RESOLVING TRUSTEE DISPUTES:
FOUNDATION SPLIT-UPS AND OTHER APPROACHES

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Relevant Experience

- Co-author, Gifting of Unusual Gifts with a Focus on Oil and Gas and Real Estate, presented at the 29th Annual Nonprofit Organizations Institute, January 18-20, 2012
- Co-author and co-presenter, The Design and Implementation of Conflict of Interest and Gift Acceptance Policies, presented to the Fort Worth chapter of the Texas Society of CPAs, September 25, 2012.
- Co-author and co-presenter, Nuts & Bolts: Estate & Charitable Planning 101, presented to the North Texas Chapter of the Partnership for Philanthropic Planning, March 12, 2013.
- Co-author and co-presenter, Legal & Tax Uncertainty: How to Work with Your Donors to Plan for It, presented to the North Texas Chapter of the Partnership for Philanthropic Planning, March 12, 2013.
- Co-author, Charitable Remainder Trusts, presented to the Planned Giving Council of Houston, March 28, 2013.

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INTRODUCTION

Like any corporation, a nonprofit organization must deal with internal conflict issues, whether between the Board and the Executive Director, the Board and the staff, or among Board members themselves. The potential for conflict may be even higher with a family foundation, where conflict easily brews between family members with varying ideas regarding the legacy of the organization. How the conflict is addressed and resolved could have life-changing effects on the organization, even to the point of the termination of the entity. The key in resolving these disputes and avoiding a split-up comes in how the organization is prepared to handle these issues, both in its policies and its daily practices. In the event the internal conflicts are unresolvable to the point of irreparable division within the foundation, the foundation should be dissolved in the most administratively and tax efficient way. While this reference outline focuses on private foundations, many of these ideas can be applied to other categories of tax-exempt organizations as well.

I. CASE EXAMPLE

The Cy Twombly Foundation is currently enveloped in a lawsuit between its directors, rather than serving the charitable purposes of its famed founder – likely not what Mr. Twombly envisioned when he passed in 2011, leaving behind his vast collection of art pieces to be used for greater purposes. The dispute began when one of the four board members, Mr. Saliba, mentioned during a board meeting that the foundation had been paying investment fees to his investment company.[1] There were two problems with this: (1) the foundation had never approved such fees, and as such, the rest of the board was unaware of this insider benefit, and (2) the investment company was not registered as required by state and federal law, meaning the payment of the fees was illegal, even if they had been approved by the board. In February of 2013, another board member, Mr. Lerner, filed suit in Delaware state court, asking a judge to intervene in the internal board dispute that soon followed. This lawsuit asked the judge to appoint Cy Twombly's son, Alessandro, to the board, to break the deadlock between the four board members. In March of 2013, the foundation's president and vice president filed a lawsuit accusing Mr. Saliba, assisted by Mr. Lerner, not only a foundation director, but also a well-known art-world lawyer, of stealing hundreds of thousands of dollars in unauthorized fees for investment services. The suit states that Mr. Lerner and Mr. Saliba grossly overstated the value of the artwork left to the foundation. They purportedly hired an appraiser to value the artwork, who never physically inspected any of the pieces themselves, but rather used a written inventory by an archivist hired by Mr. Lerner and Mr. Saliba. At first glance, there are serious issues regarding self-dealing, conflicts of interest, lack of disclosure, and potentially fraudulent behavior.

While the outcome of this litigation is far from over, the surety in this situation is the foundation's reputation will never be the same, and its ability to achieve its original purposes likely will forever be affected. What began as an internal dispute has now caused significant public relations issues, which may have been avoided with proper practices and policies in place. This is just one example of the drastic effects foundation disputes, gone unchecked and unresolved, and the lack of following good governance practices, can have on the foundation's legacy.

II. COMMON ISSUES LEADING TO DISPUTES

A. Non-Functional Boards

Some of the most common issues that allow conflicts to brew among board members include disputes over strategy, conflicts of interest, power struggles, personality conflicts and misunderstanding the management of the organization.[2] Boards of foundations can become infected with poor communication, passivity and inadequate information leading to poor decision-making, and a lack of intellectual diversity.[3]

Issues are also created when the board lacks a clear structure and individual board members do not understand their duties or roles on the board.[4] Shared leadership can easily generate conflict, especially when the board is made of people with varied and diverse backgrounds.[5] Further, board members who spend the majority of their time in other fields may have different

[1] Kennedy, Randy and Carol Vogel, "Turmoil at Cy Twombly Foundation," THE NEW YORK TIMES, March 13, 2013, http://www.nytimes.com/2013/03/14/arts/design/cy-twombly-foundation-embroiled-in-lawsuits.html?pagewanted=all&_r=0.

[2] Reuben, Richard C., "Corporate Governance: A Practical Guide for Dispute Resolution Professionals," American Bar Association Section of Dispute Resolution, 2005.

[3] *Id.*

[4] Miree, Kathryn W., "Managing the Board: Governance, Administration and Marketing," Planned Giving Design Center Network.

[5] Angelica, Marion Peters, "Resolving Board Conflicts," http://www.tgci.com/magazine/ResolvingBoardConflicts.pdf.

goals or methods of handling business, which do not coincide with the mission of the foundation or its ethical obligations.[6]

Unless they have been through some kind of training and development program, it is likely the board members are unaware of their duties, roles and responsibilities as a fiduciary.[7] When the lines of accountability and board leadership are unclear and undefined, this may lead to internal struggles and unrealistic expectations of how the foundation should be run.[8] If the expectations are not clear, the foundation will get little from its board members.[9]

A lack of strict requirements on the board members to attend meetings and actively engage in the foundation's programs can also cause internal disputes.[10] If the board members are not asked to work or attend meetings, they are likely not going to be involved with the organization's mission or programs and little input will be generated from them.

The organization will be less functional when members have no connection with or interest in the foundation itself, so the board members should be chosen wisely, which again may create issues if the foundation is being governed by members of a family, and not by a wide range of individuals.[11] Further, without some type of specified term limits or procedure for replacing board members, the board can grow stale and prevent the foundation from growing to its full potential.

Disruptive directors can also cause severe governance issues, whether the director is verbally abusive, overly critical, refuses to participate, or engages in other extraordinary boardroom conduct that materially interferes with the board's ability to focus on its charitable objectives.[12] This can cause other directors to lose focus, refrain from meaningful discourse, and be unwilling to attend board meetings or even continue board service.[13] This type of behavior gone unaddressed can seriously diminish the effectiveness of the board. A board works most effectively when there is a culture of open, assertive but respectful discussions.[14] The board must have some type of leverage and tools to be able to redirect or stop disruptive behavior. Having the right to remove a director without cause in the organization's bylaws gives the board this needed leverage. Also, the adoption of a written code of conduct may help govern personal decorum, but mechanisms such as advanced letters of resignation and suspension are generally counterproductive in a voluntary service position such as this.[15]

As with any other entity, if there is not a dispute resolution mechanism in place to help resolve the situations constructively, these issues can become more serious, threatening the success of the foundation.[16] Many conflicts lay buried until they come to surface in an emotional upheaval, which makes dealing with the conflict even more difficult when not identified and resolved immediately.[17]

B. Family Foundations

Specifically with family foundations, which attempt to keep the organizational management within the same family, generational differences can give rise to a different variety of conflicts that must be dealt with in perhaps a more sensitive manner than when dealing with unrelated parties. Also, existing personal issues between family members can often create disputes in the boardroom; thus, the implementation of regular practices and policies as well as the use of outside advisors can be instrumental in keeping the foundation in harmony and focused on its charitable missions. Overall, the intent is to maintain the family relationship integrity, while using the foundation as a family to reach a common goal.[18]

Just determining how to bring new family members into the foundation management can cause conflict in itself. The older generation may desire younger family members to join the foundation while the generations can work together, and thus train the younger family members the values and goals of the organization. The younger generation may well benefit from being given a lesson on the history of the family's philanthropy and the expectations and responsibilities as a board member, but these younger people may not be willing to hear it.[19] Also, perhaps the younger generation is not eager or willing to join the foundation.[20] Or, not all members of the older generation may trust the younger members of the family with its foundation.

[6] *Id.*
[7] Miree, *supra* note 4.
[8] Angelica, *supra* note 5.
[9] Miree, *supra* note 4.
[10] Miree, *supra* note 4.
[11] *Id.*
[12] Peregrine, Michael W., "The Disruptive Director: Symptoms and Solutions," GOVERNANCE INSTITUTE, April 2012.
[13] *Id.*
[14] Reuben, Richard C., "Corporate Governance: A Practical Guide for Dispute Resolution Professionals," American Bar Association Section of Dispute Resolution, 2005.
[15] *Peregrine, supra* note 12.
[16] Reuben, *supra* note 14.
[17] Angelica, *supra* note 5.
[18] Sullivan, Paul, "Family Foundations Prepare for the Next Generation," THE NEW YORK TIMES, February 8, 2013.
[19] *Id.*
[20] *Id.*

Issues may also arise in determining how and when these younger board members should be given a vote. Some families may choose to let younger members sit in on meetings, but not have a vote; others may give the younger generation a separate portion of funds as a test for board membership to see how they manage their fund.[21] However, the general consensus is that the most successful foundations are those that are most open and allow the members, even the new, younger generation, to be fully involved in the voting process.[22] In order for the board to function efficiently as a unit, all members should be given an open discussion forum. The next generation needs to be kept engaged, which may mean slowly giving them a part of the decision-making responsibilities such that there is an integrated flow of ideas.[23] This can also help prevent the board from becoming stale, lacking from new, innovative ways of pursuing the charitable mission of the foundation. Outside advisors can even be brought in to help formulate the objectives of the foundation to make it easier for all generations involved in the foundation to make decisions based on those objective goals.[24] Having that outside advisor can also help when there is disagreement over a decision, and the family can turn to the neutral decision-maker on what will or will not best serve the strategy they have jointly put in place.

Avoiding disputes in a family foundation may well come down to how the foundation board chooses to maintain the original mission of the organization. Thus, the younger generation must understand that their role is to maintain those priorities and vision of the foundation, not to interject their own personal objectives once that they have some decision-making ability. Some type of board commitment form, which informs the board members of their duties, roles and responsibilities in light of the mission statement of the organization can be very instrumental in helping to avoid these issues. Although having several generations actively engaged in the same foundation may cause there to be varying values and concerns, based on different viewpoints of the world, the foundation's mission statement must remain the cornerstone of the key decisions.[25] If a board member cannot agree to stay true to the foundation's mission, perhaps he or she would be of better use in another area of the foundation's programs, rather than sitting on the board. This is where having set policies regarding board term limits and the removal of board members can be helpful in solving disputes.

[21] *Id.*
[22] *Id.*
[23] *Id.*
[24] *Id.*
[25] *Id.*

Further, how the board members interact play a significant role in whether a disagreement will come to a full-blown dispute involving other members of the foundation. The level of trust between the board members, strength of interpersonal relationships and power dynamics will affect the extent to which disagreements arise and brew into conflict, all which become more apparent when dealing with a board made up of family members, who may have a history of distrust or personal issues with each other. Having a reasonable level of trust between the board trustees becomes especially significant, as the board often considers issues with no "right" answer, and the motives of individuals in making certain arguments is open to interpretation.[26] If there is little trust between the board members, they will be more likely to be suspicious and scrutinize other members' arguments in such subjective decision-making, potentially leading to contentious disputes; whereas a high level of trust can act as a stabilizing influence.[27] Also, the stronger the relationships are between the various foundation trustees, the more capacity there is to alleviate disagreement and prevent those conflicts from maturing into more serious disputes. Finally, whether and how the family members exert their power as board members can implicate conflict, either soothing or breeding it. When power is used to exert dominance over others, whether it is between different generations or branches of a family, there is more potential for escalation of a disagreement into a mature conflict. However, that same power can be used to bring people together, assuring the full consideration of all issues and contributing to constructive outcomes.[28]

C. Issues Outside the Boardroom

The organization must be aware of the board members' actions outside of the organization, whether in personal or business contexts, that could dramatically affect the director's service on the board or even the public image of the foundation. This could include allegations or determinations of violations of civil or criminal law, regulatory sanctions, unethical or immoral conduct, or a member could be the subject of some type of government or internal corporate investigation.[29] Directors in these circumstances may voluntarily resign, in order to keep the issues away from the foundation, or they may refuse to leave,

[26] Reuben, Richard C., "Corporate Governance: A Practical Guide for Dispute Resolution Professionals," American Bar Association Section of Dispute Resolution, 2005.
[27] *Id.*
[28] *Id.*
[29] Peregrine, Michael W., "Director Fitness Concerns: Confronting Sticky Issues," The Governance Institute's E-Briefings, Vol. 9, No. 4, July 2012.

knowing or believing the accusations are false, and not wanting to appear guilty by resigning.

The board must have strong member accountability and governance policies in place, to be prepared to handle sensitive director fitness issues arising in circumstances occurring outside the boardroom.[30] This is a duty of loyalty concern for the board, as a core duty and obligation requires it to preserve the organization's reputation and effective governance, over and above personal relationships with other board members. Arguments of fairness, decency and equity arise when a board is confronted with the implications of the external issues of a board member, especially when dealing with a member who has a long history of service to the organization. The board must handle these issues proactively, such as through defining "fitness to serve" criteria in one of its set policies, as discussed below, and actively following such policy to uphold the ethical obligations of the organization.

BE PROACTIVE: HOW TO AVOID DISPUTES AND SPLIT-UPS

I. GOOD GOVERNANCE POLICIES

The IRS has posited that organizations practicing what the IRS considers "good governance" are more likely to be in compliance with the federal tax laws, avoid excise taxes, and fulfill the organization's exempt purposes.[31] This starts with the organization's mission statement, which, when clearly articulated, can serve as a guide to the organization's board and program functions. It helps steer the organization in the right path, to accomplish its exempt purposes, explain why the charity exists and what activities it should undertake. Further, the implementation of policies such as a conflict of interest policy and a whistleblower policy, among others, can be helpful in guiding the board to make good decisions for the foundation and avoid internal conflict issues in the process. Implementing, and more importantly, *following* these policies can help maintain the organization's vision and governance structure and guide the board in dealing with internal conflicts and maintaining family stability in the midst of a dispute.

A. Code of Ethics

The board bears the responsibility for setting the ethical standards of the organization and ensuring those standards are followed throughout the foundation's procedures and practices.[32] The board should consider adopting and regularly reviewing a code of ethics depicting the type of behavior it wants to encourage and the type of behavior which is unacceptable. The code of ethics should guide the directors, officers, and any employees in their conduct of the foundation's business. This should also serve as a tool to communicate the culture of legal compliance and ethical integrity expected throughout the organization internally, as well as externally to the public.

A good code of ethics begins with the mission of the foundation, reminding the key decision-makers why the foundation exists, and what the basis for its work and decision-making should be at all levels of the organization. The policy can then go on to specify the expectations of the directors, officers and employees, for example: that they bring objective thinking and critical analysis to the organization's deliberations, and that they approach all matters with an open mind, encouraging respectful disagreements to facilitate the exchange of various ideas and approaches to organizational matters. It may then affirm that the directors will not engage in activities that would be considered or even appear to be self-dealing, such as receiving financial or other gifts from the organization or its vendors. A sample code of ethics policy is attached for reference (Attachment 1).

When a code of ethics has been adopted and is regularly used, it can then be relied on in a conflict situation when an internal director or trustee is not following the stated guidelines. If a foundation manager has violated those provisions, the foundation can (in a sense) "blame" the code of ethics for the consequences to such person rather than having to find someone to do the "dirty work" and make determinations of ethical proportions on a case-by-case basis. The code of ethics should be reviewed on a regular basis, such as annually or bi-annually, to ensure the stated guidelines are still applicable and reflect the ethical considerations of the organization and tax laws. The board members should also be required to annually re-read and confirm their agreement to follow the code of ethics, so this policy is not lost in the daily grind of the operations of the organization.

B. Conflict of Interest Policy

The directors of the foundation owe fiduciary duties to the organization, including a duty of care and a duty of loyalty. The duty of care requires the directors to act in good faith, with the care an ordinarily prudent person in a similar case would exercise, and in a manner the director reasonably believes to be in the organization's best interests. Similarly, the duty of loyalty requires the directors to

[30] *Id.*

[31] *See*, *e.g.*, Internal Revenue Service, "Good Governance Practices for 501(c)(3) Organizations," http://www.irs.gov/pub/irs-tege/governance-practices.pdf (issued as a discussion draft in February 2007, though subsequently removed).

[32] *Id.*

act in the interest of the organization, rather than for some other personal or business interests. A good conflict of interest policy helps the directors fulfill these duties, while also eliminating the risk of self-dealing transactions and private benefit to the directors.

Some organizations deal with this issue in their bylaws, but more often the policy is adopted through board resolution.[33] A good conflict of interest policy requires disclosure by the board of directors, officers, key employees, and sometimes even additional persons related to the organization, of any transactions (proposed or otherwise) or relationships that may cause a conflict of interest, whether it be personally or financially.[34] It is even possible for directors to have positional conflicts on matters of policy which may not be fully covered by a policy limited to financial or personal interests.[35] While the IRS does not include significant others in its definition of family relationships, the organization may want to recognize significant others of its insiders as "family" in the conflict of interest policy requirements, in order to avoid potentially devastating and public conflicts that may arise. This is especially true when parties (although not related by blood or marriage) are living in the same household with someone such as a board member or officer, and may be close enough to the inside of the organization to have a conflict of interest arise.

The policy should include a process to evaluate any disclosures made, so that the non-interested directors can determine whether there is a conflict of interest present, the nature of that conflict of interest and whether it can be handled properly. Because foundations are subject to the prohibition on self-dealing found in Section 4941 of the Code, the foundation's conflict of interest policy should not be so broad as to allow a conflict of interest that would nevertheless constitute self-dealing. Finally, the policy should include in its process the requirement that the director who disclosed the potential conflict of interest be dismissed from the meeting to discuss the conflict, and that there be good record-keeping of the process followed in dealing with the conflict of interest. The board should record in the minutes of the meeting the process followed and how the conflict of interest was handled.

Without a conflict of interest of policy, board members may disagree over the significance of a conflict of interest and whether it should be disclosed to the board; however, the failure to disclose even what may appear to be a conflict can foster distrust, which affects other deliberations when the undisclosed conflict is later brought to light.[36] If the board member has another interest which would compromise his ability to be objective in making decisions that affect the foundation, then he should disclose the interest and remove himself from the discussions.[37] When not disclosed or handled properly, perceived conflicts bear a far greater risk of creating further disputes within the board than when they are disclosed and can be handled according to the conflict of interest policy in place.[38]

For example, if a foundation is proposing to purchase a tract of land for its exempt purposes, but the land is owned by an entity in which a director holds a fifteen percent (15%) interest, this would be a conflict of interest that should be disclosed in a board meeting. During the meeting, the director(s) having an interest in the transaction should present to the rest of the board what exactly his interest is in the proposed transaction, including all material facts. After this disclosure, that interested director should leave the meeting, so the remainder of the disinterested directors may discuss the proposed transaction and take a vote. The board should determine whether the foundation can obtain a more advantageous transaction or arrangement from another source which would not cause a conflict of interest; however, if this is not reasonably possible, then the board must determine by vote whether the transaction is in the foundation's best interests, for its benefit and whether the terms are fair and reasonable. This entire process should be documented in the minutes of the meeting, including the name of the person(s) who had a financial interest, the nature of that interest, the determination of a conflict of interest, who was present for discussions and the votes related to the transaction, the content of the discussion and the record of votes taken. The minutes should also reflect why the board decided the particular property fits the needs of the foundation.

At least once a year, all of the persons subject to the policy should complete a reporting statement, disclosing any relationships that could raise a conflict of interest during that year (see Attachment 2 for an example). In addition, the policy should require the disclosure of these situations as they arise throughout the year.

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33 Kramer, Donald W., "Conflict of Interest Policies Help Avoid Problems," NONPROFIT ISSUES, Vol. X No. 10, February 2013.

34 Kramer, Donald W., Noel A. Fleming and Deborah J. Zateeny, "Advising Non-Profits: Top Ten Policies and Practices for Nonprofit Organizations," The American Law Institute, March 26, 2013, video presentation.

35 Kramer, *supra* note 33.

36 Reuben, Richard C., "Corporate Governance: A Practical Guide for Dispute Resolution Professionals," American Bar Association Section of Dispute Resolution, 2005.

37 *Id.*

38 *Id.*

One of the challenges when dealing with family foundations is finding disinterested directors that can make decisions on conflict issues. Where all directors are members of the same family, the policy may well treat all directors as interested. In such instances, the foundation may choose to have an alternate procedure in place to allow the directors to seek disinterested advice and make a decision based upon that disinterested advice in a way that they believe serves the best interests of the foundation. For example, a foundation may include an alternate provision in its conflict of interest policy providing that if all directors have a conflict, the foundation will appoint a committee comprised of advisors to the foundation, including the foundation's accountants, attorneys, or other individuals as selected by the directors, to review any particular transaction or arrangement and make a recommendation to the governing body or committee with respect to the adoption of the particular transaction or arrangement. While such advice will not relieve the governing body or committee from exercising its governance obligations, it will provide an objective review to assist the governing body or committee.

C. Advanced Resignation Protocol

To address sensitive director fitness issues arising in circumstances occurring outside the boardroom, the board may want to adopt an advanced resignation protocol, either as part of the conflict of interest policy, or through a free standing policy. This type of process would cover situations in which a member is under some type of criminal or civil investigation, or has been involved in some fraudulent or immoral behavior in their personal or business life.[39] Because the other board members may have a difficult time removing the subject board member on their own, this type of protocol can be helpful in managing the board's obligation to maintain the organization's reputation and fiduciary culture.

The policy would advise the directors of the type of external personal or business circumstances that could potentially affect their fitness for board service, and require them to promptly disclose such development to the board or a governance committee. Along with the disclosure, the policy could require that member to tender his resignation, and the non-conflicted board members then have the option of accepting or rejecting the resignation after a diligent review of the circumstances and reputational impact on the organization. Alternatively, the policy could require the board member to disclose the issue to a specified point person (board chair and/or executive leadership) upon becoming subject to the specified types of judicial or regulatory proceedings, giving the board the freedom to decide how to react to the disclosure and rely on its removal powers to ultimately deal with the situation.

The policy must define the types of conduct or situations that would trigger the removal action; this would likely include violations of criminal law, as well as civil judgments relating to the basic qualifications for board service and violations of standards of professional conduct or ethics (such as in medicine or law). Including matters of morality may be too subjective of a criteria, although depending upon the family, may be included. Matters of gossip or media rumors likely should not be included as a triggering event. With formal criminal or civil allegations, although the principal of "innocent until proven guilty" remains true, this must be balanced against the larger risk of reputational damage to the foundation should the director continue serving during the proceedings. In determining what fitness-to-serve criteria should include, the board may desire to involve its general counsel or an ethics advisor and form a governance committee to develop and regularly review such policy.

D. Roles & Responsibilities

Directors should ensure that policies and procedures are established and followed to help them meet their fiduciary duty of care. As referenced above, the duty of care requires the directors to act in good faith, with the care an ordinarily prudent person in a similar case would exercise, and in a manner the director reasonably believes to be in the organization's best interests. A policy can be enacted so that each director is familiar with the foundation's activities, knows if, and how, those activities promote the foundation's mission and achieve its goals, and has full and accurate information to make informed decisions about the foundation.[40] The board member's roles and responsibilities should be laid out in a clear, articulate way, perhaps in a Board Commitment Form, for each member to sign and review on a regular basis.

The directors are responsible for monitoring the foundation's programs and performance, to ensure the organization is fulfilling its mission and operating at maximum effectiveness.[41] They should also ensure financial, legal and ethical integrity of the organization, through budget management, financial controls, risk management, and setting ethical standards.[42] The board is responsible for providing adequate resources for the

[39] Peregrine, *supra* note 29.

[40] IRS, *supra* note 31.

[41] Kramer, Donald W., "Board Roles and Responsibilities – and Potential Liabilities," Nonprofit Issues, January 16, 2013.

[42] *Id.*

organization (financial and human), ensuring adequate leadership, enhancing the organization's public relations and attending to the overall health and development of the board.[43]

A Board Commitment form may also list the specific responsibilities and expectations of the individual board members. This may include the requirement to regularly attend board meetings, actively participate in meetings and support the organization in the community, personal financial contributions, and any term limitations.

Rather than having rigid term limits, the policy could provide the requirement that the board members perform regular self-assessments, so that the directors or trustees self-determine at what point they are no longer an asset to the organization and they should quietly step down, allowing a new member to join the board.[44] Rigid term limits with automatic discharge of board directors at a specified time could cause issues within the organization; whether a specific foundation should include term limits is dependent upon the nature of that foundation and the board. The Bylaws typically provide that a majority of the board may remove a director for cause; however, family harmony can be sought by giving the director the opportunity to be heard before being removed.

The foundation should set out the considerations to be made when inviting a new member to the board. How many other boards does that person serve on? How committed is this person to the mission of the organization? Are they truly interested in what the foundation does, or is he/she just a big donor, important to your organization financially, but someone who will not contribute to discussions? The foundation may also consider whether the policy should specify a set minimum financial contribution to be met by each board member, or should the policy allow each person to give something according to their personal resources, so that the policy promotes the ideal of fundraising? The board policies should promote and re-enforce the practices it uses within the community.

E. Whistleblower Policy

Another policy closely related to the organization's code of ethics and conflict of interest policy is the whistleblower policy. Having a set whistleblower policy is good governance, for the foundation to effectively handle complaints and establish procedures for directors or employees to report suspected internal issues in confidence.[45] If there is no policy in place, it is more likely that the complainant will go outside of the organization to report it, giving the organization itself no chance to handle the problem internally first. The policy and procedures being regularly followed can help avoid the issue becoming an immediate public relations disaster.

The whistleblower policy should clearly identify who is covered by the policy, which usually includes the directors, officers, employees, and perhaps volunteers, and describe the types of issues that should be disclosed under the policy, such as violations of law or violations of the organization's own policies.[46] The policy should then provide for a reporting mechanism, by which the complainant files a report, and with whom it should be filed.[47] The policy should offer an anonymous reporting option, and should state that the reports of any violations or suspected violations are to be kept confidential, to the extent possible. The policy should require that the complainant be acting in good faith and have reasonable grounds for believing the information disclosed indicates a violation of some policy or law. Any person making a good faith report under the policy shall suffer no harassment, retaliation or adverse employment consequences; in the event some type of retaliation does occur, the policy should also provide for the method of reporting such retaliation, whether to the President or Chairman of the Board. Finally, the policy should specify the process by which the report is to be investigated and resolved. See Attachment 3 for an example Whistleblower Policy.

II. GOOD GOVERNANCE PROCEDURES

A. Selection & Training of Board

Substantial time and effort should be dedicated to both selecting board members and developing and training them. The selection process can be used to reconfigure a board that has either become dysfunctional, or has had significant disputes and conflicts in the past; thus, it is important to be able to move members on and off the board through some type of regular nominating committee process and/or review.

1. <u>Selection Process</u>

Rather than beginning the process of finding new board members (particularly non-family members) by having current members throw out names of potential candidates without much analytical thought, the board should consider what critical skills are currently missing from the board, and think of potential

43 *Id.*

44 Kramer, Donald W., Noel A. Fleming and Deborah J. Zateeny, "Advising Non-Profits: Top Ten Policies and Practices for Nonprofit Organizations," The American Law Institute, March 26, 2013, video presentation.

45 IRS, *supra* note 31.

46 Kramer, *supra* note 44.

47 *Id.*

candidates for each of those. Critical board functions include leadership, financial skills, fundraising experience, organizational skills, political or social connections, special events experience, prior success with nonprofit boards, or program administration experience. If a nominating committee is given the task of selecting candidates, it may want to seek input from the other board members and staff.

Potential board member candidates should also be evaluated in terms of their contact with or motivation to work for the organization specifically.[48] This could be in terms of a family history of support, experience in the organization's field or sector, family use of the organization's services, or some other personal connection with the organization's purposes.[49] A person's motivation for joining the board significantly influences his or her perspective on the nature of his or her service to the organization.[50] The organization therefore should be careful in selecting board members who have a connection to its mission.

Further, the candidate's prior record of board service should be reviewed for trouble signs, such as incomplete terms.[51] Any references or current and former boardroom colleagues may be interviewed to see if this nominee will be a good fit for the foundation.[52] The organization should also check public and judicial records for any warning signs, which may include criminal records, and conduct a personal interview with the nominee.[53]

The focus in selecting directors/trustees should be on the key areas of the board that are weak and can be improved through new members. It may even be that a former board member should be rotated back onto the board, or into some other key role to influence the foundation's growth and development.

2. <u>Training</u>

Training should be used to explain the mission and purposes of the organization, the directors' fiduciary duties and key responsibilities, and how they should be fulfilling those duties all the while furthering the charitable purposes of the foundation.[54] The training process should be completed both with new members and as a part of a refresher course for the existing board members. When proper training is done, the directors will be more willing to participate in the development of the organization, procuring donors, adding vision to the planning process and bringing their own ideas to the table for discussion.[55] The training should focus on the basic board duties and organizational policies, including the governing documents (such as the articles of incorporation, bylaws, internal policies and procedures) and federal and state legal requirements. New members should be explained the history and significant moments of growth in the organization's life span, to fully understand the mission in order to be able to properly govern and represent the foundation in the community. The board should also regularly review the organization's strategic plans as well as the budgets.

It may be helpful to ascertain the interests of each board member, and assign them to committees with corresponding roles.[56] The organization should provide job descriptions, meeting schedules for each committee, and discuss the roles of the committee before asking new members to choose their favorite.[57] This will give the organization a more committed group, and they will be more inclined to participate, with clearly defined roles.[58]

The information from the training program should be reinforced throughout the year, which may be through reporting, asking for feedback and encouraging input. It may be helpful to have the board members complete an annual evaluation, to review their roles in conjunction with the organization's strategic plan. The survey should allow an objective review and analysis of the results, with items such as: whether the board understands the mission and purpose, whether the board understands its fiduciary responsibilities, whether the board monitors the foundation's financial condition, whether the board reviews the foundation's compliance with regulatory requirements, and whether the board is involved in following the policies of the organization.

B. Defined Structure to Address Disputes

The organization should have a process and procedure in place for dealing with conflicts early, and have a pre-determined conflict manager for any internal issues.[59] The executive director should likely not be the chosen conflict manager; rather, there should be some designated person for managing the internal conflict, such as a skilled board chair who can

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48 Miree, Kathryn W., "Managing the Board: Governance, Administration and Marketing," Planned Giving Design Center Network.
49 *Id.*
50 *Id.*
51 Peregrine, Michael W., "The Disruptive Director: Symptoms and Solutions," GOVERNANCE INSTITUTE, April 2012.
52 *Id.*
53 *Id.*
54 Miree, *supra* note 48.

55 *Id.*
56 *Id.*
57 *Id.*
58 *Id.*
59 Angelica, Marion Peters, "Resolving Board Conflicts," http://www.tgci.com/magazine/ResolvingBoardConflicts.pdf.

encourage the parties to resolve the issues outside the boardroom.[60] An option for the conflict procedure would be to set up a private meeting between the directors in conflict, to encourage diplomacy (while making sure there is no quorum so this does not turn into an official board meeting). If the board chair is unable or unwilling to be this person to manage conflict, the organization should seek another leader, perhaps a vice chair, or a highly respected past board chair or board member. The key is to make sure the designated conflict manager has conflict management skills, is respected by all parties, is viewed as impartial, and can be objective. If none of these persons fit the skillset, then the organization should consider outside sources.

III. BYLAWS

The organization's bylaws should also serve as a tool to deal with, and perhaps avoid, internal conflicts leading to the demise of the organization. First, the bylaws should include provisions governing the board of directors or trustees itself, such as how many directors there must be, how they are elected, how vacancies are filled in the middle of a term and any set term limits. The bylaws should specify a process for the removal of a board member with or without cause, so that those members who are not supportive of the common goal of the organization can be removed. This process may involve a hearing in which the board member subject to removal has a chance to speak his side of the issue, perhaps in front of an advisory committee of the board or some outside advisor, or the process may just require a vote of the majority of the board members, depending on the size and function of the foundation. The bylaws should allow the board to create advisory boards and committees, and specify those term limits, vote requirements, and removal provisions. The bylaws should specify how officers are elected and removed, as well as give job descriptions of each officer position. Finally, the bylaws should reinforce the prohibitions of private inurement and self-dealing transactions, but allow reasonable compensation.

DEALING WITH CONFLICTS

I. IN GENERAL

Once a conflict or dispute has arisen, the board needs to ensure the conflict is managed to a resolution, keeping as many board members committed to the foundation as possible, and avoiding any unnecessary public relations issues. Dealing with the conflict as soon as it arises hopefully will avoid the progression of the conflict to the point of forcing board members out or even the termination of the foundation. The conflict can be dealt with internally, through the system the organization has in place, or if that is insufficient, the dispute may need to be handled by an outside, neutral, advisor.

II. DEALING WITH CONFLICT INTERNALLY

A. Staff & Board Conflicts

Whether the conflict is between the staff and board, or between board members themselves, there should be some type of process to address the issues and move toward joint resolution. The board chair or a personnel committee may be the chosen advisor to hear and resolve these conflicts. If there is not such a committee, it may be wise to have the board delegate the task to an executive subcommittee.[61] Using a subcommittee gives the organization two chances for internal conflict resolution: first through the subcommittee, then through use of the full board, if necessary.[62] Also, use of a subcommittee keeps the conflict more confidential and frees the remainder of the board members to attend to the organization's other business.[63] The subcommittee should hear from all of the parties and help devise and test potential solutions.[64] The subcommittee may also serve as arbitrator, developing a resolution it thinks is best for the situation and organization. The subcommittee's decision can either be final, or be subject to ratification by the full board, depending on the terms set out in the Bylaws. Either way, the full board should always be informed of the outcome of the conflict and its implications for the organization.[65] If the parties are still dissatisfied, the conflict resolution procedure should provide another hearing with the full board.

B. Dealing with Disruptive Directors

When dealing with a director who is causing disruption in the boardroom, there should be attempts to solve the issue before the removal of the director.[66] First, the organization (whether it is a board chair or selected sub-committee to hear these issues) should attempt to understand what is at the core of his conduct. There may be some merit to his position, or some good faith belief that his conduct will help the organization. Sometimes the problem is in the way the person is communicating the message, rather than the message itself.

Periodic governance evaluation procedures can also be helpful to combat disruptive behavior, especially when board members are asked to comment

60 *Id.*

61 *Id.*
62 *Id.*
63 *Id.*
64 *Id.*
65 *Id.*
66 Peregrine, *supra* note 51.

on the effectiveness of their colleagues according to specified criteria, and when those comments are then shared with the full board.[67] When evidence of some type of improper behavior arises, the implicated director should be cautioned by his or her board peers about the damaging effects of his behavior and be encouraged to adopt a more productive manner for expressing his views.[68] In extreme cases, the board leadership may decide to bring in a third party facilitator to confront the disruptive director on behalf of the board, and act as more of a counselor to the implicated board member, to encourage a change in behavior.[69] Ultimately, it may be a matter of allowing the implicated director's term to expire without re-nomination, or the board may need to take a more proactive step of removing the director. Adopting a protocol along an escalating scale may mitigate some of the immediate concerns of having a disruptive director, and reserve the right of removal until it is necessary. If the board determines removal is necessary, the records would show the prior, good faith efforts by the board to resolve the issues.

C. Board & Executive Conflicts

A conflict between an executive director and the board usually causes either the executive to resign or be fired, or perhaps board members to resign. Either way, the foundation loses significant leadership and expertise in this situation. When small conflicts occur between the executive and the board, they should be immediately dealt with and resolved; if gone unnoticed or unaddressed, the conflict may not be resolvable. If there is an extreme conflict between the executive and board, an external resource usually is the best option.[70] This could include a mediator, organizational consultant, previous board chair, executive or similar leader with conflict management skills. Regardless of the resource chosen, it is imperative to make sure that resource is regarded as neutral by all parties.

III. USING OUTSIDE RESOURCES TO DEAL WITH CONFLICT

An outside advisor can be helpful in training the board members to effectively deal with conflict themselves, as well as facilitating the conflict management, or actually resolving the dispute for the board members.[71] The capacity in which the outside advisor will be most helpful to the conflict resolution depends on the parties involved, the type of conflict, and the progression of the issues.

A. Professional Conflict Management Training

The organization may choose to have a dispute resolution training professional educate the board members on how to effectively avoid disputes and disruptions in the furtherance of the organization's charitable goals. The training may involve working with small groups of board members, individual members or the board as a whole. Conflict quickly brews when views are aired confrontationally and without showing respect for potentially different views of other board trustees, which can stifle communication and alienate other board members, leaving issues unresolved.[72] Thus, the training should emphasize communication skills, listening and assertion.

Training should include the characteristics of good listening and the art of active listening, emphasizing the nature and importance of asking clarifying questions, opening up the speaker rather than inhibiting them.[73] Board members should work from a learning stance, meaning the listener recognizes that people's perceptions of situations vary, and the failure to recognize the potential differences in perceptions could itself lead to unnecessary conflict.[74] Rather than assuming the listener knows what the speaker is saying, he operates from the assumption that he does not know what or why the speaker is saying what he is – working from a point of inquiry rather than assumption.

Board members also need to be trained on how to assert their perspective effectively, communicating respect for the listener and the content of the statement, rather than appearing defensive or confrontational when making an assertive statement. Finally, directors can benefit from training on how to keep discussions focused on the issues at hand and the interests of the organization, and not on any side disagreement with personalities, setting apart any emotional responses and personality clashes that may arise in the process.[75]

B. Third-Party Conflict Management Facilitator

Another helpful way to have an outside advisor resolve conflicts is to have the third party facilitate the conflict management, interacting with the board in its resolution of a dispute, but not going so far as to decide the disagreement for them. This may be done again either with a small committee or the full board. The third party can help facilitate the board's consideration

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67 *Id.*
68 *Id.*
69 *Id.*
70 Angelica, *supra* note 59.
71 Reuben, Richard C., "Corporate Governance: A Practical Guide for Dispute Resolution Professionals," American Bar Association Section of Dispute Resolution, 2005.
72 *Id.*
73 *Id.*
74 *Id.*
75 *Id.*

of the issue and foster dialogue on interests, concerns, problems and practical solutions. The fact that this third party is disinterested is advantageous to the dispute-management process, allowing for the expression of ideas and opinions that otherwise may be immediately devalued by the persons in conflict, had they been brought forth directly by a disputing party.[76]

The neutrality of this third party presence may also make the conflict resolution process and ultimate decision more acceptable and legitimate in the eyes of the disputing parties. Through this process, the disputing parties are given a chance to participate and the participants are treated fairly.[77]

Because the process fosters mutual understanding and respect, there is a greater chance of having compliance with and support for the ultimate decision made. Participation is important, to show the parties are respected and are given a voice. It also helps ensure there are multiple viewpoints being expressed, and ensures compliance with the process because the participating members have been able to have their views expressed and considered by the other parties.[78] Further, transparency in the resolution process offers confidence in the conflict management process, ensuring it is not influenced by hidden agendas or other issues, and provides for accountability for all involved. Ensuring that the board members are treated equally and fairly in the conflict management means they can have more confidence in the process, as opposed to feeling like one disputing party was given more attention or consideration than another. Finally, having a legitimate conflict management process builds the relationships and good will among board members, allowing the foundation to continue moving towards its purposes and goals even in the midst of a dispute. It adds to the energy and effectiveness of the board as decision-makers, promotes cohesiveness, and team spirit.[79]

C. Mediation and Arbitration

If the dispute has risen to an extreme level, it may be more appropriate to have a third party dispute resolution professional serve as a fact-finder, mediator or arbitrator. The board members may choose to have the professional serve as a fact-finder, a neutral third party investigating facts that are in question and providing an independent report, perhaps with a recommendation of a solution or set of solutions. For example, if there are fact issues involved in a potential conflict of interest situation, it may be helpful to have this independent third party resolve some of those issues.[80] The importance here is that the third party does not have a stake in the outcome or what the board ultimately decides to do, such that there is both actual and perceived neutrality.

A mediator works with either the full board or committee to help the disputing parties come to a resolution, similar to the facilitator role described above. The mediator does not make the decision for the parties, but rather facilitates the process of coming to a solution, as a third-party neutral. The mediation process is kept confidential, and helps the parties mutually move to a resolution. If needed to prevent the dispute from splitting up the foundation, the organization may choose to proceed with arbitration. An arbitrator would make the decision on the dispute, which could be binding or non-binding depending on the group (or committee) who chose to resolve the issues by arbitration.

No matter what type of third party professional the organization decides to help resolve the dispute, the precise role to be performed must be made clear from the beginning.[81] If the parties choose one role and decide to change the role during the process (for example from a facilitator to an arbitrator), there must be full disclosure of the different nature of the new role and potential risks to the disputing parties.

D. Moving from Consensual to Coercive Resolution

In the event the parties cannot agree upon an arbitrator or fact-finder and are otherwise unsuccessful through their efforts of conflict resolution, the parties may choose to turn to litigation. Where the conflict is generated as a result of discordant personalities or different views of how a foundation should operate, litigation would be a method of last resort. However, in other situations litigation may be the preferred method. For example, where conflict arises from a director's breach of fiduciary duty that has caused harm to the foundation and such director is unwilling to unwind the transaction or otherwise make restitution the directors may find it necessary to file a lawsuit to hold the individual accountable for breach of fiduciary duty. Generally, this will follow removal of the individual from the foundation. In any such instance, the remaining directors must satisfy their fiduciary duties—particularly those of care and loyalty—in protecting the organization, its assets and its mission. Depending upon the facts, this may take the form of removing the subject director, reporting a diversion of assets on a Form 990–PF and Form 4720, seeking restitution, filing suit, or even seeking criminal charges. No general rule can be given because the

76 *Id.*
77 *Id.*
78 *Id.*
79 *Id.*
80 *Id.*
81 Reuben, *supra* note 71.

action taken will necessarily depend upon the particular facts. However, in any such situation, the remaining directors must be aware of their own duties to the foundation and seek to fulfill those duties putting the foundation in the best position possible, based upon all the facts. The directors should consider the nature of the breach, the injury to the foundation, the willingness (or unwillingness) of the breaching director to unwind or otherwise cure a transaction, the likelihood of restitution, other assets available should restitution be brought through criminal proceedings, indemnification obligations of the foundation, public relations issues, and the costs to the foundation of pursuing any such claims. All of these factors must be weighed by the directors in the exercise of their duty of care and duty of loyalty.

WHEN DISPUTES GO TOO FAR

I. SPLIT-UP AND TERMINATION OPTIONS

When a private foundation has become divisive and a burden on the family or board members, the foundation may choose to terminate and distribute its assets to one or more public charities or to another private foundation (or foundations) with similar charitable purposes, or possibly various purposes to meet the divergent charitable goals of the group. The board could choose to distribute all of its net assets to a donor advised fund, but not necessarily terminate the foundation, and continue as a board in an advisory role as to the use of the fund's assets. The foundation may also choose to split up into multiple private foundations, continuing the existing foundation with a portion of its assets and board members.

The bylaws and certificate of formation should provide that in the event of termination, the foundation's assets are to be transferred to a religious, charitable or similar organization(s) that qualifies under Section 501(c)(3) of the Code. If a transfer of assets pursuant to an re-organization, liquidation, merger, etc. is made to an organization *not* described in Section 501(c)(3) or treated as such under Section 4947, such transfer of assets is considered a taxable expenditure under Section 4945(d)(5).[82] Thus, the transfer of assets must be to a 501(c)(3) organization or to one treated as described in Section 501(c)(3) under Section 4947.[83]

A. General Rules

Once an organization is a private foundation, it can only terminate its private foundation status by showing that regulatory supervision is no longer necessary, i.e. by complying with the requirements of Section 507, so that its assets are subject to public supervision, either through the transfer of its assets to a Section 509(a)(1) charity, or by payment of the Section 507 tax.[84] The rule is once a private foundation, always a private foundation, unless status is terminated under Section 507.[85] The word "termination" as used in Section 507 is a term of art under federal law, as it does not refer to the organization's legal existence, which may continue under state law despite termination under Section 507.

Private foundation status exists independent of an organization's exempt status; thus, for non-exempt charitable and split interest trusts, Code Section 4947 provides that these trusts are treated as organizations described in Section 501(c)(3), and therefore they are subject to both the provisions of Section 509 and Chapter 42.[86] Section 507 applies to non-exempt charitable trusts which are private foundations. Section 507 also generally applies to split interest trusts.[87]

Section 507 covers three ways a private foundation may distribute its assets and terminate its status, and another method in which it may split-up, but the private foundation's status is not terminated. The below solutions can function to support the founder's fundamental charitable goals, without the costs and headaches of continuing with the management of the private foundation.

B. Section 507(a) Termination

Under Section 507(a), a private foundation's status will only be terminated if the organization notifies the Secretary of its intent to terminate (voluntary termination), or if there have been repeated or flagrant violations of the Chapter 42 provisions (involuntary termination). Section 507(c) imposes a tax on each organization whose private foundation status is voluntarily or involuntarily terminated under Section 507(a). The organization must pay the 507(c) tax, less any amount abated under 507(g), or have the entire amount abated under 507(g).[88] The tax imposed is the lesser of: (i) the amount the foundation substantiated by adequate records or other corroborating evidence as the aggregate tax benefit resulting from the tax exempt status of the foundation, or (ii) the value of the net assets of the foundation. The value of the organization's net assets for purposes of Section 507(c) is to be determined at whichever time such value is higher: either the first day action is taken by the foundation which culminates in its ceasing to be a

[82] Treas. Reg. § 1.507-3(b).
[83] *Id.*

[84] IRS Internal Revenue Manual, 7.26.7, Termination of Private Foundation Status; http://www.irs.gov/irm/part7/irm_07-026-007.html.
[85] *Id.*
[86] IRS Manual 7.26.7., *supra* note 84.
[87] *Id.*
[88] *Id.*

private foundation, or the date it ceases to be a private foundation.[89] Thus, if a foundation voluntarily terminates its status under Section 507(a) and distributes all of its net assets in the process, then it will have no tax to pay under Section 507(c).[90]

1. Voluntary Termination (507(a)(1))

Section 1.507-1(b)(1) of the Regulations provides that in order to voluntarily terminate its private foundation status under Section 507(a), the foundation must submit a statement to the Manager of Exempt Organizations Determinations, Tax Exempt and Government Entities Division, of its intent to terminate, including a detailed computation of the amount of tax under Section 507(c). Any 507(a)(1) termination does not relieve the foundation or any disqualified person(s) of tax liability under Chapter 42 for acts or failures to act prior to termination, or for additional taxes imposed for failures to correct those acts.[91]

If a private foundation voluntarily terminates its status under 507(a) but continues operation afterwards, it will need to re-apply for recognition of exemption as a 501(c)(3), if it wishes to be treated as exempt.[92]

A transfer of all of the assets of a private foundation or a significant disposition of assets by a private foundation is not deemed to result in the termination of the transferor foundation unless it elects to terminate under 507(a)(1) or is involuntarily terminated under 507(a)(2).[93] For example, if a private foundation transfers all of its assets to one or more other private foundations (or a private foundation and a public charity) pursuant to Section 507(b)(2) and Reg. 1.507-3(c), the transferor foundation is not treated as having voluntarily terminated its private foundation status under 507(a)(1).[94] Also, if a private foundation transfers all of its assets to a Section 509(a)(2) organization, the transferor foundation will continue to be treated as a private foundation. Thus, if a bequest to the foundation is made in a year following the year of the transfer, it will be regarded as having been made to a private foundation and the foundation will be subject to the provisions of Chapter 42 with regards to those funds.[95]

If liability for any tax under Chapter 42 is incurred by the transferor foundation in the process of making such a transfer, the transferee organization may be liable for the payment of those taxes.[96]

A private foundation which transfers all of its net assets away is required to file the annual 990-PF for the taxable year in which that transfer occurs; however, later returns are not required to be filed so long as the foundation has no legal or equitable title in any assets nor engages in any activity subsequent to that year.[97]

C. Section 507(b)(1) Terminations

Two types of termination are available under Section 507(b)(1): distribution of the foundation's net assets to specified public charities, or the conversion to and operation as a public charity. Foundations terminating their status under 507(b) are not subject to the 507(c) termination tax.

1. Distribution to Public Charity (507(b)(1)(A))

Under Section 507(b)(1)(A), a foundation may terminate its status by distributing all of its net assets to one or more organizations described in 170(b)(1)(A) (other than clauses (vii) and (viii)), each of which has been in existence and so qualified for at least 60 calendar months immediately preceding such distribution.[98] Also, the foundation must not have committed any act or failure to act giving rise to liability for tax under Chapter 42, and it must distribute all of its "right, title and interest in and to" all of its net assets in order to qualify for termination under this section.[99]

A private foundation terminating its status pursuant to Section 507(b)(1)(A) remains subject to the provisions of Chapter 42 until it distributes all of its net assets to the organizations described in Section 507(b)(1)(A).[100] The foundation will only be considered to have distributed all of its net assets within this section if it transfers all of its right, title and interest in and to all of its net assets to one or more organizations referred to in Section 507(b)(1)(A).[101] To fulfill this requirement, the transferor foundation may not impose any material restrictions or conditions which prevent the transferee organization from freely and effectively employing the transferred assets, or the income from those assets, in furtherance of its exempt purposes.[102]

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[89] Treas. Reg. § 1.507-7(a).
[90] The 507(c) tax does not apply to a 507(b)(1)(A) or 507(b)(2) transfer unless 507(a) becomes applicable. Treas. Reg. § 1.507-4(b).
[91] Treas. Reg. § 1.507-1(b)(2).
[92] Treas. Reg. § 1.507-1(b)(3).
[93] Treas. Reg. § 1.507-1(b)(7).
[94] Treas. Reg. § 1.507-1(b)(6).
[95] *Id.*
[96] Treas. Reg. § 1.507-1(b)(8).
[97] Treas. Reg. § 1.507-1(b)(9).
[98] I.R.C. § 507(b)(1)(A); Treas. Reg. § 1.507-2(a)(1).
[99] IRS Internal Revenue Manual, 7.26.7, Termination of Private Foundation Status; http://www.irs.gov/irm/part7/irm_07-026-007.html.
[100] Treas. Reg. § 1.507-2(a)(4).
[101] Treas. Reg. § 1.507-2(a)(7).
[102] Treas. Reg. § 1.507-2(a)(8).

If a private foundation distributes all of its net assets to public charities pursuant to the requirements of 507(b)(1)(A), the foundation's status is automatically terminated.[103] The foundation is not required to file a notice of termination under Section 507(a)(1); thus, the private foundation can make the distributions without giving advance notice to the IRS of its intent to terminate and is not liable for tax under Section 507(c).[104]

The qualifying distributees under Section 507(b)(1)(A) include: (i) churches or conventions or associations of churches (170(b)(1)(A)(i)), (ii) schools (170(b)(1)(A)(ii)), (iii) hospitals (170(b)(1)(A)(iii)), (iv) medical research organizations operated in conjunction with a hospital (170(b)(1)(A)(iii)), (v) organizations receiving substantial public support or governmental support and operated for the benefit of a college or university owned or operated by a governmental unit (170(b)(1)(A)(iv)), (vi) governmental units described in Code Section 170(c)(1) (170(b)(1)(A)(v)), and (vii) organizations that normally receive a substantial part of their support from the public or government (170(b)(1)(A)(vi)).[105] Also, the distributee organization must have been in existence and have been so described for a continuous period of at least 60 calendar months immediately before the distribution. However, a distributee organization in existence less than 60 months will qualify as a proper distributee if it was formed from the consolidation of two public charities, each of which would have been in existence for 60 months at the time of distribution had they not been consolidated.[106] A private foundation seeking to terminate its status under this section may rely on a final ruling or determination letter issued to a potential distributee organization that such organization is described in Section 170(b)(1)(A)(i) through (vi), unless public notice is given that this classification has been revoked or the grantor has some knowledge of the distributee's classification revocation. If the transferee organization becomes a private foundation within three years from the date of transfer, the transfer will be considered a transfer under Section 507(b)(2) (see below for the rules related to this type of transfer) rather than a 507(b)(1)(A) termination.[107]

However, if a private foundation distributes all of its net assets to one or more Section 509(a)(1) public charities, at least one of which has been in existence for less than 60 continuous calendar months, or to one or more 509(a)(2) or (a)(3) organizations, the private foundation's status is <u>not</u> terminated, unless the foundation gives the notice under Section 507(a)(1).[108] Similarly, if the foundation transfers less than all of its net assets to qualifying distributees under 507(b)(1)(A), it will have not terminated its foundation status pursuant to these provisions, and must follow the notice provisions of 507(a)(1) if it intends to terminate. The submission of a Form 990-PF marked "Final" <u>does not</u> constitute notice of termination of private foundation status under Section 507(a)(1).[109] If the private foundation does not give notice and does not terminate, the foundation is not subject to tax under Section 507(c).[110] If the private foundation chooses to provide notice, thus terminating its status, it is subject to the tax under Section 507(c) on the date notice is given.[111] However, if the foundation has no net assets on the day it provides notice, the tax imposed by Section 507(c) will be zero.[112]

For example, if a foundation chooses to distribute all of its net assets to a museum (a 509(a)(2) <u>organization</u>), upon distribution of all of its net assets, the foundation's status is not terminated (and thus, no tax is due under Section 507(c)), unless it chooses to give notice under section 507(a)(1). The same would be true if the foundation distributes all of its net assets, without imposing any material restrictions on the transferred assets, to a zoo or some type of supporting organization.

Therefore, if the foundation board determines that its purposes would best be served by turning its assets over to a public charity, and can jointly agree on one or more public charities that would accomplish its purposes, the foundation can distribute all of its net assets to that public charity (or charities) in accordance with the rules above. In order to terminate its status under 507(b)(1)(A), the foundation must satisfy its outstanding liabilities, including any federal taxes, and distribute the remaining assets to qualified organizations. If the foundation is terminated, it should file a final 990-PF with the IRS for that year. The organization may also have to comply with applicable state law requirements when terminating.

2. <u>Operation as Public Charity (507(b)(1)(B))</u>

A foundation may also voluntarily terminate its private foundation status by operating as a public charity for 60 months, without incurring the 507(c) termination tax. The foundation must not be found to have engaged in willful, repeated acts or failures to act

[103] Rev. Rul. 2003-13.
[104] Treas. Reg. §1.507-2(a).
[105] Treas. Reg. §1.507-2(a).
[106] Rev. Rul. 75-289; IRS Rev Manual 7.26.7, *supra* note 99.
[107] Treas. Reg. §1.507-3(e).

[108] Rev. Rul. 2003-13.
[109] Treas. Reg. §1.507-1(b)(1).
[110] Rev. Rul. 2003-13.
[111] *Id.*
[112] *Id.*

giving rise to Chapter 42 tax liability, must meet the requirements of Section 509(a)(1), (2) or (3) for a continuous period of 60 calendar months beginning with the first day of the taxable year, and must notify the Service prior to that period it is terminating its private foundation status, according to the notification requirements of Reg. 1.507-2(b)(1)(ii). The organization must satisfy the IRS that immediately after the applicable time period, the organization has complied with the requirements of 509(a)(1), (2) or (3) during that time.

To accomplish the termination of private foundation status and conversion to a public charity, the organization must change its organizational structure, its operations, the sources of its support, or a combination of these items, in order to meet the requirements of 509(a)(1), (2) or (3) for a continuous period of 60 calendar months. Thus, it is unlikely a foundation which has been divided due to internal conflicts to the point of termination will desire to go through the hassles of converting to a public charity. Rather, the foundation would be better off distributing all of its assets to another exempt organization, whether a public charity and/or other private foundations.[113]

3. Distribution to Donor Advised Fund

Family dynamics as well as the hassle of managing a foundation can become burdensome; a useful alternative to the private foundation structure is transferring the assets to a donor advised fund ("DAF"), a tool that allows the family to be involved in supporting the foundation's charitable goals by directing grants to its specified causes.[114] While a private foundation can distribute its assets to a public charity such as a school or hospital, not every public charity is the ideal transferee of these assets; some public charities go through so many personnel changes that records get lost or money earmarked for a certain cause are re-routed to other purposes.[115] A donor advised fund is a segregated account funded by a donor, but operated by a public charity (or "sponsoring" charity).[116] The DAF is essentially an agreement between the donor and charity giving the donor the (non-binding) right to advise the charity on how his or her contributions to the charity are to be utilized for charitable purposes.[117] To create the DAF, the donor simply makes one or more irrevocable, outright charitable contributions to the charity.[118] The family can choose their level of participation when using the DAF structure.[119]

One of the many benefits of the DAF structure is that the sponsoring charity assumes the fiduciary responsibility for investing fund assets, making grants and complying with federal and state reporting requirements.[120] The donor and donor's family can remain involved in the philanthropy aspect of the fund, with the ability to recommend grants to qualifying charities on an advisory basis, without the burdens of governance and management of a foundation.[121] The donor is also able to choose the name of the DAF, so the family's legacy of philanthropy can be continued, or the donor can choose to remain anonymous, as the sponsoring charity's Form 990 does not disclose information specific to the DAFs.

The DAF also provides better charitable contribution limitations for its donor(s): when an individual donor makes a contribution to a public charity, the donor can generally deduct the contribution for income tax purposes, to the extent it does not exceed 50% of his/her contribution base (vs. a 30% limit as to contributions to private foundations).[122] If the donor(s) make the gift to the DAF during lifetime, the donor is entitled to an immediate income tax charitable deduction.

Further, if there is a disagreement between family members or directors on how to use and disperse a foundation's assets, the foundation can be terminated and the assets assigned to several DAFs, with different advisors.[123] Likewise, if heirs of the founder are not willing to continue the foundation or respect the original purpose of the foundation, the conversion can

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[113] To see the complete set of rules related to converting to a public charity, see Reg. 1.507-2.

[114] Marer, Eva, "The Mechanics of Terminating a Private Foundation," Council on Foundations and Community Foundations of America, 2005.

[115] *Id.*

[116] Batson, Jr.,Ted R., "Closing a Private Foundation into a Donor-Advised Fund," http://www.charitabletrust.com/Newsletter/Newsletter_Archive/Supporting-Documents/Closing-a-PF-into-a-DAF.pdf.

[117] Ackerman, Jonathan D., Emanuel J. Kallina, II & Kathy Hanson, "Charitable Giving With Donor Advised Funds – Part 1," Planned Giving Design Center Network.

[118] *Id.*

[119] Marer, Eva, "The Mechanics of Terminating a Private Foundation," Council on Foundations and Community Foundations of America, 2005.

[120] Batson, *supra* note 116.

[121] *Id.*

[122] Ackerman, Jonathan D., Emanuel J. Kallina, II & Kathy Hanson, "Charitable Giving With Donor Advised Funds – Part 1," Planned Giving Design Center Network.

[123] "Is it time to convert? Private foundations versus donor-advised funds," The Dallas Foundation, Giving Counsel, Summer 2012, http://www.dallasfoundation.org/Portals/0/Uploads/Documents/Giving_news_6-12.pdf.

allow the founder's mission to continue in the form of a DAF.[124]

Various organizations offer DAFs, including local community foundations, national community foundations, colleges, universities, and commercial programs operated by investment firms (e.g., Fidelity, Schwab or Vanguard). If the board of a foundation decides it is time to convert to a DAF, it should identify the key criteria to be used in selecting a DAF program; this may be the existence of grantmaking limitations, available investment options, or support for international grantmaking.

A private foundation can transfer its assets to a qualified public charity without penalty under the rules of Section 507 described above. Thus, in accordance with these provisions, if the sponsoring charity of the fund is tax-exempt under Section 509(a)(1) and has been in existence at least 60 continuous months, then upon the foundation's transfer of all of its assets to the donor advised fund, the foundation is terminated and is not required to give notice to the IRS. If the sponsoring charity is a Section 509(a)(1) charity in existence for less than 60 months, or a Section 509(a)(2) or (a)(3) charity, then the foundation is not automatically terminated upon distribution to the donor advised fund. To terminate the foundation, the organization would need to give notice to the IRS and pay any tax due under Section 507(c). The foundation would then file its final 990-PF with the IRS. Further, upon termination, if the foundation is organized as a corporation, it will likely need to notify the Secretary of State of its intent to cease operations (or other applicable state agency administering corporations in that state).[125] If the foundation is organized as a charitable trust, additional requirements may apply under the appropriate state laws.

For example, in PLR 8836033, the IRS approved the distribution of all of a private foundation's assets to a donor advised fund at a local community foundation that had been established as a 509(a)(1) publicly supported organization for less than 60 months. Following the distribution of the assets, the foundation decided to remain in existence solely to advise the community foundation on the use of the donor advised fund. The foundation's trustees remained on the board to be the initial advisors to the fund, whose recommendations on the use of the assets would be similar to the stated purposes of the community foundation. Because the purposes of the donor advised fund would be considered within the exempt purposes of the community foundation (public charity), that limitation did not constitute a "prohibited material restriction or condition" under Section 507. The IRS held that (i) the foundation continued to qualify as a private foundation, (ii) the distribution of its assets did not result in termination of its status, but was a proper distribution of assets under Section 507, and (iii) the foundation would incur no excise taxes under Chapter 42.

In PLR 200009048, the IRS favorably ruled on a private foundation's transfer all of its assets to a community foundation, (a publicly-supported 509(a)(1) public charity) which had been in existence for at least 60 continuous months prior to the transfer, under a donor-advised fund agreement. The foundation would dissolve after the disposition, but the advisory committee of the fund would be comprised of the trustees of the foundation, to make non-binding recommendations to the public charity's board of directors. The public charity therefore had the ultimate control and authority over the assets, such that there would be no material restrictions or conditions on the use of the fund assets.

D. Section 507(b)(2) Distribution to Private Foundation

A private foundation may transfer all of its assets to one or more private foundations, who will generally "inherit" the characteristics of the transferor foundation. The transferor foundation may then voluntarily terminate under Section 507(a), by "paying" the 507(c) tax of zero (as the transferor would have zero assets at the date of termination).[126] Another option would be to split the foundation into several foundations, by creating one or more new private foundations, and distributing a portion of the transferor's assets to those foundations, to effectuate divergent charitable interests or conflict in the foundation's management.

If a foundation makes a distribution of its assets to another private foundation, as described below, the foundation's status is not automatically terminated under Section 507(a)(1); rather, the private foundation must give notice under Section 507(a) in order to terminate its status.[127] The transfer must still satisfy the requirements of any applicable provision of Chapter 42.[128]

If a private foundation transfers its assets to another private foundation pursuant to any liquidation, merger, redemption, recapitalization or other organization or adjustment, the transferee foundation is not treated as a newly created organization.[129] This

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[124] *Id.*

[125] Batson, *supra* note 116.

[126] IRS Internal Revenue Manual, 7.26.7, Termination of Private Foundation Status; http://www.irs.gov/irm/part7/irm_07-026-007.html.

[127] Treas. Reg. § 1.507-3(d).

[128] *Id.*

[129] I.R.C. § 507(b)(2); Treas. Reg. § 1.507-3(a).

includes any partial liquidation or any other "significant"[130] disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions from current income (i.e. those described in Section 4942).[131] An example of a partial liquidation may be where a private foundation disposes of a substantial portion of its assets, such as ½, to another private foundation in order to effectuate the separation of family or trustee interests. Additionally, if a private foundation transfers all or part of its net assets to a 509(a)(1), (2) or (3) organization(s) and within three years of the date of transfer, one or more of those transferee organizations lose its public charity status and becomes a private foundation, then the transfer of assets is treated as having been a transfer made to a private foundation under Section 507(b)(2) and these rules will be treated as applying from the date on which any transfer was made.[132] A transfer of assets by a private foundation to an entity not described in Code Section 501(c)(3) or treated as described in Code Section 501(c)(3) via Section 4947(a)(1) constitutes a taxable expenditure under Section 4945(d)(5).[133]

The transferee organization is treated as possessing those characteristics of the transferor organization: this includes the aggregate tax benefit of the transferor (with some restrictions) as well as the tax implications of Chapter 42.[134] A transferee foundation which is not effectively controlled, directly or indirectly by the same person(s) who effectively control the transferor foundation cannot succeed to an aggregate tax benefit in excess of the fair market value of the assets transferred at the time of transfer. If the private foundation incurs liability under Chapter 42 prior to or as a result of making the transfer of assets to one or more private foundations, transferee liability may apply so that each transferee foundation is treated as receiving the transferred assets subject to the liability.[135]

Any person who is a substantial contributor to the transferor foundation is also treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the $5,000/2% test as to the transferee foundation. This same rule applies if the transferor foundation makes a transfer to multiple transferee foundations: that person will be a substantial contributor as to all transferee foundations.

If a private foundation transfers all of its net assets to one or more private foundations which are effectively controlled (as defined in Reg. 1.482-1(a)(3)), directly or indirectly, by the same person(s) which effectively controlled the transferor foundation, for purposes of Chapter 42 and Sections 507 through 509, the transferee foundation is treated as if it is the transferor.[136] If the transfer is made to multiple controlled foundations, then each transferee is to be treated as the transferor in proportion to the portion of the fair market value of the transferor's assets which it received. This rule does not apply to the reporting requirements of the transferor foundation under Sections 6033 and 6043, meaning the transferor foundation must still file a 990-PF for the year it transfers all of its net assets and fulfill its other reporting requirements.

Any private foundation which has disposed of all of its assets must file a final Form 990-PF for that year (which includes compliance with any expenditure responsibility reporting requirements).[137] This applies whether or not the foundation has terminated its private foundation status by giving the Section 507(a) notice.[138] The due date of the return is the 15th day of the fifth month following complete liquidation, dissolution or termination.[139] If the entity remains in existence as a dormant shell, without equitable title to assets and without any activity, it is not required to file returns in later years; however, if it receives new assets or resumes activities, it must resume filing the Form 990-PF for those years. Further, Section 6043 requires the transferor foundation to attach a statement to the Form 990-PF for the year in which it has a liquidation, dissolution or termination.[140] The transferor should attach a certified copy of the liquidation plan or any resolutions, as well as a schedule of the names and addresses of recipients of its assets and an explanation of the nature and fair market value of the assets given to each recipient. If the foundation has terminated its status, it should also check the "Final" box on the first page of the form.[141]

The foundation board could potentially distribute all of its net assets to one or more existing private

[130] "Significant disposition of assets" includes a disposition for a taxable year where the dispositions to a private foundation(s) for that year, and as a part of a series of related transactions in prior years, total to 25% or more of the fair market value of the foundation's net assets at the beginning of the first taxable year in the series of related dispositions. Treas. Reg. § 1.507-3(c).
[131] Treas. Reg. § 1.507-3(c).
[132] Treas. Reg. § 1.507-3(e).
[133] Treas. Reg. § 1.507-3(b).
[134] Treas. Reg. § 1.507-3(a).
[135] Treas. Reg. § 1.507-3(a)(4).
[136] Treas. Reg. § 1.507-3(a)(9).
[137] Blazek, Jody, "The IRS Provides Good News for Terminating Private Foundations," 14 TXNEXEMPT 171, January/February 2003.
[138] *Id.*
[139] *Id.*
[140] *Id.*
[141] *Id.*

foundations, with similar charitable goals, and choose to provide notice of termination to the IRS. Likewise, the board members could create new foundations, to further the divergent charitable purposes of the group, and split the assets between them, either choosing to retain the existing foundation and continue it with certain trustees, or dissolve the existing entity altogether. As a part of this process, the transferor foundation must satisfy its outstanding liabilities, distribute out its assets, and (if it chooses to dissolve) terminate its status under these federal guidelines, including the filing of its final 990-PF, as well as any state law requirements.

1. Examples

A. For example, P is a private foundation, whose directors have divergent charitable goals. X, Y and Z are also classified as private foundations under Section 509(a). Under a plan of dissolution, after satisfying all of its outstanding liabilities, P distributes all of its remaining assets in equal shares to X, Y and Z. X agrees to exercise expenditure responsibility for all outstanding grants made by P. The day after distributing all of its assets, P files articles of dissolution with the appropriate state authority. This transfer of assets is a 507(b)(2) transfer, which does not constitute termination of the transferor's private foundation status absent the foundation giving the IRS notice of termination under 507(a)(1). Thus, P's dissolution under state law has no effect on whether P has terminated its private foundation status for federal tax purposes. Since P did not give notice of its intent to terminate, P retains its private foundation status. While it must file a Form 990-PF for the taxable year of the transfer, it is not required to file a Form 990-PF for later tax years in which it does not have equitable title to any assets and does not engage in any activity. If in the future P receives additional assets or engages in other activities, it must file a Form 990-PF. Also, because it has not terminated its status, it continues to be treated as a private foundation. Regardless of whether P chooses to provide notice of its intent to terminate, the transferee foundations, X, Y and Z, are treated as possessing the aggregate tax benefit of P, in proportion to the assets transferred to each.[142]

B. In PLR 201243015, an existing private operating foundation ("A") owned real estate that was initially used for its exempt purposes, but became run-down and unusable for A's purposes. A's founders, who were also directors, founded a second private operating foundation ("B"), to operate an artist-in-residence program for emerging artists. B could use A's real estate in furtherance of its exempt purposes, so A proposed to give that and other personal property to B, as well as provide grants to B in the future as part of its regular grant-making. The value of the assets being transferred exceeded 25% of the value of A's net assets, but A would not notify IRS of intent to terminate. B would be operated and controlled by the same directors and officers controlling A.
Since A transferred over 25% of its fair market value of net assets to B for no consideration, this is a Section 507(b)(2) transfer. Also, B would not be considered a new organization and instead would assume A's aggregate tax benefit in proportion to the fair market value of property it received, over A's total net asset value prior to the transfer.
The transfer did not result in termination under Section 507. The 507(b)(2) transfer of assets was considered a grant to B for capital endowment purposes (because A did not transfer *all* of its net assets, meaning B is not treated as A), thus, the transfer was a taxable expenditure under Section 4945 unless A complies with expenditure responsibility requirements of Section 4945(h). A must make annual reports for year in which grant is made and the following two years in order to comply with Section 4945.

C. An example of using these mechanisms to deal with management conflicts can be found in PLR 201244020. In this case, the initial private foundation made grants to other exempt organizations, including providing funding to scholarship programs administered by educational institutions. The initial foundation had four directors on its board, all family members, with other members of the family serving as grant advisors. To eliminate conflict between management and the divergence of charitable interests of the directors, the board decided to distribute an amount equal to 1/3 of the foundation's assets to each of two new foundations, X and Y. X and Y would be effectively controlled by the same persons as

[142] Rev. Rul. 2002-28.

the transferor foundation; however, two of the board members would resign from the transferor board, one serving as a director of each X and Y. Also, the grant advisors would resign and serve as officers of X and Y. The remaining board members of the transferor would then fill the vacant board and officer positions with other members of their family.

The transferor would retain 1/3 of its assets following the distributions to X and Y, and continue operations as a private foundation. Because neither X nor Y would be treated as if it were the transferor and the transferees were controlled by the transferor, the transferor was required to comply with the expenditure responsibility requirements of Section 4945(h), or the transfers would be considered taxable expenditures.

D. The IRS again approved the distribution of net assets to other private foundations in PLR 201231014. Here, three siblings were the Trustees of a charitable lead unitrust ("CLUT"), as well as the trust's remainder beneficiaries. However, the siblings had differing charitable philosophies and goals, and believed their charitable purposes would be better managed separately, by dividing the trust into successor trusts, each which would function as a CLUT.

The Trustees proposed to transfer, pro rata, 2/3 of the trust's net assets to one successor trust, Trust I, and the other 1/3 to another successor trust, Trust II, for no consideration. Two siblings would govern Trust I and the other sibling would govern Trust II, with the transfers being approved by state court. The two new trusts would have the same provisions as the original trust instrument.

The Trustee siblings also governed Foundation, the trust's only lead beneficiary during the 16 year CLUT term. The two siblings governing Trust I also governed Foundation I; the third sibling governing Trust II also governed Foundation II, along with his family. Simultaneously with the trust's division, the Foundation would divide and transfer pro-rata 2/3 of its net assets to Foundation I and 1/3 to Foundation II, then terminate and dissolve. The three foundations were all private foundations, with the same or similar exempt purposes. Foundation I would be the charitable lead beneficiary of Trust I, and Foundation II would be the charitable lead beneficiary of Trust II; neither trust instrument would change the identity of the remainder beneficiaries, nor alter the income or remainder interests in any way.

The proposed transfers from the initial CLUT to the successor trusts were held to not result in termination of private foundation status of the initial trust under Section 507(a) as a nonexempt split-interest trust under Section 4947(a)(2), but would constitute a transfer between private foundations (all of which are nonexempt split-interest trusts under Section 4947(a)(2)) within the contemplation of Section 507(b)(2).

II. TAX CONSEQUENCES

Any Section 507(a)(1) voluntary termination does not relieve the terminating foundation or any disqualified person(s) from tax liability imposed under Chapter 42, for acts or failures to act prior to termination, or for additional taxes imposed for failures to correct those acts.[143]

In order to terminate under 507(b)(1)(A), the foundation cannot be found to have committed an act or failure to act giving rise to liability for tax under Chapter 42. Further, the transferor foundation terminating its status pursuant to Section 507(b)(1)(A) remains subject to the provisions of Chapter 42 until it has properly distributed all of its net assets to the qualified distributee charities.

If the foundation is transferring all of its net assets to one or more private foundation(s) pursuant to Section 507(b)(2), and the transferor foundation incurs liability under Chapter 42 prior to or as a result of making that transfer, transferee liability could apply so that each transferee is treated as receiving the assets subject to that liability.[144] In general, the transferee is not considered a newly created organization; rather, it is treated as possessing those attributes and characteristics of the transferor under Chapter 42. Thus, any undistributed income, excess business holdings, expenditure responsibility reporting, defined substantial contributors and other tax attributes are treated as transferred along with the assets, regardless of whether the transferor foundation is commonly controlled.[145] The following discusses the tax implications under Chapter 42, if any, of the termination and transfer to a public charity or private foundation.

A. Net Investment Income Tax

Section 4940 imposes an excise tax on a private

143 Treas. Reg. § 1.507-1(b)(2).
144 Treas. Reg. § 1.507-3(a)(4).
145 Blazek, Jody, "The IRS Provides Good News for Terminating Foundations," 14 TXNEXEMPT 171, January/February, 2003.

foundation's net investment income for the taxable year; net investment income for this purpose is defined as the sum of gross investment income and capital gain net income over the allowed deductions. Only four specific types of income are subject to the net investment income tax: dividends, interest, rents and royalties. However, a distribution of property for purposes described in Section 170(c)(1) or (2)(B) which is a qualifying distribution under Section 4942 is not considered a sale or disposition of property for net investment income tax calculations.[146]

1. <u>Termination by Distribution to Public Charity</u>

If the private foundation is terminating under Section 507(b)(1)(A) by transferring all of its net assets to one or more public charities, the foundation remains subject to Chapter 42 taxes until the distribution of all of its assets has been completed in conformity with Section 507(b)(1)(A). When a private foundation transfers all of its net assets to a transferee Section 509 public charity, not controlled by the foundation or by one or more disqualified persons with respect to the foundation, and the foundation has not previously terminated its private foundation status, then the distributions to the public charity do not constitute an investment of the foundation for purposes of Section 4940. Therefore, the distributions do not give rise to any taxable net investment income.[147] This also assumes that the transferee public charity retains it public charity classification for at least three years after the date of distribution, and that the private foundation does not impose any material restrictions on the transferred assets, and retains sufficient income or assets to pay any chapter 42 taxes (such as the tax under Section 4940 for the portion of the taxable year prior to the distribution) and pays such taxes when due.[148]

If the foundation is converting to a public charity under Section 507(b)(1)(B), the organization must pay the Section 4940 tax during the taxable year(s) during the 60-month conversion period. However, a claim for refund may be filed upon successful completion of the 60-month 507(b)(1)(B) termination.

2. <u>Distribution to Private Foundation</u>

In a transfer of a foundation's net assets to another private foundation, the transfer does not constitute an investment of the transferor foundation for purposes of Section 4940, such that the transaction does not give rise to net investment income subject to this tax.[149] The value of the net assets received by the transferee are reported as a donation, if the recipient foundation is not commonly controlled. If the transferee is commonly controlled, then the value of the assets received should be reflected as an extraordinary increase in net assets, not reported as revenue.[150]

Further, if the transferee foundation(s) is effectively controlled by the same person(s) that effectively controlled the transferor, any excess 4940 tax paid by the transferor may be used by the transferees to offset the transferees' 4940 tax liability. When there are several transferees, proportionality is appropriate and the transferees will succeed to their relative portion of any excess 4940 tax paid by the transferor.[151] Since the overpayment of tax is an asset of the transferor, it should specify in the transfer documents that it is donating that overpayment to the transferee(s).[152] Thus, the IRS cannot impose the transfer tax the day after all of the assets have been transferred.[153]

Due to the carryover treatment of the transferor's tax attributes, a transferee foundation receiving such assets as investment properties (i.e. rental buildings), mineral interests and assets used to manage such properties should calculate depreciation or depletion of these assets following the tax methodology and basis used by the transferor.[154] Also, the basis of transferred assets for purposes of calculating taxable gain or loss for an investment property (subject to the net investment income tax) would be the same as the tax basis for the transferor.[155]

B. Self-Dealing

Section 4941 imposes an excise tax on each act of self-dealing between a disqualified person and a private foundation; however, "disqualified person" does not include an organization described in Section 501(c)(3) (other than a 509(a)(4) organization). Any public recognition a person may receive arising from the charitable activities of a private foundation to which a person is a substantial contributor is generally an incidental and tenuous benefit, not resulting in a self-dealing transaction.[156] Thus, a grant by a foundation to another organization controlled by the same person(s) generally is not an act of self-dealing, just because the same disqualified persons or substantial contributor is involved in both organizations.[157]

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146 Treas. Reg. § 53.4940-1(f)(1).
147 Treas. Reg. § 53.4940-1; Rev. Rul. 2003-13.
148 Rev. Rul. 2003-13.
149 Rev. Rul. 2002-28.
150 Blazek, *supra* note 145.
151 Rev. Rul. 2002-28.
152 Blazek, *supra* note 145.
153 *Id.*
154 *Id.*
155 *Id.*
156 PLR 201243015.
157 *Id.*

Under the estate administration exception to self-dealing, , indirect self-dealing does not include a transaction with respect to a private foundation's interest or expectancy in property (whether or not encumbered) held by an estate or revocable trust (including a trust that has become irrevocable on a grantor's death), regardless of when title to the property vests under local law, if:

> (1) the estate administrator or executor, or trustee of the revocable trust, either possesses a power of sale with respect to the property, has the power to reallocate the property to another beneficiary, or is required to sell the property under the terms of an option subject to which the property was acquired by the estate or revocable trust; (2) the transaction is approved by the probate court having jurisdiction over the estate (or by another court having jurisdiction over the estate, trust, or over the foundation); (3) the transaction occurs before the estate is considered terminated for federal income tax purposes pursuant to paragraph (a) of Regs. §1.641(b)-3 (or in the case of a revocable trust, before it is considered subject to §4947); (4) the estate or trust receives an amount that equals or exceeds the fair market value of the foundation's interest or expectancy in such property at the time of the transaction, taking into account the terms of any option subject to which the property was acquired by the estate or trust; and (5) with respect to transactions occurring after April 16, 1973, the transaction either (i) results in the foundation receiving an interest or expectancy at least as liquid as the one it gave up, (ii) results in the foundation receiving an asset related to the active carrying out of its exempt purposes, or (iii) is required under the terms of an option that is binding on the estate or trust.[158]

Because "disqualified person" does not include a 501(c)(3) organization, the transfer to a private foundation does not constitute self-dealing, even if the transferee foundation is effectively controlled by the same person(s) as the transferor.[159] A transferee private foundation should take caution, however, recognizing the possibility that relatives not treated as disqualified persons as to the transferor might become disqualified after the transfer – they may have some other connection to relatives of board members or businesses owned by the transferee foundation.[160]

Further, any termination and distribution of assets to a public charity according to the rules of Section 507 likewise would not be considered a self-dealing transaction.[161]

C. Minimum Distributions

Section 4942 imposes a tax on the undistributed income of a private foundation for a taxable year; "undistributed income" is the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made out of such distributable amount for such taxable year. "Distributable amount" is the sum of the minimum investment return, reduced by taxes paid for unrelated business income and net investment income.

"Qualifying distributions" are those amounts paid to accomplish one or more charitable purposes, *other than a contribution to an organization controlled directly or indirectly by the foundation or by one or more disqualified persons* or a contribution to a private non-operating foundation, unless certain requirements are satisfied. The term "controlled" for purposes of section 4942 of the Code is generally defined in the following manner: an organization is "controlled" by a private foundation, or one or more disqualified persons with respect to the foundation, if any of such persons may, by aggregating their votes or positions of authority, require the donee organization to make an expenditure, or prevent the donee organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.[162]

If an organization distributes assets to another organization controlled, directly or indirectly by the same person(s), both organizations must follow the requirements of Section 4942.[163]

While the defined term "qualifying distribution" generally does not include a contribution to a controlled organization, it does include a contribution to a 501(c)(3) controlled by the foundation or one or more disqualified persons, if not later than the close of the first taxable year after that contribution is received the organization makes a qualifying distribution equal to the amount of the contribution.[164]

1. Distribution to Public Charity

If (i) the private foundation is transferring all of its net assets to a transferee public charity, (ii) the transferee public charity retains it public charity classification for at least three years after the date of

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158 Treas. Reg. § 53.4941(d)-1(b)(3).
159 Rev. Rul. 2002-28.
160 Blazek, *supra* note 145.
161 Rev. Rul. 2003-13.
162 Treas. Reg. § 53.4942(a)-3(a)(3).
163 PLR 201243015.
164 *Id*.

distribution, (iii) the public charity is not controlled by the foundation or by one or more disqualified persons with respect to the foundation, (iv) the foundation has not previously terminated its private foundation status, (iv) the private foundation does not impose any material restrictions on the transferred assets, and (v) the foundation retains sufficient income or assets to pay any chapter 42 taxes (such as the tax under Section 4940 for the portion of the taxable year prior to the distribution) and pays such taxes when due, then the transfer of all of its net assets to the public charity will be considered "qualifying distributions" under Section 4942.[165] This is true because the distributions are paid to accomplish one or more purposes described in section 170(c)(2)(B) and are not made to organizations controlled directly or indirectly by the foundation or by one or more disqualified persons as to the foundation.[166]

2. <u>Distribution to Private Foundation</u>

The transferor foundation is required to meet the distribution requirements of Section 4942 for the taxable year in which it makes a transfer of all, or a substantial portion of, its net assets to another private foundation; however, it is possible for the transfer itself to be counted toward the fulfillment of that requirement.[167]

The transfer of assets to an uncontrolled foundation offsets the distribution in the transferor's final tax year.[168] However, when a transferor foundation transfers all of its assets to one or more controlled foundations, the transferee foundations are treated as though they are the transferor for purposes of Section 4942. Therefore, the transfers are <u>not</u> treated as qualifying distributions of the transferor foundation.[169]

The transferee foundation(s) assume its proportionate share of the transferor foundation's undistributed income under 4942.[170] This necessitates good planning on the part of the transferee foundation(s); usually, new private foundations have no distribution requirements in their first year – the distributable amount calculated on the basis of their assets for the first year do not have to be paid out until the end of the next succeeding year.[171] However, the "next succeeding year" of the transferor is the year the transferee receives its assets, thus, the remaining distributable amount must be paid out by the transferee in that first year in which it has received assets from the transferor.[172]

When a private foundation transfers all of its assets to another foundation effectively controlled by the same person(s), the transferee foundation may reduce its distributable amount under Section 4942 by the amount of the transferor's excess qualifying distributions as described in Section 4942(i).[173] For example, T, a charitable trust, is classified as an exempt private foundation; the trustees determine T's charitable purposes would better be served by operating in a corporate form, so they create W, a new private foundation, to carry out T's activities. T transfers all assets and liabilities to W.[174] W has thus assumed all obligations regarding T's undistributed income within the meaning of Section 4942, if any, and reduces its own distributable amount under Section 4942 by T's excess qualifying distributions.

When the transferor has disposed of all of its assets, the recordkeeping requirements do not apply for a taxable year in which the transferor has no assets.[175]

D. Excess Business Holdings

Section 4943 imposes an excise tax on the excess business holdings of a private foundation in a business enterprise. The business holdings of a private foundation and any disqualified persons (combined) may not exceed 20% of voting stock in a corporation (which is not substantially related), or 35% if the control of the corporation is in at least one person who is not a disqualified person as to the foundation, or 20% of the beneficial or profits interest in an unrelated unincorporated business. A private foundation may not own *any* holdings in an unrelated sole proprietorship, but it may own a de minimis 2% of voting stock in a corporation.

1. <u>Distribution to Public Charity</u>

The transferor foundation terminating its status pursuant to Section 507(b)(1)(A) remains subject to the provisions of Chapter 42 until it has properly distributed all of its net assets to the proper distributee charities. In order to terminate under 507(b)(1)(A), the foundation cannot be found to have committed an act or failure to act giving rise to liability for tax under Chapter 42. Thus, if the foundation was in the process of ridding itself of excess business holdings, it should do so prior to termination. The actual distribution of a private foundation's net assets to a public charity (or charities) under Section 507(b)(1) does not cause the

[165] Rev. Rul. 2003-13.
[166] *Id.*
[167] Treas. Reg. § 1.507-3(a)(5).
[168] Blazek, Jody, "The IRS Provides Good News for Terminating Private Foundations," 14 TXNEXEMPT 171, January/February 2003.
[169] Rev. Rul. 2002-28.
[170] *Id.*
[171] Blazek, *supra* note 168.
[172] *Id.*
[173] Rev. Rul. 78-387; Rev. Rul. 2002-28.
[174] Rev. Rul. 2002-28.
[175] Treas. Reg. § 1.507-3(a)(5).

foundation to have taxable excess business holdings.[176]

2. Distribution to Private Foundation

Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under Section 4943 depends on the facts and circumstances related to the transaction. Any person who is a substantial contributor to the transferor foundation is also treated as a substantial contributor with respect to the transferee foundation, regardless of whether such person meets the $5,000/2% test as to the transferee foundation.[177] For purposes of Section 4943, the applicable time period includes the period during which the transferor foundation held such assets as well as the period during which the transferee holds such assets.[178]

When a transferor foundation transfers all of its assets to a foundation(s) effectively controlled by the same persons controlling the transferor, the transferee foundations are treated as if they are the transferor for purposes of Sections 4943 and 4946; therefore, the disqualified persons of the transferee foundation are determined in part by treating the transferee as though it is the transferor. [179]

E. Jeopardizing Investments

Section 4944 imposes a tax on any amount invested by a private foundation in a way which jeopardizes the carrying out of any one of the foundation's exempt purposes. Whether an asset is a jeopardizing investment is determined at the time of its acquisition.[180] While there are no *per se* violations of this rule, foundation managers must exercise ordinary business care and prudence in making investments on behalf of the foundation.

1. Distribution to Public Charity

If the private foundation is transferring all of its net assets to a transferee public charity pursuant to Section 507(b)(1)(A), and the foundation retains sufficient income or assets to pay any chapter 42 taxes (such as the tax under *Section* 4940 for the portion of the taxable year prior to the distribution) and pays such taxes when due, then the distribution of the foundation's net assets does not constitute an investment for purposes of Section 4944, and thus are not "jeopardizing investments" subject to tax.

2. Distribution to Private Foundation

The transfers to another foundation do not constitute investments of the transferor under Section 4944, and thus do not give rise to tax for an investment jeopardizing the foundation's exempt purposes. Whether an asset received by the transferee foundation is considered a jeopardizing investment is based on the facts and circumstances existing when the transferor originally acquired it.[181] If jeopardy is found to have existed, the transferee will be responsible for removing the asset from jeopardy and paying any taxes and penalties due.[182]

F. Expenditure Responsibility

Section 4945 imposes a tax on any taxable expenditure made by a private foundation. This term includes any amount paid or incurred by a private foundation as a grant to an organization, unless the organization is an exempt operating foundation or is a 509(a)(1), (2) or (3) organization. As part of its expenditure responsibility requirements, Section 4945 dictates that a private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to see that a grant made under Section 4945 is spent solely for the purpose for which it was made, and that the foundation obtains full and complete reports from the grantee on how the funds are spent, and makes full and detailed reports regarding such expenditures to the Secretary.

1. Distribution to Public Charity

If (i) the private foundation is transferring all of its net assets to a transferee public charity, (ii) the transferee public charity retains it public charity classification for at least three years after the date of distribution, (iii) the public charity is not controlled by the foundation or by one or more disqualified persons with respect to the foundation, (iv) the foundation has not previously terminated its private foundation status, (iv) the private foundation does not impose any material restrictions on the transferred assets, and (v) the foundation retains sufficient income or assets to pay any chapter 42 taxes (such as the tax under Section 4940 for the portion of the taxable year prior to the distribution) and pays such taxes when due, then the distribution of the foundation's net assets are not "taxable expenditures" under Section 4945.[183] Thus, the foundation will not be required to exercise expenditure responsibility with respect to the distributions made.[184]

2. Distribution to Private Foundation

The transferor foundation must exercise

[176] Rev. Rul. 2003-13.
[177] Treas. Reg. § 1.507-3(a)(3).
[178] Treas. Reg. § 1.507-3(a)(6).
[179] Rev. Rul. 2002-28.
[180] Blazek, *supra* note 168.
[181] *Id.*
[182] *Id.*
[183] Rev. Rul. 2003-13.
[184] *Id.*

expenditure responsibility over its outstanding grants until it disposes of all of its assets. The obligation transfers with the assets, such that the transferee foundation(s) must exercise expenditure responsibility regarding any outstanding grants of the transferor.[185] When assets are transferred to a foundation(s) not commonly controlled, the transfer requires an expenditure responsibility report in the transferor's final return. Such transfers are without consideration and thus can be treated as qualifying distributions, if the transferor submits an expenditure responsibility report in its final return. The uncontrolled transferee foundation must also exercise responsibility and report on the outstanding grants of the transferor.[186]

A. Full Transfer of Assets: When the transferor is making the transfer to a foundation not effectively controlled by the same person(s), and has disposed of all of its assets, during the period the transferor has no assets, Section 4945(d)(4) and (h) do not apply to the transferee or transferor in regards to any expenditure responsibility grants made by the transferor.[187] The transferor foundation must still meet the Section 4945 reporting requirements for the outstanding grants for the year in which the transfers are made.[188]

   When the transferor has transferred all of its net assets, and the transferee foundation is effectively controlled by the same person(s) controlling the transferor foundation, the transferee is treated as the transferor, rather than as receiving expenditure responsibility grants. Thus, there are no expenditure responsibility requirements to be exercised by the transferor, regarding the transfers to the transferee foundation. The transferee foundation(s) assume expenditure responsibility for all of the transferor's outstanding grants. If there are multiple transferees, they each must exercise expenditure responsibility for *all* outstanding grants of the transferor. However, if the transferor assigns, and a specific transferee assumes, the transferor's expenditure responsibility with respect to a certain grant, only that transferee assuming the transferor's expenditure responsibility is required to exercise that expenditure responsibility.

   For example, A and B are the trustees of P charitable trust, a private foundation and are the only substantial contributors to P. To facilitate the accomplishment of diverse charitable purposes, A and B create and control R Foundation, S Foundation and T Foundation. A and B then transfer all of the net assets of P to R, S and T, equally. At the end of that year in which the transfers are made, P has an outstanding grant to Foundation W, for which it is required to exercise expenditure responsibility under sections 4945(d)(4) and (h). R, S and T are treated as if they are P, in the proportion the fair market value of the assets transferred to each of them bears to the fair market value of P's assets right before the transfer (i.e. equal thirds). Thus, absent a provision for exercising expenditure responsibility regarding the grant to W, each of them must exercise expenditure responsibility with respect to that grant. Also, because R, S and T are treated as P, rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements to be exercised regarding the transfers to R, S and T.[189]

   Any private foundation which has disposed of *all* of its assets must file a Form 990-PF for that year of transfer, and comply with any expenditure responsibility reporting obligations on the return.[190] Any unfinished steps in the expenditure responsibility process, such as securing and reporting follow-up grantee reports, become the obligation of the transferee foundations.[191]

B. Partial Transfer of Assets: If less than all of the foundation's net assets are transferred, then the transfer is considered a grant and the transferor must continue to exercise expenditure responsibility as to those transfers, or else the transfer will be considered a taxable expenditure under Section 4945.[192] Thus, the transferor will remain liable to exercise expenditure responsibility for all periods in which any portion of the transferred assets remain with the transferee(s).[193]

III. CONCLUSION

Foundation Trustees or Directors can attempt to avoid internal disputes through the use of good

185 Blazek, *supra* note 168.
186 *Id.*
187 Treas. Reg. § 1.507-3(a)(7).
188 *Id.*
189 Treas. Reg. § 1.507-3(a)(9), Ex. 2.
190 Blazek, *supra* note 168.
191 *Id.*
192 PLR 201244020.
193 *See* PLR 8817045.

policies, governing documents, and proper governance practices, including training and facilitation of open discussions. When family foundations suffer from divisiveness within the organization, whether due to conflicts of interest, personality clashes, unclear roles and responsibilities, existing family animosities, or differences in charitable inclinations, the policies and practices in place, as well as the use of outside advisors can be instrumental in properly addressing and resolving disputes. However, when the conflict escalates to a point of making the further governance and management of the foundation a burden on the family, the founders' vision and mission may best be served by splitting up the foundation among multiple organizations or terminating and distributing its assets to other public charities where its charitable goals can better be furthered.

ATTACHMENT 1 – CODE OF ETHICS

__________ Foundation, Inc. (the "Organization") seeks to integrate the personal style and flexibility of a charitable endeavor with the best practices of the nonprofit community. With this goal in mind, the following standards have been adopted to guide the directors, officers, and employees in their conduct of all Organization business.

- The Mission of the Organization: Catalyzing the economic development of ________ and revitalizing the quality of life of its residents, by constructing a sports facility and creating employment opportunities within __________, and to thereby promote social welfare and support the local community, shall guide the Organization's work, and inasmuch as possible shall be the basis for board and staff decision-making at all levels of the Organization.

- Everyone will be expected to bring objective thinking, critical analysis, along with a discerning, prayerful and empathetic heart to the Organization's deliberations.

- Everyone will be tolerant of the ideas and positions of others, and all matters will be approached with an open mind. Respectful and gently remonstrative disagreements are permitted and, in fact, encouraged to facilitate a process of arriving at the best possible decision at any level throughout the Organization.

- Decisions and judgments will be based on the most complete and accurate information that is available and each director will be expected to familiarize him/her-self as effectively as possible with any information that is disseminated for a meeting.

- Board members shall serve without compensation.

- No director or staff person will use his or her position with the Organization in a manner that will inure financially to his or her benefit.

- Decisions of the Organization's board of directors will be made, whenever possible, through a process of consensus. Appropriate discretion is important when discussing the board's deliberations outside of the confines of meetings.

- To avoid the appearance or potential of any conflict of interest, board members and staff will follow the Organization's Conflict of Interest Policy.

- Staff and board directors will not accept any gifts, payments, or loans from vendors or suppliers of goods or services to the Organization.

ATTACHMENT 2

CONFLICT OF INTEREST
ANNUAL REPORTING STATEMENT

Certification

I have read and understand ________[organization]'s Policy on Conflicts of Interest and Disclosure of Certain Interests. I hereby declare and certify the following material business relationships and board memberships with other charitable entities and material management roles with respect to the foregoing that are related to the work of the [organization]:

Disclosure Statement

(If necessary, attach additional documentation.)

I agree to promptly inform the board upon the occurrence of each event that could potentially result in my involvement in (or implication in) a conflict of interest.

Date ____________________ ________________________
Signature

____
Title

ATTACHMENT 3

WHISTLEBLOWER POLICY

I. General

__________, Inc. (the "Organization") is committed to lawful and ethical behavior in all of its activities and requires directors, officers and employees to act in accordance with applicable laws, regulations and policies and to observe high standards of business and personal ethics in the conduct of their duties and responsibilities. As employees and representatives of the Organization, we must practice honesty and integrity in fulfilling our responsibilities.

II. Reporting

The Organization encourages its directors, officers, and employees to share their questions, concerns, suggestions, or complaints with someone who can address them properly. Any employee, officer, or director who reasonably believes that some policy, practice, or activity of the Organization is in violation of law or Organization policy should file a complaint with the President or the Chairman of the Board of Directors. If the wrongful conduct implicates one or both of the President or the Chairman of the Board of Directors, or if the reporting individual is not comfortable speaking with or not satisfied with the response of the foregoing individuals, the issue may be reported to any member of the Board of Directors. Violations or suspected violations may be submitted on a confidential basis by the complainant or may be submitted anonymously. Reports of violations or suspected violations will be kept confidential to the extent possible, consistent with the need to conduct an adequate investigation.

III. No Retaliation

No director, officer or employee who makes a good faith report under this Whistleblower Policy or who cooperates in inquiries or investigations shall suffer harassment, retaliation or adverse employment consequence. An employee who retaliates against someone who has reported a violation in good faith is subject to discipline up to and including termination of employment. This Whistleblower Policy is intended to encourage and enable employees, officers, and directors and others to raise serious concerns within the Organization prior to seeking resolution outside the Organization.

Any director, officer or employee who believes that he or she has been subjected to any form of retaliation as a result of making a good faith report under this Whistleblower Policy should immediately report the retaliation to the President or the Chairman of the Board of Directors.

IV. Investigation

The President, Chairman of the Board of Directors, or a representative of the Board of Directors will notify the sender and acknowledge receipt of the reported violation or suspected violation within five business days. All reports will be promptly investigated in a manner intended to protect confidentiality, consistent with a full and fair investigation, and appropriate corrective action will be taken if warranted by the investigation. A summary of the investigation will be presented to the Board of Directors.

V. Accounting and Auditing Matters

The Board of Directors shall address all reported concerns or complaints regarding corporate accounting practices, internal controls or auditing. The President or the Chairman of the Board of Directors shall immediately notify the Board of Directors of any such complaint and work with the Board until the matter is resolved.

VI. Acting in Good Faith

Anyone making a complaint concerning a violation or suspected violation of some policy, practice or activity of the Organization must be acting in good faith and have reasonable grounds for believing the information disclosed indicates a violation of a policy, practice or activity of the Organization. Any allegations that prove not to be substantiated and which prove to have been made maliciously or knowingly to be false will be viewed as a serious disciplinary offense.