaction that was approved and the date it was approved,

ii. The members of the authorized body who were present during the debate on the transaction that was approved and who voted on it,

iii. The comparability data obtained and relied upon by the authorized body and how the data was obtained, and

iv. Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction. Treas. Reg. §53.4958-6

If the payment is not a fixed payment, generally, the rebuttable presumption arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are satisfied.

VIII. ISSUES APPLICABLE TO ALL CHARITABLE ORGANIZATIONS - UNRELATED BUSINESS TAXABLE INCOME ("UBTI")

A. UBTI, In General

UBTI generally arises in two situations: 1) when the charitable organization has income from an unrelated trade or business; or, 2) when the charitable organization has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1); § 514(a)(1); and § 514(a)(2).

1. Income From an Unrelated Trade or Business

A charitable organization must include in its unrelated business income and pay income tax on the gross income from any regularly conducted trade or business which is not substantially related to the performance of the organization's exempt function. Treas. Reg. § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105, (1986). This includes income when an exempt organization is a partner, limited or general, in a partnership which carries on a trade or business wholly unrelated to the exempt organization's purposes, regardless of whether or not the income from the trade or business is actually distributed. See I.R.C. § 512(c)(1); Treas. Reg. § 1.681(a)-2(a). See also, *Service Bolt & Nut Co. Profit Sharing Trust v. Comr.*, 78 T.C. 812 (1982). "Unrelated trade or business" does not include: 1) any trade or business in which substantially all the work in carrying on the trade or business is performed for the exempt organization without compensation; 2) any trade or business carried on by an I.R.C. § 501(c)(3) organization or by an I.R.C. § 511(a)(2)(B) governmental college or university, primarily for the convenience of its members, students, patients, officers or employees; or 3) any trade or business which consists of selling merchandise, substantially all of which is received by the organization as gifts or contributions. I.R.C. § 513(a). The income and deductions are subject to the modifications under I.R.C. § 512(b).

2. Exclusion of Items from UBTI

Some items excluded from UBTI are dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, income from research for the U.S., income of a college, university or hospital, or income for fundamental research. I.R.C. § 512(b).

a. Example 1

If the charitable organization holds a pass-through interest (for income tax purposes) in a factory, which is an operating business, the charitable organization will have UBTI to the extent it has income from the operation of the factory.

b. Example 2

If the charitable organization holds an interest in a partnership which owns rental real property, exclusively, and there is no debt related to the property, the charitable organization will not have UBTI because the income is from passive rental real property.

3. Income or Deductions Incurred With Respect to "Debt-Financed Property"

A charitable organization has unrelated business income and must pay income tax if it has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1), § 514(a)(2). "Debt-financed property" includes any property held to produce income (including gains from disposition of property) and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property or the property secures the debt) at any time during the taxable year. I.R.C. §514 (b)(1); Treas. Reg. § 1.514(b)-1.

"Acquisition indebtedness" is generally the indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of the acquisition. See I.R.C. § 514(c)(1); Treas. Reg. § 1.514 (c)-1. If proceeds from the debt financed property are used to acquire or improve property, the debt is considered to be "acquisition indebtedness" related to "debt financed property" even if the debt is not secured by the property. Deeds of trust, conditional sales contracts, chattel mortgages, security interests under the Uniform Commercial Code, pledges, agreements to hold title in escrow and tax liens not subject to I.R.C. § 514(c)(2) are all treated as similar to mortgages for purposes of applying I.R.C. § 514(c)(2)(A).

4. Exclusions from "Debt-Financed Property":

a. Property used by an organization in performing its exempt function, I.R.C. § 514(b)(1)(A).

b. Debt-financed property used in an unrelated trade or business to the extent that the income from the property is taken into account in computing the gross income of the unrelated trade or business so as to prevent double taxation of a single item of income as both income from an unrelated business under I.R.C. § 514(a)(1) and debt-financed income under I.R.C. § 514(b)(1)(B).

c. Property used to derive research income, I.R.C. §514(b)(1)(C); Treas. Reg. §1.514(b)-1.

d. Property used in certain excepted trades or businesses [not including any property to the extent that the property is used in a trade or business subject to the volunteer exception, the convenience exception or the donations exception]. I.R.C. § 514(b)(1)(D).

e. Life income contracts. Treas. Reg. § 1.514(b)-1(c)(3)(i).

f. Property acquired for prospective exempt use. Treas. Reg. §1.514(b)-1(d).

g. Although a very limited exclusion, I.R.C. § 514(c)(9)(A) provides that indebtedness incurred in acquiring or improving any real property is excluded from the application of I.R.C. § 514, subject to the exceptions outlined in I.R.C. § 514(c)(9)(B). The four "qualified organizations" eligible to use the exception under I.R.C. § 514(c)(9) are as follows:

(1) Educational organizations described in I.R.C. §170(b)(1)(A)(ii);

(2) Affiliated support organizations described in I.R.C. § 509(a)(3) of educational organizations described in I.R.C. § 170(b)(1)(A)(ii);

(3) Qualified trusts under I.R.C. § 401 that consist of a trust that forms part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of employees and their beneficiaries; and,

(4) Multiple-parent title holding organizations described in I.R.C. § 501(c)(25).

IX. STATE LAW INVESTMENT STANDARDS

A. UPMIFA

In 2007, Texas adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"). It can be found in Chapter 163 of the Texas Property Code. UPMIFA was developed by the National Conference of Commissioners on Uniform State Laws in 2006 to provide much-needed updates to antiquated endowment fund investment and management standards that had been on the books for decades. The previous act, the Uniform Management of Institutional Funds Act, allowed the release of restrictions on endowment fund spending in certain circumstances, and provided an endowment spending rate that did not take into account trust accounting principles of what is income versus what is principal. UPMIFA provides modern articulations of the prudence standards for the management and investment of charitable funds and for endowment spending. Many of the revisions found in UPMIFA are based upon the Uniform Prudent Investor Act (UPIA), found in Chapter 117 of the Texas Property Code. Directors of charitable organizations owe a duty of care in investing and managing an organization, including its financial assets, under Texas state law, as discussed in Section II above. The leaders of Texas nonprofit organizations should take special care to ensure whether UPMIFA applies to their organization, and if so, to follow it closely. UPMIFA gives special importance to the donor's intent as expressed in the gift instrument. To the extent the gift instrument conflicts with UPMIFA, the instrument controls.

1. Does UPMIFA Apply?

UPMIFA in Texas applies to Texas "institutions" managing "institutional funds" or "endowment funds".

a. Is the organization an institution?

"Institution" is defined to include: (1) a person, other than an individual, organized and operated exclusively for charitable purposes; (2) a government or governmental subdivision, agency or instrumentality, to the extent that it holds funds exclusively for a charitable purpose; and (3) a trust that had both charitable and noncharitable interests, after all noncharitable interests have terminated. See Tex. Prop. Code § 163.003(4).

b. Is the organization managing an institutional fund?

"Institutional fund" means a fund held by an institution exclusively for charitable purposes. The term does not include: (A) program related assets; (B) a fund held for an institution by a trustee that is not an institution; or (C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund. See Tex. Prop. Code § 163.003(5).

If the answer to these questions is yes, then the governing body of the charitable organization must follow UPMIFA. Note that UPMIFA does not apply to trusts managed by corporate or individual trustees, but the Act does apply to trusts managed by charities. The management and investment of a charity whose governing instrument is a trust document (and whose trustee is not a charity) is instead governed by the Texas Uniform Prudent Investor Act (located in Chapter 117 of the Texas Property Code).

2. UPMIFA Applies – So What?

Now that you've determined UPMIFA applies, what does it say? Section 163.004 sets forth standards of conduct in managing and investing institutional funds. Section 163.005 promulgates the spending rates for endowment funds. Section 163.006 addresses an institution's ability to delegate management and investment functions (i.e. to a financial planner or asset manager). Section 163.007 discusses how certain restrictions on management, investment or purpose of an institutional fund can be modified or released.

a. Duties Under UPMIFA with respect to managing and investing institutional funds:

i. Consider the charitable purposes of the institution and the purposes of the institutional fund.

Section 163.004(a) states that subject to the intent of a donor expressed in a gift instrument, an institution, in managing and investing an institutional fund, shall consider the charitable purposes of the institution and the purposes of the institutional fund.

ii. Duty of loyalty.

Section 163.004(b) requires *each person responsible for managing and investing an institutional fund* to comply with the duty of loyalty imposed by law other than UPMIFA – this is the same as the common law duty of loyalty discussed in Section II above.

iii. Manage and invest the fund in good faith and with care.

Each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances. Tex Prop. Code § 163.004(b).

iv. Diversify, Diversify, Diversify.

An institution SHALL diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification. Tex. Prop. Code § 163.004(e)(4).

v. Incur only appropriate and reasonable costs in managing and investing an institutional fund.

"Appropriate and reasonable" is measured in relation to the assets, the purposes of the institution, and the skills available to the institution. Tex. Prop. Code § 163.004(c)(1).

vi. Verify Facts.

Make a reasonable effort to verify facts relevant to management and investment of the fund Tex. Prop. Code § 163.004(c)(2).

vii. If you are an expert – you must use your expertise.

A person that has special skills or expertise or is selected in reliance upon the person's representation that the person has special skills or expertise, has a duty to use those skills or that expertise in managing and investing the institutional funds. Tex. Prop. Code § 163.004(e)(6).

b. Factors that the institution must consider in managing and investing an institutional fund

i. General economic conditions
ii. The possible effect of inflation or deflation
iii. the expected tax consequences, if any, of investment decisions or strategies
iv. the role that each investment or course of action plays within the overall investment portfolio of the fund
v. the expected total return from income and the appreciation of investments
vi. other resources of the institution
vii. the needs of the institution and the fund to make distributions and to preserve capital <u>*and*</u>
viii. an asset's special relationship or special value, if any, to the charitable purposes of the institution

Only those factors that are relevant must be considered. Tex. Prop. Code § 163.004(e)(1).

c. Key Idea

Management and investment decisions about an individual asset must be made not in isolation but rather in the context of the institutional fund's portfolio of investments as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the fund and to the institution**.** Tex. Prop. Code §163.004(e)(2).

d. Timing is everything

Within a reasonable time after receiving property, an institution shall make and carry out decisions concerning the retention or disposition of the property or to rebalance a portfolio, in order to bring the institutional fund into compliance with the purposes, terms and distribution requirements of the institution as necessary to meet other circumstances of the institution and the requirements of UPMIFA. Tex. Prop. Code § 163.004(e)(5).

3. <u>Is the Institutional Fund an Endowment Fund?</u>

a. Definition

"Endowment Fund" means an institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use. Tex. Prop. Code §163.003(2). "Gift instrument" means a record or records, including an institutional solicitation, under which property is granted to, transferred to, or held by an institution as an institutional fund. Tex. Prop. Code §163.003(3).

b. Is the fund wholly expendable by the institution on a current basis?

i. You must use the magic words.

Terms designating a gift as an endowment, or a direction or authorization in the gift instrument to use only "income", "interest", "dividends", or "rents, issues, or profits", or "to preserve the principal intact", create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund

ii. Limitation.

These terms do not otherwise limit the authority of the institution to appropriate the funds for expenditure or accumulation as discussed in (3), below.

c. Standards for appropriation

i. Duty of care and good faith by institution:

In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances.

ii. The institution shall consider the following factors in determining whether to appropriate or accumulate endowment funds**:**

(1) the duration and preservation of the endowment fund
(2) the purposes of the institution and the endowment fund
(3) general economic conditions
(4) the possible effect of inflation or deflation
(5) the expected total return from income and the appreciation of investments
(6) other resources of the institution <u>*and*</u>
(7) the investment policy of the institution

NOTE: Institutions are presumed to have an investment policy under this section of UPMIFA. If you don't have an investment policy – get one! Doesn't matter how small or large you are – UPMIFA assumes you have one (and the IRS will look for one on audit).

iii. General rule.

Subject to the intent of the donor as expressed in the gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the institution

determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established.

d. Rebuttable Presumptions of Imprudence

i. Endowment Funds with aggregate value of $1 million or more.

If an institution appropriates for expenditure in any year more than 7% of the fair market value of the endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation was made ("three year rolling average"), this creates a rebuttable presumption of imprudence. Tex. Prop. Code § 163.005(d).

ii. Endowment Funds with an aggregate value of less than $1 million.

Same rebuttable presumption is created if the appropriation for expenditure exceeds 5% of the fair market value of the endowment fund (using the same three year rolling average). Tex. Prop. Code § 163.005(e).

iii. Endowment Funds in existence for fewer than three years.

Instead of using the three year rolling average, the value must be calculated for the period the endowment fund has been in existence.

iv. University Systems (defined in Texas Education Code § 61.003(10).

For funds with an aggregate value of $450 million or more, the same rule as 163.005(d) and (e) applies (but the percentage threshold is 9%). Tex. Prop. Code § 163.005(f).

v. Caveat.

Subsections (d), (e) and (f) of § 163.005 do not: 1) apply to an appropriation for expenditure permitted under law other than UPMIFA or by the gift instrument; or 2) create a presumption of prudence for an appropriation for expenditure of an amount less than or equal to [7%, 5% or 9%, as applicable] of the fair market value of the endowment fund.

e. Collective Investment

If an institution pools the assets of individual endowment funds for collective investment, this section applies to the pooled fund and does not apply to individual endowment funds, including individual endowment funds for which the nature of the underlying asset or donor restrictions preclude inclusion in a pool but which are managed by the institution in accordance with a collective investment policy. Tex. Prop. Code § 163.005(g).

4. Delegation

Like UPIA allows delegation in the realm of trusts, UPMIFA allows an institution to designate an external agent to manage and invest an institutional fund, to the extent that such delegation is prudent under the circumstances. Tex. Prop. Code §163.006. UPIA's delegation statute (Texas' version) is more restrictive than UPMIFA.

a. Good faith and duty of care.

Under Tex. Prop. Code § 163.006, an institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances in:

i. Selecting an agent
ii. Establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund; and
iii. Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.

b. Agent's duty

In performing a delegated function, an agent owes a duty to the institution to exercise

reasonable care to comply with the scope and terms of the delegation. Tex. Prop. Code §163.006(b).

c. No Liability for Institution

An institution that complies with Subsection (a) is not liable for the decisions or actions of an agent to which the function was delegated.

d. Personal jurisdiction

By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from or related to the delegation of the performance of the delegated function. Tex. Prop. Code § 163.006(d).

e. Eligible delegates

An institution may delegate management and investment functions to its committees, officers, or employees as authorized by Texas law (other than UPMIFA).

5. Release or Modification

UPMIFA permits release or modification of restrictions on institutional fund management, investment and/or purpose in limited circumstances.

a. With donor consent.

If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution. Tex. Prop. Code § 163.007(a)

b. Modification of a Restriction regarding investment or management without donor consent.

An institution may apply to a court for modification of a restriction on management or investment of an institutional fund, on the grounds of impracticability or wastefulness, if it impairs the management or investment of the fund, or if, because of circumstances no anticipated by the donor, a modification of a restriction will further the purposes of the fund, and the court may modify. To the extent practicable, any modification must be made in accordance with the donor's probable intention. Tex. Prop. Code § 163.007(b)

c. Modification of a purpose without donor consent.

An institution may apply to a court for modification of a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund, if such purpose or restriction becomes unlawful, impracticable, impossible to achieve, or wasteful, and the court may modify in a manner consistent with the charitable purposes expressed in the gift instrument. Tex. Prop. Code § 163.007(c)

d. AG involvement.

If an institution applies to a court for modification under 2 and 3 above, Chapter 123 of the Texas Property Code applies (and therefore the AG must be notified in accordance with that chapter). See Tex. Prop. Code § 163.007(b) and (c).

e. Small, old institutional funds.

If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, 60 days after receipt of notice by the AG, may release or modify the restriction, in whole or in part, if:

i. The institutional fund subject to the restriction has a total value of less than $25,000;
ii. More than 20 years have elapsed since the fund was established; and

iii. The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.

The notification to the AG must be accompanied by a copy of the gift instrument and a statement of facts sufficient to evidence compliance with a, b and c above. Tex. Prop. Code § 163.006(d).

6. On Review

The determination as to whether an institution has complied with UPMIFA in managing or investing an institutional fund is determined in light of the facts and circumstances existing at the time a decision is made or an action is taken, and not by hindsight. Tex. Prop. Code § 163.008.

B. UPIA

Texas adopted the Uniform Prudent Investor Act ("UPIA") in 2004. Like UPMIFA, UPIA is based on modern portfolio theory, and incorporated major changes such as permitting delegation of investment authority, including diversification in the definition of prudent investing, and applying the prudence standard to a single investment in light of the whole portfolio, among others.

1. The Duty to Beneficiaries

A trustee who invests and manages trust assets owes a duty to the beneficiaries of the trust to comply with the prudent investor rule set forth in this chapter. Tex. Prop. Code § 117.003(a).

2. The Prudent Investor Rule

A trustee shall invest and manage trust assets as a prudent investor would, by considering the purposes, terms, distribution requirements, and other circumstances of the trust. In satisfying this standard, the trustee shall exercise reasonable care, skill, and caution. Tex. Prop. Code § 117.004(a).

3. Modification to the Rule

The Prudent Investor Rule is a default rule which may be expanded, restricted, eliminated, or otherwise altered by the provisions of a trust. A trustee is not liable to a beneficiary to the extent that the trustee acted in reasonable reliance on the provisions of the trust. Tex. Prop. Code § 117.003(b).

4. Applying the Standard – Evaluate the Investment in Light of the Portfolio as a Whole

A trustee's investment and management decisions respecting individual assets must be evaluated not in isolation but in the context of the trust portfolio as a whole and as a part of an overall investment strategy having risk and return objectives reasonably suited to the trust. Among circumstances that a trustee shall consider in investing and managing trust assets are such of the following as are relevant to the trust or its beneficiaries:

(1) general economic conditions;
(2) the possible effect of inflation or deflation;
(3) the expected tax consequences of investment decisions or strategies;
(4) the role that each investment or course of action plays within the overall trust portfolio, which may include financial assets, interests in closely held enterprises, tangible and intangible personal property, and real property;
(5) the expected total return from income and the appreciation of capital;
(6) other resources of the beneficiaries;
(7) needs for liquidity, regularity of income, and preservation or appreciation of capital; and
(8) an asset's special relationship or special value, if any, to the purposes of the trust or to one or more of the beneficiaries.

Tex. Prop. Code §117.004(b)-(c).

5. Thou Shalt Verify Facts

Like in UPMIFA, a trustee under UPIA must make a reasonable effort to verify facts relevant to the investment and management of trust assets. Tex. Prop. Code §117.004(d).

6. No Per Se Restrictions

A trustee may invest in any kind of property or type of investment consistent with the Prudent Investor Act. Tex. Prop. Code §117.004(e).

7. Use 'Em if You Got 'Em

A trustee who has special skills or expertise, or is named trustee in reliance upon the trustee's representation that the trustee has special skills or expertise, has a duty to use those special skills or expertise. Tex. Prop. Code §117.004(f).

8. Diversify, Diversify, Diversify

A trustee shall diversify the investments of the trust unless the trustee reasonably determines that, because of special circumstances, the purposes of the trust are better served without diversifying. Tex. Prop. Code § 117.005.

9. Wait – I'm New – Where Do I Start?

Within a reasonable time after accepting a trusteeship or receiving trust assets, a trustee shall review the trust assets and make and implement decisions concerning the retention and disposition of assets, in order to bring the trust portfolio into compliance with the purposes, terms, distribution requirements, and other circumstances of the trust, and with the requirements of this chapter. Tex. Prop. Code § 117.006.

10. Loyalty

A trustee shall invest and manage the trust assets solely in the interest of the beneficiaries. This means the trustee must act exclusively for the beneficiaries, as opposed to acting for the trustee's own interest or that of third parties. Tex. Prop. Code § 117.007.

11. Impartiality

If a trust has two or more beneficiaries, the trustee shall act impartially in investing and managing the trust assets, taking into account any differing interests of the beneficiaries. Tex. Prop. Code § 117.008.

12. Fees

In investing and managing trust assets, a trustee may only incur costs that are appropriate and reasonable in relation to the assets, the purposes of the trust, and the skills of the trustee. Wasting beneficiaries' money is imprudent (duh). Trustees are obligated to minimize investment and management costs. Tex. Prop. Code § 117.009.

13. Review

The determination as to whether a trustee has complied with UPIA is based on the facts and circumstances as they existed at the time of investment. Tex. Prop. Code § 117.110.

14. Can I Delegate?

The delegation provision under UPIA is similar to UPMIFA's, EXCEPT – trustees under UPIA still leave themselves exposed to liability for their delegate's actions in certain circumstances. A trustee may delegate investment and management functions that a

prudent trustee of comparable skills could properly delegate under the circumstances.

a. The trustee shall exercise reasonable care, skill, and caution in:

(1) selecting an agent;
(2) establishing the scope and terms of the delegation, consistent with the purposes and terms of the trust; and
(3) periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the terms of the delegation.

b. In performing a delegated function, an agent owes a duty to the trust to exercise reasonable care to comply with the terms of the delegation.

c. A trustee who complies with the requirements of Subsection (a) is not liable to the beneficiaries or to the trust for the decisions or actions of the agent to whom the function was delegated, unless:

(1) the agent is an affiliate of the trustee; or

(2) under the terms of the delegation:

(A) the trustee or a beneficiary of the trust is required to arbitrate disputes with the agent; or

(B) the period for bringing an action by the trustee or a beneficiary of the trust with respect to an agent's actions is shortened from that which is applicable to trustees under the law of this state.

d. If an agent accepts delegation from the trustee of a trust subject to the laws of Texas, it consents to personal jurisdiction in Texas.

Tex. Prop. Code § 117.011.

X. CHARITABLE IMMUNITY:TEXAS

A. Background

1. No common law charitable immunity

a. Historically immune

b. TSC abrogated in 1971

c. Pendulum swung back in 1987 with passage of Charitable Liability and Immunity Act of 1987 (Section 84.001 et seq Texas Civil Practice & Remedies Code)

B. Immunity: Parameters

1. An organization exempt from federal income taxation as a 501(c)(3), organized and operated exclusively for charitable or religious purposes

2. Any bona fide religious or charitable organization organized and operated exclusively for the promotion of social welfare [if it meets a six part test which mirrors the test for 501(c)(3) status]

3. Once within the definition, the volunteers, employees, and organization qualify for immunity under specific guidelines

4. No Volunteer immunity for intentional torts, willful misconduct, gross negligence

C. Volunteer Immunity

1. A volunteer is a person rendering services to or on behalf of a charitable organization who does not receive compensation (other than reimbursement for expenses)

2. Volunteer is immune if acting in course and scope of duties or functions, including as an officer, director or trustee

3. A director or officer must be in good faith

4. Still have liability up to personal insurance if damage arises from operation of any motor-driven equipment

5. For non-hospital employees and non-hospital organizations, limited immunity if obtain requisite amounts of insurance

(1) $500,000/$1,000,000/$100,000

(2) Must be in course and scope

(3) Act does not apply to acts/omissions that are willful, intentional, wantonly negligent, or done with conscious indifference or reckless disregard

D. Volunteer Protection Act

42 U.S.C. Sec. 14501 et al (1997) Says Volunteers not liable if:

1. Acting within scope of responsibilities

2. Properly licensed if required

3. No willful or gross negligence

4. Not covered: use of motor vehicle/aircraft

Preempts state law unless state law provides additional protection

XI. AUTHORITY OF AG AS TO CHARITABLE ORGANIZATIONS

A. Common Law Authority

B. Constitutional Authority

C. Statutory Authority

1. Charitable Trusts Chapter 123 of the Texas Property Code

(1) Defines charitable trusts to include virtually all charitable entities

(2) AG is a proper (although not necessary party) to proceedings involving charitable trusts (must receive notice and have right to intervene on behalf of public)

(3) Doesn't provide any substantive rights (builds on common law authority)

2. Business Organizations Code

a. Provides AG various powers and investigative authority over nonprofits. Many powers implied from provisions of the Act which require corporate compliance (*e.g.* keeping accurate books and records)

b. Provides AG authority to present a written request to examine the operations of the corporation (without notice)

c. Authority to apply for involuntary dissolution (and liquidation)

d. Authority to apply for appointment of a receiver

3. AG Authority Under the DTPA

a. False, misleading, or deceptive acts or practices in the conduct of any trade or commerce (Note: AG Charitable Trusts Section is part of the Consumer Protection Division)

b. Applies to nonprofits even if they don't charge

c. Applies to fraudulent solicitations regardless of whether goods or services are offered as part of the solicitation

d. Authorizes pre-suit investigations

e. Authorizes suits for enforcement

f. Imposes penalties for noncompliance

Enhanced penalty in the event AG determines act or practice seeking to acquire or deprive money from a consumer 65 or older

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