Taxation of Tax Exempt and Non-Profit Entities
May 20, 2009
6:00 – 8:30 p.m.
California Society of Enrolled Agents Palomar Chapter

I. Fundamentals

Conceptual Requirements

There are six requirements that NORTH COUNTY ENROLLED AGENTS FOUNDATION must meet for income tax exemption under IRS Section 501(c)(3).

#1 - Organized for charitable purposes.
   • Largely a paperwork test.

#2 - Operated for charitable purposes.
   • What the organization does, must “relieve the government of its burden.” This changes slowly over time.

#3 - Limited legislative activity.
   • It is acceptable to support or oppose ballot propositions which relate to schools/children.

#4 - No political activity.
   • It is NEVER, NEVER, NEVER acceptable to support or oppose a candidate. It does not matter the office if he or she is elected, then “hands off”

   • It is wrong to pass a resolution of the NORTH COUNTY ENROLLED AGENTS FOUNDATION board supporting Dostart for Governor and urging all NORTH COUNTY ENROLLED AGENTS FOUNDATION members to vote for Dostart. NORTH COUNTY ENROLLED AGENTS FOUNDATION may not contribute NORTH COUNTY ENROLLED AGENTS FOUNDATION money, nor NORTH COUNTY ENROLLED AGENTS FOUNDATION name, to any candidate.

   • Dostart the candidate may list that he was once an officer of NORTH COUNTY ENROLLED AGENTS FOUNDATION (since this is solely factual and the candidate refers to his own past NORTH COUNTY ENROLLED AGENTS FOUNDATION activity).
• It is permissible under federal law to state that, “__________, who is the President of NORTH COUNTY ENROLLED AGENTS FOUNDATION*, endorses Dostart and calls upon all patriotic Americans to vote for Dostart for Governor”

• For federal purposes: The “*” must then show “The organizational affiliation is shown for purposes of identification of the endorser and does not signify endorsement by the organization.”

#5 - Not more than incidental private benefit.
• This rule is for “outside third parties” and calls for “balancing.”

• A balancing test would occur in a situation where a credit union provides a free Web page to NORTH COUNTY ENROLLED AGENTS FOUNDATION that is accessed by going through the credit union Web page.

• More than incidental private benefit occurs if you have to give name and phone number as well as open a credit union account to access the NORTH COUNTY ENROLLED AGENTS FOUNDATION Web page.

• Incidental private benefit would not occur if simply one mouse click moves you from the credit union home page to the NORTH COUNTY ENROLLED AGENTS FOUNDATION Web site.

• The hosting credit union cannot restrict the NORTH COUNTY ENROLLED AGENTS FOUNDATION from posting on the NORTH COUNTY ENROLLED AGENTS FOUNDATION Web site acknowledgments to other financial institutions.

#6 - No private inurement.
• This rule is for “insiders” and results in an automatic loss of exemption.

  Federal Law - It is only acceptable if payment is not excessive
  
  State Law - A majority of the board may not be compensated for services.
  - Up to 49% of the board may be compensated.
  - Compensation may be direct or indirect.
    - Anyone related to the compensated recipient is treated as compensated for purposes of this rule.

An organization may voluntarily adopt a policy which is higher or tougher than the federal/state minimums set forth above.

Filing Requirements

Upon filing its Articles of Incorporation, a nonprofit is subject to the following state and federal filing requirements:
A. The first Statement By Domestic Nonprofit Corporation (a required biennial filing with the California Secretary of State). The statement sets forth the officers and registered agent of the corporation.

B. Initial registration with the State of California Office of The Attorney General Registry of Charitable Trusts (Form CT-1). Every charitable corporation, association and trustee holding assets for charitable purposes or doing business in the State of California must register with the Attorney General. Registration is required of every trustee subject to the Uniform Supervision of Trustees for Charitable Purposes Act within thirty days after receipt of assets (cash or other forms of property) for the charitable purposes for which organized.

C. IRS Form SS-4 Application for the federal employer identification number that is issued by the Internal Revenue Service.

D. IRS Form 1023 Application for Federal tax exempt status. Filing of Form 1023 is not required for a church (although it is recommended if the church will apply for property tax exemption).

E. Application for state tax exempt status with the California Franchise Tax Board (FTB Form 3500A Submission of Exemption Request).

F. IRS Form 990 Annual Information Return. The newly revised Form 990 allows an organization to describe its exempt accomplishments and mission up-front and provides more opportunities throughout the form for the organization to explain its activities. Other major changes were made to the form’s summary page, governance section, and various schedules, including those relating to executive compensation, related organizations, foreign activities, hospitals, non-cash contributions and tax exempt bonds. A checklist of schedules was also added. (Sample Schedules (L,O, R, etc.) are attached at the end of this document.)

The IRS is providing a graduated transition period for smaller organizations. These organizations will be allowed to file the Form 990-EZ instead of the Form 990. For the 2008 tax year (returns filed in 2009), organizations with gross receipts over $1.0 million or total assets over $2.5 million will be required to file the Form 990. For the 2009 tax year (returns filed in 2010), organizations with gross receipts over $500,000 or total assets over $1.25 million will be required to file the Form 990. The filing thresholds will be set permanently at $200,000 gross receipts and $500,000 total assets beginning with the 2010 tax year. Also, starting with the 2010 tax year, the IRS will increase the filing threshold for organizations required to file Form 990-N (the e-postcard) from $25,000 to $50,000.

The final Form 990 and background material explaining the changes from the current form and the June draft are available on the Exempt Organizations portion of the IRS Web site, IRS.gov/eo.
Organizations not required to file IRS Form 990:

- Churches. (Including affiliated organizations.)
- Governmental agencies.
- Nonprofit organizations whose gross receipts are less than $25,000.
- Private foundations. (File Form 990-PF.)

See IRS Publication 557 for a more detailed list.

G. FTB Form 199 Annual Information Return

H. Attorney General Form RRF-1 Registration/Renewal Report

Miscellaneous Items of Interest

A. Public Inspection Binder:

All charities are required to maintain a Public Inspection Binder ("PIB") at their principal place of business. The PIB shall consist of the organization's IRS determination letter, IRS Form 1023 application, and the three most recent IRS Form 990s.

B. Limitations on Political Activity:

Federal law prohibits 501(c)(3) organizations, including charities and churches from becoming directly or indirectly involved in campaigns of political candidates. The prohibition against political campaign activity has been in effect for more than half a century and bars certain tax-exempt organizations from engaging on behalf of or in opposition to political candidates. However, these organizations can engage in advocating for or against issues and, to a limited extent, ballot initiatives or other legislative activities.

"The political contests, especially for president, are starting earlier than usual. The IRS, as it has in the past, wants to remind charities and churches of the ban on political campaign activity. We also want to urge nonprofit and religious organizations to review the guidance we have issued to help them avoid any problems," said Steven T. Miller, Commissioner of IRS' Tax Exempt and Government Entities Division.

To help educate the leadership of charitable entities, the IRS issued Revenue Ruling 2007-41 outlining a number of scenarios to help charities and churches understand the ban on political campaign activity and actions that may arise. In addition to the revenue ruling, the IRS has other helpful information for churches and charities on its website at www.irs.gov/eo. For example, IRS Publication 1828, Tax Guide for Churches and Religious Organizations, contains a discussion of the law affecting political campaign activity by churches and religious institutions.

Violation of the law can result in imposition of an excise tax or, in extreme cases, a loss of tax exempt status.
C. Joint Ventures (between for-profit and nonprofit entities)

Tax-exempt organizations are entering into business arenas traditionally held captive by taxable commercial entities. Exempt organizations are becoming more entrepreneurial, as government funding for the nonprofit sector has decreased and "competition" among nonprofits for contributions from the general public has increased.

A joint venture is created when two or more persons enter into an arrangement to invest a project and the parties share the control, benefits, and risks of the project. The Tax Court has defined a joint venture as "a special combination of two or more persons where in some specific venture a profit is jointly sought without any actual partnership or corporate designation." See Sierra Club v. Commissioner, 103 T.C. 307, 322, affirmed in part, reversed in part, and remanded 86 F.3d 1526 (9th Cir. 1996).

Exempt organizations can be found operating diverse business enterprises such as organizing travel tours; publishing magazines; selling medical equipment; art work, t-shirts, jewelry, life and health insurance; developing retirement communities; conducting business and estate-planning seminars; managing investment firms.

Joint ventures between nonprofit and for-profit organizations are one method by which nonprofits can expand their activities. Joint ventures give nonprofits the opportunity to raise capital outside of individual and corporate giving while offering third parties a stake in the enterprise; neither can be done directly with nonprofits since they are not "owned" and only distribute earnings for their respective charitable purposes.

Rev. Rul. 98-15 provides examples illustrating whether nonprofit hospitals that participate in joint ventures with for-profit entities continue to qualify for exemption as organizations described in section 501(c)(3) of the Code, and the tax consequences of doing so. Rev. Rul. 98-15 was released to help resolve tax questions regarding joint ventures between nonprofit tax exempt organizations and taxable, for-profit corporations. The revenue ruling Whole Hospital Joint Ventures (98-15) may also be useful in examining joint ventures with for-profit partners entered into by exempt organizations other than health care organizations.

Rev. Rul. 98-15 does not seek to curb all joint ventures between for-profit and tax exempt hospitals. It allows tax exempt hospitals the flexibility to partner with another organization or corporation. However, it does require that charitable purposes supersede profit maximization purposes. It dictates that health care services benefit the community as a whole. It obliges exempt organizations that enter into such partnerships to ensure that the partnership furthers charitable purposes; and does not result in greater than incidental private benefit to the taxable partner nor to other private parties. Thus, while the factual scenarios discussed in the revenue ruling represent newly evolved developments, the reasoning of the revenue ruling is not a departure from existing law.

Revenue Ruling 2004-51 illustrates the tax consequences for a section 501(c)(3) organization that enters into a joint venture with a for-profit organization as an insubstantial part of its activities. This ruling is helpful because it is a published authority that is outside the health care field. It demonstrates that when only a portion of an exempt entity’s assets are used in a joint venture with a
for-profit entity, the exempt entity’s Section 501(c)(3) status is not at risk, and the only issue is whether the exempt entity’s share of the income is UBIT. However, the fact that the ruling involved a 50-50 governance split leaves open the question of whether an exempt entity’s share of income will be UBIT if the exempt entity has a lesser interest in the joint venture.

D. California Nonprofit Integrity Act of 2004

On September 30, 2004, Governor Schwarzenegger signed into law SB 1262, the Nonprofit Integrity Act of 2004. The “Act” addresses two broad areas of nonprofit activity: governance of charitable organizations, and fundraising by or on behalf of charitable organizations.

The Act is an effort to increase the financial accountability of charitable entities, charitable solicitors, and professional fundraising advisors. The Act makes nearly 30 pages of detailed changes in various state code sections regarding requirements for financial accountability, corporate governance, financial controls, fund-raising practices, and disclosures. The specific codes which are amended by the Act are as follows: Business and Professions Code Section 17510.5; Government Code Sections 12581-86, 12599 and 12599.1; and adds Sections 12599.3, 12599.6 and 12599.7 to the Government Code.

The Act imposes requirements upon California charities that are similar to those imposed by the federal Sarbanes-Oxley Act of 2002 (15 U.S.C. Section 7201 et seq.). That federal law, sometimes referred to as “SOX,” requires a corporation’s board of directors to be more vigilant about the financial information it presents to the public and regulatory bodies, and addresses the inherent conflicts in accounting firms performing both audit and non-audit activities. Because SOX applies only to publicly traded companies and does not apply to charitable organizations, the Act borrows some of SOX’s accounting and audit provisions and applies them to charitable organizations.

The California Act imposes the following requirements:

1. Charitable corporations, unincorporated associations, and trustees:

   Accountability:

   A. Requires certain charities to prepare annual financial statements audited by independent certified public accountants.

   The charities subject to this new requirement are those charitable corporations, unincorporated associations, and charitable trusts required to file reports with the Attorney General. The charitable corporations include foreign corporations doing business or holding property in California for charitable purposes. (On the other hand, educational institutions, hospitals, cemeteries, and religious organizations that are exempt from the obligation to file reports with the Attorney General, are not subject to this mandatory audit requirement or to the requirements for audit committees and for public disclosure of audited statements discussed below.

   B. Requires every charity that files reports with the Attorney General under the Act, and that accrues in any given fiscal year gross revenues of $2,000,000 or more to prepare and file annual
financial statements using generally accepted accounting principles that are audited by an
independent certified public accountant in conformance with generally accepted accounting
principles. (If the charity is under the control of another organization, the controlling organization
may prepare consolidated financial statements;

C. The charity must have an audit committee, appointed by the board of directors, to
oversee the audit. The audit committee may include non-board members. The audit committee may
include members of the finance committee, but the chair of the audit committee may not be a
member of the finance committee, and the members of the finance committee must constitute less
than half of the audit committee.

The audit committee may not include any member of the staff, including top management,
nor any person who has a material financial interest in any entity doing business with the charitable
organization.

If audit committee members are paid, they may not receive compensation in excess of the
amounts received, if any, by members of the board of directors for service on the board.

Five duties of the audit committee are spelled out in the Act. Audit committees: (1) shall
recommend to the board of directors the retention and termination of the independent auditor, (2)
may negotiate the compensation of the auditor on behalf of the board, (3) shall confer with the
auditor to satisfy the committee members that the financial affairs of the charitable organization is in
order, (4) shall review and determine whether to accept the audit, (5) shall approve performance of
any nonaudit services by the auditing firm. (Gov. Code §12586(e)(2).);

D. The board of directors of the charitable corporation or unincorporated association, or
the trustees of a charitable trust, must review and approve the compensation of the entity’s president
and its treasurer/chief financial officer to assure that such compensation is just and reasonable. The
review must occur when the officer is hired, when the term of employment of the officer is renewed
or extended, and when the compensation is modified, unless the modification applies to substantially
all employees;

Fundraising:

E. Requires charities and commercial fundraisers soliciting contributions to include
specified disclosures in any written solicitation, any oral solicitation, or any other means of
solicitation not involving personal contact with the person solicited, including solicitations over the
internet and telephone solicitations;

F. Prohibits certain conduct with respect to any solicitation or charitable promotion,
including using unfair or deceptive practices; suggesting a contribution is for the benefit of a
particular charity, whether by name or other representations, when it is not; misrepresenting that any
particular person endorses the charity without that person’s written consent; and representing that
any part of contributions received will be given to another charity unless that charity has consented
in a written document, signed by two authorized representatives of that charity;
G. Requires that charities enter into written contracts with commercial fundraisers and professional fundraising advisors for each solicitation campaign or event;

H. Requires that written contracts with commercial fundraisers contain clauses providing the following:
   i. Allowing the charity to cancel the contract with the within 10 days of execution of the contract;
   ii. Allowing the charity to cancel the contract without cause with 30 days notice; and
   iii. Allowing the charity to cancel the contract at any time if the cancellation is for cause.

2. Commercial fundraisers:

Charitable organizations must “establish and exercise control” of both their own fundraising activities but over fundraising activities conducted by others for their benefit.

That control must include approval of all written contracts, and the charitable organization must assure that fundraising activities are conducted without coercion. There are several specific requirements as regards use of commercial fundraisers.

A. Not less than 10 working days prior to commencement of each solicitation campaign, the fundraiser must file with the Attorney General’s Registry of Charitable Trusts, a notice on a form prescribed by the Attorney General that sets forth the following information:
   i. The name, address, and telephone number of the commercial fundraiser for charitable purposes;
   ii. The name, address, and telephone number of the charitable organization with whom the commercial fundraiser has contracted;
   iii. The fundraising methods to be used;
   iv. The projected dates when performance under the contract will commence and terminate; and
   v. The name, address, and telephone number of the person responsible for directing and supervising the work of the commercial fundraiser under the contract.

B. Requires a written contract between commercial fundraisers and charities for each solicitation campaign or event containing, among other things, the following information:
   i. A statement of the charitable purpose of the campaign or event;
   ii. If the commercial fundraiser is to be paid a fixed fee, a statement of the fee and a good faith estimate of what percentage the fee will constitute of the total collections of the campaign or event;
   iii. If the commercial fundraiser is to be paid a percentage fee, a statement of the percentage of collections that the charity will receive;
iv. A requirement that all funds in the control or custody of the commercial fundraiser be deposited into the charity’s bank or delivered to the charity within five (5) working days of receipt;

v. The specified termination provisions set forth above.

C. Requires maintaining records for each solicitation for 10 years and making the records available to the Attorney General upon demand; and

D. Prohibits certain conduct with respect to any solicitation or charitable promotion, including: using unfair or deceptive practices; misrepresenting that any particular person endorses the charity without that person’s written consent; misrepresenting the amount of money the charity will receive; and representing that tickets will be donated for use by another unless specified conditions are met.

3. Fundraising counsel:

A. Requires not less than 10 working days prior to commencement of each solicitation campaign, the filing with the Attorney General’s Registry of Charitable Trusts of a notice containing, among other things, contact information for the person responsible for directing and supervising the work of the fundraising counsel under the contract; and

B. Requires a written contract with specified provisions between fundraising counsel and charities for each service that will be performed.

II. Internal Investigations

The number of and reasons for internal investigations continues to rise, and given the current market environment, this trend will likely continue. An internal investigation assists the corporation in determining the extent of potential criminal or civil liability to enable the corporation to make fully informed decisions for mitigating potential exposure.

When should you conduct an internal investigation? Warning signs that should prompt an internal investigation:

- Outside complaints (customers, contractors, suppliers, compliance hotline tips, etc.);
- Internal complaints (employee to supervisor, supervisors to officials, etc.);
- Government audits and reports with questionable or surprising results;
- Internal audit findings with questionable or surprising results;
- External audit findings of dubious results;
- Requests for information by government authorities, whether by informal means or by formal subpoena;
- Civil suits by former employees.

Despite the expense and managerial commitment necessary to conduct a proper internal investigation, organizations should generally initiate such investigations when they learn of government investigations or serious allegations of wrongdoing.
Directors of nonprofit organizations are charged with fundamental fiduciary duties of care and loyalty that obligate them to certain tasks with respect to warning signs: evaluate and respond with requisite process to reasonably available material information; act in accordance with the best interests of the organization and its charitable mission; act when there is a known duty to act; and do not act with an intent to violate applicable law. Employers should adhere to established policies and procedures for resolving conflicts. To the extent possible, investigations should be conducted with a well organized and consistent approach.

When confronted with an internal controversy, the board may consider the following:

1. The board should confirm the presence of an effective internal reporting system. The board should be in a position to learn of problems as they arise. Employees and legal counsel should have vehicles through which to communicate their concerns to management or the board about potential illegal or otherwise improper activities that may present a material risk to the organization. There should be an explicit understanding with senior management or leadership of the need to advise the board promptly of potentially problematic conduct by the organization or one of its internal constituents. The board must be empowered to exercise its oversight obligation when circumstances so warrant. It is imperative that employers respond quickly and efficiently to complaints. Within 24 hours of receipt of an complaint, employers should acknowledge the complaint and determine if an investigation should be made.

2. When presented with a controversy, the board must exercise judgment and discretion to determine the proper course of action. Not all incidents require an investigative response. The advice of executive leadership and legal advisors should be sought before a decision is made to proceed with an internal investigation.

Management's fiduciary duties to the corporation may include the duty to initiate an investigation when there are indications of misconduct, and failure to investigate could subject management to civil liability.

A corporation can use an internal investigation to minimize the effect of negative publicity that has arisen from allegations of wrongdoing. The investigation distances the corporation from any wrongful acts by its employees. The fact that the investigation has been launch demonstrates the corporation's good faith and may help restore or maintain donors' confidence.

3. If a decision is made to proceed with an internal review or investigation, the board should first decide who should be responsible for managing the investigation.

Under all circumstances, the decision on who should manage the investigation should be made with the advice of legal counsel as the decision may have significant implications on the ultimate credibility of the process. The board should be informed as to basic facts underlying the investigation and its findings. Possible investigators include human resource personnel, private investigators, outside consultants, and/or legal counsel. The organization should consider having one
or more board members involved in the investigation. Attorneys, especially former prosecuting attorneys, are best suited to conduct internal investigations.

4. Selecting appropriate legal counsel to conduct the investigation is an important board decision. Factors to be taken into consideration include the counsel’s investigative experience, ability to be un-bias, familiarity with the applicable law, potential conflicts of interest, familiarity with the organization and with the subject of the investigation, and the extent of the counsel’s prior representation of the organization.

5. The parties must remember that they are acting at the direction and under the supervision of the board of directors. The board will ultimately make decisions on the investigation. The board is not obligated to adopt all of the investigator’s conclusions and recommendations. Rather, the board should consider them on their own merits. The investigator should present the board with an investigative report. A credible internal investigation can prevent a wide-ranging government investigation into the corporation's affairs and give the corporation more control over the nature and focus of the government investigation.

6. Like all investigations, the basic elements of an internal investigation are document review and witness interviews.

   - Identify the appropriate corporate contact
   - Gather documents
   - Generate a list of persons to interview
   - Develop a coherent theory

The potential need for an internal, board-directed review of corporate activities, management and/or governance is a fact of life in today’s corporate environment. Non-attorney investigators should be supervised by an attorney so that no part of the investigation is outside the immediate control of an attorney capable of establishing the privilege.

To avoid indictment, the corporation should have full knowledge of all of the relevant facts so that an appropriate preindictment defense may be presented to the government. Self-reporting and timely cooperation will reduce the culpability score and financial exposure under the Federal Sentencing Guidelines.

7. Two privileges are often asserted to prevent public disclosure of the results of an internal investigation. The attorney-client privilege and the work product doctrine.

At the outset of an internal investigation, one must be careful to create the proper relationship. the engagement letter between the company and independent counsel should make clear that counsel is being retained to conduct an internal investigation for the purposes of advising management and the board.

The work product doctrine protects the results of the attorney's work, which includes mental impressions, conclusions, opinions, and legal theories.
There are simple steps that can make the assertion of privileges for documents created during an internal investigation stronger. Demonstrating that documents were expected to remain confidential is a key element of a privilege claim. Simply marking documents as "privileged and confidential," though elementary in preparation for litigation, should not be overlooked.

To best protect attorney-client privilege to witness interviews, the witness must understand that the content of the interview is privileged and confidential. Counsel should request that the witness sign a post interview statement reflecting this.

To preserve the privilege for work of consultants and outside witnesses, counsel should hire the consultants directly and they should report directly to counsel. The engagement letter to the outside witness or consultants should make clear that they are being hired to assist counsel in advising the company.

It is likely that the results of an investigation will be disclosed to the government, potential plaintiffs, or the public. Plaintiffs may be able to use the investigative report as a guide to litigation and as evidence of wrongdoing. The corporation may be dissuaded from voluntarily waiving the privilege given the prospect of facing an argument in subsequent or parallel litigation that a privilege has been waived as to other parties. Disclosure to third parties generally waives the privilege. The corporation is likely to be faced with an argument that its disclosure to one party has waived any privilege over confidential materials generated or gathered during the investigation.

### III. Penalties

**Civil Tax Penalties and Guidance**

1.1 IRC Chapter 42: 26 USC §§ 4940 to 4948  
Private Foundation Excise Taxes  
Self-dealing, failure to distribute, excess business holdings, jeopardizing investments, taxable expenditures, certain nonexempt trusts, certain foreign organizations.

1.2 4958  
Excise Tax on Excess Benefit Transactions  
Excise tax on current and former public charities and social welfare organizations that directly or indirectly engage in transactions the provide more than incidental benefit. Excise taxes on disqualified person (25%, 200% if not promptly corrected) and on entity management (10%).

1.3 4965  
Excise Tax on Tax-Exempt Entity Participating in Tax Shelter  
Amount is greater of (i) corporate tax rate, times net income, or (ii) 75% of proceeds received by tax-exempt entity. If "subsequently listed" then applies only to income after being listed. However, if entity "knew" it was a tax shelter, then excise tax is greater of (a) 100% of net income or (b) 75% of proceeds received by the tax-exempt, plus (c) $20,000 per approval on entity manager.
| 1.4 | 4966 – 4967 | Donor Advised Fund Excise Taxes | 4966 - 20% tax on advice resulting in "taxable distributions"
4967 – 125% of benefit tax on advice causing advised fund distribution that results in more than incidental benefit
4967 – 10% tax on the amount of such benefit |
| 1.5 | 6011(g) | Disclosure of Reportable Transaction to Tax-Exempt Entity | 6011(g) - Any taxable party to a tax shelter transaction shall disclose to any tax-exempt entity which is a party to such transaction that such transaction is such.
6707A – Penalty is $10,000 if individual and $50,000 otherwise; provided that if a listed transaction then $100,000 and $200,000, respectively. |
<p>| 1.6 | 6033 | Returns by exempt organizations | Shall file annual return (Form 990), return reporting status as party to a reportable transaction, and lobbying amounts [section 11 tax imposed if does not report lobbying amounts]. Churches and certain organizations excepted. |
| 1.7 | 6046, 6046A | Returns of US Persons Acquiring 10% or more of Foreign entities | Requires notification to IRS if US Person acquires 10% or more of foreign entity |
| 1.8 | 6048, 6050D | Information with respect to certain foreign trusts | Requires reporting of creation of any foreign trust by any US Person |
| 1.9 | 6050D | Returns relating to energy grants and financing | Every person administering federal, state, or local program to provide subsidized financing or grants for projects to conserve or produce energy shall file return identifying each grantee |
| 1.10 | 6050I | Returns relating to cash received in trade or business, etc. | Any person who receives &gt;$10,000 cash – including foreign currency and monetary instruments -- in 1 transaction (or 2 or more related transactions) must report particulars to both (i) IRS and (ii) person identified in report to IRS. |
| 1.11 | 6050L | Returns relating to certain dispositions of donated property | Donee of charitable contribution property that disposes within 3 years (10 years if IP) must report to IRS and to Donor, if value donated was &gt; $5,000 (publicly traded securities excepted). |</p>
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<tr>
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<th>Code</th>
<th>Description</th>
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<tbody>
<tr>
<td>1.12</td>
<td>6050V</td>
<td>Returns relating to applicable insurance contracts in which certain Exempt Organization hold interests</td>
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<td>Organizations described in section 170(c), and others, must report direct or indirect acquisition of insurance contract (life, endowment, etc.) as part of a structured transaction involving a pool of such contracts, subject to various exceptions.</td>
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<tr>
<td>1.13</td>
<td>6104(d)</td>
<td>Public inspection of certain annual returns…and application for exemption.</td>
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<td>Requires entities exempt under 501(c) or (d) to make complete tax exemption application and last three income returns (including UBIT) available to public.</td>
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<td>1.14</td>
<td>6111</td>
<td>Disclosure of reportable transaction</td>
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<td>Any person who provides any material aid, assistance or advice with respect to carrying out any reportable transactions and who receives &gt;$50,000 must identify transaction and parties to IRS.</td>
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<td>1.15</td>
<td>6113</td>
<td>Disclosure of nondeductibility of contributions</td>
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<td>Must include conspicuous statement that contributions are not deductible if no contribution deduction permitted under law and entity’s (or group of related entities) receipts do not exceed $100,000.</td>
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<td>1.16</td>
<td>6115</td>
<td>Disclosure related to Quid Pro Quo contributions</td>
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<td>Organization described in section 170(c)(2-5) must provide donor of quid pro quo contribution in excess of $75 (i) statement that deduction limited, and (ii) good faith estimate of value of goods or services provided.</td>
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<td>1.17</td>
<td>6652(c)(1)(A)</td>
<td>Failure to file certain information returns, registration statements, etc.</td>
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<td>Returns required by sections 6033 or 6012(a)(6), 6034 (certain trusts), and 6043 (terminations of exempt status) late filed subject to penalties of $10 per day up to $5,000. Failure to permit public inspection per section 6104(d) penalty is $20 per day.</td>
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<td>1.18</td>
<td>6652(c)(1)(C) and (D)</td>
<td>Failure to allow inspection of annual returns and exemption applications</td>
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<td>Failure of split-interest trust with gross income &gt;$250,000 to timely file returns $100 per day, and an equal penalty imposed on the responsible person if knowingly fails to timely file.</td>
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<td>1.19</td>
<td>6662</td>
<td>Imposition of accuracy-related penalty on underpayments</td>
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<td>20% penalty on underpayment of income tax attributable to substantial (150%) valuation misstatement. If underpayment is due to “gross” (200%) valuation misstatement, penalty is 40%.</td>
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<td>1.20</td>
<td>6662A</td>
<td>Imposition of accuracy-related penalty on understatements with</td>
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<td>Additional tax of 20% of such tax understatement arising from reportable transaction, unless not disclosed per 6664(d)(2)(A) in which case 30%.</td>
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<tr>
<td>Section</td>
<td>Code</td>
<td>Description</td>
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<tr>
<td>1.21</td>
<td>6677</td>
<td>Failure to file information with respect to foreign trust</td>
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<tr>
<td>1.22</td>
<td>6679</td>
<td>Failure to file returns, etc., with respect to foreign corporations for foreign partnerships</td>
</tr>
<tr>
<td>1.23</td>
<td>6684</td>
<td>Assessable penalties with respect to liability for tax under chapter 42</td>
</tr>
<tr>
<td>1.24</td>
<td>6685</td>
<td>Willful failure to allow inspection</td>
</tr>
<tr>
<td>1.25</td>
<td>6700</td>
<td>Promoting abusive tax shelters, etc.</td>
</tr>
<tr>
<td>1.26</td>
<td>6701</td>
<td>Penalties for aiding and abetting understatement of tax liability</td>
</tr>
<tr>
<td>1.27</td>
<td>6707</td>
<td>Failure to furnish information regarding tax shelters</td>
</tr>
<tr>
<td>1.28</td>
<td>6710</td>
<td>Failure to disclose that contributions are nondeductible</td>
</tr>
</tbody>
</table>
1.29 6711 Failure by tax-exempt organization to disclose that certain information or service available from Federal Government

If tax-exempt organization offers to sell information that could be readily obtained for not more than nominal charge, and tax-exempt fails to so disclose, penalty of greater of (i) $1,000 per day on which such a failure occurred or (ii) 50% of the costs of such offers and solicitations.

1.30 6714 Failure to meet disclosure requirements applicable to quid pro quo contributions

Organization failing to meet section 6115 disclosure: penalty of $10 per contribution not to exceed $5,000 for a particular fundraising event or mailing.

2. Non-Tax Statutes and Penalties

<table>
<thead>
<tr>
<th>Cite:</th>
<th>Title:</th>
<th>Explanation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.2 31 C.F.R. § 103.24</td>
<td>Reports of Foreign Financial Accounts</td>
<td>Authorizes Treasury Form TD F 90-22.1, also known as “FBAR” form</td>
</tr>
<tr>
<td>2.3 18 U.S.C. § 1956 18 U.S.C. § 1957</td>
<td>Laundering of Monetary Instruments; Engaging in Monetary Transactions in Property Derived from Specified Unlawful Activity</td>
<td>Sections 1956 (20 year felony) and 1957 (10 year felony) are principal anti-money laundering statutes</td>
</tr>
</tbody>
</table>

3. Criminal Tax Penalties and Cases

Recent Criminal Tax Convictions Involving Exempt Organizations

<table>
<thead>
<tr>
<th>Cite:</th>
<th>Title:</th>
<th>Explanation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 U.S. v. Fumo Crim.Act.No.06-316 E.D. PA. Mar. 2009</td>
<td>Founder and executive director were convicted of fraud and conspiracy to commit fraud, conspiracy to obstruct the Internal Revenue Service, and aiding and abetting in the filing of false tax returns.</td>
<td></td>
</tr>
<tr>
<td>3.2 U.S. v. Mabayyid 567 F.Supp.2d 223 D.Mass. 2008</td>
<td>Founder, President and Treasurer were convicted of concealing material facts, making false statements, and corruptly obstructing and impeding the Internal Revenue</td>
<td></td>
</tr>
</tbody>
</table>

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3.3 U.S. v. Holy Land Foundation  
No. 3:04-CR-0240-N.D.Tex. 2008
Founders and directors were convicted of conspiracy to impede and impair the Internal Revenue Service, and filing false returns. The organization and directors also were convicted on conspiracy to provide material support to a foreign terrorist organization and money laundering.

3.4 U.S. v. Madison  
Executive director was convicted of attempting to evade or defeat tax, and making false statements to the Internal Revenue Service. CPA was convicted of aiding the preparation of returns containing false statements.


<table>
<thead>
<tr>
<th>Cite:</th>
<th>Title:</th>
<th>Explanation:</th>
</tr>
</thead>
<tbody>
<tr>
<td>4.1 26 U.S.C. § 7201</td>
<td>Attempt to Evade or Defeat Tax</td>
<td>Classic statute charged for income tax evasion (5 year felony)</td>
</tr>
<tr>
<td>4.2 26 U.S.C. § 7203</td>
<td>Failure to File Return, Supply Information or Pay Tax</td>
<td>Misdemeanor statute commonly used for knowing failure to file tax returns</td>
</tr>
<tr>
<td>4.3 26 U.S.C. § 7206(1)</td>
<td>Fraud and False Statements</td>
<td>Statute prohibiting subscribing under penalty of perjury to a false return, statement or document (3 year felony)</td>
</tr>
<tr>
<td>4.4 26 U.S.C. § 7206(2)</td>
<td>Fraud and False Statements</td>
<td>Penalizes those who aid and abet in Fraud and False Statement, often used against tax preparers</td>
</tr>
<tr>
<td>4.5 26 U.S.C. 7212</td>
<td>Attempts to Interfere with Administration of Internal Revenue Laws</td>
<td>Obstructs or impedes through corruption or force the administration of the Internal Revenue Laws</td>
</tr>
<tr>
<td>4.6 18 U.S.C. § 371</td>
<td>Conspiracy to Commit Offense or to Defraud the United States</td>
<td>Conspiracy statute used to prosecute conspiracies to violate the tax laws, also known as <em>Klein</em> conspiracy. (5 year felony)</td>
</tr>
<tr>
<td>4.7 18 U.S.C. § 1001</td>
<td>False Statements</td>
<td>Statute applies to falsification, concealment or cover up any trick, scheme, or device of a material fact, or making any materially false, fictitious, or fraudulent statement, to the United States.</td>
</tr>
<tr>
<td>4.8 31 U.S.C. § 5324</td>
<td>Structuring transactions to evade reporting requirement prohibited</td>
<td>Structuring cash transactions to avoid reporting.</td>
</tr>
</tbody>
</table>
IV. Litigation

During times of threatened or pending litigation matters, duties that directors and officers owe to a nonprofit organization extend into unfamiliar areas that require an extra measure of care.

Directors of nonprofit organizations generally have two main fiduciary duties: duty of care and duty of loyalty. The duty of care requires the director to act with the care a person in a like position would reasonably believe to be appropriate under similar circumstances. The duty of loyalty requires the director to act in good faith and in a manner that the director reasonably believes to be in the best interests of the organization.

Top management, including the organization's Chairman and legal counsel, should determine how to proceed with a potential litigation claim. These individuals will need to consider if the claim is likely to be covered by the organization's insurance policies, and whether notice of the claim should be made to the organization's insurance company. Legal counsel will coordinate an investigation and produce a summary of counsel's legal interpretation of the claim.

Written notice of the claim should be provided to the organization's insurance company in a timely manner. This notice should be made by legal counsel. A copy of the notice should be provided to the organization's insurance agent.

Facts surrounding potential litigation should not be discussed outside of the organization; nor should detailed information be disseminated within the organization to staff who have little, if any, involvement in the particular matter. In addition to the fact that outside communications can often prejudice a case, any potential settlement or resolution of litigation often involves a commitment to keeping matters confidential. This commitment will be much easier to meet if only those who need to know the particular facts of a matter are so informed.

On January 20, 2003, the U.S. Department of Justice ("DOJ") released a revised Principles of Federal Prosecution of Business Organizations. The full text of the revised guidelines may be found at www.usdoj.gov/dag/cftf/corporate_guidelines.htm. The new guidelines identify several factors that prosecutors should consider in evaluating "the proper treatment of a corporate target" including the nature of the offense, a corporation's history of similar conduct, the existence and adequacy of a corporation's compliance program, and a corporation's timely and voluntary disclosure of wrongdoing. The new guidelines identify factors that prosecutors should consider in reaching a decision.

Documents, charts, letters, drafts, memoranda, or other written materials (including electronic form) related to potential or actual litigation must be handled with extreme care and in a confidential manner. To the extent that these materials have been created for the primary purpose of facilitating the provision of legal advice, or have been prepared in anticipation of litigation, whether by lawyers or non-lawyers, they should be marked "Confidential-Subject to Attorney-Client Privilege/Work Product privilege." These materials should be kept in secure files and distributed only to intended recipients. These materials should never be disclosed outside the organization without the authorization of counsel.
Organizations should not destroy any written materials within the custody or control of the organization, specifically including any of its employees or agents, that are in any way related to the issues involved in litigation. It is often difficult to foresee what documents will ultimately be relevant to a particular matter as it progresses toward litigation. Precaution should be taken to preserve any document related to the issues involved in the matter. When litigation is initiated, an appropriate officer of the organization should issue an organization-wide directive explaining the issues involved in the litigation and instructing all staff members that no relevant documents are to be destroyed.

As discussed in II. 7 above, there are certain communications that are protected from disclosure. The attorney-client privilege protects from disclosure communications involving direct oral and written exchanges between lawyer and client, including communications between a nonprofit organization's employees or agents and its lawyer.

For experts that may testify at trial, an adverse party may be entitled to know and receive everything on which the particular expert's opinion is based, regardless of whether the underlying documents are otherwise protected from disclosure. The same is not true for consultants who will not testify at trial.

Settlement offers are initially reviewed by the organization's Chairman and legal counsel. No settlements or terms of settlement may be accepted without prior approval of the Board of Directors and the insurance carrier.
Select Form 990 Schedules

SCHEDULE E
(Former 990 or 990-EZ)

To be completed by organizations that answer "Yes" to Form 990, Part IV, line 13, or Form 990-EZ, Part VI, line 48.

Name of the organization

Employer identification number

1. Does the organization have a racially nondiscriminatory policy toward students by statement in its charter, bylaws, other governing instrument, or in a resolution of its governing body?

YES NO

2. Does the organization include a statement of its racially nondiscriminatory policy toward students in all its brochures, catalogues, and other written communications with the public dealing with student admissions, programs, and scholarships?

YES NO

3. Has the organization publicized its racially nondiscriminatory policy through newspaper or broadcast media during the period of solicitation for students, or during the registration period if it has no solicitation program, in a way that makes the policy known to all parts of the general community it serves? If "yes," please describe. If "No," please explain.

YES NO

4. Does the organization maintain the following:
   a. Records indicating the racial composition of the student body, faculty, and administrative staff?
   b. Records documenting that scholarships and other financial assistance are awarded on a racially nondiscriminatory basis?
   c. Copies of all catalogues, brochures, announcements, and other written communications to the public dealing with student admissions, programs, and scholarships?
   d. Copies of all material used by the organization or on its behalf to solicit contributions?

5. Does the organization discriminate by race in any way with respect to:
   a. Students' rights or privileges?
   b. Admissions policies?
   c. Employment of faculty or administrative staff?
   d. Scholarships or other financial assistance?
   e. Educational policies?
   f. Use of facilities?
   g. Athletic programs?
   h. Other extracurricular activities?

If you answered "Yes" to any of the above, please explain. (If you need more space, attach a separate statement.)

YES NO

6a. Does the organization receive any financial aid or assistance from a governmental agency?
   b. Has the organization's right to such aid ever been revoked or suspended?

If you answered "Yes" to either 6a or b, please explain using an attached statement.

7. Does the organization certify that it has complied with the applicable requirements of sections 4.01 through 4.05 of Rev. Proc. 75-50, 1975-2 C.B. 587, covering racial nondiscrimination? If "No," attach an explanation.

YES NO
### Part I  Charity Care and Certain Other Community Benefits at Cost (Optional for 2008)

1a. Does the organization have a charity care policy? If "No," skip to question 6a.

b. If "Yes," is it a written policy?

2. If the organization has multiple hospitals, indicate which of the following best describes application of the charity care policy to the various hospitals.
   - [ ] applied uniformly to all hospitals
   - [ ] generally tailored to individual hospitals
   - [ ] applied uniformly to most hospitals

3. Answer the following based on the charity care eligibility criteria that applies to the largest number of the organization's patients.
   - a. Does the organization use Federal Poverty Guidelines (FPG) to determine eligibility for providing free or discounted care to low income individuals? If "Yes," indicate which of the following is the family income limit for eligibility for free care.
     - [ ] 100% FPG
     - [ ] 150% FPG
     - [ ] 200% FPG
     - [ ] Other __% FPG
   - b. Does the organization use Federal Poverty Guidelines (FPG) to determine eligibility for providing discounted care to low income individuals? If "Yes," indicate which of the following is the family income limit for eligibility for discounted care.
     - [ ] 200% FPG
     - [ ] 250% FPG
     - [ ] 300% FPG
     - [ ] 350% FPG
     - [ ] 400% FPG
     - [ ] Other __% FPG
   - c. If the organization does not use FPG to determine eligibility, describe in Part VI the income based criteria for determining eligibility for free or discounted care. Include in the description whether the organization uses an asset test or other threshold, regardless of income, to determine eligibility for free or discounted care.

4. Does the organization's policy provide free or discounted care to the "medically indigent"?

5a. Does the organization budget amounts for free or discounted care provided under its charity care policy?

b. If "Yes," did the organization's charity care expenses exceed the budgeted amount?

c. If "Yes" to 5b, as a result of budget considerations, was the organization unable to provide free or discounted care to a patient who was eligible for free or discounted care?

6a. Does the organization prepare an annual community benefit report?

b. If "Yes," does the organization make it available to the public?

Complete the following table using the worksheets provided in the Schedule H instructions. Do not submit these worksheets with the Schedule H.

<table>
<thead>
<tr>
<th>Charity Care and Means-Tested Programs</th>
<th>(a) Number of activities or programs (optional)</th>
<th>(b) Persons served (optional)</th>
<th>(c) Total community benefit expense</th>
<th>(d) Direct offsetting revenue</th>
<th>(e) Net community benefit expense</th>
<th>(f) Percent of total expenses</th>
</tr>
</thead>
<tbody>
<tr>
<td>a. Charity care at cost (from worksheets 1 and 2)</td>
<td></td>
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<td>b. Unreimbursed Medicaid (from worksheet 3, column a)</td>
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<td>c. Unreimbursed costs – other means-tested government programs (from worksheet 3, column b)</td>
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<tr>
<td>d. Total Charity Care and Means-Tested Programs</td>
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<td>e. Other Benefits</td>
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<tr>
<td>f. Community health improvement services and community benefit operations (from worksheet 4)</td>
<td></td>
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<td>g. Health professions education (from worksheet 5)</td>
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<td>h. Subsidized health services (from worksheet 6)</td>
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<td>i. Research (from worksheet 7)</td>
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<tr>
<td>j. Cash and in-kind contributions to community groups (from worksheet 8)</td>
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<td>k. Total Other Benefits</td>
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<td>l. Total lines 7d and 7i</td>
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</tbody>
</table>
### Part II: Community Building Activities (Complete this table if the organization conducted any community building activities) (Optional for 2008)

<table>
<thead>
<tr>
<th>(a) Number of activities or programs (optional)</th>
<th>(b) Persons served (optional)</th>
<th>(c) Total community building expense</th>
<th>(d) Direct offsetting revenue</th>
<th>(e) Net community building expense</th>
<th>(f) Percent of total expense</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Physical improvements and housing</td>
<td></td>
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<tr>
<td>2 Economic development</td>
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<tr>
<td>3 Community support</td>
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<td>4 Environmental improvements</td>
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<tr>
<td>5 Leadership development and training for community members</td>
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<tr>
<td>6 Coalition building</td>
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<tr>
<td>7 Community health improvement advocacy</td>
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<tr>
<td>8 Workforce development</td>
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<tr>
<td>9 Other</td>
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<td>10 Total</td>
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</tbody>
</table>

### Part III: Bad Debt, Medicare, & Collection Practices (Optional for 2008)

#### Section A—Bad Debt Expense

1. Does the organization report bad debt expense in accordance with Healthcare Financial Management Association Statement No. 18?  
   - Yes  
   - No  

2. Enter the amount of the organization's bad debt expense (at cost)  

3. Enter the estimated amount of the organization's bad debt expense (at cost) attributable to patients eligible under the organization's charity care policy.  

4. Provide in Part VI the text of the footnote to the organization's financial statements that describes bad debt expense. In addition, describe the costing methodology used in determining the amounts reported on lines 2 and 3 or rationale for including other bad debt amounts in community benefit.

#### Section B—Medicare

5. Enter total revenue received from Medicare (including DIS and IME)  

6. Enter Medicare allowable costs of care relating to payments on line 5  

7. Enter, line 5 less line 6—surplus or (shortfall)  

8. Describe in Part VI the extent to which any shortfall reported in line 7 should be treated as community benefit, and the costing methodology or source used to determine the amount reported on line 6 and indicate which of the following methods was used:  
   - [ ] cost accounting system  
   - [ ] cost to charge ratio  
   - [ ] Other

#### Section C—Collection Practices

9a. Does the organization have a written debt collection policy?  

9b. If “Yes,” does the organization’s collection policy contain provisions on the collection practices to be followed for patients who are known to qualify for charity care or financial assistance?  

### Part IV: Management Companies and Joint Ventures (Optional for 2008)

<table>
<thead>
<tr>
<th>(a) Name of entity</th>
<th>(b) Description of primary activity of entity</th>
<th>(c) Organization’s profit % or stock ownership %</th>
<th>(d) Officers, directors, trustees, or key employees’ profit % or stock ownership %</th>
<th>(e) Physicians’ profit % or stock ownership %</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
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</tbody>
</table>
### Part V Facility Information (Required for 2008)

<table>
<thead>
<tr>
<th>Name and address</th>
<th>Licensed hospital</th>
<th>General medical &amp; surgical</th>
<th>Children’s hospital</th>
<th>Teaching hospital</th>
<th>Critical access hospital</th>
<th>Research facility</th>
<th>ER/4-hour</th>
<th>Bi-Other</th>
<th>Other (Describe)</th>
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<tbody>
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Part VI  Supplemental Information (Optional for 2008)

Complete this part to provide the following information:

1. Provide the description required for Part I, line 3c, Part III, line 4, Part III, line 8, and Part III, line 9b.

2. Describe how the organization assesses the health care needs of the communities it serves—“Needs Assessment.”

3. Describe how the organization informs and educates patients and persons who may be billed for patient care about their eligibility for assistance under federal, state or local government programs or under the organization’s charity care policy. “Patient Education of Eligibility for Assistance.”

4. Describe the community the organization serves, taking into account the geographic area and demographic constituents it serves. “Community Information.”

5. Describe how the organization’s community building activities, as reported in Part II, promote the health of the communities the organization serves. “Community Building Activities.”

6. Provide any other information important to describing how the organization’s hospitals or other health care facilities further its exempt purpose by promoting the health of the community (e.g., open medical staff, community board, use of surplus funds, etc.).

7. If the organization is part of an affiliated health care system, describe the respective roles of the organization and its affiliates in promoting the health of the communities served.

8. If applicable, identify all states with which the organization, or a related organization, files a community benefit report.
## Part I  Questions Regarding Compensation

1a Check the appropriate box(es) if the organization provided any of the following to or for a person listed in Form 990, Part VII, Section A, line 1a. Complete Part III to provide any relevant information regarding these items.

- [ ] first-class or charter travel
- [ ] housing allowance or residence for personal use
- [ ] travel for companions
- [ ] payments for business use of personal residence
- [ ] tax indemnification and gross-up payments
- [ ] health or social club dues or initiation fees
- [ ] discretionary spending account
- [ ] personal services (e.g., maid, chauffeur, chef)

b If line 1a is checked, did the organization follow a written policy regarding payment or reimbursement or provision of all of the expenses described above? If "No," complete Part III to explain.

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
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<tbody>
<tr>
<td>1b</td>
<td>If line 1a is checked, did the organization follow a written policy regarding payment or reimbursement or provision of all of the expenses described above?</td>
</tr>
</tbody>
</table>

2 Did the organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director, regarding the items checked in line 1a?

<table>
<thead>
<tr>
<th>Line</th>
<th>Description</th>
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</thead>
<tbody>
<tr>
<td>2</td>
<td>Did the organization require substantiation prior to reimbursing or allowing expenses incurred by all officers, directors, trustees, and the CEO/Executive Director, regarding the items checked in line 1a?</td>
</tr>
</tbody>
</table>

3 Indicate which, if any, of the following organizations was established by the organization to compensate the organization's CEO/Executive Director. Check all that apply.

- [ ] compensation committee
- [ ] written employment contract
- [ ] independent compensation consultant
- [ ] compensation survey or study
- [ ] Form 990 of other organizations
- [ ] approval by the board or compensation committee

4 During the year, did any person listed in Form 990, Part VII, Section A, line 1a:

   a. receive a severance payment or change of control payment?

   b. participate in, or receive payment from, a supplemental nonqualified retirement plan?

   c. participate in, or receive payment from, an equity-based compensation arrangement?

If "Yes" to any of 4a-c, list the persons and provide the applicable amounts for each item in Part III.

5 501(c)(3) and 501(c)(4) organizations only must complete lines 5–8.

5 For persons listed in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the revenue of:

   a. the organization?

   b. any related organization?

   If "Yes," describe in Part III.

6 For persons listed in Form 990, Part VII, Section A, line 1a, did the organization pay or accrue any compensation contingent on the net earnings of:

   a. the organization?

   b. any related organization?

   If "Yes," describe in Part III.

7 For persons listed in Form 990, Part VII, Section A, line 1a, did the organization provide any non-fixed payments not described in lines 5 and 6? If "Yes," describe in Part III.

8 Were any amounts reported in Form 990, Part VII, paid or accrued pursuant to a contract that was subject to the initial contract exception described in Regs. section 53.4956-4(a)(3)? If "Yes," describe in Part III.
Part II  Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees. Schedule J-1 if additional spaces needed.

For each individual whose compensation must be reported in Schedule J, report compensation from the organization on row (a) and from related organizations described in the instructions on row (b). Do not list any individuals that are not listed on Form 990, Part VII.

Note: The sum of columns (Bb), (C), (D), and (E) must equal the applicable column (D) or (E) amounts on Form 990, Part VII, line 1a.

<table>
<thead>
<tr>
<th>A) Name</th>
<th>B) Breakdown of W-2 and/or 1099-MISC compensation</th>
<th>C) Deferred Compensation</th>
<th>D) Total of column B, D, F</th>
<th>E) Compensation reported in a or Form 990 or Form W-2C</th>
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Part III  Supplemental Information

Complete this part to provide the information, explanation, or descriptions required for Part I, lines 1a, 1b, 4a, 5a, 5b, 6a, 6b, 7, and 8.

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### Part I: Continuation Officers, Directors, Trustees, Key Employees, and Highest Compensated Employees (Schedule J, Part I)

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<tr>
<th>(A) Name</th>
<th>(B) Total of W-2 and/or Form 1099-MISC compensation</th>
<th>(C) Deferred compensation</th>
<th>(D) Incentive compensation</th>
<th>(E) Other compensation</th>
<th>(F) Nonvested benefits</th>
<th>(G) Total of column (E) + (F)</th>
<th>(H) Compensation reported in prior Form 990 or Form 990-EZ</th>
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For Paperwork Reduction Act Notice, see the Instructions for Form 990.
continued from previous page

<table>
<thead>
<tr>
<th>(A) Name and Title</th>
<th>(B) Average Hours per Week</th>
<th>(C) Position (check all that apply)</th>
<th>(D) Reportable compensation from the organization (W-2/1099-MISC)</th>
<th>(E) Estimated amount of other compensation from the organization and related organizations</th>
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For Paperwork Reduction Act Notice, see the Instructions for Form 990.
### Part I Excess Benefit Transactions (501(c)(3) and (c)(4) organizations only)
To be completed by organizations that answered "Yes" on Form 990, Part IV, lines 25a or b, or Form 990-EZ, Part V, line 40b.

<table>
<thead>
<tr>
<th></th>
<th>(a) Name of disqualified person</th>
<th>(b) Description of transaction</th>
<th>(c) Corrected?</th>
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<td>Yes</td>
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<tr>
<td>2</td>
<td>Enter the amount of tax imposed on the organization managers or disqualified persons during the year under section 4968</td>
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<tr>
<td>3</td>
<td>Enter the amount, if any, on line 2, above, reimbursed by the organization</td>
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### Part II Loans to and from Interested Persons
To be completed by organizations that answered "Yes" on Form 990, Part IV, line 26, or Form 990-EZ, Part V, line 38b.

<table>
<thead>
<tr>
<th>(a) Name of interested person and purpose</th>
<th>(b) Loan to or from the organization</th>
<th>(c) Original principal amount $</th>
<th>(d) Balance due $</th>
<th>(e) In default?</th>
<th>(f) Approved by board or committee?</th>
<th>(g) Written agreement</th>
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<td>To</td>
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<td>Yes</td>
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Total: $                             

### Part III Grants or Assistance Benefiting Interested Persons
To be completed by organizations that answered "Yes" on Form 990, Part IV, line 27.

<table>
<thead>
<tr>
<th>(a) Name of interested person</th>
<th>(b) Relationship between interested person and the organization</th>
<th>(c) Amount of grant or type of assistance</th>
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### Part IV Business Transactions Involving Interested Persons
To be completed by organizations that answered "Yes" on Form 990, Part IV, lines 28a, b, or c.

<table>
<thead>
<tr>
<th>(a) Name of interested person</th>
<th>(b) Relationship between interested person and the organization</th>
<th>(c) Amount of transaction $</th>
<th>(d) Description of transaction</th>
<th>(e) Sharing of organization's revenues?</th>
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For Paperwork Reduction Act Notice, see the instructions for Form 990.
### Part I  Identification of Disregarded Entities

<table>
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<tr>
<th>(A) Name, address, and EIN of disregarded entity</th>
<th>(B) Primary Activity</th>
<th>(C) Legal domicile (State or Foreign Country)</th>
<th>(D) Total income ($</th>
<th>(E) End-of-year assets ($)</th>
<th>(F) Direct Controlling Entity</th>
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### Part II  Identification of Related Tax-Exempt Organizations

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<th>(A) Name, address, and EIN of related organization</th>
<th>(B) Primary Activity</th>
<th>(C) Legal domicile (State or Foreign Country)</th>
<th>(D) Exempt Code section</th>
<th>(E) Public charity status (if 501(c)(3))</th>
<th>(F) Direct Controlling Entity</th>
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For Paperwork Reduction Act Notice, see the Instructions for Form 990.
### Part III Identification of Related Organizations Taxable as a Partnership

<table>
<thead>
<tr>
<th>Column A: Name, address, and EIN of related organization</th>
<th>Column B: Primary activity</th>
<th>Column C: Legal domicile (State or Foreign Country)</th>
<th>Column D: Direct Controlling Entity</th>
<th>Column E: Preeminent income (rental, investment, unrelated)</th>
<th>Column F: Share of total income ($)</th>
<th>Column G: Share of end-of-year assets ($)</th>
<th>Column H: Dependent status</th>
<th>Column I: Code W-2B amount on Form W-2 ($)</th>
<th>Column J: General or Managing Partner</th>
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### Part IV Identification of Related Organizations Taxable as a Corporation or Trust

<table>
<thead>
<tr>
<th>Column A: Name, address, and EIN of related organization</th>
<th>Column B: Primary activity</th>
<th>Column C: Legal domicile (State or Foreign Country)</th>
<th>Column D: Direct Controlling Entity</th>
<th>Column E: Type of entity (C Corp., E Corp.)</th>
<th>Column F: Share of total income ($)</th>
<th>Column G: Share of end-of-year assets ($)</th>
<th>Column H: Percentage ownership</th>
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<td>(a) Name, address, and EIN of disregarded entity</td>
<td>(b) Primary Activity</td>
<td>(c) Legal domicile (State or foreign country)</td>
<td>(d) Total income (§)</td>
<td>(e) End-of-year assets (§)</td>
<td>(f) Direct Controlling Entity</td>
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For Paperwork Reduction Act Notice, see the Instructions for Form 990.  

Draft as of  
December 19, 2007  
DO NOT FILE
### Part II  Continuation of Identification of Related Tax-Exempt Organizations

<table>
<thead>
<tr>
<th>(A) Name, address, and EIN of related organization</th>
<th>(B) Primary Activity</th>
<th>(C) Legal Capacity (State or Foreign Country)</th>
<th>(D) Exempt Code(s) under 501(c)(3)</th>
<th>(E) Public Charity status or Direct Controlling Entity</th>
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Schedule R-1 (Form 990) 2008
**Part III**  Continuation of Identification of Related Organizations Taxable as a Partnership

<table>
<thead>
<tr>
<th>(A) Name, address, and EIN of related organization</th>
<th>(B) Primary activity</th>
<th>(C) Legal domicile (State or Foreign Country)</th>
<th>(D) Direct Controlling Entity</th>
<th>(E) Prototype income (related, investment, unrelated)</th>
<th>(F) Share of total income</th>
<th>(G) Share of end-of-year assets</th>
<th>(H) Code V-IV(B) amount on Box 20 of K-1 (G)</th>
<th>(I) General or Managing Partner?</th>
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**Part IV**  Continuation of Identification of Related Organizations Taxable as a Corporation or Trust

<table>
<thead>
<tr>
<th>(A) Name, address, and EIN of related organization</th>
<th>(B) Primary activity</th>
<th>(C) Legal domicile (State or Foreign Country)</th>
<th>(D) Direct Controlling Entity</th>
<th>(E) Type of entity (C Corp, S Corp, or Trust)</th>
<th>(F) Share of total income</th>
<th>(G) Share of end-of-year assets</th>
<th>(H) Percentage ownership</th>
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Draft as of December 19, 2007

DO NOT FILE
### Part V  Continuation of Transactions with Related Organizations (Schedule R, Part V, line 2)

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<th>Name of other organization</th>
<th>Transaction Type (X)</th>
<th>Amount involved ($)</th>
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Schedule R-1 (Form 990) 2009
### Part VI  Continuation of Unrelated Organizations Taxable as a Partnership

<table>
<thead>
<tr>
<th>(A) Name, address, and EIN of entity</th>
<th>(B) Primary Activity</th>
<th>(C) Legal domicile (state or foreign country)</th>
<th>(D) Are all partners 501(c)(3) organizations?</th>
<th>(E) Share of unrelated business income (in Form 990)</th>
<th>(F) Organization described?</th>
<th>(G) Code in IRS amount on line 20 of Form 990</th>
<th>(H) Control or Managing Member?</th>
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Schedule R-1 (Form 990) 2009
Part VI  Governance, Management, and Disclosure (Sections A, B, and C request information about policies not required by the Internal Revenue Code.)

Section A. Governing Body and Management

For each "Yes" response to lines 2-7 below, and for a "No" response to lines 8 or 9b below, describe the circumstances, process, or changes in Schedule O. See instructions.

1a Enter the number of voting members of the governing body
1b Enter the number of voting members that are independent

2 Did any officer, director, trustee, or key employee have a family relationship or a business relationship with any other officer, director, trustee, or key employee?
3 Did the organization delegate control over management duties customarily performed by or under the direct supervision of officers, directors or trustees, or key employees to a management company or other person?
4 Did the organization make any significant changes to its organizational documents since the prior Form 990 was filed?
5 Did the organization become aware during the year of a material diversion of the organization's assets?
6 Does the organization have members or stockholders?
7a Does the organization have members, stockholders, or other persons who may elect one or more members of the governing body?
7b Are any decisions of the governing body subject to approval by members, stockholders, or other persons?
8 Did the organization contemporaneously document the meetings held or written actions undertaken during the year by the following:
   a the governing body
   b each committee with authority to act on behalf of the governing body?
9a Does the organization have local chapters, branches, or affiliates?
9b If "Yes," does the organization have written policies and procedures governing the activities of such chapters, affiliates, and branches to ensure their operations are consistent with those of the organization?

10 Was a copy of the Form 990 provided to the organization's governing body before it was filed? All organizations must describe in Schedule O the process, if any, the organization uses to review the Form 990.

11 Is there any officer, director, or trustee, or key employee listed in Part VII, Section A, who cannot be reached at the organization's mailing address? If "Yes," provide the names and addresses in Schedule O.

Section B. Policies

12a Does the organization have a written conflict of interest policy? If "Yes".
12b Are officers, directors, or trustees, and key employees required to disclose annually interests that could give rise to conflicts?
12c Does the organization regularly and consistently monitor and enforce compliance with the policy? If "Yes," describe in Schedule O how this is done.
13 Does the organization have a written whistleblower policy?
14 Does the organization have a written document retention and destruction policy?
15 Did the process for determining compensation of the following persons include a review and approval by independent persons, comparability data, and contemporaneous substantiation of the deliberation and decision:
   a The organization's CEO, Executive Director, or top management official?
   b Other officers or key employees of the organization?
16a Did the organization invest in, contribute assets to, or participate in a joint venture or similar arrangement with a taxable entity during the year?
16b If "Yes," has the organization adopted a written policy or procedure requiring the organization to evaluate its participation in joint venture arrangements under applicable Federal tax law, and taken steps to safeguard the organization's exempt status with respect to such arrangements?

Section C. Disclosure

17 List the States with which a copy of this Form 990 is required to be filed.
18 IRC Section 6104 requires an organization to make its Form 1023 (or 1024 if applicable), 990, and 990-T (501(c)(3)s only) available for public inspection. Indicate how you make these available. Check all that apply.
   □ own website  □ another's website  □ upon request
19 Describe in Schedule O whether (and if so, how) the organization makes its governing documents, conflict of interest policy, and financial statements available to the public.
20 State the name, physical address, and telephone number of the person who possesses the books and records of the organization:

Form 990 (2008)
[Name of Nonprofit]

EMPLOYEE PROTECTION (WHISTLEBLOWER) POLICY

If any employee reasonably believes that some policy, practice, or activity of [Name of Nonprofit] is in violation of law, a written complaint must be filed by that employee with the President or Legal Counsel of [Name of Nonprofit]. If the Foundation's President is suspected to be the person acting in violation of the law, a written complaint must be filed by that employee with the Foundation's Vice-President or Legal Counsel.

Telephone communications should be directed to the numbers listed below:

President and CEO
Vice President
Legal Counsel

Written communications to such persons should be sent to either of the following addresses:

President and CEO:

Vice-President:

Legal Counsel:

It is the intent of [Name of Nonprofit] to adhere to all laws and regulations that apply to the organization and the underlying purpose of this policy is to support the organization's goal of legal compliance. The support of all employees is necessary to achieving compliance with various laws and regulations. An employee is protected from retaliation only if the employee brings the alleged unlawful activity, policy, or practice to the attention of [Name of Nonprofit] and provides the [Name of Nonprofit] with a reasonable opportunity to investigate and correct the alleged unlawful activity. The protection described below is only available to employees that comply with this requirement.

[Name of Nonprofit] will not retaliate against an employee who in good faith, has made a protest or raised a complaint against some practice of [Name of Nonprofit], or of another individual or entity with whom [Name of Nonprofit] has a business relationship, on the basis of a reasonable belief that the practice is in violation of law, or a clear mandate of public policy.

My signature below indicates my receipt and understanding of this policy. I also verify that I have been provided with an opportunity to ask questions about the policy.

_________________________          _______________________
Employee signature                      Date
Name of Entity
CONFLICT OF INTEREST POLICY

Article I
Purpose

The purpose of this Conflict of Interest Policy ("Policy") is to protect ___name of entity____ (the "Corporation") interests when its Board of Directors ("Board") is contemplating entering into a transaction or arrangement that might benefit the private interest of an officer or director of the Corporation. This policy is intended to supplement but not replace any applicable federal or state laws governing conflicts of interest applicable to nonprofit and charitable corporations.

Article II
Definitions

1. Interested Person

Any director, principal officer, or member of a committee with Board delegated powers who has a direct or indirect financial interest, as defined below, is an interested person. In addition, any family member of an interested person shall also be considered an interested person. For purposes of this Policy, "family member" shall include any persons meeting the following criteria within the 60 months preceding the approval vote: spouses, brothers or sisters (by whole or half blood), spouses of brothers or sisters (by whole or half blood), ancestors, children, grandchildren, great grandchildren, and spouses of children, grandchildren, and great grandchildren.

2. Financial Interest

A person has financial interest if the person has, directly or indirectly, through business, investment or family –

a. an ownership or investment interest in any entity with which the Corporation has a transaction or arrangement, or

b. a compensation arrangement with a corporation or with any entity or individual with which the Corporation has a transaction or arrangement, or

c. a potential ownership or investment interest in, or compensation arrangement with, any entity or individual with which the Corporation is negotiating a transaction or arrangement.

Compensation includes direct and indirect remuneration as well as gifts or favors that are substantial in nature.
Article III

Procedures

1. Duty to Disclose

In connection with any actual or possible conflicts of interest, an interested person must at the time of each Board discussion of an item as to which he or she has an conflict of interest, disclose the existence and nature of his or her financial interest and all material facts to the Board and all members of any committees with Board delegated powers considering the proposed transaction or arrangement.

2. Determining Whether a Conflict of Interest Exists

After disclosure of the financial interest and all material facts, and after any discussion with the interested person, all interested persons shall leave the Board or committee meeting while the Board discusses and votes upon whether the Corporation will conduct the transaction. The remaining Board or committee members shall decide if a conflict of interest exists.

3. Procedures for Addressing the Conflict of Interest

   a. An interested person may make a presentation at the Board or committee meeting, but after such presentation, he/she shall leave the meeting during the discussion of, and the vote on, the transaction or arrangement that presents the conflict of interest.

   b. The chairperson of the Board or committee shall, if appropriate, appoint a disinterested person or committee to investigate alternatives to the proposed transaction or arrangement.

   c. The Board shall obtain adequate information to conduct a thorough analysis of whether the Corporation is receiving fair market value in the transaction.

   d. After exercising due diligence, the Board or committee shall determine whether the Corporation can, with reasonable efforts, obtain a more advantageous transaction or arrangement from a person or entity with whom the Corporation does not have a conflict of interest.

   e. If a more advantageous transaction or arrangement is not reasonably attainable, the Board or committee shall determine by a majority vote of the disinterested directors whether the transaction or arrangement is in the Corporation's best interest and for its own benefit, and whether the transaction is fair and reasonable to the Corporation, and shall make its decision as to whether to enter into the transaction or arrangement in conformity with such determination.

4. Violation of the Conflicts of Interest Policy

   a. If the Board or committee has reasonable cause to believe that a member has failed to disclose an actual or possible conflict of interest, it shall inform the member of the
basis for such belief and afford the member an opportunity to explain the alleged failure to disclose.

b. If, after hearing the response of the member and making such further investigation as may be warranted in the circumstances, the Board or committee determines that the member has in fact willfully failed to disclose an actual or possible conflict of interest, it shall take appropriate disciplinary and corrective action.

Article IV
Records of Proceedings

The Minutes of the Board and all committees with board-delegated powers shall contain the following:

1. The names of the persons who disclosed or otherwise were found to have an actual or possible conflict of interest, the nature of the interest, any action taken to determine whether a conflict of interest was present, including any and all information reviewed by the Board or committee in making its decision, and the board’s or committee’s decision as to whether a conflict of interest in fact existed.

2. The names of persons who were present for discussion of the transaction or arrangement, the content of the discussion, including any alternatives to the proposed transaction or arrangement, and a record of any votes taken in connection therewith.

Article V
Compensation Committees

A voting member of any committee whose jurisdiction includes compensation matters and who receives compensation, directly or indirectly, from the Corporation for services is precluded from voting on matters pertaining to that member’s compensation.

Article VI
Annual Statements

Each director, principal officer and member of a committee with board delegated powers shall annually sign a statement which affirms that such person –

a. has received a copy of the Conflicts of Interest Policy,

b. has read and understands the Policy,

c. has agreed to comply with the Policy, and

d. understands that the Corporation is a charitable organization and that in order to maintain its federal and state tax exemptions it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.
Article VII
Periodic Reviews

To ensure that the Corporation operates in a manner consistent with its charitable purposes and that
it does not engage in activities that could jeopardize its status as an organization exempt from
federal and state income tax, periodic reviews shall be conducted. The periodic reviews shall, at a
minimum include the following subjects:

a. Whether compensation arrangements and benefits are reasonable and are the result of
arm’s-length bargaining.

b. Whether any transactions entered into since the prior periodic review resulted in
mumement or impermissible private benefit.

Article VIII
Use of Outside Experts

In conducting the periodic reviews provided for in Article VII, the Corporation may, but need not,
use outside advisors. If outside experts are used, such use shall not relieve the board of its
responsibility for ensuring that periodic reviews are conducted.

Article IX
Questionnaire

In order to assist the Corporation in complying with federal and state requirements, including but
not limited to those set forth in Internal Revenue Code section 4958, and in California Corporations
Code sections 5227 and 5233, all Board members shall annually (and upon election to the Board)
complete the attached questionnaire. Completion of the questionnaire shall not relieve any Board
member of his or her duty to advice the Board of any actual or potential conflict of interest
concerning any matter before the Board, as set forth in Article III, Section 1.
Name: _______________________________________________________

Address: _____________________________________________________________________

______________________________________________________________________________

Telephone Number: (        ) ______________________

Occupation: ________________________________

Name of Employer: ________________________________

Employer’s Address: _____________________________________________________________________

______________________________________________________________________________

1. Are you currently being compensated (excluding reasonable compensation paid to you as a director or trustee) by _____________________________ (the “Corporation”) for services rendered to the Corporation (whether as a part-time or full-time employee, independent contractor, consultant or otherwise):

   A. within the previous 12 months?:

      (Check One) _____ Yes _____ No

   B. within the previous 60 months?:

      (Check One) _____ Yes _____ No

   Additional Comments: ________________________________

   _______________________________________________________________________

2. Do you anticipate the receipt of compensation from the Corporation for the rendering of services as described in question 1 above during the upcoming 12 months?

   (Check One) _____ Yes _____ No
3. Do you have an ownership or investment interest in any entity with which the Corporation has engaged in a transaction or arrangement within the previous 12 months?

(Check One) _____ Yes _____ No

Additional Comments:

__________________________________________

__________________________________________

__________________________________________

4. Do you anticipate obtaining an ownership or investment interest in any entity with which it is likely the Corporation will engage in a transaction or arrangement within the upcoming 12 months?

(Check One) _____ Yes _____ No

Additional Comments:

__________________________________________

__________________________________________

__________________________________________

5. If any person bearing any of the following relationships to you has been compensated by the Corporation within the previous 60 months for services rendered to it as described in question 1 above or has an ownership or investment interest in any entity with which the Corporation has engaged in a transaction or arrangement within the previous 60 months, please list his or her name in the following space and indicate the person’s relationship to you by using the relationships designated below (if no such person is being compensated or has such an interest, please print the word "none" in the first space):

(Relationships: brother or sister (by whole or half blood), ancestor, spouse, brother-in-law or sister-in-law (by whole or half blood), son-in-law, daughter-in-law, father-in-law, mother-in-law, children, grandchildren, great grandchildren, and spouses of children, grandchildren, or great grandchildren).

Name  Relationship

__________________________________________

__________________________________________

__________________________________________

Additional Comments:

__________________________________________

__________________________________________
6. If any person bearing any relationship to you as described in question 5 above will likely receive compensation from the Corporation for the rendering of services to it as described in question 1 above, or anticipates obtaining an ownership or investment interest in any entity with which the Corporation will engage in a transaction or arrangement within the next 12 months, please list his or her name in the following space and indicate that person’s relationship to you (if no such person anticipates receipt of such compensation, please print the word "none" in the first space):

<table>
<thead>
<tr>
<th>Name</th>
<th>Relationship</th>
</tr>
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<tbody>
<tr>
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</tbody>
</table>

Additional Comments: __________________________________________

7. Are you a director, an officer, or an employee in any business or entity (e.g., a bank, real estate brokerage firm, consulting firm, construction company, insurance brokerage firm, architectural firm, law firm, accounting firm, medical group, etc.) which has done business with the Corporation, or currently is or is contemplating doing business with the Corporation:

A. within the previous 12 months?:
   (Check One) _____ Yes _____ No

B. within the previous 60 months?:
   (Check One) _____ Yes _____ No

If yes, please explain (type of business, type(s) of transaction(s), relationship):

__________________________________________________________________
__________________________________________________________________
__________________________________________________________________
__________________________________________________________________

Please summarize your compensation or other financial arrangements, if any, with such business or entity concerning compensation received by you, directly or indirectly, from any such business transaction with the Corporation:

__________________________________________________________________
__________________________________________________________________
Annual Statement

I hereby affirm that I:–

a. have received a copy of the ______________________ Conflicts of Interest Policy,

b. have read and understand the Policy,

c. agree to comply with the Policy, and

d. understand that the Corporation is a charitable organization and that in order to maintain its federal and state tax exemptions it must engage primarily in activities which accomplish one or more of its tax-exempt purposes.

Date: ______________, 20___.

Sign below to certify both the accuracy of the Questionnaire and to the Annual Statement.

_________________________________________    ______________________________
(Print name)                                      (Signature)
12586. (a) Except as otherwise provided and except corporate trustees which are subject to the jurisdiction of the Commissioner of Financial Institutions of the State of California under Division 1 (commencing with Section 99) of the Financial Code or to the Comptroller of the Currency of the United States, every charitable corporation, unincorporated association, and trustee subject to this article shall, in addition to filing copies of the instruments previously required, file with the Attorney General periodic written reports, under oath, setting forth information as to the nature of the assets held for charitable purposes and the administration thereof by the corporation, unincorporated association, or trustee, in accordance with rules and regulations of the Attorney General.

(b) The Attorney General shall make rules and regulations as to the time for filing reports, the contents thereof, and the manner of executing and filing them. The Attorney General may classify trusts and other relationships concerning property held for a charitable purpose as to purpose, nature of assets, duration of the trust or other relationship, amount of assets, amounts to be devoted to charitable purposes, nature of trustee, or otherwise, and may establish different rules for the different classes as to time and nature of the reports required to the ends (1) that he or she shall receive reasonably current, periodic reports as to all charitable trusts or other relationships of a similar nature, which will enable him or her to ascertain whether they are being properly administered, and (2) that periodic reports shall not unreasonably add to the expense of the administration of charitable trusts and similar relationships. The Attorney General may suspend the filing of reports as to a particular charitable trust or relationship for a reasonable, specifically designated time upon written application of the trustee filed with the Attorney General and after the Attorney General has filed in the register of charitable trusts a written statement that the interests of the beneficiaries will not be prejudiced thereby and that periodic reports are not required for proper supervision by his or her office.

(c) A copy of an account filed by the trustee in any court having jurisdiction of the trust or other relationship, if the account substantially complies with the rules and regulations of the Attorney General, may be filed as a report required by this section.

(d) The first periodic written report, unless the filing thereof is suspended as herein provided, shall be filed not later than four months and 15 days following the close of the first calendar or fiscal year in which property is initially received. If any part of the income or principal of a trust previously established is authorized or required to be applied to a charitable purpose at the time this article takes effect, the first report shall be filed at the close of the calendar or fiscal year in which it was registered with the Attorney General or not later than four months and 15 days following the close of the calendar or fiscal period.

(e) Every charitable corporation, unincorporated association, and trustee required to file reports with the Attorney General pursuant to this section that receives or accrues in any fiscal year gross revenue of two million dollars ($2,000,000) or more, exclusive of grants from, and contracts for services with, governmental entities
for which the governmental entity requires an accounting of the funds received, shall do the following:

(1) Prepare annual financial statements using generally accepted accounting principles that are audited by an independent certified public accountant in conformity with generally accepted auditing standards. For any nonaudit services performed by the firm conducting the audit, the firm and its individual auditors shall adhere to the standards for auditor independence set forth in the latest revision of the Government Auditing Standards, issued by the Comptroller General of the United States (the Yellow Book). The Attorney General may, by regulation, prescribe standards for auditor independence in the performance of nonaudit services, including standards different from those set forth in the Yellow Book. If a charitable corporation or unincorporated association that is required to prepare an annual financial statement pursuant to this subdivision is under the control of another organization, the controlling organization may prepare a consolidated financial statement. The audited financial statements shall be available for inspection by the Attorney General and by members of the public no later than nine months after the close of the fiscal year to which the statements relate. A charity shall make its annual audited financial statements available to the public in the same manner that is prescribed for IRS Form 990 by the latest revision of Section 6104 (d) of the Internal Revenue Code and associated regulations.

(2) If it is a corporation, have an audit committee appointed by the board of directors. The audit committee may include persons who are not members of the board of directors, but the member or members of the audit committee shall not include any members of the staff, including the president or chief executive officer and the treasurer or chief financial officer. If the corporation has a finance committee, it must be separate from the audit committee. Members of the finance committee may serve on the audit committee; however, the chairperson of the audit committee may not be a member of the finance committee and members of the finance committee shall constitute less than one-half of the membership of the audit committee. Members of the audit committee shall not receive any compensation from the corporation in excess of the compensation, if any, received by members of the board of directors for service on the board and shall not have a material financial interest in any entity doing business with the corporation. Subject to the supervision of the board of directors, the audit committee shall be responsible for recommending to the board of directors the retention and termination of the independent auditor and may negotiate the independent auditor's compensation, on behalf of the board of directors. The audit committee shall confer with the auditor to satisfy its members that the financial affairs of the corporation are in order, shall review and determine whether to accept the audit, shall assure that any nonaudit services performed by the auditing firm conform with standards for auditor independence referred to in paragraph (1), and shall approve performance of nonaudit services by the auditing firm. If the charitable corporation that is required to have an audit committee pursuant to this subdivision is under the control of another corporation, the audit committee may be part of the board of directors of the controlling corporation.

(f) If, independent of the audit requirement set forth in paragraph (1) of subdivision (e), a charitable corporation, unincorporated association, or trustee required to file reports with
the Attorney General pursuant to this section prepares financial statements that are audited by a certified public accountant, the audited financial statements shall be available for inspection by the Attorney General and shall be made available to members of the public in conformity with paragraph (l) of subdivision (e).

(g) The board of directors of a charitable corporation or unincorporated association, or an authorized committee of the board, and the trustee or trustees of a charitable trust shall review and approve the compensation, including benefits, of the president or chief executive officer and the treasurer or chief financial officer to assure that it is just and reasonable. This review and approval shall occur initially upon the hiring of the officer, whenever the term of employment, if any, of the officer is renewed or extended, and whenever the officer's compensation is modified. Separate review and approval shall not be required if a modification of compensation extends to substantially all employees. If a charitable corporation is affiliated with other charitable corporations, the requirements of this section shall be satisfied if review and approval is obtained from the board, or an authorized committee of the board, of the charitable corporation that makes retention and compensation decisions regarding a particular individual.

12586.1. In addition to a registration fee, a charitable corporation or trustee, commercial fundraiser, fundraising counsel, or coventurer may be assessed a late fee or an additional fee of twenty-five dollars ($25) for each month or part of the month after the date on which the registration statement and financial report were due to be filed or after the period of extension granted for the filing if the charitable corporation or trustee, commercial fundraiser, fundraising counsel, or coventurer does any of the following:

(a) Exists and operates in California without being registered.

(b) Solicits contributions in California without being registered or, if applicable, bonded.

(c) Fails to file its first report no later than four months and 15 days following the close of each calendar or fiscal year and has not requested an extension of time to file the annual report.

(d) Fails to file its subsequent annual report no later than four months and 15 days following the close of each calendar or fiscal year subsequent to the filing of the first report and has not requested an extension of time to file the annual report.

(e) Fails to file its annual registration/renewal form within the time specified by the Attorney General irrespective of other report filing requirements.

(f) Fails to correct the deficiencies in its registration or annual report within 10 days of receipt of written notice of those deficiencies.

12586.2. All fines, penalties, attorney's fees, if any, as authorized by law, and costs of investigation paid to the Attorney General pursuant to Section 12598 shall be used by the Department of Justice solely for the administration of the Attorney General's charitable trust enforcement responsibilities.
18501. This part may be cited as the Uniform Prudent Management of
Institutional Funds Act.

18502. As used in this part, the following terms shall have the
following meanings:
   (a) "Charitable purpose" means the relief of poverty, the
advancement of education or religion, the promotion of health, the
promotion of a governmental purpose, or any other purpose the
achievement of which is beneficial to the community.
   (b) "Endowment fund" means an institutional fund or part thereof
that, under the terms of a gift instrument, is not wholly expendable
by the institution on a current basis. The term does not include
assets that an institution designates as an endowment fund for its
own use.
   (c) "Gift instrument" means a record or records, including an
institutional solicitation, under which property is granted to,
transferred to, or held by an institution as an institutional fund.
   (d) "Institution" means any of the following:
      (1) A person, other than an individual, organized and operated
exclusively for charitable purposes.
      (2) A government or governmental subdivision, agency, or
instrumentality, to the extent that it holds funds exclusively for a
charitable purpose.
      (3) A trust that had both charitable and noncharitable interests,
after all noncharitable interests have terminated.
   (e) "Institutional fund" means a fund held by an institution
exclusively for charitable purposes. The term does not include any of
the following:
      (1) Program-related assets.
      (2) A fund held for an institution by a trustee that is not an
institution.
      (3) A fund in which a beneficiary that is not an institution has
an interest, other than an interest that could arise upon violation
or failure of the purposes of the fund.
   (f) "Person" means an individual, corporation, business trust,
estate, trust, partnership, limited liability company, association,
joint venture, public corporation, government or governmental
subdivision, agency, or instrumentality, or any other legal or
commercial entity.
   (g) "Program-related asset" means an asset held by an institution
primarily to accomplish a charitable purpose of the institution and
not primarily for investment.
   (h) "Record" means information that is inscribed on a tangible
medium or that is stored in an electronic or other medium and is
retrievable in perceivable form.

18503. (a) Subject to the intent of a donor expressed in a gift
instrument, an institution, in managing and investing an
institutional fund, shall consider the charitable purposes of the
institution and the purposes of the institutional fund.
   (b) In addition to complying with the duty of loyalty imposed by
law other than this part, each person responsible for managing and
investing an institutional fund shall manage and invest the fund in
good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

(c) In managing and investing an institutional fund, an institution is subject to both of the following:

(1) It may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution.

(2) It shall make a reasonable effort to verify facts relevant to the management and investment of the fund.

(d) An institution may pool two or more institutional funds for purposes of management and investment.

(e) Except as otherwise provided by a gift instrument, the following rules apply:

(1) In managing and investing an institutional fund, all of the following factors, if relevant, must be considered:

(A) General economic conditions.

(B) The possible effect of inflation or deflation.

(C) The expected tax consequences, if any, of investment decisions or strategies.

(D) The role that each investment or course of action plays within the overall investment portfolio of the fund.

(E) The expected total return from income and the appreciation of investments.

(F) Other resources of the institution.

(G) The needs of the institution and the fund to make distributions and to preserve capital.

(H) An asset's special relationship or special value, if any, to the charitable purposes of the institution.

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

(3) Except as otherwise provided by law other than this part, an institution may invest in any kind of property or type of investment consistent with this section.

(4) An institution shall diversify the investments of an institutional fund unless the institution reasonably determines that, because of special circumstances, the purposes of the fund are better served without diversification.

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

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

(f) Nothing in this section alters the duties and liabilities of a director of a nonprofit public benefit corporation under Section 5240 of the Corporations Code.

18504. (a) Subject to the intent of a donor expressed in the gift instrument, an institution may appropriate for expenditure or
accumulate so much of an endowment fund as the institution determines is prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in the gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, all of the following factors:

(1) The duration and preservation of the endowment fund.
(2) The purposes of the institution and the endowment fund.
(3) General economic conditions.
(4) The possible effect of inflation or deflation.
(5) The expected total return from income and the appreciation of investments.
(6) Other resources of the institution.
(7) The investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subdivision (a), a gift instrument must specifically state the limitation.

c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only "income," "interest," "dividends," or "rents, issues, or profits," or "to preserve the principal intact," or words of similar import have both of the following effects:

(1) To create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund.
(2) To not otherwise limit the authority to appropriate for expenditure or accumulate under subdivision (a).

(d) The appropriation for expenditure in any year of an amount greater than 7 percent of the fair market value of an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure is made, creates a rebuttable presumption of imprudence. For an endowment fund in existence for fewer than three years, the fair market value of the endowment fund shall be calculated for the period the endowment fund has been in existence. This subdivision does not do any of the following:

(1) Apply to an appropriation for expenditure permitted under law other than this part or by the gift instrument.
(2) Apply to a private or public postsecondary educational institution, or to a campus foundation established by and operated under the auspices of such an educational institution.
(3) Create a presumption of prudence for an appropriation for expenditure of an amount less than or equal to 7 percent of the fair market value of the endowment fund.

18505. (a) Subject to any specific limitation set forth in a gift instrument or in law other than this part, an institution may delegate to an external agent the management and investment of an institutional fund to the extent that an institution could prudently delegate under the circumstances. An institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, in all of the following:
(1) Selecting an agent.
(2) Establishing the scope and terms of the delegation, consistent with the purposes of the institution and the institutional fund.
(3) Periodically reviewing the agent's actions in order to monitor the agent's performance and compliance with the scope and terms of the delegation.
(b) In performing a delegated function, an agent owes a duty to the institution to exercise reasonable care to comply with the scope and terms of the delegation.
(c) An institution that complies with subdivision (a) is not liable for the decisions or actions of an agent to which the function was delegated except to the extent a trustee would be liable for those actions or decisions under Sections 16052 and 16401.
(d) By accepting delegation of a management or investment function from an institution that is subject to the laws of this state, an agent submits to the jurisdiction of the courts of this state in all proceedings arising from or related to the delegation or the performance of the delegated function.
(e) An institution may delegate management and investment functions to its committees, officers, or employees as authorized by law of this state other than this part.

18506. (a) If the donor consents in a record, an institution may release or modify, in whole or in part, a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.
(b) The court, upon application of an institution, may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution shall notify the Attorney General of the application, and the Attorney General must be given an opportunity to be heard. To the extent practicable, any modification must be made in accordance with the donor's probable intention.
(c) If a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, the court, upon application of an institution, may modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument. The institution shall notify the Attorney General of the application, and the Attorney General must be given an opportunity to be heard.
(d) If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of an institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution, 60 days after notification to the Attorney General and to the donor at the donor's last known address in the records of the institution, may release or modify the restriction, in whole or part, if all of the following apply:
(1) The institutional fund subject to the restriction has a total value of less than one hundred thousand dollars ($100,000).
(2) More than 20 years have elapsed since the fund was
(3) The institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument. An institution that releases or modifies a restriction under this subdivision may, if appropriate circumstances arise thereafter, use the property in accordance with the restriction notwithstanding its release or modification, and that use is deemed to satisfy the consistency requirement of this paragraph.

18507. Compliance with this part is determined in light of the facts and circumstances existing at the time a decision is made or action is taken, and not by hindsight.

18508. This part applies to institutional funds existing on or established after January 1, 2009. As applied to institutional funds existing on January 1, 2009, this part governs only decisions made or actions taken on or after that date.

18509. This part modifies, limits, and supersedes the Electronic Signatures in Global and National Commerce Act (15 U.S.C. Sec. 7001 et seq.), but does not modify, limit, or supersede Section 101 of that act (15 U.S.C. Sec. 7001(a)), or authorize electronic delivery of any of the notices described in Section 103 of that act (15 U.S.C. Sec. 7003(b)).
Private Foundations and the Protection of Assets
by Marcus S. Owens and Nancy Ortmeyer Kuhn

Date: May 5, 2009

Marcus S. Owens and Nancy Ortmeyer Kuhn examine the difficult and potentially fatal situations for charities that invested with firms involved in recent investment scandals.

Marcus S. Owens and Nancy Ortmeyer Kuhn are attorneys with Caplin & Drysdale Chartered, Washington.

* * * * *

Mr. Ponzi has given me assurance that his promises to pay are good. I believe him.


Events of the recent past, including the Foundation for New Era Philanthropy,¹ the Madoff investment scandal, and the just-emerging situations involving the Stanford Financial Group and the Walsh and Greenwood investment entities,² raise difficult and potentially fatal situations for charities who invested with those firms. Those scandals should also trigger a moment of reflection in the minds of directors, trustees, and managers of all private foundations. This is because private foundations, unlike public charities or other types of exempt organizations, are subject to a stringent, restrictive set of excise taxes that are the result of scandals a half-century old. One such tax is section 4944,³ the tax imposed on a private foundation's investments that jeopardize the foundation's charitable purpose. This excise tax is 10 percent⁴ of the amount of the investment and is paid by the private foundation. There is an additional 10 percent⁵ excise tax on the foundation manager if that manager knew the investment would jeopardize the foundation's ability to carry out its exempt purpose, unless the participation is not willful and is due to reasonable cause. The manager's tax is capped at $10,000 for the first-tier tax. The second-tier taxes for the foundation and its managers are imposed if the investment is not removed from jeopardy within the taxable period. Those excise taxes are 25 percent of the investment paid by the foundation and 5 percent of the investment paid by the manager, with the manager's second-tier tax capped at $20,000 for each investment.⁶ The tax period begins with the date the investment was made and ends on the date the notice of deficiency is issued or excise taxes assessed. Unfortunately, the preceding description of the mechanical application of the law fails to adequately grapple with the reality faced by those foundation officials who awake to the immediacy of financial fraud.

The most important issue that arises is whether private foundations have invested in such a way that jeopardizes their ability to carry out their charitable purposes. Certainly, in retrospect and in a very objective way, that is true regarding many that entrusted funds to Bernard Madoff. However, the test for purposes of the federal excise tax is whether at the time of the initial investment or at the dates of any subsequent investments, the foundation's investment decisions were sufficiently reckless to jeopardize the organization's assets and its ability to carry on its exempt purpose. Also, both private foundations and public charities must meet the fiduciary duty of care standard, which is enforced by state attorneys general. The decision on whether that standard is met requires a facts and circumstances determination of whether adequate due diligence was performed at the time of the investments, and whether adequate
monitoring of the investments occurred -- the same facts that will shield foundation officials from potential liability under federal excise tax.

As previously stated, most states have empowered their attorneys general to oversee charitable trusts and corporations, and to ensure that charitable assets are protected. To that end, the Revised Model Nonprofit Corporation Act recommends that states, to protect the public interest, adopt generally accepted standards of conduct for nonprofit directors and officers. These recommended standards include the duty of care, the duty of loyalty, and the duty of obedience. Also, fiduciaries to a nonprofit must exercise due diligence and active oversight, even if the fiduciaries are volunteer board members with limited time. Although most states do not have the staffing to vigorously enforce these fiduciary standards, there appears to be a trend toward more interest in enforcement, particularly in California, New York, and Massachusetts.

The Headlines Aren't Good -- What Can Be Done?

Each foundation that awakes to financial news that some of its investments have collapsed needs to retain documentation detailing the procedures that were followed in deciding to make those investments, and the continuing procedures it used in its decisions to increase or alter its investments. If questioned by the IRS or a state attorney general, the foundation managers will need to show that, when they made the investment, they exercised ordinary business care and prudence in providing for the long- and short-term financial needs of the foundation. The IRS or states attorney general will then apply the previously mentioned facts and circumstances test to the actions of the manager(s). The factors that will be considered in this facts and circumstances test, as listed in the Treasury regulations, include whether the foundation managers took into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio regarding the type of security, type of industry, maturity of the company invested in, the degree of risk, and the potential for return. Particular scrutiny will be given to securities traded on margin, any trading in commodity futures, investments in working interests in oil and gas wells, the purchase of puts and calls, straddles, the purchase of warrants, and selling short. Generally, reliance on the written advice of counsel will satisfy the business care and prudence test. In that case the foundation manager tax would not apply to the manager, assuming all material facts were disclosed to legal counsel. However, the jeopardizing investment excise tax against the private foundation could still be applicable.

If the foundation is able to document that ordinary business care was exercised when the investment was made and that the investment did not jeopardize the foundation's ability to carry on its charitable activities, the regulations verify that "the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of the investment, the foundation subsequently realizes a loss." Any time the terms of the investment are changed, a new investment will be deemed to have been entered into and the ordinary business care and prudence test will need to be met regarding that new investment date as well. Any investments that are gratuitously transferred or acquired by the foundation are not subject to the jeopardizing investment excise tax, unless the investments are altered in any way after the acquisition.

For many private foundations, this factual determination will depend on the types of investments that were made. Many investors invested in other hedge funds, which then invested with Madoff. The blogs, e-mails, and general chatter on the Internet indicate that statements received reflecting the Madoff investments were sketchy, at best. There were other warnings as well. An article in Barron's in 2001 reported the following:

What Madoff told us was, "If you invest with me, you must never tell anyone that you're invested with me. It's no one's business what goes on here," says an investment manager who took over a
pool of assets that included an investment in a Madoff fund. "When he couldn't explain how they were up or down in a particular month," he added, "I pulled the money out."10

The Securities and Exchange Commission's complaint, filed on December 11, 2008, in federal court in Manhattan, alleges that Madoff and Bernard L. Madoff Investment Securities LLC have committed a $50 billion fraud and violated a variety of provisions in the Securities Acts. The complaint alleges that Madoff, just before the filing of the complaint, informed two senior employees that his investment advisory business was a fraud. Madoff told those employees that he was "finished," that he had "absolutely nothing," that "it's all just one big lie," and that it was "basically, a giant Ponzi scheme."11

Even where foundations did not invest directly with Madoff, a factor to consider is whether the investments were monitored appropriately and whether the private foundation managers understood the statements and the foundation's investments. It may be that as long as the "too good to be true" annual returns on their investments remained solid, there was little concern with how those returns were managed by Madoff in a market that was increasingly volatile. Will those managers be able to meet the business judgment test? It depends on the scope of the investments made, the contemporaneous documentation retained by the foundation illustrating any due diligence engaged in by the foundation, the diversification of investment policies of the foundation, and the amounts at issue. For those managers who invested all, or almost all, of the foundation's assets in one investment fund, even if that fund is diversified internally, that may be a difficult test to meet.12 The financial statements received by the private foundation will also need to bear scrutiny and provide reasonably diligent explanations regarding the investments, the return on investment, the diversification of assets within the fund, and other information that would help support the fiduciary standards imposed on foundation managers, even if that information ultimately is determined to be false.

Applying the business judgment test in the context of investments with Stanford International Bank, private foundations may have considered the certificates of deposits to be a safer investment than the stock market. However, new allegations by the SEC indicate that was not so. The investment advisers used by Stanford investors allegedly were handpicked by Mr. Stanford and not independent advisers.13 Although the facts are still being revealed, any investments with a Stanford entity may also result in substantial losses for the investors.

Carolyn Weiss, Healthcare Foundation of New Jersey's CFO, is one executive who did perform extensive due diligence and avoided the Madoff investments. Her organization had no exposure as a result of the Madoff scandal. In an interview with The New Jersey Jewish News, she said that she looks for a specific form filed with the SEC known as SEC form ADV. She reported that some of the information included on that form would have tipped off careful investors. According to Weiss, Madoff did not always file the SEC form, which is another red flag. She said, "There's a lot of information out there; you've got to read it."14 The question for the IRS is whether this heightened level of due diligence is necessary to meet the standard required in the code and accompanying regulations.

Daniel E. Smith of Benefit Technology Inc. has put together an interesting compilation of information for Nicholas Kristof of The New York Times, providing a preliminary list of the foundations that have ties to Madoff. Smith also lists information from a variety of sources, including the foundations' Forms 990-PF.15 Many of the Forms 990-PF reflected substantial rates of return on the Madoff investments, even though reporting occurred during a difficult economic environment. However, is that enough of a red flag to cause a manager, exercising reasonable business judgment, to start asking questions and demanding answers and/or his money?

Few tracks exist regarding enforcement of section 4944: There are few court cases, revenue rulings, or private letter rulings that are even slightly relevant to this situation, perhaps because of the historic conservative investment strategies of many foundations. However, in Thorne v. Commissioner, 99 T.C.
67 (1992), the Tax Court reviewed the IRS's determination that Thorne was liable for the second-tier foundation manager tax because he had not removed the jeopardizing investment from jeopardy. The court ultimately found that he was not liable for the excise tax because he did not receive a notice or request to remove the jeopardizing investment, thus there was no "refusal to correct." Also, the court found a split burden of proof, in which the foundation must prove by a preponderance of the evidence error in the IRS's deficiency determination of the excise tax imposed for a jeopardy investment.

However, the commissioner must prove knowing, willful, or fraudulent conduct by clear and convincing evidence for purposes of the excise tax imposed on the manager(s). For purposes of this opinion, the court assumed that the foundation at issue was liable for the section 4944 excise tax. The foundation had invested all of its assets in a Bahamian bank which, unknown to the manager, had lost its business license many years earlier. The manager relied on the verbal advice of a tax adviser and did not verify the bona fides of the bank. The court did not indicate the presence of any contemporaneous written records exhibiting due diligence. Thus, the court relied on a technicality to absolve the foundation manager of liability under section 4944, while finding that Thorne was liable for penalties under section 6684 for conduct that was willful and flagrant regarding excise taxes imposed under section 4945 for taxable expenditures.

In recent testimony before the Senate Finance Committee, IRS Commissioner Douglas Shulman noted during the question and answer session that "[Section 4944] is a tool that is available to us that we certainly will consider" in deciding whether the IRS will take steps to impose taxes on board members of private foundations which invested in Ponzi schemes.

As indicated in Thorne, section 6684 provides another penalty the IRS could use to exact additional amounts from the foundation managers and/or private foundations. In any situation in which a taxpayer becomes liable, in part, for a private foundation excise tax by reason of any act or failure to act that is not due to reasonable cause, the person "shall be liable for a penalty equal to the amount" of the excise tax. Thus, if the IRS concludes that a private foundation made jeopardizing investments and the conduct was willful and flagrant, this penalty tax will act to double the taxpayer's liability.

The recent private letter rulings that have been issued interpreting the jeopardizing investment excise tax deal largely with whether it will apply when one private foundation transfers assets to another private foundation. While the IRS, as a standard procedural matter, reviews a foundation's compliance with all the private foundation excise taxes in each examination, greater scrutiny may be in the offing. Congress recently passed legislation doubling the first-tier excise tax on the foundation from 5 percent to 10 percent, and remarks by a Senate Finance Committee staffer indicate that there is concern from Finance Committee ranking minority member Chuck Grassley, R-Iowa, and others on the Finance Committee that these rules need to be enforced. The minority tax counsel on the Finance Committee, Theresa Pattara, spoke with The Chronicle of Philanthropy recently and said:

I'd be curious to know if any of those foundations considered the impact of [section] 4944 before they made those investments. It would be fair to ask for board minutes, the thought processes, and the decision making they went through before putting all their money at risk.

Her boss, Senator Grassley, has said private foundation excise taxes should be extended to public charities: "Better transparency of investments might help to prevent this kind of mess in the future. It may be time to re-examine that reform." Whether and how the IRS might respond to the reports of foundation investments in Madoff and similar Ponzi schemes is unknown. Equally unknown are important details of the foundation fiduciaries' actions in making the investments. A final unknown is the extent to which the failed SEC review of Madoff will be a factor in any IRS or state attorney general review. Foundations pointing to the abortive SEC investigation should be prepared to
demonstrate contemporaneous knowledge of the investigation and its conclusions before making investment decisions, an unlikely fact pattern given the date and circumstances of the SEC review. Nevertheless, if reasonable due diligence was conducted it would seem that a good case could be made that reasonable care and prudence was exercised by the private foundations and their managers. However, there is always the possibility that the IRS will assert those excise taxes in the coming years as part of future examinations. Any private foundation or charitable trust with investments which incurs significant losses should proactively gather the documentation that is needed to show that ordinary business care and prudence was exercised. Clearly, the unfortunate experience of those foundations that did invest with Madoff underscores the need for all foundations and charities to undertake and document due diligence regarding current and future investments.

On April 8–9, 2009, the Bernard L. Madoff Investment Securities (BLMIS) bankruptcy trustee, Irving Picard, filed two largely identical suits in Federal Bankruptcy Court in the Southern District of New York, in an attempt to "clawback" $150 million that was paid to Banque Jacob Safra (Gibraltar) for the investor Vizcaya Partners Limited located in the British Virgin Islands. Vizcaya Partners, through Safra, invested more than $327 million with BLMIS starting in January 2002. On October 31, 2008, BLMIS wired $150 million to Safra, apparently for the benefit of Vizcaya. Since the October 31 date is within the 90-day period before the bankruptcy filing date, that is, the preference period, the Trustee can file suit to try and "claw back" the funds into the bankruptcy estate, to be shared ratably by all general unsecured creditors. However, Vizcaya Partners may be able to argue that the payment was "in the ordinary course of business," a defense allowed under section 547 of the Bankruptcy Code. There may be other defenses available to Vizcaya as well, depending on the facts of the situation.

An issue for any private foundation with Madoff investments is whether the foundation is at risk for a similar clawback action. Each private foundation with such an investment will need to analyze any payments it received from BLMIS in the days preceding Madoff’s collapse. Relevant questions to review include whether any payments from BLMIS were made during the 90-day preference period (one year if the payment is to an "insider"). If so, then the private foundation investor may be at risk for involvement in a clawback suit, and ultimately be required to either voluntarily pay back some or all of those payments, or defend against the allegations. The Bankruptcy Code generally allows the Trustee two years from the date the bankruptcy petition was filed to bring a clawback, or avoidance, claim. In the event any payments were made "in the ordinary course of business" the foundation may have a valid defense. Another tool for the bankruptcy trustee is to bring an action for the avoidance of fraudulent transfers. In New York, the statute of limitations usually permits fraudulent transfer suits until six years after the transfer took place. Both New York state law and the Bankruptcy Code specify that a transfer made with actual or constructive intent to hinder, delay or defraud creditors is a fraudulent transfer that may be set aside. In addition, fraudulent transfer claims may attempt to claw back both false profits and a return of the principal investment, in certain circumstances. A good faith defense may be available to certain investors, generally those who are not the initial transferees. We note that in the 1995 collapse of New Era Philanthropy, all those who received cash payments just before the collapse agreed to share some of their proceeds with other victims. Many of the investors in New Era Philanthropy were public charities or private foundations. The settlement was presumably accomplished in order to avoid litigation.

To the extent that a private foundation has any capital gains for tax year 2008 that would otherwise be subject to the section 4940 excise tax on investment income, the private foundation may offset those capital gains with any capital losses suffered as result of their Madoff investments. However, those capital losses may not be used to offset gross investment income, nor may the capital losses be used to offset capital gains in prior or future tax years. There is no provision in the statute or Treasury regulations relating to the allowance of a theft loss as an offset to the section 4940 excise tax, and there is no indication that the IRS will issue guidance on the topic. However, given the dire situation in which the Madoff investments have left some private foundations, it may be beneficial to seek a private ruling if the
private foundation has ordinary investment income in 2008 that could theoretically be offset by a theft loss under the more general rules set forth in section 165 for business and personal losses. Also, if the private foundation now believes it overated its net investment income in prior years resulting in section 4940 excise taxes, there may be an opportunity to claim refunds for those amounts paid on "phantom" investment income. Foundations should consult counsel with expertise in private foundation excise taxes before making decisions in reaction to failed or underperforming investments.

Fittingly, the Madoff Family Foundation, Bernard Madoff, president, reported on its Form 990-PF that on December 31, 2007, the Madoff Family Foundation's assets had a fair market value of $19,125,499 with $19,060,372 invested with B.L. Madoff investments. The Form 990-PF also reported capital gains in the amounts of $1,350,806, $51,099 in 2007 from the "sales" of securities in the B.L. Madoff accounts, and "dividends" in the amount of $719,594. It is doubtful that the president of Madoff Family Foundation will be able to escape the section 4944 excise taxes for jeopardizing the investments of the Madoff Family Foundation, or the section 6684 penalty. It is unknown whether the Madoff Family Foundation received any payments in the latter part of 2008. Curiously, the Mark & Stephanie Madoff Foundation and the Deborah & Andrew Madoff Foundation, both formed by Madoff children, do not appear to have invested any of their foundations' assets with Bernard Madoff.

**FOOTNOTES**

1 The Foundation for New Era Philanthropy, operated by John Bennett, was a notorious Ponzi scheme. The foundation raised more than $500 million from 1,100 donors and embezzled $135 million of that amount. It operated from 1989 until its collapse in 1995.


3 All section references are to the Internal Revenue Code of 1986, as currently amended and in effect.

4 The excise tax is 5 percent for tax years beginning on or before Aug. 17, 2006.

5 The manager's excise tax is 5 percent/$5,000 for tax years beginning on or before Aug. 17, 2006.

6 The second-tier manager's excise tax is capped at $10,000 for each investment for tax years beginning on or before Aug. 17, 2006.


8 Reg. section 53.4944-1(a)(2)(i).

9 Id.


See reg. section 53.4944-1(d), Example 3: "After careful research into how best to diversify [the private foundation's] investments, provide for [the private foundation's] long-term financial needs, and protect against the effects of long-term inflation, [the foundation manager] decides to allocate a portion of investment assets to unimproved real estate." The regulation concludes that the investment will not be classified as a jeopardizing investment; see also TAM 8101007 (Oct. 15, 1980): "The trustee . . . must evaluate an investment in such a manner that makes preservation of the fund the primary consideration. In addition to considering the risk of a particular investment, the trustee, generally, must also distribute the risk of loss by reasonable diversification."


"IRS Considers Taxing Trustees of Funds That Were Victims of Madoff Scam," by Grant Williams, Chronicle of Philanthropy (Mar. 26, 2009).

See LTR 200832029 (May 15, 2008), Doc 2008-17342, 2008 TNT 155-32. The transfer of assets from one private foundation to another private foundation with similar exempt purposes does not constitute an investment that jeopardizes the transferor private foundation's exempt purposes under section 4944.


Id.

Id.

Irving H. Picard, Trustee for SIPA Liquidation v. Vizcaya Partners Limited and Banque Jacob Safra (Gibraltar) Ltd. a.k.a. Bank J. Safra Limited, Complaints 09-01153 (Apr. 8, 2009) and 09-01154 (Apr. 9, 2009), United States Bankruptcy Court Southern District of New York (Manhattan). [NOTE: Complaint 09-01154 appears to be a corrective filing, to prevent Vizcaya from filing counterclaims before repaying the $150 million at issue, pursuant to section 502(d) of the Bankruptcy Code.]

11 U.S.C. section 547. The small body of law on whether investors redeeming from a Ponzi scheme can rely on the section 547 "ordinary course" exception, while not uniform, suggests that an investor/creditor making occasional withdrawals may have difficulty invoking the exception.

N.Y. C.P.L.R. section 213.

See 11 U.S.C. section 548(c); 11. U.S.C. section 550; N.Y. Debt. & Cred. section 272 with regard to the good faith defense.

See 11 U.S.C. section 548(c); 11. U.S.C. section 550; N.Y. Debt. & Cred. section 272 with regard to the good faith defense.
27 Reg. section 53.4940-1(f)(3).

28 Section 4940(c)(3).


UPMIFA: New Law Affects Lawyers Advising
(and Serving on) Charity Boards in California

by
Paul J. Dostart,
Barbara A. Rosen
and
Patrick B. Sternal

California lawyers who advise or serve on boards of California charitable organizations need to know about a new California law affecting those organizations' management of their financial assets. California adopted the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"), codified in California Probate Code ("Prob. Code") §§18501 through 18510 and applicable to funds existing on or established after January 1, 2009. These sections replace the previous incarnation of the law, referred to as UMIFA, that applied to the management and investment of funds prior to January 1, 2009. UPMIFA makes a few simple, but significant, changes to California law regulating the management of endowment funds held by charities. It also provides a standard of care for the management and investment of institutional funds, as well as rules for board delegation of management and investment duties. California lawyers need to know how UPMIFA may affect their clients.

Summary of Three UPMIFA Changes to the Law of Endowments

UPMIFA makes three critical changes to the law regulating endowments: (1) It redefines the term "endowment fund" in perhaps a surprising way; (2) it abandons the long-standing "historical dollar value" regime to accounting for restricted or endowment funds; and (3) UPMIFA establishes a presumptively imprudent level of spending from certain restricted and endowment funds. Other important changes that may have a greater effect on day-to-day operations were also made by UPMIFA and are discussed below.

Redefining Endowment. UPMIFA defines an endowment fund as any institutional fund or part thereof that, "under the terms of a gift instrument, is not wholly expendable by the institution on a current basis" and specifically excludes board-designated or “quasi” endowments from that definition.

Abandonment of "Historic Dollar Value" Standard. The concept of "Historic Dollar Value"
"HDV") is now dead in California. In the "old days" (i.e., prior to January 1, 2009), if a donor gave $1 million with instructions to "spend only the income but hold the principal as endowment" the charity typically identified the HDV gift of $1 million as "endowment" and could spend whatever income became available in excess of that HDV level. That system led to wonderful cash flows during years when high returns were achieved. When a down year came and the value of the corpus of the original gift dropped to, say, $950,000, distributions had to be curtailed. Charities whose monthly expense budgets had built in the returns from higher-earning years were squeezed, especially if the down market occurred later in the fiscal year after distributions had already been made based upon optimistic return assumptions. Could the charity use its budget assumption for the full fiscal year, hoping for a December rally in the market? Even simple cases presented challenging questions: If the $1 million gift fund had shrunk to $950,000, and in the following year the principal earned $60,000, how much was spendable – all $60,000 of the "income," or just the $10,000 in excess of the HDV?

UPMIFA puts those days behind us. Directors and advisors of California charities now have a standard to follow in up years and down. The key to understanding the new standard is to remember that HDV is dead. There will no longer be an all-encompassing focus on the original gift as under the HDV standard. While the new standards seem simple, careful analysis is required.

Establishment of 7% Presumptive Imprudent Standard. As enacted in California, UPMIFA provides that the governing board's appropriation for expenditure in any year of an amount greater than 7 percent of the fair market value of an endowment fund creates a rebuttable presumption of imprudence, but that spending less does not guarantee prudence.

Many Other Important Changes Made by UPMIFA

The new UPMIFA regime provides for diversification and pooling of assets, total return investment, and whole portfolio management, but this must be done on a fund by fund basis. In addition, UPMIFA introduces concepts of prudent investment that supporters suggest will facilitate better returns with less risk.

Three Key UPMIFA Definitions

Prob. Code §18502 provides several definitions to facilitate an understanding of UPMIFA, including the following three key definitions:

Institutional Fund. UPMIFA defines “institutional fund” as a fund held by an institution exclusively for charitable purposes. An institutional fund may also be an endowment, as further
discussed in the definition of endowment, below. The term “institutional fund” does not include: (A) program-related assets; (B) a fund held for an institution by a trustee that is not an institution; or (C) a fund in which a beneficiary that is not an institution has an interest, other than an interest that could arise upon violation or failure of the purposes of the fund. Thus, a bank's trust company that holds and manages assets as trustee for a charitable organization is not holding an institutional fund and UPMIFA does not apply to such funds.

**Gift Instrument.** The term “gift instrument” refers to the document governing property transferred to or held by an institution as an institutional fund.

**Endowment Fund.** UPMIFA defines “endowment fund” as an “institutional fund or part thereof that, under the terms of a gift instrument, is not wholly expendable by the institution on a current basis. The term does not include assets that an institution designates as an endowment fund for its own use.” The key element of this definition is that the fund may not be currently spent in its entirety. Thus, a donor cover letter specifying that a gift not be spent for two years renders that gift an "endowment fund" for those two years. A potential source of confusion arises because some provisions of UPMIFA refer to “endowment funds” whereas other provisions refer to “institutional funds.” The definition of institutional funds omits the timing element for expenditure that is essential to the definition of endowment funds. Thus, not all institutional funds are endowment funds, but all endowment funds are institutional funds. Because of this distinction, it is important to note which of these two terms is being used in a particular sections of UPMIFA.

**Prudent Investment of Institutional Funds under UPMIFA**

**General Standard of Care.** UPMIFA provides a prudent person standard for the management of institutional funds (a term that, as noted above, includes all endowment funds held by an "institution"). Under UPMIFA, each person responsible for managing and investing an institutional fund shall manage and invest the fund in good faith and with the care an ordinarily prudent person in a like position would exercise under similar circumstances.

**UPMIFA Factors to Be Considered in Management of Institutional Funds.** In managing and investing an institutional fund, an institution is subject to both of the following limitations: (1) It may incur only costs that are appropriate and reasonable in relation to the assets, the purposes of the institution, and the skills available to the institution; and (2) It shall make a reasonable effort to verify facts relevant to the management and investment of the fund. UPMIFA expressly permits an institution to pool two or more institutional funds for purposes of management and investment.
Except as otherwise provided by a gift instrument, an institution managing institutional funds must also consider each of the following factors to the extent applicable:

(A) General economic conditions.
(B) The possible effect of inflation or deflation.
(C) The expected tax consequences, if any, of investment decisions or strategies.
(D) The role that each investment or course of action plays within the overall investment portfolio of the fund.
(E) The expected total return from income and the appreciation of investments.
(F) Other resources of the institution.
(G) The needs of the institution and the fund to make distributions and to preserve capital.
(H) An asset's special relationship or special value, if any, to the charitable purposes of the institution.

Delegation of Investment Management

An institutional may delegate the management and investment of an institutional fund to its committees, officers, employees, or agents, including investment counsel. Alternatively, the institution may, exercising good faith and proper care, contract with independent investment advisers, investment counsel or managers, banks, or trust companies to manage its investments. Consistent with the other provisions of UPMIFA, the applicable gift instrument or applicable law may authorize or require variations from the foregoing.

Release of Restrictions in Gift Instrument Under UPMIFA

The release of restrictions on the use or investment of an institutional fund contained in an applicable gift instrument may be highly attractive to a board of directors seeking complete discretion on the use of the funds on a current basis. UPMIFA permits an institution, with the donor’s written consent, to release in whole or part a restriction imposed by the applicable gift instrument on the use or investment of an institutional fund. A release or modification may not allow a fund to be used for a purpose other than a charitable purpose of the institution.

When donor consent cannot be obtained, upon application of an institution, the superior court may modify a restriction contained in a gift instrument regarding the management or investment of an institutional fund if the restriction has become impracticable or wasteful, if it impairs the management or investment of the fund, or if, because of circumstances not anticipated by the donor, a modification of a restriction will further the purposes of the fund. The institution is required to
notify the Attorney General of the application, and the Attorney General must be given an opportunity to be heard. To the extent practicable, any modification must be made in accordance with the donor’s probable intention. At least one recent pre-UPMIFA case appears to lower the standard of determining what was a "material purpose" as intended by the donor written instrument.ix

Likewise, if a particular charitable purpose or a restriction contained in a gift instrument on the use of an institutional fund becomes unlawful, impracticable, impossible to achieve, or wasteful, and donor consent to a change cannot be obtained, the court may, upon application of an institution, modify the purpose of the fund or the restriction on the use of the fund in a manner consistent with the charitable purposes expressed in the gift instrument.x The institution shall notify the Attorney General of the application, and the Attorney General must be given an opportunity to be heard.xi

There is a similar procedure for modifying some small institutionalized funds. If an institution determines that a restriction contained in a gift instrument on the management, investment, or purpose of a small, long-established institutional fund is unlawful, impracticable, impossible to achieve, or wasteful, the institution may be able in some circumstances to modify the restriction without need to seek court approval.xii To do so, the charity must first deliver 60 days notice to the Attorney General of the intended action, and thereafter release or modify the restriction, in whole or part, provided that:

1. the institutional fund subject to the restriction has a total value of less than $100,000;
2. more than 20 years have elapsed since the fund was established; and
3. the institution uses the property in a manner consistent with the charitable purposes expressed in the gift instrument.xiii

Of course, if the Attorney General has concerns, he or she can seek the agreement of the charity to change or abandon the modification, and if that fails, can commence a court action to enjoin it. Thus, in all types of modification the Attorney General continues to be the protector both of the donor's intent and of the public's interest in charitable funds.

Prudent Distributions from an Endowment under UPMIFA

7 Percent Limitation. UPMIFA contains straightforward provisions governing the spending of "endowment funds" (as defined above). Section 4 of UPMIFA, codified at Cal Prob. Code §18504, reads as follows:

"(a) Subject to the intent of a donor expressed in a gift instrument, an institution may appropriate for expenditure or accumulate so much of an endowment fund as the
institution determines to be prudent for the uses, benefits, purposes, and duration for which the endowment fund is established. Unless stated otherwise in a gift instrument, the assets in an endowment fund are donor-restricted assets until appropriated for expenditure by the institution. In making a determination to appropriate or accumulate, the institution shall act in good faith, with the care that an ordinarily prudent person in a like position would exercise under similar circumstances, and shall consider, if relevant, the following factors:

1. The duration and preservation of the endowment fund.
2. The purposes of the institution and the endowment fund.
3. General economic conditions.
4. The possible effect of inflation or deflation.
5. The expected total return from income and the appreciation of investments.
6. Other resources of the institution.
7. The investment policy of the institution.

(b) To limit the authority to appropriate for expenditure or accumulate under subsection (a), a gift instrument must specifically state the limitation.

(c) Terms in a gift instrument designating a gift as an endowment, or a direction or authorization in the gift instrument to use only “income,” “interest,” “dividends,” or “rents, issues, or profits,” or “to preserve the principal intact,” or words of similar import having both of the following effects:

1. To create an endowment fund of permanent duration unless other language in the gift instrument limits the duration or purpose of the fund.
2. To not otherwise limit the authority to appropriate for expenditure or accumulate under subsection (a).

(d) The appropriation for expenditure in any year of an amount greater than 7 percent of the fair market value an endowment fund, calculated on the basis of market values determined at least quarterly and averaged over a period of not less than three years immediately preceding the year in which the appropriation for expenditure was made, creates a rebuttable presumption of imprudence. For an endowment fund in existence for fewer than three years, the fair market value of the
endowment fund shall be calculated for the period of time the endowment fund has been in existence. This subsection does not do any of the following:

(1) Apply to an appropriation for expenditure permitted under law other than this part or by the gift instrument

(2) Apply to a private or public post-secondary educational institution or to a campus foundation established by and operated under the auspices of such and educational institution.

(3) Create a presumption of prudence for an appropriation for expenditure of an amount less than or equal to 7 percent of the fair market value of the endowment fund."

It is significant that Prob. Code §18504 creates a rebuttable presumption of imprudence if expenditures in one year exceed 7 percent of the average fair market value of the assets of an endowment fund averaged over not less than the three immediately preceding years. The statute applies a rolling average of twelve or more calendar quarters in determining the fair market value of the fund for purposes of calculating the base against which the 7 percent factor is multiplied, thereby providing substantial flexibility for organizations computing average fair market values for this purpose. It appears that an organization may use as many calendar quarters as it deems appropriate, as long as it includes at least the immediately preceding twelve calendar quarters. An institution can rebut the presumption of imprudence if circumstances in a particular year make expenditures above that amount prudent.

Depending on the terms of the endowment agreement, expenditures from an endowment fund may include distributions for charitable purposes and amounts used for the management and administration of the fund, including annual charges for fundraising if appropriate in the circumstances. All costs or fees associated with an endowment fund are factors that prudent decision makers must consider.

**Distributions Above 7 Percent.** Spending above 7 percent in any one year will not necessarily be imprudent. For some endowment funds fluctuating spending rates may be appropriate. It seems logical that in appropriate circumstances an endowment fund might prudently spend little or nothing in some years and more than seven percent in other years. The charity should maintain adequate records during the accumulation period and should document the decision-making process in the high-expenditure year to be able to meet the burden of production associated with the
presumption.

**Distributing Below 7 Percent.** Charities, their managers and their lawyers should be aware of the express statement in Prob. Code § 18504(d)(3) that no presumption of prudence arises for an appropriation for expenditure of an amount less than or equal to 7 percent of the fair market value of the endowment fund. Thus, high costs or fees of investment management could be considered imprudent regardless of whether spending exceeds 7 percent of the fund's value.

**Supremacy of Spending Instructions in Gift Instrument** The expenditure rule of Prob. Code §18504 applies only to the extent that a donor and an institution have not reached some other agreement about spending from an endowment. If a gift instrument sets forth specific requirements for spending, then the charity must comply with those requirements if it has accepted the gift, and if such spending is not otherwise improper under the law. For example, if the gift instrument specifies that "up to Ten Percent of this endowment gift" may be spent each year for a particular charitable project, the charity would only be presumed to be imprudent if it spent over 10 percent of the average three-year value.

However, if the gift instrument uses more general language, for example directing the charity to "hold the fund as an endowment" or "retain principal and spend income," then Prob. Code §18504 provides a rule of construction to guide the charity.

Prob. Code §18504 allows an institution flexibility to maintain appropriate levels of expenditures in time of economic downturn, as well as during year of economic growth. In some years, accumulation rather than spending will be prudent, and in other years an institution may appropriately make expenditures even if a fund has not generated any investment return that year.

In abandoning HDV, UPMIFA no longer restricts spending to amounts above historic dollar value. Under UPMIFA, a charity may spend the amount the charity's board deems prudent after considering the donor's intent that the endowment fund continue permanently (or for some other stated period), the purposes of the fund, and relevant economic factors. UPMIFA encourages charities to establish a spending policy that will look beyond short-term fluctuations in the value of the fund.

**Continuing Conflict Between Probate Code and Corporations Code**

Investment criteria for assets held for investment by a nonprofit public benefit corporation are provided by California Corporations Code (“CCC”) §5240. That section makes clear that the investment criteria specified therein do not apply to the investment of assets that are directly related
to the corporation’s public or charitable programs. Such a provision is consistent with Prob Code § 18502(e)(1). As such, both codes except "exempt-function" assets from the standard of prudence. For example, investment in low-income housing that barely breaks even, but which furthers the charitable purpose of a particular charity is not imprudent, even if ten percent interest rates could be had from Federal Treasury Bonds.

The apparent conflict lies in the omission of the Corporations Code investment standard to specifically adopt a "total portfolio" as opposed to "individual asset" approach to the making of a speculative investment. CCC §5240(b) states that the board of a nonprofit public benefit corporation must observe the following standards: “(1) Avoid speculation, looking instead to the permanent disposition of the funds, considering the probable income, as well as the probable safety, of the corporation’s capital.” and “(2) Comply with additional standards, if any, imposed by the articles, bylaws, or express terms of the instrument or agreement that contributed the assets to the corporation.”

In contrast, UPMIFA states, among other things, that the institution must consider "the role that each investment or course of action plays within the overall investment portfolio of the fund."xii This language indicates that a small percentage of "high-risk" or "alternative" investments might be appropriate in a particular portfolio, but that conclusion is certainly not obvious from the above-quoted language from CCC §5240(b).

In addition, Prob. Code §18503 provides a nonexclusive list of actions that the institution may take with respect to investments.

The language of CCC §5240 provides the basis for the apparent conflict because it acknowledges the applicability of UPMIFA with respect to the investment criteria governing assets held by the corporation, but CCC §5240(e) then continues to state that nothing in UPMIFA “alters the status of governing boards, or the duties and liabilities of directors, under this part.”

**UPMIFA Not Generally Applicable to Nonprofit Mutual Benefit Corporations**

Except in the unusual instance in which a mutual benefit corporation is holding funds for exclusively charitable purposes, UPMIFA will generally not apply to mutual benefit corporations. The investment of assets held by a nonprofit mutual benefit corporation are governed by the general standards of care applicable to the performance of duties by a director, which are found at CCC §7231(a).
Summary and Recommendations

The governing board of a California charity is responsible for establishing and adhering to guidelines for the management and investment of the charity's assets, including any of its institutional funds. Guidelines for institutional funds should include (i) parameters for asset allocation; (ii) procedures for the selection and monitoring of investment managers/advisors; and (iii) the establishment of spending policies, including specific provisions governing the disbursement of funds from endowments, that are consistent with donor limitations. A charity's board typically fulfills these responsibilities by delegation to or with the assistance of a finance committee, an investment committee, and/or an investment sub-committee of a finance committee. All of these responsibilities must be carried out with prudence as described above.

In many ways UPMIFA may be seen as a codification of practices and considerations that many charities have already incorporated in their administration of the investment and management of available financial assets. With the enactment of UPMIFA in California, California charities holding significant "institutional funds" should now review their investment and spending policies to make sure they are consistent with the following:

- The investment considerations specified in UPMIFA are stated in the charity's investment policy and that policy is understood and carried out by the charity’s board and staff. The spending standards and related considerations specified in UPMIFA should be stated in any endowment spending policy.
- Investment advisors should be selected through an appropriate competitive evaluation process, and such designations should be reviewed on an appropriate periodic basis.
- Regular meetings with the charity's investment advisors should be conducted to review and verify underlying facts regarding the activities and results achieved by the investment advisors and the performance of such advisors, as measured against UPMIFA standards, competitive market performance criteria, the commitments made by the advisors, and any specific policies and procedures adopted by the charity. The meetings should also focus on monitoring the actual performance of each investment fund, including a review of any performance evaluations provided by the advisors, to determine whether the investment goals and objectives are being met, and to assure that appropriate action is taken if such goals and objectives are not being met.
consistently, with due regard for overall market conditions, over a reasonable period of time.

- The market value of each invested endowment fund should be determined on at least a quarterly basis and the spending policy controlled to be consistent with the prudence standard.

- In the rare event that a charity distributes more than seven percent from any endowment fund, the policy should provide for documentation of a compelling case to rebut the presumption of imprudence resulting from such presumptively excess spending.

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iii Prob. Code §18508.

iv Prob. Code §§18503 &18505.

v Prob. Code §18502(b).

vi Prob. Code §18503.


x Prob. Code §18506.

xi Id.

xii Id.

xiii Id.

xiv Prob. Code §18503.