CLUB-RELATED FOUNDATIONS

PART THREE IN A SERIES ON CLUB PHILANTHROPY

Concepts, Caveats and Case Studies

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As discussed in the first article in this series, many clubs have established or are beginning to consider establishing a club-related foundation. The impetus for creating a foundation may be a member's interest in making a substantial contribution (and receiving a tax deduction), a desire to garner donations for various worthy purposes, or an interest in pursuing charitable activities that complement the primary mission of the club.

In this third article in *Club Director's* Philanthropy in Clubs series, we take a more in-depth look into foundations, including best practices, mistakes to avoid, and what is involved in successfully managing a foundation. Three case studies highlight what can go wrong and include the key takeaways to be learned from each example.

CLUB-RELATED FOUNDATIONS

Understanding Foundations

A foundation is a nonprofit legal entity just like a private club, but there are important differences. While a club is typically a nonprofit 501(c)(7) organization, a foundation is a nonprofit 501(c)(3) organization, which means that it is a charity. As a charity, the foundation must receive public support and serve the public interest.

Public support means financial contributions—and, the contributions must come from a relatively large number of donors rather than from just a few. It is important to note that public support may be from members, nonmembers or corporations.

Public interest means that the activities and the expenditures of the foundation benefit the public in some way. Any private benefit, such as to the club or its members, must be incidental and insubstantial. For example, a foundation established to preserve an historic building on the National Register, which happens to be owned and occupied by the club, spends money to preserve the infrastructure of the club. The foundation's expenditures are made in furtherance of its IRS-approved mission even though the club and its members benefit incidentally. Any non-incidental or substantial benefit to the club or its members would constitute private inurement, which is prohibited and could cause the foundation to forfeit its tax-exempt status.

Advantages of Establishing a Foundation

The primary advantages of a foundation have to do with the tax deductibility of donations for the donor. Gifts to the foundation during the donor's lifetime are deductible for income tax purposes. Gifts to the foundation after the donor's death are deductible for estate tax purposes if the donor's estate is in excess of $11.58 million (the current exemption level). Also, a foundation can offer certain tax-favored opportunities to donors, such as charitable gift annuities. Because of the tax advantages, donors as a general rule tend to be more inclined to contribute cash, securities and other assets to the foundation as opposed to making those contributions to the club. However, some clubs have decided against establishing a foundation because many of their members have indicated a willingness to support the club with donations for various special needs and projects even though they do not receive a tax deduction for donations made to the club.

Disadvantages of Establishing a Foundation

Though the tax advantages may provide an attractive incentive to prospective donors, the club must weigh the various administrative and regulatory requirements that it must deal with in establishing and maintaining the foundation, which is a separate legal entity that must be conscientiously managed indefinitely. The management responsibility for a foundation can sometimes become cloudy, i.e., who is primarily responsible for managing the foundation? The club general manager? The club controller? The foundation board? Ideally there will be good cooperation but there is turnover with all of these, and this can result in management lapses that can have adverse con-

Best Practices for Club-Related Foundations

- The foundation should have its own board of directors, separate from the club board.
- The foundation must have its own set of books and its own checking account.
- The foundation should have its own legal counsel, not the club's legal counsel.
- The foundation should have regular board meetings with minutes taken.
- The foundation should reimburse the club for any club staff time spent on foundation administrative or other activities.
- The foundation should keep detailed records of all donations and donors and be meticulous in providing accurate tax receipts to donors in conformity with IRS regulations.
- Since fund-raising will likely be the revenue-generating engine for the foundation, it needs to be clearly understood who is responsible for fund-raising on a project-specific basis and on an on-going basis.

Avoiding Mistakes with a Club-Related Foundation: What NOT to Do

- Do not take liberties when spending the foundation's money; every expenditure should be consistent with the IRS-approved mission of the foundation.
- Avoid private inurement in all the foundation's activities and expenditures.
- Never commingle foundation funds with the funds of the club.
- Be very cautious about transferring club assets to the foundation; once in the foundation, the club will not be able to get them back.

Any non-incidental or substantial benefit to the club or its members would constitute private inurement, which is prohibited and could cause the foundation to forfeit its tax-exempt status.

sequences. These factors are important and must be weighed before a decision is made to establish a foundation.

Another consideration will be initial and ongoing costs associated with having a foundation. For example, there will be legal fees associated with setting up the corporation and developing the articles of incorporation and the by-laws, as well as costs associated with annual tax returns and other filings, and the costs of annual audits by a CPA firm. Foundation funds can be used to pay these costs, but they do consume resources that could otherwise be spent on other things.

Case Studies: Things Can Go Wrong with Foundations

Three case studies are presented to illustrate some of the pitfalls of not maintaining strong adherence and oversight to the legal and fiduciary requirements of foundations.

CASE STUDY #1

ABC Club owns and occupies an historic building that was placed on the National Register of Historic Places by the U.S. Department of the Interior. The club's legal counsel submitted Form 1023 to the Internal Revenue Service and received approval for the newly formed ABC Preservation Foundation to engage in restoration of the building's infrastructure. Club members enthusiastically responded to a fund-raising campaign by the foundation, orchestrated by the new club president who told members that they could receive tax deductions for their contributions and the money would be used to remodel the club's casual grill, which was badly in need of an upgrade including new furniture. Even though the club's controller warned the general manager that such a remodel probably would not fit the definition of "infrastructure," the money was raised by the foundation and the remodel was undertaken. The president's view was that "we will never be audited." Unfortunately, the IRS did come knocking and disallowed the expenditure and other transactions that in their view were outside the defined scope of the previously approved Form 1023. The foundation had to spend many thousands of dollars (which it had to borrow from the club) in legal and accounting fees on this matter, which is still on appeal with the IRS.

Key Takeaways:

- It is best to use specialized legal counsel in preparing Form 1023 when applying for tax-exempt status from the IRS.
- Do not assume that your club or a club-related foundation will never be audited.
- In making expenditures of foundation funds, always stay within the bright lines of compliance with the IRS-approved mission.

CASE STUDY #2

XYZ Club's general manager hired a new controller recommended by one of the board members. The controller had many years of experience with a local construction company that had recently gone out of business. The controller knew nothing about club accounting or tax issues, let alone foundations. When the controller asked to attend a seminar about nonprofit organizations, he was not allowed to go because the cost was not in the budget. The controller was hired in December and the club and its XYZ foundation both had November 30 year ends. During January, the controller was scrambling to close the year and get prepared for the audit. Unfortunately, January 31 came and went and the tax receipt letters to the foundation's donors were not issued. Club staff was inundated with phone calls from members and nonmembers regarding their tax receipt letters. In March a notice was received from the state indicating that the foundation was being administratively dissolved because the requisite nonprofit annual registration filings had not been made for the last two years. The controller resigned in April.

Key Takeaways:

- Many financial executives enter the club industry having little or no experience with nonprofit organizations, including clubs and foundations. To set such executives up for success, the club must make sure they are provided the education they need on a continuing basis.
- Compliance with federal, state and local regulations and timely filings are critically important.
- Note that you should be concerned about regulations not only in the state where the foundation is established but also in any state in which you solicit contributions.
- Turnover in key positions in a club can disrupt operations and undermine compliance efforts.

CASE STUDY #3

PDQ Club established the PDQ Art Foundation several years ago. The foundation's board was populated with members who had a strong interest in art but knew little about foundations. The foundation was successful in garnering both contributions of art and cash contributions. Prior to establishing the foundation, the club had received several paintings as donations, a few of which needed restoration. The club's new Finance Chair, upon realizing that the foundation had accumulated thousands of dollars, decided that the money should be spent on restoring the club's art. Her statement was that "this is the reason we set up the art foundation." Against the advice of the general manager and the controller that such an expenditure would constitute private inurement, the club's paintings were restored using art foundation funds. Two years later the IRS performed a routine audit of PDQ Club and during that process became aware of the PDQ Art Foundation. After discovering that there were no minutes to substantiate meetings of the art foundation board, the IRS auditor decided to open a file on the art foundation. The auditor discovered the use of the art foundation funds to restore the club's art and also discovered that the foundation had not fulfilled the commitment it made on its Form 1023 to make its art available for public viewing on a regular basis. The IRS revoked the foundation's exempt status and it was required to divest itself of its assets (mainly artwork) by contributing them to another 501(c)(3) organization.

Key Takeaways:

- Violations of the private inurement prohibition should be taken very seriously.
- Board leadership should adhere to management's guidance, especially when it comes to compliance and tax issues.
- Noncompliance can have significant adverse ramifications.

Foundation Summary Concepts

A club foundation will be more successful if it keeps to these important concepts:

- The primary reason for establishing a foundation is to allow donors to receive a tax deduction for the value of their gifts.
- A foundation is a legal entity and as such must be managed conscientiously over time.
- Establishing and supporting a foundation can represent a major commitment of time and resources for a club and its governance structure.
- Without strong, ongoing support from the club's leadership, it may prove difficult for the foundation to achieve success.
- Compliance is key. Taking on the risks associated with noncompliance can lead to huge legal fees and possibly the loss of the foundation's tax-exempt status along with other adverse ramifications.
- The IRS prohibition against private inurement needs to be taken seriously. The foundation should make sure that expenditures are always made only for things consistent with its IRS-approved mission.
- A foundation is permitted to donate money to other 501(c)(3) organizations, even if their mission is different from that of the foundation.
- In all likelihood, the foundation will eventually come under scrutiny from the IRS and/or other governmental bodies. CD

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