CORPORATE FOUNDATIONS
& GRANTMAKING TOOLKIT

MADE IN CREATIVE COLLABORATION BY:

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Foundation Source

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INTRODUCTION

Nearly all companies engage in corporate philanthropy as a means of giving back to the communities in which they operate. This includes financial contributions, product donations, in-kind services, and employee matching and volunteering.

However, only a fraction of these companies take advantage of the additional benefits that come from adding a corporate foundation to their philanthropic efforts.

This toolkit will help you understand the benefits of a corporate foundation and provide an overview of the operational requirements.

WHAT IS A CORPORATE FOUNDATION?

Technically, a corporate foundation is classified by the Internal Revenue Service as a type of 501(c)(3) public charity called a "private non-operating foundation." The Internal Revenue Code does not distinguish corporate foundations from family foundations. Both are subject to the same regulations. From a practical stand point, however, there are differences in funding and governance. A corporate foundation is funded by a company, instead of an individual or family. And the board members of a corporate foundation are typically company executives.

WHY SET UP A CORPORATE FOUNDATION?

Corporate foundations provide companies with a host of benefits that are not available through a corporate giving program. These include:

TAX DEDUCTIONS

The company receives a charitable tax deducation when it makes a contribution to its own foundation. In addition, the company maintains control over those charitable assets.

PHILANTHROPIC DISCIPLINE

Creating a separate legal entity helps instill the discipline to set strategic and tactical goals for the company's philanthropic activities:

- Clarifies the company's philanthropic vision, both internally and externally
- Formalizes the mission and process of awarding grants
- Insulates executives from funding requests by friends, relatives, business acquaintances, and employees.

EXPANDED PHILANTHROPIC OPTIONS

Corporate foundations can engage in a wide range of charitable activities that would not be tax deductible if handled directly by the company:

- International grants made directly to organizations outside of the U.S.
- Employer-related scholarship programs
- Grants to individuals for disaster relief and economic hardship
- Loans for a charitable purpose that are paid back to the foundation
- Grants to for-profit entities, when used for a charitable purpose

DIRECT SUPPORT TO EMPLOYEES FOR EMERGENCY RELIEF

When employees are affected by a “qualified” federal disaster (i.e. one that’s been declared by the president or FEMA), corporate foundations are permitted to provide funds for emergency relief without advance approval from the IRS. However, because the foundation is prohibited from making grants that could be a substitute for an employee benefit, or a means to recruit or retain a workforce, there are important compliance considerations. For example, the foundation must set up an independent selection committee, and relief can only be given to a certain percentage of employees.

CONSISTENT GIVING

The foundation can build a reserve in years when company profits are high that can later be utilized in leaner years.

ASSET “CATCH BASIN”

The company can avoid capital gains taxes when real estate, stock, and other appreciated assets are donated to the foundation.

ENHANCED REPUTATION

The foundation’s charitable activities reflect positively on the company for which it is named. They demonstrate a long-term commitment to philanthropy and contribute to the legacy of the CEO.

REDUCED COMPANY OVERHEAD

Staffing and overhead can be paid by the foundation and counted toward its 5% minimum distribution requirement, resulting in a reduced cost to the company.

SIMPLIFIED RECORDKEEPING

Corporate foundations are not required to collect substantiation receipts for gifts of $250 or more, a great advantage when used in conjunction with employee matching programs.

ESTABLISHING A FOUNDATION

A corporate foundation is a distinct legal entity, typically set up as a non-stock corporation. Additional requirements for the corporate entity vary depending on the state of incorporation and whether it will engage in any fundraising activities. Many foundations choose to incorporate in Delaware because it allows single-director corporations and board meetings to be held electronically (i.e., conference calls, video conferencing).

In order for donations to a private foundation to be tax deductible, the foundation must be officially recognized by the IRS as a 501(c)(3) charitable organization. The application is submitted via IRS Form 1023.

The 1023 must be filed with the IRS within 15 months after the end of the month in which the foundation was formed. Upon approval of the application, the effective date of the organization's 501(c)(3) status will be retroactive to the date it was formed. If the 1023 is filed more than 15 months from organization formation the exempt status will be retroactive only to the date of application.

If you intend to award scholarships from your corporate foundation, an activity that requires IRS approval in advance, you should consider making that application along with your 1023 filing.

The benefits of IRS recognition of 501(c)(3) status include:

- Public recognition of tax-exempt status
- Assurance to donors of deductibility of contributions
- Exemption from certain state taxes
- Exemption from certain federal taxes
- Nonprofit mailing privileges

NEEDED ESTABLISHING RESOURCES

You can hire an attorney to create your corporate foundation. It is highly recommended that you use an attorney who has specific expertise in setting up foundations, so you don't run into unfore-seen problems down the road.

Another option is to work with Foundation Source, a partner of YourCause. Foundation Source can provide a new corporate foundation in about a week and for a very reasonable cost. They'll provide the corporate entity, bylaws, and recommended governance policies; and they'll file IRS Form 1023 for recognition of exempt status. This is a service they've provided for thousands of foundations, from coast to coast.

Foundation Source also offers a comprehensive suite of outsourced support services to keep your corporate foundation running efficiently and effectively, without having to hire additional staff or build infrastructure. Their services include administrative support, active compliance monitoring, philanthropic advisory services, tax and legal expertise, and online foundation management tools.

ORGANIZATIONAL BASICS

The decisions your company makes now - including the name of the foundation, the composition of its board, its mission statement, and its communication plans - will lay the groundwork for its future operations and charitable activities.

NAMING THE FOUNDATION

Be aware that there are some ground rules for selecting a name based on the state of incorporation. For example, Delaware requires that both for-profit and nonprofit corporation names contain one of the following 16 words or abbreviations: Association, Company, Co., Corporation, Corp., Club, Foundation, Fund, Incorporated, Inc., Institute, Limited, Ltd., Society, Syndicate, or Union.

For corporate foundations, the most obvious choice is to name the foundation after the company. An eponymous foundation can associate the company's name with a particular cause. Of course, using the company's name is not your only option. Your foundation's name could broadcast its charitable purpose (e.g., The Environmental Foundation) or be completely generic (e.g., The Harvest Foundation), reflecting a desire for relative anonymity. Although a generic name can make it easier to maintain a low profile, absolute anonymity is difficult to obtain because the identities of board members and substantial contributors are on the foundation's annual tax return and are a matter of public record.

STRUCTURING YOUR BOARD

With a corporate foundation, the company itself decides who sits on the initial board. This is important because your initial board will set foundation policy, provide oversight, and ensure accountability for performance. The board's responsibilities include:

- Determining mission and purpose
- Engaging in strategic planning
- Establishing policies and procedures
- Approving and monitoring grantmaking
- Providing fiscal oversight
- Ensuring adherence to federal and state regulations
- Representing the foundation to external audiences

The size of the board should be sufficient to provide effective oversight of the foundation, and its constituent members should possess enough expertise and experience in these areas to be an effective governing body. If company executives lack some of these capabilities, outside board members can fill the gaps, such as community representatives and trusted advisors who can lend their professional knowledge. If you are going to focus on a specific area of giving, outsiders who can offer insight into that particular charitable interest (for example, a doctor who specializes in childhood asthma) can make valuable contributions to your board.

DRAFTING A MISSION STATEMENT

The IRS requires that private foundations have a statement dedicating the organization exclusively to charitable purposes. To fulfill this mandate, many foundations adopt the broad statutory language that defines all nonprofits (e.g., “for religious, scientific, literary, educational or other charitable purposes”). Beyond this, there is no legal requirement to create a mission statement.

However, in addition to informing the grantee community about your foundation’s purpose and goals, research has shown that a focused mission can:

- Define the company’s intentions for future board members
- Ensure that board members are clear about what the foundation aims to accomplish
- Provide a reference point to assess the foundation’s accomplishments and discourage mission drift
- Establish an external identity that signals to other funders how they can collaborate
- Lend credibility to the foundation, leading others to take your goals seriously
- Shield company executives from having to say “yes” to every organization’s grant request

So, what makes a good mission statement? A good mission statement is short, direct, easily understood, and specific. It should pass the “elevator test” (you could convey it to someone during the course of a brief elevator ride). For example: “We are committed to identifying, understanding, and impacting the root causes of the growing opioid epidemic.”

PLANNING YOUR BOARD MEETINGS

Regular meetings are critical for making investment and grantmaking decisions, deciding policy, benchmarking progress toward foundation goals, and adjusting foundation strategies where warranted. Your board will want to review the foundation financials, make any officer/director changes, go over the grantmaking budget, etc.

Whether meeting in person or virtually, the board should keep written minutes. Minutes can help you keep track of ideas, observations regarding investment performance, field reports, and other items that might otherwise be lost from memory. And from a compliance standpoint, having a signed, formal, and permanent record of the actions taken by the board of directors is an important safeguard in the event that the IRS ever audits your foundation.

Minutes generally include:

- A report on foundation activities since the last meeting
- A review of potential grants and reports submitted on current grants
- A financial report that compares the foundation's budget to actual financial activity during the current fiscal year
- An investment report on the performance of foundation assets and any changes to investment strategies
- Review and approval or denial of all actions that require board approval based on applicable state and federal law
- Review and approval or denial of proposals that are submitted to the board for review
- Approval and ratification of any actions taken by officers since the last meeting
- Approval, signature, and submission of minutes from the last meeting

GOVERNANCE & POLICIES

Although foundations are considered the most flexible of all charitable vehicles, they are subject to federal, state, and IRS regulations.

Most of these regulations are intended to ensure that, in return for their tax-exempt status, corporate foundations benefit the public, and not the company and individuals who created them. To keep your foundation functioning safely within legal and ethical bounds, you will need to establish some important groundwork: the policies and governance structure that will serve as the foundation's infrastructure.

CORE CONCEPTS

All of the policies that you'll need (in fact, all of the actions you'll ever take on behalf of the foundation) reflect, in substance and spirit, the fiduciary duties of care, loyalty, and obedience. These duties set the tone for board service and reflect the standards that have grown out of corporate law. Put simply, here is what these duties mean:

DUTY OF CARE

The duty of care requires every director to act reasonably, in good faith, and with prudence. Directors have the responsibility to be informed about an issue before making a business decision about it. Directors should use their best judgment in making decisions and be vigilant in fiduciary oversight. Of course, to do any of these things requires attendance at board meetings and keeping apprised of foundation actions. Directors should choose fellow board members carefully, and should monitor their actions. Finally, the duty of care requires that directors acknowledge that ultimate responsibility for the foundation rests with themselves.

DUTY OF LOYALTY

The duty of loyalty also requires directors to act in good faith, but is very strict in that it expressly prohibits directors from unfairly profiting, directly or indirectly, from the foundation. Directors will need to put personal and professional interests aside if they conflict with the foundation's greater good, and take pains to identify and avoid potential conflicts of interest.

DUTY OF OBEDIENCE

This duty necessitates abstaining from acts that are beyond the scope of one's authority or beyond the permissible activities of the foundation.

In sum, these duties require the board to act in the best interest of the foundation and not the personal interests of the directors. If a director breaches any of these fiduciary duties, he or she may be found personally liable to the foundation and the state or federal government.

To ensure that every board member understands these duties, it is essential that the board members familiarize themselves with the foundation's charter documents that define its philanthropic mission. These documents typically give guidance as to how the foundation should be governed and how new board members are to be elected (or existing members replaced).

Further guidance can be found in the foundation's articles of incorporation, which typically contain a statement of the foundation's charitable purpose and outline its legal powers and authority.

Bylaws are also created when the foundation is established. These are legally binding rules that outline how the board will operate and should be used to guide actions and decisions. Bylaws are not static, however, and should be reviewed regularly to ensure that they accurately reflect how the foundation works. If the bylaws no longer reflect the needs of the foundation, the board has the authority to amend them.

WRITTEN POLICIES

Although they lack the formality of bylaws, written policies are an important way to codify the foundation's expectations for board members and the general rules for daily operation. Here are the policies we recommend:

- An investment policy that includes objectives, benchmarks for assessing performance, and types of investments that are or are not permissible for the foundation.
- A conflict-of-interest policy that identifies when professional or personal interests compete, and that sets rules for managing these potential conflicts (e.g. when to disclose, when to abstain from voting).
- An expense policy that describes the types of expenses and travel that are considered reasonable and necessary for accomplishing the foundation's charitable mission.
- Retention guidelines for written documents, specifying how long to retain documents and records, especially as they relate to grantmaking and board decision-making.
- A compensation policy (if you intend to pay board members or staff) that details the process used to benchmark and set compensation.

FOUNDATION INVESTMENTS

Corporate foundations have tremendous control and discretion over the investment of their assets. They are free to invest in a broad range of assets—including publicly traded securities, private stock, real estate, artwork, or other tangible property—with few restrictions as long as they exercise responsible stewardship.

A sound investment policy places a reasonably high priority on protecting principal, and aims to earn enough income, with sufficient liquidity, to meet the annual 5% minimum distribution requirement. Generally, management of the portfolio is looked at as a whole rather than on an investment-by-investment basis. While some types of investments are subject to higher scrutiny, they are not strictly prohibited.

These include:

- **Trading on margin**
- **Commodity futures**
- **Working interests in gas and oil**
- **Puts, calls, and straddles**
- **Purchase of warrants**
- **Selling shares short**
- **Junk bonds**
- **Risk arbitrage**
- **Hedge funds**
- **Derivatives**
- **Distressed real estate**
- **International equities in third-world countries**

In creating an investment strategy, board members should determine what constitutes an acceptable level of risk for the foundation, taking into account whether it will operate as a "pass-through" foundation that is funded annually and spends down its assets each year or whether the foundation plans to spend down its endowment and exist in perpetuity (in which case the foundation may be able to tolerate more volatility). Here are some of the elements that contribute to a successful investment policy:

- The officers responsible for investments should be financially savvy themselves or delegate investment management to financial experts.

- If foundation investments extend beyond the realm of cash, stocks, bonds, and mutual funds into limited partnerships, hedge funds, real estate, and other "alternative assets," the foundation should consult an advisor with a working knowledge of the Internal Revenue Code and Treasury Regulations so as to avoid unfavorable tax treatment and potential violations.

- The foundation should also plan activities so as to reduce the foundation's excise tax rate from 2% to 1% in years when it realizes significant investment income, such as from large capital gains.

GRANTMAKING BASICS

Before making your first grant, you'll need to do some planning and make a few key decisions. First, you'll need to determine how much the foundation is legally required to distribute and how much it will distribute annually. (See the next section on IRS Regulations Governing Corporate Foundations: Minimum Distribution Requirement.) Next, you'll need to decide who will be allowed to make grants on behalf of the company's foundation and whether those decisions are made individually or collectively. You'll also need to decide how potential grant recipients will be identified, and how funding decisions will be made.

CREATE A SPENDING PLAN

A spending plan documents how foundation funds should be disbursed. Creating one now helps set guidelines for current and future board members. Your spending plan should balance philanthropic objectives with fiscal realities, and you'll also want to give some thought as to how the foundation's goals and finances might evolve over time.

While family foundations typically use the investment returns from their endowments to fund their annual grantmaking, many corporate foundations operate on a "pass-through" basis. They receive annual funding based on company profits, and those funds are mostly spent down each year. Here are some of the questions you might consider for both present and future needs:

- Do you plan to exceed the 5% minimum distribution requirement?
- Do you want to grow the foundation's endowment, or are you satisfied to keep up with inflation?
- What returns can you expect on your investments, and will they keep pace with your distributions?
- Do you have cash flow and cash reserves to meet operational needs?
- Is the foundation fully funded, or will it receive additional assets?

Once you've answered these questions, you'll want to turn your attention to your spending plan for your grantmaking. How much will the foundation give to the nonprofits that the company and its executives have previously supported (your "historical" interests)? How much should be set aside for targeted programs that the board will undertake collectively? How much should be put on hold in reserve for special opportunities that might present themselves?

A foundation with a $500,000 minimum distribution requirement might initially divide it up in the following way:

- $100,000 historical/company interests
- $300,000 mission/targeted programs
- $100,000 special opportunities

GRANTMAKING STRATEGY

Companies new to philanthropy often choose to "get their feet wet" by making grants to a wide variety of organizations in the communities where they have a corporate footprint, and letting the foundation's purpose reveal itself over time. However, even during this period of experimentation, it is possible to maximize your social impact and lay the groundwork for more focused, strategic grantmaking. The following questions will help you develop a system for identifying potential grantees, evaluating proposals, and determining the terms and conditions of your grants.

DO YOU WANT TO SEEK OR BE FOUND?

Will you actively search for organizations to support, or will you publicize your areas of interest and solicit proposals from nonprofits? Would you like to do both?

WHERE ARE THE FOUNDATION'S BOUNDARIES?

Will you consider making grants only in certain geographic regions, areas of philanthropic interest, or for a specific issue? For example, you might decide to make grants solely to projects in communities where your company operates. Alternatively, you could decide to fund only nonprofits in STEM workforce development or marine habitat preservation.

HOW LONG WILL YOUR FOUNDATION FUND AN ORGANIZATION?

Some foundations provide one-time grants without the possibility of continuation in order to constantly fund new ideas and deter grantees from becoming dependent on the foundation's support. Other foundations offer multiple-year funding, providing a steady flow of support over time.

WHAT TYPES OF GRANTS WILL YOUR FOUNDATION GIVE?

Will your foundation give unrestricted grants, or will it be focused on specific programs? General operating support allows the grantee to determine how the funds will be used. Charities particularly value this kind of support because it provides funding for any activity—including the grantee's operating expenses and overhead. A project grant, by contrast, provides support for a specific set of charitable activities that the organization plans to undertake.

FIND WORTHY GRANTEES

Although it's easy to find eligible nonprofits with a simple web search, it's more difficult to evaluate the many funding opportunities and identify the ones that best align with your philanthropic goals. A good place to start is with a visit to each nonprofit's website. As you browse, keep these questions in mind:

- **Does the organization have a clearly articulated mission statement?**

  Vague and ambiguous intent often leads to vague, ineffectual action.

- **What type of activities and programs does the organization undertake?**

  Do its programs and projects seem likely to advance its mission?

- **Who is on the board?**

  Ideally, the board is comprised of a collection of people who support the organization through fundraising and program expertise. It's a red flag if members of the board are not giving to the organization.

- **How long has the organization been in operation?**

  What is its history of accomplishment?

- **How many people are served by the nonprofit?**

  The size of the target population should give you some indication of how the organization compares with other nonprofits working within the same arena.

- **Does the nonprofit provide evidence of its success?**

  Although nonprofits often struggle to quantify results, an organization should have more to offer than a few touching testimonials.

- **Has the nonprofit been embroiled in controversy or scandal?**

  Google the organization to see if it has been in the news. A bad reputation in the nonprofit world, whether or not it's deserved, can undermine an organization's effectiveness.

NONPROFIT PARTNERSHIPS

It used to be that good corporate citizenship consisted primarily of grants to community organizations such as soup kitchens and little league teams. But what were once ad-hoc donations have now evolved into something far more sophisticated. For many companies, philanthropy is closely tied to corporate identity, supporting the company's marketing and branding objectives, engaging its employees, and enhancing its relationship with the community (or communities) it serves. The emerging trend is for a company's values, interests, and brand to be integrated into everything it does, including and especially its philanthropy.

Many corporations choose to focus their giving on a signature charitable issue or cause that they can "own." By concentrating on a core issue, especially one that is aligned with the company's business interests, companies find that they can have a significant social impact while reaping other substantial benefits: heightened brand awareness; deep engagement with employees; goodwill with the community; and positive publicity. Moreover, by choosing an issue that aligns with the business and with which it is therefore familiar, the company enhances its chances for success. Instead of finding its way on unfamiliar ground, the company can harness its native expertise, resources, and networks.

Having chosen a core issue, corporations commonly work toward their philanthropic goals by forming long-term, strategic partnerships with nonprofit organizations. Consider a technology company that wants to support and encourage the next generation of talent in the fields of science, technology, engineering, and math (STEM).

The company could make grants to colleges and universities with academic programs in STEM subjects. By making these grants consistently and with the right partners, the company can achieve both its philanthropic aims (fostering the next generation of STEM professionals) and corporate objectives (brand recognition, positive publicity, etc.). A thoughtful partnership could indirectly benefit the company's business by:

- Publicizing the company's efforts to prepare the next generation for STEM careers
- Aligning the company's philanthropic pursuits with its commitment to high-tech innovation

- Building brand equity by linking the company's name with prestigious academic institutions
- Providing opportunities for employees to mentor and cultivate talent

Choosing the right partner is essential for success— on both sides of the equation. Beyond the fate of any specific philanthropic initiative, there are long-term benefits to be had for both partners.

The corporation stands to benefit from the nonprofit partner's:

- Community roots and goodwill
- Expertise in the chosen funding area (e.g. autism, environmental, conservation)
- Knowledgeable staff to function as "boots on the ground"
- Organizational reputation and credibility
- Track record of achievement

Although the most obvious benefit to the nonprofit partner is a steady, reliable stream of funding, there are additional ways in which partnership with a corporation can be helpful. The nonprofit partner stands to gain:

- Heightened awareness of the organization and its mission
- Exposure to a broader funding base
- Connection to the corporation's vendors and business partners
- A ready source of volunteers among corporate employees
- Access to professional expertise and services (IT, marketing, etc.)
- In-kind donations of goods and service

Clearly, these are the upsides of a successful partnership. Because there are serious downsides to a failed partnership, including reputational harm, it's critically important that both the corporation and nonprofit do their due diligence, ensure their respective organizations are a good fit, and define the scope of their partnership before committing to one another.

IRS REQUIREMENTS

IRS FORM 900-PF

Corporate foundations are required to file an annual information return with the IRS known as the 990-PF. This form is used to report charitable activities, distributions, expenditures, and asset balances, and to calculate the excise tax that is based on investment income. Additionally, this form is used to determine whether the foundation met its annual 5% minimum payout requirement and to calculate the payout requirement for the following year. It must be filed by all recognized corporate foundations, as well as those foundations that have applications for exempt status pending on the due date for filing the 990-PF.

Because the 990-PF is a lengthy, specialized filing, you should ensure that the person or entity preparing this filing on behalf of your foundation has significant experience in doing so.

IRS FORM 1099/1042

Foundations that pay outside professionals, consultants, or independent contractors (non-employees) at least $600 during the tax year are required to provide those individuals with a record of those payments using IRS Form 1099, as well as to file that form with the IRS. For non-U.S. citizens doing business in the U.S., Form 1042 is used instead.

MINIMUM DISTRIBUTION REQUIREMENT (5% RULE)

The IRS requires each foundation to make qualifying distributions (see below) of at least 5% of its net average assets from the preceding year. Because foundations in their first year of existence do not have previous year assets, they are not required to make any distribution in that first year. However, if the foundation does make charitable distributions in its first year of existence, those distributions will roll forward to reduce future years' distribution requirements. For foundations that operate on a pass-through basis and spend down most of their funding each year, this rule has little significance.

For new foundations that report on a calendar year, the calculations for that initial year of funding should be prorated based on date of formation. Because of this, the required distribution for the following year is typically much lower than subsequent years. Any grant distributions that exceed the required amount can be carried forward for up to five years.

Formulas for calculating the net average assets and the minimum distribution requirement are complex. The foundation must make sure the person or organization performing the calculations does so correctly to avoid penalties.

QUALIFYING DISTRIBUTIONS

Qualifying distributions are those disbursements by the foundation that count toward satisfying its annual 5% minimum distribution requirement. Qualifying distributions primarily include grants as well as reasonable and necessary administrative expenses for running the foundation. Other qualifying expenses include direct charitable activities and Program-Related Investments.

Administrative expenses can include salaries, consulting fees, foundation-related travel expenses, office supplies, telephone, rent, etc., so long as they are reasonable and necessary to achieving the foundation's mission. Investment management fees, custodial fees, and expenses to oversee investments, however, do not count as qualifying distributions.

EXCISE TAX

Corporate foundations are required to pay an excise tax of 1 - 2% on net investment income and realized capital gains. The excise tax is reported on Form 990-PF, and must be paid annually at the time for filing that return, or in quarterly estimated tax payments if the total tax for the year is $500 or more. There are some exceptions.

The standard excise tax rate is 2%. However, by planning carefully and managing the foundation's funding and giving activities, it can reduce the excise tax rate to 1% in select years, without significantly affecting the organizations it supports.

PUBLIC INSPECTION & DISCLOSURE

The IRS requires corporate foundations make certain documents available for public inspection and disclosure. These include the 990-PF, as of the day it is filed with the IRS, and all documents that were included in the foundation's IRS 1023 filing package (cover letter, charter documents, and any correspondence with the IRS).

Public inspection means the documents are available for review at the foundation's place of business during regular business hours. Public disclosure means making hard copies available (for which you can charge a reasonable copying fee) or by distribution on the Internet.

UNRELATED BUSINESS TAXABLE INCOME (UBTI)

When a tax-exempt organization generates revenue from a business activity that is not substantially related to its charitable purpose, that revenue is known as Unrelated Business Taxable Income (UBTI) and is subject to taxation. The tax on UBTI is meant to prevent exempt entities from having an unfair competitive advantage over commercial enterprises, which are subject to taxation.

Another way to have UBTI is to buy investments or assets using borrowed funds, i.e., acquisition indebtedness, which may partially or wholly "taint" such assets, so that income generated by those assets (e.g., interest, dividends, rent) and capital gains realized upon their sale may give rise to UBTI. These calculations are complicated and beyond the scope of this toolkit.

A common way to have UBTI is to invest in partnerships, either because the partnership is a business enterprise or the partnership itself borrows money to finance the acquisition of investment assets. If a partnership is told that a partner is a private foundation, the partnership will indicate the foundation's share of UBTI, if any, on the K-1's issued to the foundation each year.

Corporate foundations are largely precluded from directly engaging in business or owning a substantial interest in a business enterprise, so they must be wary of generating excessive UBTI. This income is taxable at for-profit income tax rates and requires additional filings with the IRS (Form 990-T). As a result, most foundations tend to steer away from investments that generate more than normal UBTI.

Generally, interest from investments, dividends, and capital gains is not considered UBTI (unless the investments generating such income were acquired using borrowed funds).

Rules and regulations regarding UBTI are complex, so please consult with a tax advisor who is well versed on corporate foundations.

COMPLIANCE CONCERNS

Unfortunately, IRS regulations governing foundations are often complex and sometimes gray. What may seem like common sense when dealing with foundation transactions may in fact lead to compliance issues, potential fines, and even loss of exempt status. Here are a number of common compliance pitfalls that corporate foundations should be aware of.

DISQUALIFIED PERSONS

Whether a transaction between a private foundation and another party is an act of self-dealing (see next section) depends on whether the other party is a "disqualified person," or entity, with respect to the foundation. Disqualified persons include:

- A substantial contributor to the foundation, which is the creator of a foundation formed as a trust, or any person or entity that has contributed in aggregate more than $5,000 to the foundation, where that amount represents more than 2% of total contributions made to that foundation since its inception, as of the close of any given year. Typically, a company that funds its own foundation falls into this category.
- Foundation managers, which include a foundation's officers, directors, trustees, and individuals having similar powers or responsibilities.
- Owners of more than 20% interest of an organization that is a substantial contributor to the foundation.
- Family members of those listed above, which include an individual's spouse, ancestors, lineal descendants, and the spouses of his or her lineal descendants.
- Organizations in which any of those listed above collectively hold, directly or indirectly, more than a 35% interest.

SELF-DEALING

Self-dealing is any transaction between the foundation and its "insiders," or disqualified persons that is viewed as beneficial to the insider and not in support of the foundation's core philanthropic interests. Generally, foundations and their insiders must avoid the following six activities:

1) Sale, exchange, or lease of property between the foundation and a disqualified person

2) Loan of money or other extension of credit between a disqualified person and the foundation

3) Furnishing of goods, services, or facilities by a disqualified person to the foundation and vice versa

4) Payment of compensation and/or reimbursement of expenses by the foundation (exceptions below)

5) Use of or any benefit from income or assets belonging to the foundation. This includes retaining foundation assets, such as a painting, on private premises.

6) Agreement by the foundation to pay a government official.

Exceptions to these rules are provided by the Internal Revenue Code for certain transactions that benefit the foundation. Practical examples of these exceptions include:

- Rent-free office space provided by the company
- Reasonable salaries for directors and officers, and reimbursement of reasonable expenses
- Loan of funds to the foundation at no interest

In the course of carrying out foundation operations, company employees may be presented with an opportunity to benefit personally from a grant made by the company foundation.

For instance, a grantee may provide free concert tickets to the corporate foundation, which, in turn, may wish to distribute the tickets to company employees who are unaffiliated with the foundation. This situation should be avoided because a self-dealing violation may result.

There is some flexibility if a foundation's own employees, officers, or directors attend an event on the foundation's behalf with a specific charitable task in mind, such as monitoring a grantee's performance, conducting a site visit, or showing support for the grantee by attending an event. However, if a company wishes to show its support for a charity by buying a table at an event and filling it up with company employees and their spouses who are not connected to the foundation, then the company itself, rather than the foundation, should make this purchase.

SHARING OF OFFICE SPACE

As a disqualified entity, the company cannot charge its foundation to lease space in any of its facilities, even if it does so on highly favorable terms. It can provide office space at no charge.

What is less known is that a corporate foundation that leases space from the company at no charge may, under certain conditions, be able to pay its fair share of related expenses for its use. For example, the foundation may be able to pay a percentage of the utility bills provided that it pays the utility company directly and not the for-profit parent company. We recommend that companies consult counsel before making any such arrangements.

GRANT RECOGNITION

Grantee organizations often thank their corporate donors by giving them public recognition for their generous support. Sometimes the company itself is acknowledged for donations made through the corporate foundation. Even though this sort of public recognition and goodwill benefits the company, it should not result in self-dealing violations because the benefits to the company generally are considered to be merely "tenuous and incidental."

However, companies need to be careful: Public recognition is one thing; but advertising the company's services, products, or facilities as a result of the foundation's donation is quite another. If corporate foundation grants are used to obtain advertising for the company's for-profit business, a self-dealing violation may result because the benefit to the company could then be more than merely tenuous and incidental.

COMPENSATION

Corporate foundations are permitted to have paid employees carry out their missions, particularly if their charitable activities are time-consuming or complex.

If employees are compensated, the foundation should follow best practices by ensuring that the services rendered are necessary and professional in nature, and that the proposed compensation is reasonable.

Reasonableness of compensation can be established by a process known as "benchmarking," which entails comparing the proposed compensation arrangement to compensation paid by similarly situated foundations and service providers.

Naturally, an employee who is paid by both the corporate foundation and the company should not render services to the company while on the foundation's "clock."

A company may provide services to its foundation for a reasonable fee, like any other paid service provider, if the services rendered are necessary and represent "personal services," which are generally professional in nature.

EMPLOYER SCHOLARSHIP PROGRAMS

Private foundations may receive permission from the IRS to offer scholarships directly to needy individuals and even, under certain conditions, to its own employees and children of employees. However, it is important to note that special rules apply when a company provides scholarships to its employees, officers, and directors, and to their children through its foundation's "employer-related scholarship program."

These rules are intended to prevent a company from improperly using its foundation's scholarship program as a back-door way to recruit and retain employees, and to increase the value of benefits and compensation provided to the company's employee base. For example, the rules require that scholarship recipients be selected by an independent committee composed of individuals who are not connected to the company or the company foundation and who are not former employees of either entity.

The rules also restrict the number of scholarship grants that may be awarded on an annual basis. To prevent the corporate foundation from granting scholarships to every eligible applicant, thereby effectively making the scholarship into an employment benefit, the foundation may award the scholarships only to a percentage of eligible applicants.

CONCLUSION

We hope this Corporate Foundations & Grantmaking Toolkit has been useful in helping you understand the benefits of a corporate foundation and the basic operational requirements.