

Legal Issues for Community Foundations:  
Understanding the Separate Rules that Apply to  
Community Foundations

A presentation to the Community Foundation of Southern New Jersey

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## **WHAT IS A COMMUNITY FOUNDATION?**

1. A legal entity under state law. Could be a trust or a nonprofit corporation created under a state Nonprofit Corporation Act.

2. That files for recognition from the IRS as a 501(c)(3) organization. As a 501(c)(3) the community foundation is exempt from federal income tax and also able to provide a deduction to donors that make contributions.

3. That asks for recognition from the IRS as a 501(c)(3) public charity (as opposed to a 501(c)(3) private foundation).

4. That is different from other 501(c)(3) public charities in its mission and in its variance power. A community foundation's mission is to hold contributions in different funds (most funds are held on an endowed basis) and make distributions for charitable purposes. In a single entity community foundation the different "funds" are generally accounting entries, each representing an allocation of the community foundation's pooled investment.

5. That offer donors different types of funds. Typically, a community foundation offers five or six different types of funds, each of which can be created on an endowed (income only distributed) or nonendowed (income and principal may be distributed) basis.

(a) Unrestricted funds – the community foundation has complete discretion to make grants.

(b) Designated funds – the donor names at the creation of the fund a public charity that is the beneficiary of distributions.

(c) Field of interest funds – the donor names the charitable purpose (healthcare, education) for which distributions may be made.

(d) Donor advised funds – the donor retains the right to recommend the public charity or entities that will receive distributions.

(e) Scholarship funds – a scholarship fund is not a donor advised fund because the community foundation chooses members of the committee that recommend scholarship recipients. The donor and related individuals cannot constitute as much as 50% of the committee.

(f) Agency endowment funds – these are typically created by another public charity for its own benefit.

## **THE TRADITIONAL COMMUNITY FOUNDATION**

In the traditional community foundation, banks held and invested different charitable trusts and a separate 501(c)(3) charitable organization identified the recipients of the charitable distributions. The trusts held by the banks would have been treated as private foundations after 1969, but for IRS rules permitting them and separate corporations and unincorporated associations to be treated as one 501(c)(3) organization for tax purposes if certain requirements of the Treasury Regulations are met. (These component fund requirements are in addition to the requirements that must be met by all 501(c)(3)s.)

The single entity requirements are:

6. A name identifying the community foundation as a community foundation or fund.
  7. A common governing instrument, such as a master trust agreement, that governs all the funds of the community foundation. Each donor states in his or her gift agreement that the donor's fund will be subject to the common governing instrument.
  8. A common governing body that directs or monitors the distributions from the funds for charitable purposes.
  9. The common governing body must have a variance power – the power to modify any restriction or condition on the use of funds if, in its sole judgment, such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment or inconsistent with the charitable needs of the community served.
- The governing body must have the power to replace a trustee, custodian or agent if he or she has breached a fiduciary duty under state law, or has failed to produce a reasonable return of net income over a reasonable period of time.
10. The common governing body must commit itself to obtain information and take the necessary steps to see that each participating trustee, custodian or agent administers its trust or fund in accordance with its governing investment and the standards of fiduciary conduct to produce a reasonable return consistent with preserving principal.
  11. The community foundation must prepare financial reports that treat all of the funds, whether held directly or in component parts, as funds of the community foundation.

**FROM THE POINT OF VIEW OF THE DONOR, WHAT ARE THE REQUIREMENTS FOR HAVING THE DONOR'S SEPARATE LEGAL ENTITY QUALIFY AS A COMPONENT FUND OF THE COMMUNITY FOUNDATION?**

If a donor wants his or her money invested separately, and the community foundation is willing to accept the donor's trustee as an eligible trustee, what are the requirements for the donor's entity to be treated as a component fund of the community foundation?

1. The donor's transfer to his or her trust or other legal entity must be a completed gift.
2. The gift must be for a charitable purpose.
3. The organizational documents of the community foundation must meet the single entity ("component fund") requirements.
4. The donor's entity must subject itself to the community foundation's common governing instrument.
5. The donor's fund must not be subject to any "material restriction." A material restriction is any condition or restriction that prevents the community foundation from "freely and effectively" using the transferred assets or the earnings on them in furtherance of its exempt purposes.

Most of the conditions that are material restrictions (reservation of the right to name recipients of charitable distributions, reservation of the right to control the timing of charitable distributions) would also prevent the transfer from being a completed gift. But as a technical matter the material restriction rules are more stringent than the completed gift standards.

## COMMUNITY FOUNDATIONS

### THE MATERIAL RESTRICTION RULES

Most single entity community foundations follow the material restriction rules in structuring their agreements with donors. They do this partly because the traditional fund structure used by community foundations – unrestricted, field of interest, agency designated and donor advised funds – is based on the material restriction rules. They do it partly because there is no express authority stating that the material restriction rules do not apply to funds directly held by community foundations, although many attorneys who work in this field think that, but for the single entity community foundation importing the rules into its governing documents and operations, the rules should not apply. One benefit of following the rules is that any separate entity that the community foundation accepts should qualify as a component part of the community foundation.

A. The rule: The donor may not impose any material restriction that prevents the community foundation from freely and effectively employing the transferred assets in furtherance of its exempt purposes.

B. Application of the rule: Whether a particular restriction or condition is “material” must be determined based on all the facts and circumstances surrounding the gift. Some of the more significant facts and circumstances are:

12. Whether the community foundation (including a participating trustee, custodian or agent) is the owner in fee of the transferred assets;
13. Whether the assets are to be held and administered by the community foundation in a manner consistent with its exempt purposes;
14. Whether the governing body of the community foundation has the ultimate authority and control over the assets and the income derived from them; and
15. Whether, and to what extent, the governing body of the community foundation is organized and operated so as to be independent from the donor.

C. Factors that are deemed not material restrictions:

1. A name that memorializes the donor.
2. Designation by the donor of a charitable purpose or a public charity as the beneficiary of the fund. (Field of interest and designated funds.)
3. Creation of the fund as an endowment.

4. A requirement that the community foundation retain the property, if such retention is important to the achievement of charitable or other similar purposes in the community because of the peculiar features of the property.

D. Factors that are deemed material restrictions:

1. The donor's retention of a right to direct distributions to particular charitable beneficiaries.
2. The donor's retention of a right to direct the timing of charitable distributions.

The IRS will examine carefully whether the giving of advice by the donor (donor advised funds) after the transfer of the assets constitutes an indirect reservation of a right to direct distributions. Where the donor provides advice, the reservation of a right to direct will be considered to exist if the only criterion considered by the community foundation in making a distribution is advice offered by the donor. Whether the donor reserves a right to direct will be determined under all the facts and circumstances, including those listed below.

The following factors will indicate that the donor has not reserved a right to direct:

- a. The community foundation has made an independent investigation evaluating whether the donor's advice is consistent with specific charitable needs most deserving of support by the community foundation;
- b. The community foundation has promulgated guidelines enumerating specific charitable needs consistent with its charitable purposes and the donor's advice is consistent with such guidelines;
- c. The community foundation has instituted an educational program publicizing to donors and others the guidelines enumerating specific charitable needs;
- d. The community foundation distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and
- e. The community foundation's solicitations specifically state that it will not be bound by advice offered by the donor.

The presence of some or all of the following factors will indicate that the donor has reserved a right to direct:

- a. The community foundation's solicitations state or imply, or its conduct creates an expectation, that the donor's advice will be followed;

b. The donor's advice is only with respect to his or her fund and the community foundation has not promulgated guidelines or instituted an educational program;

c. The community foundation has no procedure for considering advice from persons other than the donor with respect to distributions from the donor's fund; and

d. The community foundation follows the advice of all donors substantially all of the time.

3. The transfer agreement or an understanding with the donor subjects the community foundation to actions that would subject it to excise tax if it were a private foundation. (For example, an agreement with a donor that distributions would be used to support the research of a particular individual might subject a private foundation to excise tax.)

4. The community foundation assumes a liability of the donor (a lease or a contractual obligation, or accepts property subject to a liability) for purposes inconsistent with the purposes of the community foundation.

5. The community foundation agrees (expressly or impliedly) to retain securities or other investment assets received from the donor.

6. The donor or related individuals or entities retains a right of first refusal with respect to securities or other property received from the donor.

7. An agreement with the donor establishes an irrevocable relationship with respect to the maintenance or management of assets transferred by the donor, such as a continuing relationship with banks, brokerage firms, investment counselors or other advisors with respect to such property (other than a relationship with a trustee, custodian, or agent for a community foundation acting as such).

8. Any other condition imposed on action by the community foundation that prevents it from exercising ultimate control over the transferred assets consistent with its exempt purposes.