PART ONE

Introduction

In 1969, the US Congress amended the Internal Revenue Code to add far-reaching laws that imposed new requirements and new prohibitions on private foundations—often referred to as "charitable foundations" or simply as "foundations." In one significant respect, the new laws bore a striking similarity to tax laws that previously had been enacted. They were seriously and in some cases mind-numbingly complex.

Over the forty-plus years since the 1969 enactments, a limited number of new rules have been added. They are comparably complex.

The ultimate responsibility for running a foundation is vested in individuals who are identified in foundation governing instruments as "directors" or as "trustees." In this book I have adopted the designation more frequently used when applied to not-for-profit organizations—"trustees." Trustees have the obligation to ensure that the foundation's business is run in conformity with its governing instrument, applicable state laws, and the requirements and prohibitions imposed by federal laws and regulations.

The federal government expects foundation trustees to ensure that the foundations they serve will comply with the federal rules. In the context of the complexity of those rules, that is an unrealistic expectation.

Foundation trustees rarely receive training in regard to requirements and prohibitions that foundations are required to follow. Many if not most trustees have only a cursory understanding of what the rules are and why they exist. They cannot be expected to augment their understanding by reading hundreds of pages of complex laws and regulations.

Without having at least a basic understanding of the rules, a foundation trustee would be unlikely to recognize when federal rules are about to be violated or to know what questions to ask to elicit key information bearing on the

issue. A trustee without knowledge of the rules would be just as unlikely to be able to propose a workable alternative to pending foundation action that would better fit the foundation's goal. To compound the problem, individuals who are not conversant with the rules are naturally reluctant to ask questions in a meeting setting that would reveal their lack of knowledge to all who are present.

Contrast this picture with the usual situation that unfolds when someone new is elected to the board of directors of a major for-profit corporation. Written materials are provided, which include information—often detailed information—about the corporation's revenues, expenses, legal constraints, short-term business plans, long-term business plans, and opportunities. The newly elected director is given access to senior management and more experienced board members. He or she completes what amounts to a full-immersion course in the corporation, its business, its needs, and its opportunities.

Another consequence of the lack of training in the world of foundations is that trustees often have a considerable misunderstanding of the basic laws and regulations that apply to foundations. By way of example, each of the following characterizations of the applicable rules is widely believed to be correct, but each in fact is incorrect.

- The only organizations that foundations are permitted to support are organizations that qualify for tax exemption under section 501(c)(3) of the Internal Revenue Code.
- Foundations may automatically and without precondition make grants to any organizations that have section 501(c)(3) designations.
- Foundations are not permitted to make grants to for-profit companies.
- Foundations are not permitted to provide financial support to organizations that advocate particular viewpoints or positions regarding controversial issues.
- A foundation that wants to make a grant to a non-US charity must do so through that charity's section 501(c)(3) US support organization.
- A foundation may provide a non-US charity with financial support without having to meet technical "foreign grantee" requirements by making its grant to the foreign charity's section 501(c)(3) US support organization with instructions that the granted funds be transferred to the foreign charity.

- Foundations are required to receive and retain a grantee organization's written acknowledgment for each gift to a grantee in excess of $250.
- Tickets that a foundation purchases to a charity's fundraising dinner may be used by a trustee's family members and friends so long as the trustee with personal funds pays that portion of the cost of the tickets that is not tax deductible.
- A foundation trustee is permitted to sell or lease property to the foundation so long as the foundation's cost is shown by well-supported appraisals to be below market.
- All legally made grants that a foundation makes may be counted against its annual payout requirement.

These examples are just the tip of the iceberg in terms of the breadth of the lack of understanding of the rules.

In this book, I have strived to provide background information on a variety of subjects of importance to foundations. A principal objective has been to explain in understandable language rules that can be outrageously complex while not oversimplifying or "dumbing down" the rules to the point of obscuring their basic meaning. I have provided endnote annotations for the benefit of readers who wish more detailed information than the text provides.

Foundation managers do not need to understand every detail, every nuance, and every exception to the applicable rules. They must, however, attain enough of an understanding of the basic principles to be able to identify problem situations and alternative ways to accomplish the foundation's objectives, as well as recognize when the foundation needs experienced professional assistance to meet legal and regulatory requirements.

My hope is that this book will provide readers with an enhanced ability to discharge their general foundation responsibilities and to ensure compliance with applicable federal rules. A foundation's response to a governmental charge of rule violation can consume a great deal of time. A finding of violation can lead to the imposition of serious penalty taxes on both the foundation and foundation managers. In the context of legal and regulatory complexities that apply to foundations, staying out of trouble is far less costly and takes far less time than getting out of trouble.

CHAPTER 1

Private Foundations: Formation, Tax Exemption, Definitions, and Distinctions

This chapter provides a basic introduction to charitable foundations, how they are formed, and the all-important income tax exemption that has been a powerful force in their proliferation. It also describes various kinds of foundations and takes an initial step to contrast foundations with their counterparts in the world of section 501(c)(3) organizations—public charities.

1.1 FORMATION UNDER STATE LAW

Foundations are generally formed under the laws of a particular state. Most are corporations or trusts. A few are unincorporated associations.[1]

Foundations are formed to be operated as charitable organizations. As such they exist for the public benefit. They have no owners and no shareholders.

In the usual situation, a foundation's initial donors select its initial trustees. Successor trustees are selected in accordance with principles set forth in the foundation's governing instrument and in laws of the state or states having jurisdiction over the foundation.[2]

The boards of trustees of most foundations are self-perpetuating. This means that trustees elect their successors. Subject to limitations that may be imposed in a foundation's governing instrument or by applicable state law, a foundation's board of trustees can elect its own membership to successive terms of office.

1.2 ORGANIZATION AND OPERATION EXCLUSIVELY FOR CHARITABLE PURPOSES

Although foundations are formed under state law, they receive their tax-exempt status under federal law. As defined under federal law and as used in this book, the terms "exempt" and "tax-exempt" do not mean "exempt from all taxes." Rather, they mean "exempt from having to pay a federal income tax." As discussed in chapter 26, foundations are required to pay an annual federal excise tax.[3] Excise taxes in the form of penalties for noncompliance with federal rules can also be imposed.

To qualify for federal income tax exemption, foundations must be organized and operated for purposes that meet the federal law definition of "charitable." Charitable purposes are broadly defined by statute and regulations to include purposes that are charitable, educational, literary, religious, and scientific, testing for public safety, and preventing cruelty to children or animals.[4]

1.3 INCOME TAX EXEMPTION UNDER FEDERAL LAW

To be exempt from having to pay federal income tax, a foundation must receive the federal government's written determination that it is a tax-exempt section 501(c)(3) charitable organization. To obtain that determination, the foundation must complete a written application and submit it to the Internal Revenue Service. That application in its present form is called Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code.[5]

As presently constituted, Form 1023 and its accompanying instructions are some sixty pages in length. They require the applicant to provide detailed information about itself and its intentions and to add attachments when needed.

Significant noncompliance with federal law and regulations can cause a foundation to lose its tax-exempt status. Depending on the nature and degree of noncompliance, an IRS revocation may be prospective or may be retroactive to the inception of the foundation's activities.

The IRS registers its approval of a foundation's tax-exempt status through its issuance of what is frequently called a "tax exemption determination letter." This determination letter constitutes official IRS confirmation that the foundation is exempt from having to pay federal income tax and is qualified as a charitable

organization under section 501(c)(3) of the Internal Revenue Code. Normally, the written determination also confirms that its recipient is a private foundation within the meaning of section 509(a) of the Internal Revenue Code.

So long as a foundation applies for tax-exempt status within fifteen months following the end of the month in which it was formed, the IRS's approval of tax exemption will relate back to the date of the foundation's formation.[6] Following approval, the foundation will retain its tax-exempt status for as long as it fully complies with applicable federal requirements and prohibitions.

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1.4 STEWARDSHIP VERSUS OWNERSHIP

Once assets are contributed to a foundation, they no longer belong to the donor and no longer can be used for the benefit of the donor or the donor's family. The assets can never again be used for private purposes. Instead, the assets now belong to the foundation and must only be used for charitable purposes.

Donors and their family members often lose sight of this principle. That's because the very same individuals who dealt with the assets before their contribution to the foundation, as well as their family members, are dealing with the very same assets after their contribution to the foundation. The difference is that before the assets were contributed to the foundation, the donors were dealing with the assets as owners. After the contribution, they and their family members must deal with the assets as officers and trustees, not owners.

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To put it another way, the family's role after assets are contributed to the foundation is not an ownership role but a stewardship role for the benefit of the charity. As stated in the US Senate Report that accompanied the enactment of the Tax Reform Act of 1969, "Private foundations are stewards of public trusts

and their assets are no longer in the same status as the assets of individuals who may dispose of their own money in any lawful way they see fit."[8]

1.5 NONOPERATING FOUNDATIONS AND OPERATING FOUNDATIONS

Under federal law and regulations, foundations are divided into two categories: nonoperating foundations and operating foundations. Operating foundations are themselves divided into two subcategories: those that meet the definition of "exempt operating foundations" and those that don't.

That last distinction can lead to confusion in that operating and nonoperating foundations alike are exempt from having to pay federal income tax. For that reason, they sometimes are called "exempt organizations" or "exempt foundations." The use of the word "exempt" in the designation "exempt operating foundations" is intended to make it clear that such foundations are not only exempt from having to pay income tax but additionally exempt from having to pay an annual excise tax.

Conceptually, operating foundations are foundations that use most of their financial resources to run their own charitable programs. Examples are art museums formed and endowed by one individual or one family and foundations formed by artists to catalogue their works and to further their philanthropic and educational initiatives.

In contrast, nonoperating foundations generally use the bulk of their resources not to run their own programs but to make grants to other charitable organizations to support program activities run by those other organizations. They are sometimes called "grantmaking foundations."

Notwithstanding the fact that operating foundations apply most of their resources to the direct support of their own charitable programs, some operating foundations also maintain consequential programs through which they make grants to other charitable organizations. Similarly, although the principal focus of nonoperating foundations is to make grants, some nonoperating foundations allocate a portion of their resources to the running of their own charitable programs.

Under federal law, operating foundations are not subject to all the requirements that the law imposes on nonoperating foundations. As discussed in

chapter 11, for example, operating foundations are not subject to the same annual distribution requirements that are imposed on nonoperating foundations.

Most foundations are nonoperating foundations. In this book, unless the context indicates otherwise, all references to foundations, charitable foundations, and private foundations are references to nonoperating foundations.

1.6 PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

Under federal law and regulations, all section 501(c)(3) organizations are classified as either "public charities" or "private foundations." If a section 501(c)(3) organization is not one, it's the other. It cannot be both, and it cannot be neither.

The determination of whether a section 501(c)(3) organization is a public charity or a private foundation has nothing to do with whether the word "foundation" is in the organization's name. For example, the Michael J. Fox Foundation for Parkinson's Research; the Robin Hood Foundation; the Bill, Hillary & Chelsea Clinton Foundation; and the California Community Foundation are all public charities, not private foundations. The Carnegie Corporation of New York; the Lilly Endowment, Inc.; and the Duke Endowment are all private foundations.

The distinction between the two forms of section 501(c)(3) organizations—public charities and private foundations—is statutory. Without getting into details of the exceptions and the exceptions to exceptions, the basic statutory approach is to define private foundations to be all section 501(c)(3) organizations that do not qualify as public charities.[9]

The principal basis of the distinction between a private foundation and a public charity relates to the degree to which the organization receives a broad base of public support.

Public charities generally receive most of their financial support from a broad base, consisting of the general public, corporations, foundations, other public charities, and governmental sources. They generally fund their operations from annual contributions from these sources. In contrast, most foundations receive endowments and regular contributions from one donor or a limited number of donors. They traditionally support their ongoing charitable activities with funds from those limited sources.

Distinctions between private foundations and public charities, and between private nonoperating foundations and private operating foundations, can be of considerable importance to any foundation. For example, a nonoperating foundation is not permitted to make a grant to another nonoperating foundation without compliance with "expenditure responsibility" requirements. If it does so, substantial penalty taxes can be imposed.[10] In contrast, a nonoperating foundation can make fully qualified grants to most types of section 501(c)(3) public charities without taking any burdensome pregrant steps.[11]

How does a foundation determine whether a particular section 501(c)(3) organization it wishes to support is a nonoperating foundation, an operating foundation, or a public charity? The information is readily available on the Internet.

1.7 COMMUNITY FOUNDATIONS AND PUBLIC FOUNDATIONS

Community foundations usually hold funds contributed by a large number of donors. Some of these funds are called "donor-advised funds." Community foundations are generally formed to address charitable needs in particular geographical areas. Examples are the New York Community Trust and the California Community Foundation.

Public foundations are generally formed to provide financial support to particular public facilities. They frequently but not always have names that include words such as "public library foundation," "public schools foundation," or "park foundation."

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Nearly all 501(c)(3) organizations that call themselves "community foundations" or "public foundations" are in fact public charities and not private foundations. Being public charities, they are not subject to the specific federal

requirements and prohibitions imposed only on private foundations.[12] Their activities are outside the scope of discussion in this book.

1.8 FAMILY FOUNDATIONS AND INDEPENDENT FOUNDATIONS

Although the term "family foundation" is not defined in the law, its meaning is well understood. Family foundations are a category—a subset—of foundations, which means that all family foundations are also foundations. It also means that some foundations are not family foundations. Foundations that are not family foundations are frequently called "independent foundations."

The difference between an independent foundation and a family foundation comes down to how the foundation was formed and how it is presently governed. To be a family foundation, the foundation must meet three tests:

- It must have been formed by one or more family members with a view toward its trustees being family members and perhaps a few close family friends.
- It must have been endowed by family members or family-owned businesses or regularly receive "pass-through" financial support from family members or businesses.
- It must continue to be governed by a board of trustees consisting of family members and close family friends.

Many foundations initially were but no longer are family foundations. This type of transition occurs as family members and family friends are succeeded on the board of trustees by individuals who are neither family nor close friends of the family of the principal donors. At that time, the foundation becomes an independent foundation. This is true even if the term "family foundation" is retained in the foundation's name.

Most of what is included in this book applies both to family foundations and to independent foundations. The principal exception is described in section 24.1, which deals with the issue of trustee succession. Trustees of independent foundations and trustees of family foundations usually approach the issue of trustee succession with different objectives in mind.

1.9 CORPORATE FOUNDATIONS

Corporate foundations are foundations formed by corporations. They can be formed as nonoperating foundations or operating foundations.

1.10 PASS-THROUGH FOUNDATIONS

The concept of a pass-through foundation is that its principal donor makes periodic contributions to the foundation. If the pass-through foundation is a grantmaking nonoperating foundation, it distributes most of the funds it receives shortly after their receipt. If it is an operating foundation, it uses most of the funds it receives to run its own programming. A pass-through foundation is more likely to be a nonoperating foundation than an operating foundation.

1.11 ARTIST'S FOUNDATIONS

The term "artist's foundation" is generally applied to describe foundations formed by individuals who have achieved success as artists. Examples of those artists include composers, choreographers, authors, filmmakers, performing artists, and visual artists.[13]

An artist might form a foundation for a variety of purposes. For example, a choreographer might form a foundation to hold ownership rights to her or his own choreography, to license the use of that choreography, and, with licensing proceeds, to provide scholarship assistance to students of dance. An author or visual artist might form a foundation to further university programs of study of his or her own works and works of other contemporary artists or to provide student scholarships for aspiring authors or visual artists.

Artist's foundations can also serve to protect the use and integrity of artistic achievements. For example, a foundation formed by a visual artist could assume responsibility for determining whether works of art purporting to be in the artist's own hand are authentic or forgeries or to create a comprehensive list with descriptions—a catalogue raisonné—of the artist's works.

The donor-artist makes the initial determination of whether the foundation will be a nonoperating foundation or an operating foundation. The decision will depend on whether the artist envisions the foundation as one that will accomplish its principal charitable objectives through making grants to other organizations or instead through running its own programs.

Of course, the impact of an artist's initial formulation of foundation objectives is not different from the impact of any other donor's formulation of directives. Circumstances can change between the time any donor makes her or his intentions known and the time that surviving trustees must make decisions regarding how to deal with the foundation's assets. Even if directives are said to be irrevocable, trustees must retain authority to take account of new circumstances that make adhering to these directives unwise or impossible.

Visual artists sometimes find the issue of when to transfer works of art they created to a formed foundation to be particularly vexing. If the artist gives a work of art to the foundation during his or her lifetime, the artist's charitable deduction is limited to the cost of materials he or she used to create the artwork.[14] That deduction could be quite small. The accompanying reality, however, is that the foundation would then own the work of art. If the foundation were to sell it, the only tax the foundation would have to pay would be an excise tax of 2 percent or 1 percent of the gain.

Alternatively, if the artist retains and then sells the work of art, the sale would be subject to a tax on the difference between the sale price and the artist's costs in creating the work of art. Particularly if we assume a high sale price and a low cost incurred in the creation of the artwork, that tax could be substantial. If the artist were then to contribute the sale proceeds to the foundation, the amount of charitable deduction that current federal tax law allows the artist to take would be limited to a percentage of his or her income.

This unique tax situation often prompts visual artists who have achieved financial success and who wish to form and endow a foundation during their lifetimes to prefer making their contributions to the foundation in the form of works of art rather than cash. Some visual artists regard even this alternative as unattractive. To the extent that they are financially able to do so, they prefer to retain works they have created for their lifetimes and by trust or will to transfer ownership of some or all of those works to the foundations they have formed.

Assuming that these foundations are qualified section 501(c)(3) charities, the artist's estate under current law is entitled to a full charitable deduction for the value of the art given to the foundation. The artist's estate then can avoid estate tax assessments on the value of those works of art.

1.12 THE BUSINESS OF FOUNDATIONS

The fact that a foundation is a tax-exempt entity does not mean that it doesn't have a business. In fact, foundations do have a business. The business of nonoperating foundations is to give away money for charitable purposes. The business of operating foundations may include giving away money for charitable purposes but is more focused on expending funds to support the operation of their own charitable programs.

In 2011, public charities reported $2.87 trillion in total assets and over $1.59 trillion in total revenues. In 2012, foundations reportedly gave away $50.9 billion. According to information available at the time of publication of this book, more than one million section 501(c)(3) organizations exist in the United States, more than eighty thousand of which are foundations.[15]

CHAPTER 2

Trustees: Governance and Fiduciary Obligation

Foundation trustees are the men and women who bear the ultimate responsibility to chart the course of a foundation's activities. This responsibility is often called the responsibility of "governance" and sometimes called "stewardship." The governance obligation imposed on a trustee is one that flows from the very fact that the individual has accepted the position of being a trustee.

To meet this responsibility, foundation trustees must take steps to ensure that the activities of the foundation they serve are in compliance with federal and state laws. They also must be mindful of restrictions that the foundation's governing instrument, bylaws, and donor-gift instruments impose on the foundation and ensure that the foundation does not do what is prohibited or fail to do what is required in those instruments.

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Within guidelines prescribed by law or in governing instruments, trustees have broad governance discretion to formulate, implement, and oversee the foundation's grants and investment programs, to set budgets, to determine the magnitude of the foundation's annual expenditures for charitable purposes, and to set policies for how foundation decisions will be made. One of their most important governance responsibilities is to elect successor trustees.[1]

In discharging their responsibilities, trustees may seek professional assistance from others and delegate certain management details to others. For

example, they may set the parameters of a grants program and hire an executive director to make grant decisions within those parameters, or they may delegate investment decisions to an investment manager or an investment committee.

No trustee delegation of authority, however, can be absolute. Trustees must maintain oversight for all matters that are delegated to others. "It is a director's responsibility to ensure an efficient means of controlling and managing the foundation."[2]

Another obligation that applies to all trustees is the high standard of conduct described as a "fiduciary obligation." As it applies to trustee responsibility, the fiduciary obligation is based on a longstanding common-law principle: individuals who control assets that aren't their own assets but rather have been dedicated for the benefit of others are held to a higher standard of conduct in dealing with those assets than the usual standard that applies to day-to-day dealings in the business world. Foundation trustees owe a fiduciary obligation to the foundation itself and to the organizations and individuals who will be the ultimate beneficiaries of the assets that the foundation holds.

The specifics of who the foundation's beneficiaries will be won't be known until the foundation expends funds by making grants or operating its own programs. The fact that the assets are to be used for the benefit of charitable beneficiaries not yet identified, however, is known from the moment that the assets are contributed to the foundation. In this sense, trustees control assets dedicated for the benefit of others—not for themselves.

It is axiomatic that if a trustee were to appropriate foundation assets for personal or family use or for the use of friends, that appropriation would result in fewer assets being available for charitable beneficiaries. Such a personal appropriation would be like a theft of assets from the class of persons for whose benefit the assets have been dedicated. It would violate the fundamental rule that "the trustee is under a duty to administer the trust solely in the interest of the beneficiaries."[3]

If a trustee appropriates foundation assets for her or his personal benefit or otherwise violates her or his fiduciary duty, the chief state enforcement officer, such as the attorney general of the state having jurisdiction over the foundation, is empowered to take enforcement action, including the recoupment of funds wrongfully taken or lost and the removal of the trustee from office. In

taking such action, the state's chief enforcement officer is acting as guardian of the interests of the foundation's charitable beneficiaries.

A violation of fiduciary duty may also constitute a violation of a federal requirement or prohibition. If it does, the federal government through the IRS or the Department of Justice would be empowered to seek redress. That redress could include the imposition of penalty excise taxes against the violator and ultimately lead to the revocation of the foundation's income tax exemption.

A classic description of a fiduciary obligation was included in an often-cited New York Court of Appeals decision written by Justice Benjamin Cardozo—then Judge Cardozo—in 1928:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the "disintegrating erosion" of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.[4]

From time to time, foundation trustees and officers ask me to provide them with a list of their principal responsibilities. To some extent the list must be tailored to the particular foundation's traditions and programs. Certain basic responsibilities, however, are always on my list. Here are the top twelve:

1. *Hands-on participation.* Attend all board of trustee meetings and meetings of board committees of which you are a member. Actively participate in these meetings. Review all minutes and reports presented at meetings for your consideration or approval, and ask questions if you feel clarification is needed. Make your suggestions for improvement in operations known to your colleagues on the board. Be sufficiently conversant with the basic federal rules that apply to foundations so that you will be able to recognize potential problem areas and know when questions need to be asked.
2. *Compliance with governing instrument and with federal and state law.* Ensure that the foundation is in compliance with all directives contained in its governing instrument, its bylaws, and restrictions imposed in gifts from

donors to the foundation. Adopt procedures to ensure that the foundation abides by all requirements and prohibitions imposed under federal and applicable state law. Require, receive, and review compliance reports at least annually. Ensure that excise tax payments and estimated payments are made on a timely basis, and that the foundation is in compliance with all federal, state, and local employee withholding tax and reporting requirements.

3. *Grants program.* Participate in the formulation of the foundation's grants program, in a periodic review of whether it continues to be relevant to the foundation's objectives, and in the periodic assessment of its effectiveness.
4. *Self-dealing.* Except as specifically authorized in federal law and regulations, never allow the foundation to make any grant or incur any other expenditure that will financially benefit a trustee, an officer or other foundation manager, a substantial contributor, or any member of that person's family or friends. Foundation trustees must never mix foundation business with personal business.
5. *Investments.* Ensure that the foundation maintains a prudent investment policy. If you do not have sufficient investment expertise, seek advice from trustees or outside professionals who do. Ensure that the board of trustees monitors investments on a regular basis or receives regular investment reports from a committee or outside advisor. Ensure that the foundation maintains a diversified investment portfolio or that it has and documents good reasons to do otherwise. Unless you have documentation justifying contrary action, avoid esoteric investments that Internal Revenue Service regulations indicate will be closely scrutinized.
6. *Delegations of authority.* Maintain sufficient oversight over all delegated matters to ensure that delegated responsibilities are being performed in accordance with the foundation's governing instrument, the trustees' policies and programs, donor-imposed restrictions, and legal requirements.
7. *Review of employee performance.* Ensure that the foundation has instituted an employee performance-review process. The board of trustees or a designated committee should review the performance of the senior employee of the foundation on an annual basis. The senior employee or another

knowledgeable trustee or designee should annually review the performance of other employees.

8. *Trustee succession.* Ensure continuity in board of trustee membership. Implement programs to ensure that all new trustees are familiar with the foundation's grantmaking programs and procedures, with requirements and prohibitions imposed under law and under the foundation's governing instrument, and with restrictions that have been imposed in donor instruments.
9. *Advisors*. Be sure that the foundation receives accounting, investment, and legal advice from knowledgeable and experienced professionals when needed.
10. *Dealing with violations of law.* If you suspect that the foundation has not met a legal requirement, bring your concern to the immediate attention of senior officers and the board of trustees so that the matter may be addressed immediately.
11. *Documentation*. Ensure that the foundation adopts a document retention policy that conforms with federal and state requirements and will meet potential needs in the eventuality of an IRS audit or state attorney general inquiry.
12. *The newspaper headline test.* Avoid taking and approving any foundation action that would give you discomfort if all the facts regarding that action were to be disclosed in a headline story on the front page of the local newspaper.

CHAPTER 3

Role of the Federal Government

Through the Internal Revenue Service, the federal government is empowered to monitor foundation compliance with federal requirements imposed on foundations and to impose civil penalties including revocation of a foundation's tax exemption in the event of noncompliance with these requirements. Particularly in areas that are regarded by foundation trustees to be technical, it is not unusual for trustees to criticize the degree of governmental involvement in foundation philanthropy.

As I will explain in this chapter, my personal view is that federal governmental involvement is both necessary and appropriate.

3.1 EARLY HISTORY

The federal government's involvement in foundation affairs began with laws that were enacted upon the adoption of the Sixteenth Amendment to the US Constitution. That amendment gave the federal government the power to collect income taxes. The amendment was ratified in 1913.

Shortly after ratification of the Sixteenth Amendment, the US Congress enacted the Revenue Act of 1913. This was the first federal law to impose a federal income tax. It also provided that charitable organizations were exempt from having to pay a federal income tax: "Nothing in this section [the Revenue Act of 1913] shall apply . . . to any corporation or association organized and operated exclusively for religious, charitable, scientific, or educational purposes, no part of the net income of which inures to the benefit of any private stockholder or individual."[1]

In 1917, four years following the enactment of the law providing charitable organizations with income tax exemption, the Congress enacted a statute that

granted taxpayers a tax deduction for the value of their gifts to charitable organizations.

The debate that led to the passage of the 1913 statute provides insight as to why the Congress was willing to extend tax exemption to charitable organizations and, four years later, to provide donors to charities with a charitable deduction. Senator Henry Hollis from New Hampshire is quoted as having provided a succinct justification: "For every dollar that a man contributes for these public charities, educational, scientific, or otherwise, the public gets 100 per cent."[2]

This concept—that the public gets 100 percent of the benefit of contributions to charitable organizations—continues to this day to be the most frequently stated justification for allowing charitable organizations a tax exemption and for allowing donors to charities a charitable deduction.

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3.2 THE FEDERAL TAX SUBSIDY

The 1913 law that exempted charitable organizations from income tax and the 1917 law that granted taxpayers a tax deduction for their contributions to charitable organizations have continued in various forms to the present time. In their present forms, they are sections 170, 501(a), and 501(c)(3) of the Internal Revenue Code.

In combination, these sections of the Internal Revenue Code have provided taxpayers with a federal tax subsidy in their support of charitable organizations. This tax subsidy has stimulated individuals and corporations to make gifts to foundations and other charitable organizations. It has been fundamental to the proliferation of charitable organizations in the United States.

The tax benefits flowing to a taxpayer on making a contribution to a foundation can be considerable. They are accompanied by an equal amount of tax loss to the government.

For example, let's assume that in a year during which a donor had taxable income of $10 million, he made a $2 million gift to a foundation he had

formed. Also assume that the donor met statutory requirements that enabled him to take a full charitable deduction for his gift.

Assuming that the donor was in the highest then-current federal income tax bracket of 35 percent, the net cost to the donor for making the gift would have been $1.3 million. That represents $2 million (the amount of the donor's gift to the foundation) less $700,000 (the amount of federal income tax the donor saved by receiving a charitable deduction on account of his $2 million gift).[3]

Let's look at this example in another way—from the perspective of the federal government. We have shown that the net cost of the gift to the donor was $1.3 million. Yet the foundation received $2 million. Where did the remaining $700,000 come from?

The answer is that it came from the federal government. The federal government forbore receipt of $700,000 in federal income taxes it would have received had the charitable gift not been made. In effect, the federal government subsidized the donor's gift to the foundation. The amount of the subsidy was $700,000.

The federal government's income tax forbearance continues to benefit the foundation after the gift is made. The foundation pays a federal excise tax on income, currently at a 2 percent rate (although sometimes at a 1 percent rate) but pays no federal income tax. The annual excise tax that the federal government will receive on account of the foundation's income derived from that $2 million will almost certainly be less than the income tax that would have been received from the individual on the same $2 million if the gift had not been made.[4]

The tax benefits to the donor and tax losses to the government apply to gifts to a family foundation controlled by the donor and the donor's family even though all involved parties—the IRS included—anticipate that members of the donor family may maintain many decades of control over how and for whose benefit the charitable funds will be expended. It should therefore come as no surprise that not all members of the US Congress have embraced the government's providing a subsidy that allows donors and family members an endless timeline to determine who will benefit from that subsidy.

3.3 THE TAX REFORM ACT OF 1969

After enactment of the 1917 law, periodic efforts were advanced in the Congress to reduce the power of foundations and to limit their activities. Investigations were initiated, issues were aired, and arguments were made. The Unrelated Business Income Tax law discussed in section 4.13 made its debut. Through the 1950s, however, no other new laws of significance to foundations were enacted.

The climate then changed. Members of Congress and senators became increasingly incensed as examples of abuse on the part of foundation donors and trustees were brought to their attention. Through testimony corroborated by documentation, various foundation donors and trustees were shown to have used foundation assets—funds exclusively committed for charitable purposes—for their own personal benefit.

Examples were cited of foundations using their economic strength to lobby for or against pending legislation and to support or oppose certain candidates for elective office. In addition, some foundations acquired attractive vacation or recreational properties with foundation funds, with donors and trustees inviting family and friends to use these facilities.

These mounting revelations led to the enactment of a new law that imposed sweeping changes on foundations. Following its adoption, the Internal Revenue Service issued detailed regulations to explain and to some extent augment the new legislation.

The new law, called the Tax Reform Act of 1969, prohibited foundations from entering into agreements or making grants that would benefit their trustees and other insiders. It imposed substantial limitations on foundation ownership of companies that their trustees or family members controlled. In addition, the Tax Reform Act prohibited foundation funding to support or oppose specific legislation or to support or oppose candidates for political office. It required foundations to limit their expenditures to those in support of charitable purposes.

The new law obligated nonoperating foundations to expend approximately 5 percent of their asset value each year for charitable purposes. Although described differently, obligations of comparable magnitude were imposed on operating foundations. The law authorized the imposition of substantial penalties if the rules were violated.[5]

3.4 IN DEFENSE OF THE FEDERAL GOVERNMENT'S INVOLVEMENT

Foundation donors and trustees sometimes complain that the federal government should not be so intrusive in dictating what foundations are required to do and what they are prohibited from doing. Complaints are also leveled at the complexity of the laws and regulations that apply to foundations and the increasing detail that must be included in Form 990-PF information returns that foundations must file with the Internal Revenue Service on an annual basis.

I am not a defender of the degree to which applicable federal laws and regulations are complicated and convoluted. In that regard, I fully subscribe to the principle that if something needs to be said, it should be said with clarity.

I do, however, firmly believe that the role of the federal government in imposing various obligations and prohibitions on foundations is a legitimate one. Through providing a charitable deduction to donors and providing income tax exemption to foundations, the federal government has "partnered" with generous taxpayers in facilitating the growth of foundations.[6]

> *Through providing a charitable deduction to donors and providing income tax exemption to foundations, the federal government has "partnered" with generous taxpayers in facilitating the growth of foundations.*

The justification for the government entering into this partnership arrangement is the foundation's obligation to use all of its assets for charitable purposes, accompanied by the obligation to use none of these assets for the personal benefit of foundation insiders. Once those obligations are violated, the justification for the partnership disappears.

Particularly in the context of the serious abuses that were brought to the government's attention at the time of the congressional hearings in the 1960s, it is appropriate for the government to set rules to ensure that the public will be protected from misuse of assets committed to charity. It is likewise appropriate for the government to enforce the rules when violations are brought to the government's attention and to impose substantial penalties for those violations.

All of these rules are to protect the public interest. As I see it, the public is entitled to that protection.

CHAPTER 4

Section 501(c)(3)

We now turn to section 501(c)(3) of the Internal Revenue Code—the federal statute that defines the types of charitable organizations that are exempt from having to pay a federal income tax. Section 501(c)(3) is the best known of all federal laws that apply to charitable organizations.

Here is section 501(c)(3) in its entirety:

> Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.[1]

In this chapter we'll consider section 501(c)(3) in the context of how its words and phrases that have received the most IRS and judicial attention have been interpreted.

4.1 THE TYPES OF ENTITIES COVERED BY SECTION 501(C)(3)

Section 501(c)(3) applies only to organizations of the type described in federal statutes and regulations. They are corporations, community chests,

funds, foundations, associations, and trusts. Section 501(c)(3) doesn't apply to individuals or to partnerships or joint ventures of individuals.[2]

The Dual Usage of the Word "Charitable"

In the context of section 501(c)(3), the word "charitable" is used in two different ways. One is as a substitute descriptor for all types of organizations that serve a purpose described in section 501(c)(3). In that sense, the word "charitable" is an umbrella label designed to cover the entire 501(c)(3) landscape. If the umbrella usage of the word "charitable" is adopted, all types of section 501(c)(3) organizations—religious, educational, scientific, and charitable itself among them—are charitable and would serve a "charitable purpose."[3]

The other use of "charitable" derives from the inclusion of the word among several other words—along with "religious," "educational," and "scientific," for example—in the list of purposes that can qualify an organization for a section 501(c)(3) tax exemption. In that sense, "charitable" is narrowly defined—not as an umbrella label but as a separate and distinct purpose. A charitable purpose in the narrowly defined sense would include support of homeless shelters and food-bank programs but not include support of religious or scientific or educational programs.

In this book, the terms "charitable" and "charitable purpose" will always be used in the broad umbrella sense unless the context indicates otherwise.

4.2 "ORGANIZED AND OPERATED EXCLUSIVELY"

Section 501(c)(3) imposes the requirement that to qualify for an exemption from having to pay federal income tax, an organization must be "organized and operated exclusively" for a charitable purpose. If an organization is operated exclusively but wasn't organized exclusively for a charitable purpose, or vice versa, it doesn't meet the dual requirement imposed by the statute and therefore doesn't qualify for the tax exemption.[4]

Section 501(c)(3) applies only to organizations of the type described in federal statutes and regulations. They are corporations, community chests, funds, foundations, associations, and trusts. Section 501(c)(3) doesn't apply to individuals or to partnerships or joint ventures of individuals.

The US Supreme Court has held that the tax-exempt status of an organization that was organized for a charitable purpose and that has been operated in pursuit of a number of important charitable purposes will be

destroyed if the organization engages in the substantial pursuit of just one noncharitable purpose.[5]

4.3 INUREMENT TO THE BENEFIT OF A PRIVATE SHAREHOLDER OR INDIVIDUAL

Section 501(c)(3) also contains a requirement that "no part of the net earnings of [the exempt organization] inures to the benefit of any private shareholder or individual." The IRS defines "private shareholder or individual" as used in section 501(c)(3) in a somewhat restrictive way to "refer to persons having a personal and private interest in the activities of the organization."[6] If the benefit is received by someone having no personal or private interest in the organization's activities, the section 501(c)(3) inurement clause is inapplicable.

The inurement clause in large measure is duplicative of the requirement that all 501(c)(3) entities must be operated exclusively for charitable purposes. Exclusive operation for charitable purposes negates the possibility of inurement for the benefit of a private shareholder or individual. Similarly, inurement for the benefit of a private shareholder or individual is inconsistent with exclusive operation for charitable purposes.

The IRS has broadened the scope of who is prohibited from receiving a private benefit from the acts of a charitable organization by defining a charitable purpose to be one that serves a public rather than a private interest. Whether an organization meets this test is determined by consideration of all facts and circumstances pertinent to the issue.[7]

IRS rulings and judicial decisions can help foundation trustees formulate an understanding of what will and what won't qualify as charitable. For example, scientific research undertaken under the auspices of a not-for-profit university will come within the definition of a section 501(c)(3) "charitable purpose." If the same scientific research were undertaken by a for-profit pharmaceutical company with stockholders, it would not come within the definition of a "charitable purpose."

Similarly, an educational program conducted by a school being operated on a nonprofit basis and a program to publish great literature undertaken by a nonprofit charitable literary society would warrant the school's and literary society's receipt of tax-exempt status. In contrast, if the education program were fostered by a for-profit school and the publication of great literature were

undertaken by a for-profit publishing house, neither of these for-profit companies would be entitled to income tax exemption.[8]

4.4 VIOLATION OF PUBLIC POLICY

The courts and IRS consistently rule that if an organization has violated public policy in the pursuit of its activities, further tax exemption will be denied. By way of example, the US Supreme Court, on the basis of the strong public policy against racial discrimination in a school or university setting, upheld the IRS's revocation of the tax-exempt status of a university that claimed that its practice of racial discrimination was based on its religious beliefs.[9]

4.5 RELIGIOUS PURPOSES

We now turn to a discussion of several of the purposes listed in section 501(c)(3) that are within the broad definition of "charitable." The starting point is to consider "religious purposes."

To make rules regarding religious purposes easier to read, the IRS uses the term "church" generically to include churches, mosques, synagogues, temples, and all other places of religious worship. With the same objective, it uses the word "minister" in the generic sense to denote members of the clergy of all religions and denominations including priests, rabbis, imams, and persons serving similar roles. This book uses the words "church" and "minister" generically for the same reason.[10]

Over the years, the IRS has revoked a number of tax exemptions that had been issued to organizations claiming to have been organized and operated for religious purposes. The revocations were based on testimony and documentation that demonstrated that the organizations in one way or another were not meeting section 501(c)(3) requirements.

Many individuals affiliated with these organizations are incensed that the government dares to take any action that is directed toward any religious organization. They argue that the First Amendment to the US Constitution protects all religious organizations from governmental intrusion and that the IRS has no business involving itself in religious matters.

An understanding of judicial interpretations of the First Amendment and issues that the IRS can raise in revocation proceedings can be of considerable importance to trustees of foundations that make grants to churches and other religious organizations—particularly to organizations not well known to the

trustees. The discussion that follows highlights key issues that the IRS and the courts have raised in the context of the "religious purposes" tax exemption. My objective is to enable foundation managers to assess organizations claiming to be churches or to serve other religious purposes in a way that is consistent with standards that the IRS considers in its own assessments of these organizations. More detail to assist trustees in making specific grant decisions is provided in chapter 15.

4.5.1 The First Amendment and Religious Beliefs

Here's what the First Amendment has to say about religion: "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof." The US Supreme Court has held, time and again, that this clause constitutes "an absolute prohibition against governmental regulation of religious beliefs." It prohibits governmental action to "aid one religion, aid all religions, or prefer one religion over another."

Consistent with these holdings, the Supreme Court has ruled that the federal government cannot force a person "to profess a belief or disbelief in any religion" or "impose requirements which aid all religions as against non-believers" or "aid those religions based on a belief in the existence of God as against those religions founded on different beliefs."[11]

4.5.2 The First Amendment and Religious Practices

Religious practices are not the same as religious beliefs and don't receive protection comparable to that provided to religious beliefs. The starting point for understanding the difference is to recognize that as broad as it is, the First Amendment does not provide a basis upon which religious organizations and their members can shield themselves from all governmental laws. The courts have consistently ruled that some laws are of such compelling interest to the government or to United States citizens that enforcement is permitted even where it precludes *practices* important to particular religions.

> *Religious practices are not the same as religious beliefs and don't receive protection comparable to that provided to religious beliefs.*

An early example is discussed in an 1878 decision of the Supreme Court considering a defendant's appeal from a bigamy conviction. The defendant, a member of the Church of Jesus Christ of Latter-

Day Saints, argued that the conviction was in violation of his First Amendment rights. He proved to the court's satisfaction that he was a member of the church and believed in its doctrines, that church members "believed that the practice of polygamy was directly enjoined upon the male members thereof by the Almighty God," and that the penalty for failure and refusal "would be damnation in the life to come."[12]

In upholding the conviction, the court drew the distinction between interference with religious beliefs and interference with religious practices:

> Laws are made for the government of actions, and while they cannot interfere with mere religious belief and opinions, they may with practices. Suppose one believed that human sacrifices were a necessary part of religious worship, would it be seriously contended that the civil government under which he lived could not interfere to prevent a sacrifice? Or if a wife religiously believed it was her duty to burn herself upon the funeral pile of her dead husband, would it be beyond the power of the civil government to prevent her carrying her belief into practice?[13]

Subsequent judicial decisions have recognized the legitimacy of governmental enforcement of laws that, in the context of compelling governmental objectives, limit religious practices.[14]

4.5.3 Meaning of "Religious" as Used in Section 501(c)(3)

The words "religion" and "religious" are not defined in either the First Amendment or in section 501(c)(3). The IRS has published language, however, that is helpful in leading to an understanding of the meaning of a "religious purpose" as contemplated in section 501(c)(3):

> It would seem that no activity should normally be treated as fulfilling an exclusively religious purpose unless its regular performance (a) can reasonably be expected to inform and instruct the people most directly affected by it with respect to some more or less specific set of beliefs about the essential nature of man as the subject of some higher power or (b) will otherwise tend to persuade or encourage such people to embrace the idea that their position in life requires them to discover and observe some minimum standard of behavior from the standpoint of overall morality.
>
> If an organization has no activities, however, which directly involve it in any church services or in any form of spiritual or otherwise morality

> oriented instruction, . . . there appears to be no adequate justification for characterizing it as an exclusively religious organization.
>
> This office has consistently adhered to the view . . . that there must be a "nexus between the asserted religious activity and the didactic or moralistic functions of the church."[15]

4.6 CHARITABLE PURPOSES

We already addressed the dual meaning of the word "charitable" in the context of section 501(c)(3). In this section, we focus on the IRS's additional explanation of "charitable" in both senses.

The IRS explains that in its narrow sense, the term "charitable" includes

> relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.[16]

4.6.1 Lessening the Burdens of Government

Most of the examples that the IRS provides in its description of charitable purposes are easily understood. However, "lessening of the burdens of Government" is not quite so clear.

The IRS has set forth three conditions that must be met if an organization is to be viewed as charitable by virtue of its lessening governmental burdens. First, the organization's activities must be activities that a governmental unit actually considers to be its burdens. Second, its activities must actually lessen the governmental burden. All relevant "facts and circumstances" are to be taken into account in making these determinations.

The third condition is that there must be an "objective manifestation by the government that it considers such activity to be part of its burden." The manifestation must come from a statement of or action by the governmental unit or the strength of the working relationship between the organization performing the activity and the governmental unit. Manifestation by an elected official or a

high ranking employee speaking without authorization from the governmental unit doesn't suffice.

Showing that the activity is actually being operated as a governmental program would be sufficient. However, saying that the activity is sometimes undertaken by the government or that an individual governmental official has expressed approval of the organization and its activities would not be sufficient.[17]

Finally, it is important to remember that all organizations claiming tax-exempt status under section 501(c)(3)—even those claiming the exemption as organizations lessening the burdens of government—must be organized and operated for purposes that are "charitable" in the broad sense. An organization that works to lessen the burdens of government but operates for the benefit of private interests will not qualify as tax exempt under section 501(c)(3).[18]

4.7 SCIENTIFIC PURPOSES

Section 501(c)(3) and its accompanying regulations do not contain a specific definition of "scientific" or "scientific purpose." A useful definition, however, appears in a decision of the Court of Claims:

> The terms "science" and "scientific" are not defined in the Internal Revenue Code, Congress apparently having chosen to rely on the commonly understood meaning of the term. The *McGraw-Hill Dictionary of Scientific and Technical Terms,* (Lapedes ed., 2d ed. 1978), p. 1414, defines "science" as a "branch of study in which facts are observed, classified, and, usually, quantitative laws are formulated and verified; [or] involves the application of mathematical reasoning and data analysis to natural phenomenon." The *Random House Dictionary of the English Language,* p. 1279 (Stein ed. 1967), defines "science" as "knowledge, as of facts and principles, gained by systemic study." Thus, in the context of this litigation, "science" will be defined as the process by which knowledge is systematized or classified through the use of observation, experimentation, or reasoning.[19]

The distinction between a charitable purpose and a commercial purpose is particularly important to foundations considering making grants to support scientific research. Here is what the IRS has to say on that subject:

> A scientific organization must be organized and operated in the public interest. . . .

> Scientific research will be regarded as carried on in the public interest: (*a*) If the results of such research (including any patents, copyrights, processes, or formulae resulting from such research) are made available to the public on a nondiscriminatory basis; (*b*) If such research is performed for the United States, or any of its agencies or instrumentalities, or for a State or political subdivision thereof; or (*c*) If such research is directed toward benefiting the public.
>
> The following are examples of scientific research which will be considered as directed toward benefiting the public, and, therefore, which will be regarded as carried on in the public interest: (1) Scientific research carried on for the purpose of aiding in the scientific education of college or university students; (2) scientific research carried on for the purpose of obtaining scientific information, which is published in a treatise, thesis, trade publication, or in any other form that is available to the interested public; (3) scientific research carried on for the purpose of discovering a cure for a disease; or (4) scientific research carried on for the purpose of aiding a community or geographical area by attracting new industry to the community or area or by encouraging the development of, or retention of, an industry in the community or area.[20]

Of course, and as discussed in section 4.3 above, the same scientific research that qualifies as charitable if conducted under the auspices of a section 501(c)(3) educational institution will not qualify as charitable if conducted by a for-profit corporation for the ultimate financial benefit of the corporation and its shareholders.

> *The distinction between a charitable purpose and a commercial purpose is particularly important to foundations considering making grants to support scientific research.*

4.8 TESTING FOR PUBLIC SAFETY

The basic principles that define testing for public safety are parallel to those that define scientific purposes. To qualify under section 501(c)(3), both must be carried on in the public interest.

As used in section 501(c)(3), "testing for public safety" is defined by the IRS to include the testing of consumer products to determine whether they are safe for use by the general public. In the context of that definition, the IRS

has ruled that the clinical testing of a drug for safety prior to Food and Drug Administration approval to meet FDA requirements for marketing is a service performed for the manufacturer, which serves a private rather than the public interest.

In contrast, the IRS has ruled that testing for public safety undertaken at the behest of a manufacturer to test commercial building products already in use does serve the public interest if done to establish that the products meet recognized national standards as well as state and local building code standards.[21]

4.9 LITERARY PURPOSES

For a literary purpose to qualify under section 501(c)(3), it too must serve a public rather than a private interest. Most IRS commentary that addresses "literary purposes" focuses on the distinction between publication for a literary or charitable purpose and publication for a commercial purpose. Here's an example from an IRS ruling:

> The information you have submitted indicates that your assistance in the publication of the book will make the book available for both scholars and for the general public. Without your assistance it is likely that the book would not be published or would have a very limited audience. Your assistance accomplishes a literary purpose and, thus, your payments are made for [charitable purposes].[22]

4.10 EDUCATIONAL PURPOSES

The IRS defines "educational" to include the instruction or training of individuals to develop or improve their capabilities and the instruction of the public on subjects useful to individuals and beneficial to the community. Of course, that instruction or training must be done for public purposes and not to serve private interests.

Examples of organizations serving educational purposes include a school, college, or professional or trade school "which has a regularly scheduled curriculum, a regular faculty, and a regularly enrolled body of students in attendance at a place where the educational activities are regularly carried on" and an organization that presents a course of instruction through correspondence or the media. Organizations that promote the arts and culture, such as muse-

ums, symphony societies, and dance and opera companies also come within the definition of "educational," as would a zoo or a planetarium.[23]

4.10.1 Education and Advocacy

In one of its regulations, the IRS states that "an organization may be educational even if it advocates a particular position or viewpoint so long as it presents a sufficiently full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion. On the other hand, an organization is not educational if its principal function is the mere presentation of unsupported opinion."[24]

4.11 LOBBYING

Section 501(c)(3) provides that "no substantial part" of a section 501(c)(3) organization's activities can be directed to "carrying on propaganda, or otherwise attempting, to influence legislation." As discussed in chapter 8, although 501(c)(3) public charities are permitted to lobby so long as the lobbying doesn't constitute a "substantial" part of their activities, the Tax Reform Act of 1969 imposes a total prohibition on foundation participation in or funding of lobbying activities.[25] This is an example of respects in which foundations are held to stricter rules than those applied to public charities.[26]

4.12 POLITICAL ACTIVITY

Section 501(c)(3) provides that tax-exempt charitable organizations may not "participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office." This means that they cannot take positions on behalf of or in opposition to any candidate for public office, whether that office be national, state, or local. They likewise are precluded from publishing or distributing statements in writing or by making oral statements on behalf of or in opposition to any candidate.[27]

Although the section 501(c)(3) provision is written as an absolute prohibition, it has been interpreted by the Internal Revenue Service and judicial decisions to be subject to various nuances and exceptions. Here's an IRS synthesis of various prior rulings on the subject:

> Section 501(c)(3) organizations are permitted to conduct certain voter education activities (including the presentation of public forums and the publication of voter education guides) if they are carried out in a nonpartisan manner. In addition, section 501(c)(3) organizations may encourage people to participate in the electoral process through voter registration and get-out-the-vote drives, conducted in a nonpartisan manner. On the other hand, voter education or registration activities conducted in a biased manner that favors (or opposes) one or more candidates is prohibited.[28]

As strict as the section 501(c)(3) rule is in prohibiting public charity and foundation participation and intervention in political campaigns, another statutory prohibition, even more strict, applies to foundations alone. That prohibition is the subject of chapter 9.

4.13 UNRELATED BUSINESS INCOME TAX

Notwithstanding their exemption from having to pay federal income taxes, section 501(c)(3) organizations may have to pay federal income tax on what is called "unrelated business income." The tax, first proposed in 1950, is called an Unrelated Business Income Tax, or UBIT.

Notwithstanding their exemption from having to pay federal income taxes, section 501(c)(3) organizations may have to pay federal income tax on what is called "unrelated business income." The tax, first enacted in 1950, is called an Unrelated Business Income Tax, or UBIT.

Before 1950, court rulings enabled a for-profit organization to avoid payment of income tax if the organization was owned by a section 501(c)(3) organization that received its profits. Members of Congress were incensed at the degree of tax avoidance that resulted from these rulings. Examples included a nationwide vendor of pasta escaping payment of income tax because a university owned its stock and therefore received its profits. Similarly, a commercial beach facility avoided tax because it was owned by a foundation that received its profits.[29]

The 1950 legislation rejected this line of judicial decisions by focusing on the tax status of the for-profit company that was the source of the profit rather than the nonprofit organization that ultimately received that profit. In general, the legislation precluded a for-profit company earning a profit from avoiding payment of income tax merely because the profit would ultimately be trans-

ferred to a section 501(c)(3) organization. In other words, the for-profit company could not invoke the tax exemption afforded the ultimate recipient of its profits. The 1950 UBIT law was strengthened on enactment of the Tax Reform Act of 1969.

Today, the Unrelated Business Income Tax is imposed only on income from activities that are not substantially related to the 501(c)(3) organization's exempt purposes. Income from a section 501(c)(3) organization's business activities conducted "primarily for the convenience of its members, students, patients, officers or employees" is not deemed to be unrelated business income and therefore is not taxed. Examples of activities conducted for convenience would be a hospital cafeteria maintained for the convenience of patients and medical staff and a college cafeteria maintained for the convenience of students and faculty.[30]