A Legal Guide To Corporate Philanthropy

by David A. Shevlin

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I. Introduction

Why focus on corporate philanthropy? Philanthropic giving from America's business sector is a major and important component of worldwide charitable giving. In August 2005 *The Chronicle of Philanthropy* reported that corporate giving had rebounded after two years of steady decline and that all businesses were increasing their philanthropy as the economy improved.[1] Furthermore, corporate giving is increasingly associated with social responsibility and how shareholders and customers view a business or product line. Finally, corporate giving has been shown to make employees feel more positive about their employer, with attendant workforce retention benefits. Philanthropy is part and parcel of a company's business.

The legal landscape for corporate philanthropy is complex and evolving. This article surveys core legal issues intrinsic to the operation of a corporate philanthropy program. We start with the fundamental question whether to give directly or through a company foundation, or both, and then we focus on governance issues — not just for the foundation but for the company's philanthropic program as a whole. We next focus on how to determine what charitable programs to fund from the company and from the foundation, with an eye on self-dealing prohibitions. Next we focus on the hot and burgeoning area of cause-related marketing. Finally, we focus on two specific areas of corporate philanthropy: employer-related scholarship programs and employer-related disaster relief programs.

II. Direct Giving vs. the Company Foundation

The threshold questions for structuring a corporate philanthropy program include whether to give directly to charities from the company or to form a separate company foundation and, if so, what charitable programs should be funded from each source. The answer is not the same for every company. The following are some considerations:

A. Advantages of the Company Foundation

1. *Allows for Consistent Giving.* Corporate earnings, of course, can and do fluctuate from year to year. Correspondingly, a company may not have the appetite or capacity to budget consistent amounts for philanthropic giving in both good years and bad years. That said, the charitable community supported by, or perhaps reliant on, the company suffers from fluctuations in support. And when the charitable community supported by the company suffers, so can the company's reputation and morale. Further, the company's charitable giving community may expect more help in its own bad years, which may be precisely the same time that the company is also experiencing a reduced capacity to give. Therefore, a company foundation allows for consistent and even giving in the bad years as well. This is particularly true for a company foundation that maintains an endowment. In a year in which the company may lack the resources or capacity to fund at the same level it has done in the past, a previously endowed company foundation can fulfill that role.[2]
2. *Allows for Strategic and Coherent Giving.* A corporate philanthropy program operated in part or in whole through the company foundation can provide a distinct lens and strategy through which the company's charitable giving program can be operated and "branded." In other words,

[1] "Corporate Giving Rebounds," *The Chronicle of Philanthropy* (Aug. 4, 2005).

[2] A cautionary note: This is not to say that a company foundation may relieve the company of its contractual or legal obligations. Later in this article we discuss impermissible transactions and relationships between a company and the company foundation, commonly known as self-dealing.

the company foundation provides a vehicle through which the company's philanthropic activities can sustain their own identity apart from the business itself.

3. *Allows for More Streamlined Processing of Requests for Philanthropic Support.* Company executives who are approached with requests for support from charitable organizations can refer the requests to the company foundation, and the company foundation can process these requests according to foundation guidelines. This provides a diplomatic and organized way to respond to large numbers of requests for philanthropic support from around the company and the community. It also helps the company capture data about the totality of its corporate giving and communicate that feel-good news within and without the company.
4. *Allows for Tax-Efficient Grants to Foreign Charities.* Generally, a U.S. company cannot claim a charitable contribution deduction for a grant to a foreign charity whereas, subject to certain requirements,[3] such deductible grants can be made in a tax-efficient way by a company foundation.
5. *Allows for Employer-Related Scholarship or Disaster-Assistance Programs.* As discussed later in this article, a company foundation can conduct scholarship or disaster-assistance programs for company employees and their children without creating taxable income to the beneficiaries.

B. Advantages of Direct Giving

1. *Administrative Costs.* Direct outright contributions to charitable organizations can minimize expenses and administrative costs that are associated with company foundations, such as staff and accounting costs.
2. *Fiscal Flexibility.* A direct outright donation format affords considerable fiscal flexibility for the company, as it can freely choose how best to make and time a donation in accordance with its goals and income situation during its fiscal year, as circumstances arise and vary.
3. *No Excise Tax Exposure.* Unlike directors of a company foundation, executives of the company (and the company itself) are not subject to private foundation excise taxes, such as the self-dealing excise tax imposed if a grant results in a return benefit to the company that is more than incidental or tenuous.[4]
4. *Supporting Charities That Lobby.* Corporate donations may be made to charities that conduct lobbying as a substantial activity. Private foundations are prohibited from funding or engaging in any lobbying activities.
5. *Corporate Sponsorship.* A company may engage in corporate sponsorships by making qualified sponsorship payments to charitable organizations, which would use or acknowledge the company's name, logo, or product lines. Corporate sponsorship grants may be made by the company foundation, but the self-dealing rules discussed later in this article place strict limits on the benefits the company may receive in return for the foundation's grant.
6. *Satisfaction of Pledges.* Under the self-dealing rules, a private foundation may not satisfy legally binding pledges made by the company. Therefore, the company can make and satisfy its own pledges, or the company foundation can make and satisfy its own pledges. This law sometimes comes as a surprise to company executives (unfortunately often after they have made legally binding pledges).
7. *Cause-Related Marketing.* Cause-related marketing programs, referred to as commercial coventure arrangements under state charitable solicitation statutes, are appropriately operated through the company because of the involvement of the company's products or services.

III. Considerations for Structuring the Governance of a Corporate Philanthropy Program, Including the Company Foundation

A. General

A corporate philanthropy program can be managed and governed with the same discipline as a company's core business activities. In that regard, the following issues merit consideration:

- How should the macro decisions regarding the company's philanthropic strategy and initiatives be made? And how should these decisions be implemented? In other words, under whose supervision should the strategy be executed? Will the advertising or corporate affairs departments supervise?

[3] *See* section 4945(h) of the Internal Revenue Code of 1986 as amended and Treas. reg. section 53.4945-5. Unless otherwise indicated, all section references are to the code. A private foundation that makes a grant to a foreign charitable organization must either exercise expenditure responsibility or make an equivalency determination in order for the grant not to be treated as a taxable expenditure. Section 4945(d)(4)(B). A discussion of the specific expenditure responsibility and equivalency determination procedures and requirements is outside the scope of this article. For further information on these topics, *see Beyond Our Borders: A Guide to Making Grants Outside the U.S.*, John A. Edie and Jane C. Nober, Council on Foundations, 3rd ed. (2002); Victoria B. Bjorklund and Joanna Pressman, *Cross-Border Philanthropy, a Complete Guide to Nonprofit Organizations*, P. Lieber and D. Levy, eds. (2005).

[4] Donations for which a charitable (as opposed to an ordinary and necessary business expense) deduction is sought still need to be analyzed for potential return benefits to the company and for application of percentage limitations that apply.

- What role should the board, officers, and employees of the company play? Who in the legal and accounting groups will participate?
- Will outside advisers with specialized expertise be engaged? Will the company's communications and Web site be used?
- For a company with a national or international presence, to what extent should philanthropic decisions be centralized and decentralized?
- Importantly, if the company has a company foundation, how should the governance of the company foundation be structured and *integrated* with the governance of the company's overall philanthropic program? Stated differently, it should be considered how best to structure the governing body of an entity that is legally distinct from the company and that must operate in furtherance of charitable, educational, and like objectives, but that still meshes with the company's overall philanthropic program or objectives.
- How do recent regulatory developments affect this analysis?

Of course, there is no single correct method or answer to the above questions. However, perhaps a common goal might be stated as the operation of a philanthropic program that is properly managed and supervised to ensure maximum impact, focused and consistent application, and compliance with all legal and regulatory requirements.

1. *Macro-Decisionmaking*

What are the macro-level decisions to be made as part of a corporate philanthropy program? The areas of focus and interest (for example, education or health) for the corporate-giving program and the company foundation are paramount considerations. Another strategic consideration is how to engage the company's employees in the corporate philanthropy program, for example, through volunteerism. Given the various macro-level decisions that require consideration, it is helpful for a company to adopt a coherent philanthropic philosophy, under the supervision of the company's board of directors. Therefore, to set the macro-level policies of the corporate philanthropy program and to oversee the program, a company might form a committee consisting of members of the company's board and company management or select from among existing committees. For a company with a company foundation, the committee should include members of the foundation's board as well.

2. *Day-to-Day Decisionmaking*

Once the macro-level policies and guidelines of the corporate philanthropy program are set, who should make the day-to-day decisions? Many companies have internal corporate affairs departments within which all or most of the company's philanthropic decisions are made (in other words, which organizations to support and in what amounts), including decisions as to what grants should be made through the company and what grants should be *requested to be made* (more on this issue below) through the company foundation. That paradigm can go far toward ensuring the implementation of a consistent and compliant philanthropy program.

However, the model of one central team of decisionmakers is not always feasible or appropriate. This author has encountered two pressure points in particular. First, it may be appropriate for local branches or offices of large national or multinational corporations to be directly involved in grant-making decisions that affect their local communities. Second, corporate executives may wish to have the flexibility to make or recommend some grants in their own discretion. Rather than informing the executive that all decisions must go through one department, what options are there?

We recommend the adoption of written policies and procedures that establish the decision-making authority for the corporate philanthropy program. For example, policies and procedures can clarify what decisions are to be made at headquarters and what decisions can be made locally, including dollar thresholds. Corporate philanthropy policies and procedures can also establish the guidelines and dollar thresholds for discretionary grantmaking by company executives. The policies should delineate how authority is to be delegated (both in regard to direct giving and foundation giving) within specified guidelines. The policies and procedures should also be adopted by the company foundation's board. In particular, the company's policies and procedures might include the following content:

- the areas of permissible grant making (for example K-12 education, housing);
- the maximum dollar amount of grants that can be made under the authority of one individual or officer without further approval;
- standards for public acknowledgment (for example, how the name and logo of the company are to appear and be used);
- restrictions on return benefits (for example, dinner tickets, and the like);
- record-keeping guidelines;
- the policies for reporting to the board of the company and the company.

a. Policies recommended by NASD and the NYSE

Companies that are members of the National Association of Securities Dealers (NASD) or the New York Stock Exchange (NYSE) should note a joint notice issued by the NASD and NYSE in 2006.[5] The notice was issued to address the potential conflicts of interest that arise when customers of these firms solicit substantial charitable contributions from the firms. Interestingly, the notice suggests the adoption of policies and procedures to deal

specifically with charitable giving. In particular, the notice suggests that a member firm's procedures could require appropriate approval for contributions above specific dollar thresholds.

B. Charitable Giving and the Governance of the Company

Under the Sarbanes-Oxley Act of 2002 and the resultant regulatory changes applicable to publicly traded companies, corporate philanthropy can now have a direct impact on the composition of the board of directors of a publicly traded company.[6] In response to the requirements of the Sarbanes-Oxley Act, the Securities and Exchange Commission has adopted rules setting minimum independence standards for directors who serve on audit committees of listed companies, and the NYSE and the NASDAQ each have a set of corporate governance listing standards that include criteria that directors must meet to be considered independent.

1. *Section 301 of Sarbanes-Oxley*

On April 9, 2003, the SEC published final rules under section 301 of the Sarbanes-Oxley Act that prohibit any national securities exchange from listing any security of an issuer that does not have an audit committee composed entirely of independent directors. Under the section 301 rules, for a director to be considered independent, the director must satisfy the following two-prong test:

- ***No compensation***: the director may not receive, directly or indirectly, any consulting, advisory, or other compensatory fee from the issuer or any of its subsidiaries (other than ordinary course directors' fees); and
- ***No affiliation***: the director may not be an affiliated person of the issuer.

Section 301 does not directly address the circumstance in which a director of the company is also a director, officer, or employee of a not-for-profit organization that receives charitable contributions from the company.

2. *New York Stock Exchange Rules*

Under rules adopted by the NYSE in response to the Sarbanes-Oxley Act, a majority of the board of directors of a company listed on the NYSE must be independent directors.[7] Specifically, the board of directors must affirmatively determine that the director has no material relationship with the company (either directly or as a partner, shareholder, or officer of an organization that has a relationship with the company). In that regard, the board must consider the materiality of charitable relationships (in other words, any relationship between a director and a beneficiary of the listed company's charitable contributions). Furthermore, listed companies must disclose in their annual proxy statements any charitable contributions made by the listed company to any charitable organization in which a director serves as an executive officer when those contributions exceed the greater of $1 million or 2 percent of the charitable organization's consolidated gross revenues.[8]

3. *NASD Rules*

Under the rules promulgated by the NASD for listing on the NASDAQ, a majority of the board of a listed company must be independent directors.[9] Specifically, an independent director must not have any relationship that would interfere with the exercise of independent judgment in carrying out the responsibilities of a director. A director is not independent if he serves as an executive officer of a charitable organization to which the company made, or from which the company received, payments that exceed 5 percent of the recipient's annual gross revenues, or $200,000, whichever is greater.[10]

4. *Relevance for Committees of the Company*

The case of *In re Oracle Corp.* is also illustrative.[11] In June 2003 the Delaware Chancery Court held that two directors who were professors at Stanford University did not qualify as independent for purposes of serving on a special litigation committee. The court looked to the significant institutional relationships the directors had with the defendant-directors. In particular, the court focused on charitable contributions made by the defendant-directors to Stanford.[12]

5. *Carryover to State Not-for-Profit Statutes*

One direct way in which the Sarbanes-Oxley Act and the principles of independence reflected in the NYSE and NASD rules are beginning to affect not-for-profit organizations generally is through changes in state statutes governing not-for-profit corporations. For example, under California's Nonprofit Integrity Act of 2004, every charitable corporation registered with the attorney general and with gross revenues of $2 million or more must establish and maintain an audit committee that may not include any members of the organization's staff, including the president or chief executive officer and the treasurer or chief financial officer.[13] In New York, a bill to

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[5] *NASD and NYSE Issue Joint Notice on Charitable Contributions*, Notice to Members 06-21 (Mar. 2006).

[6] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 16 Stat. 745 (2002). A full discussion of the Sarbanes-Oxley Act is outside the scope of this article. For more on how the Sarbanes-Oxley Act has affected the governance structure of not-for-profit organizations, *see Guide to Nonprofit Corporate Governance in the Wake of Sarbanes-Oxley*, American Bar Association Coordinating Committee on Nonprofit Governance (2005), of which the author was a member.

[7] NYSE Listed Company Manual, section 303A.01 (2003).

[8] NYSE Listed Company Manual, section 303A.02 (2003).

[9] NASD Manual, Marketplace Rules 4200(a)(15) (2005) and 4350(c)(1) (2005).

[10] *Id.*

[11] *In re* Oracle Corp., Derivative Litig., 824 A.2d 917 (Del. 2003).

[12] *Id.* at 931-34.

[13] CAL. GOV'T CODE SECTION 12586(e)(2) (2006). For a full discussion of this act, *see* Thomas Silk & Rosemary Fei, "State

(Footnote continued on next page.)

amend the New York Not-for-Profit Corporation Law submitted by that state's former attorney general and now governor would generally require an audit committee.[14] The bill would prohibit members of the audit committee from accepting any consulting, advisory, or other compensatory fee from the not-for-profit corporation or from having participated in any interested-party transactions with the not-for-profit corporation within the previous year. Technically, the relevant provisions of the proposed New York bill and the California law would not disqualify from service on a company foundation's audit committee an individual who is compensated by the company but not by the foundation.

But the transplantation of Sarbanes-Oxley principles into the not-for-profit sector merits careful consideration, particularly given the wide variety in character and purpose of different types of not-for-profit organizations. As explained in the next section below, mandating standards for company foundations that require independence from the company itself is not necessarily appropriate or practical.

C. Governance of the Company Foundation

1. *General*

A critical aspect of the governance and decisionmaking process for a corporate philanthropy program is the governance of the company foundation. As noted earlier, the foundation is a separate legal entity and, unlike the company, must operate solely in furtherance of charitable, educational, or the other exempt purposes set forth in section 501(c)(3). The directors and officers of the foundation have separate fiduciary duties to the foundation itself. Also, as discussed in further detail below, the company foundation must not engage in self-dealing transactions or other activities that result in private benefit to the company (among other parties).

But the company has an important stake in the activities of the foundation. The company is often the exclusive funder of its company foundation. The foundation is licensed by the company to use the company's name, and the foundation may use the administrative resources of the company. Perhaps the issue of the company foundation's governance can be articulated as one of balance — that is, how to balance the need of the foundation to operate as a separate legal identity in accordance to its legal requirements with the need to integrate the foundation into the company's overall philanthropic program.

Again, as discussed above, the company's policies and procedures for its corporate philanthropy program can be a good starting point for the integration of the foundation's programmatic focus with that of the company's overall program. But the composition of the board of the foundation is an important part of achieving the balance articulated above. Among the decision-making considerations in this regard are the following:

- What is the right size for the board of the company foundation?
- How should the board of the company foundation be appointed or elected?
- What should the composition of the board look like? That is, who should be on the board?

2. *Size of the Board.*

Different state not-for-profit statutes address minimum requirements for the size of the board of a not-for-profit corporation.[15] The final report of Independent Sector's Panel on the Nonprofit Sector recommends that a charitable corporation have at least three directors.[16] The appropriate size of the company foundation's board will depend on various factors, including the size of the foundation, the breadth of its activities, and, practically, the availability and willingness of individuals to serve.

3. *Election of the Board of Directors*

How are the directors of the company foundation appointed or elected? The method for electing the directors typically is set forth in a company foundation's bylaws. An entirely self-perpetuating board (in other words, a board whose members elect themselves) is not necessarily ideal. Consider the potential for a foundation's board that originally consists of members who understand and are sensitive to the relationship between the foundation and the company. Over time the composition of the board drifts, causing tensions and rifts with the company, which in this case has no control over the board's composition. We recommend affording the company some degree of institutionalized participation in the election process, if not the right to elect the entire board. Some options include the following:

- Structuring the company foundation as a membership corporation under which the corporation serves as the sole member, with the right to elect (and remove) the directors.
- Adopting two classes of directors, with one class of directors elected by the company and another class self-perpetuating. This option would allow some subset of the board to have a more direct voice in the board's composition. The class elected by the company could constitute at least a majority of the board.

SOX: Explanation of California's Charitable Integrity Act of 2004 (SB 1262)," 46 *Exempt Org. Tax Rev.* 195 (2004).

[14]AG Legis. Program 68-05 B. (N.Y., Feb. 9, 2005), section 8.

[15]By way of example, section 702 of the New York Not-for-Profit Corporation Law requires a minimum of three directors. Section 141(b) of the Delaware General Corporation Law only requires one.

[16]*Panel on the Nonprofit Sector: Strengthening Transparency Governance Accountability of Charitable Orgs.* (2005). The Panel on the Nonprofit Sector was convened by the Independent Sector, a coalition of more than 500 charities in America, and provides a forum for charities, foundations, and corporate giving programs. The final report contains more than 120 recommendations to charities, Congress, and IRS that are aimed at strengthening the transparency, governance, and accountability of the charitable giving sector.

4. *Composition of the Board*

Related to the question of how the board is chosen is, of course, the question of who is chosen. The composition of company foundation boards varies widely. Among those who serve include management of the company, directors of the company, and individuals with no position with the company.

As a starting point, for companies listed on the NYSE or traded over NASDAQ, the appointment of an independent director of the company to the foundation's board could be problematic. Recall that under the standards of the NYSE and NASD rules discussed above, directors of a charitable organization that receive significant funding from the company may not be considered independent. Therefore, the presence of an otherwise independent director of the company on the foundation's board may disqualify that individual as independent.

a. Company Insiders/Outsiders

Should the board of a company foundation include individuals with no relationship to the company? That is a decision for each company to make. Perhaps the heart of this analysis lies in the perceived value of having the participation on the board of one or more individuals with no relationship to the company. The company and the company foundation might appreciate the fresh perspective on the foundation's board of an individual who has no relationship with the company. For many company foundations, that role is often fulfilled by retired executives. The presence of a retired executive can mean the best of both worlds — independence from the company combined with sensitivity to and familiarity with the company.

But blanket rules that, in the company foundation context, would mandate participation on the board of a company foundation by individuals with no relationship to the company, or would limit participation by individuals who are compensated by the company — either as officers, directors, or employees — are not sensible. Given the appropriate and legitimate stakes that the company has in the foundation, as described above, the inclusion of individuals affiliated with the company on the company foundation's board makes good sense; defining the relationship with the company as an inherent institutional conflict does not.

Perhaps the better focus is education. In other words, directors of the company foundation should have a practical understanding of what it means to be a director of a not-for-profit organization exempt from federal income taxation and classified under section 501(c)(3), and the foundation must act solely in furtherance of its exempt purposes. Directors should understand that as directors of the foundation, they possess fiduciary duties that run to the foundation. The discussion below regarding the benefits that the company may and may not derive as a result of the foundation's activities is a critical element of that understanding.

IV. How and When Should the Company Foundation Be Funded?

A. General

As discussed above, consistent giving, even in the tough years, is one of the potential advantages of a company foundation. An endowed company foundation, through the prudent management of its endowment and the application of an appropriate spending policy, can plan for a sustainable long-term future. Of course, the creation of an endowment requires a large infusion from the company, which may or may not be possible. Another alternative is to fund the foundation year to year or from time to time. Arguably, from the company's perspective, funding the foundation that way might make the foundation more accountable to the company, both programmatically and fiscally. The inverse of the advantage for the endowed foundation serves as the principal disadvantage of this approach: the difficulty of planning a long-term philanthropic strategy, and the dependence of the foundation on the company's performance.

The code's limitations on income tax deductions for gifts by corporations are relevant but less likely to be a factor. Under section 170(b)(2), in general, a corporation's total charitable income tax deductions for any tax year may not exceed 10 percent of the corporation's taxable income, regardless of whether gifts are made to public charities or private foundations. However, while corporate giving is an important factor for shareholders concerned with social responsibility, shareholders could question a corporation that approaches or exceeds the 10 percent threshold unless the corporation is formed for social purposes.

B. Gift of Company Stock

1. *Amount of Deduction for Gifts of Company Stock*

Although perhaps unusual, the ability of the company to fund the company foundation with a gift of the company's stock raises interesting questions and issues. If the company funds the foundation with a gift of the company's own stock (commonly referred to as treasury stock), what is the value of the charitable contribution deduction the company is entitled to claim? Assuming the foundation is classified as a private foundation, can the company claim a deduction at fair market value?[17]

When a donor makes a gift of publicly traded stock to a private foundation, the question whether the donor may claim a deduction at fair market value generally centers on the whether the stock is qualified appreciated

[17]If the foundation were classified as a public charity, this would not be an issue, although valuation could be an issue. *See* section 170(e)(1).

stock. Gifts of long-term appreciated property to a private foundation are valued at the *lesser* of the adjusted basis of the property or its fair market value.[18] An exception exists for qualified appreciated stock. Under section 170(e)(5), a donor may deduct a gift of qualified appreciated stock to a private foundation at fair market value.[19] Qualified appreciated stock is stock of any corporation for which, on the contribution date, market quotes are readily available on an established securities market, provided that the sale of stock by the donor would have resulted in long-term capital gain if sold at fair market value.[20]

But in regard to a gift by the company of its own stock, the provisions of the code relating to qualified appreciated stock may not apply. While there does not appear to be authority directly on point, the following analysis may stand for the proposition that a company is entitled to a fair market value deduction for a gift of treasury stock. Section 170(e)(1) and reg. section 1.170A-4(a) generally provide that the amount of any charitable contribution of property will be reduced by the amount of gain that would have been capital gain if the contributed property had been sold at its fair market value. But section 1032(a) provides that no gain or loss will be recognized by a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Because section 1032 prevents the realization of gain, there is no amount of gain by which to reduce the deduction. Since no reduction occurs, the argument would be that the deduction may be claimed for the fair market value.

Support for this analysis can be found in Rev. Rul. 75-348 and 17 private letter rulings that follow or cite it.[21] All of those rulings involve variations on facts in which the company pledges or donates an option to purchase company stock. In several of those rulings, the IRS ruled, along the lines of the reasoning above, that the reduction provisions in section 170(e) are not applicable because of section 1032 and that the measurement of the stock's fair market value is without reduction by reference to section 1032.[22]

It would be helpful to the field if the IRS would issue precedential guidance answering this question once and for all. Doing so would also reduce the administrative burden on the IRS caused by repeated requests for private letter rulings on similar facts.

Another alternative to ensure a fair market value deduction for the company can be found under section 170(b)(1)(F)(ii). Under this provision, if the company foundation expends the company's contribution (and any income earned on it) out of its corpus within two-and-one-half months after the close of the tax year in which the contribution was made, the contribution is eligible for the same treatment as a gift to a public charity (in other words, it is deductible at fair market value).[23]

2. *Determining Fair Market Value*

a. Restrictions on Resale

But, what is fair market value? Assuming the stock donated is a publicly traded security with no restrictions on resale, the fair market value is normally the mean between the high and low bid prices on the date of contribution. But if the gift of stock is accompanied by restrictions on resale, the value of the deduction could be reduced.[24] For various reasons, the company may wish to impose restrictions on the ability of the foundation to resell the company stock donated to the foundation. In particular, the company may wish to impose restrictions on the timing and volume of the foundation's sale of the company's stock.

For example, concerns might exist as to the effect a large sale would have on the sale price of the stock. An additional concern might be the message a large sale of stock by the company foundation would send to the public. Moreover, given the relationship between the foundation and the company, the foundation might be subject to the company's insider trading policies, which permit sales of the company's stock only during defined window periods.

That said, the imposition of those restrictions by the company could have consequences for the value of the deduction, if not the ability to claim the deduction. To claim an income tax deduction in connection with a gift, the gift must constitute a completed gift, in accordance with the Treasury regulations promulgated under section 507 regarding the termination of private foundation status, as well as the guidance issued by the IRS concerning the regulations.[25] To constitute a completed gift, the

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[18]Section 170(e)(1)(B)(ii).

[19]Section 170(e)(5)(B).

[20]Section 170(e)(1)(B)(ii). Qualified appreciated stock does not include contributed stock to the extent that the amount of the stock (together with all prior contributions by the donor) exceeds 10 percent (in value) of all the outstanding stock of the corporation.

[21]Rev. Rul. 75-348, 1975-2 C.B. 75. A private letter ruling may be relied on only by the taxpayers to whom the ruling was issued. Although such rulings do not have precedential authority except for the taxpayers who obtained them, they are instructive of the IRS's views on a particular matter.

[22]*See, for example*, LTR 200202034 (Jan. 1, 2002) and LTR 199915037 (Jan. 12, 1999).

[23]*See* section 4942 for a further explanation of expenditures out of corpus.

[24]Treas. reg. section 1.170A-1(c)(3) states that if a donor makes a charitable contribution of stock when the donor could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is what the gift would have been sold for at the time of the contribution.

[25]Absent other statutory authority, the IRS has analogized to the Treasury regulations in determining when a completed transfer occurs in contexts other than termination of private foundation status. *See, for example*, LTR 200149045 (Aug. 3, 2001) (stating that "while [Treas. reg. section 1.507-2(a)(8)] applies to a specific situation involving a terminating private foundation, the regulation bears in general on the question whether the donee organization exercises dominion and control over an asset so as to be considered its owner").

company must transfer "all of its right, title, and interest in and to all of its net assets" as opposed to imposing a "material restriction or condition that prevents the transferee organization . . . from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes."[26] The Treasury regulations set forth several considerations in this regard. Among the adverse factors is a requirement expressly or impliedly to retain any investment, except as required by law or regulatory authority.

Even if the gift were to qualify as a completed gift, substantial restrictions on resale could affect the fair market value of the gift. If the foundation were bound by the terms of the gift to retain the stock for an extended period, arguably a full fair market value deduction would not be appropriate.

What if the only express limitation were insider trading restrictions? The uncertainty inherent in this question argues for a gift to be timed to coincide with the foundation's ability to freely and fully dispose of the stock. If the foundation chooses not to dispose of all or some of the stock, the foundation's choice should not affect the company's ability to deduct the gift at full fair market value.

b. Filing Requirements

The IRS imposes particular substantiation and information reporting requirements on specific gifts of nonpublicly traded stock or nonpublicly traded securities. Donors of gifts of such property must attach an IRS Form 8283 with their income tax returns. The donor is required to obtain a qualified appraisal for a gift of nonpublicly traded stock or securities that exceeds $5,000 in value.[27] For purposes of Form 8283, nonpublicly traded stock or securities are defined as any stock or securities of a corporation that are not publicly traded securities.[28] Publicly traded securities are defined as securities for which market quotations are readily available on an established securities market.[29]

c. Other Considerations

Other considerations apply to a gift of company stock. Section 4943(a) imposes an excise tax of 10 percent[30] on the value of a private foundation's excess business holdings. A foundation has excess business holdings if it, together with its disqualified persons, own more than 20 percent of the voting stock of a company (35 percent in some circumstances). Under section 4946, a company foundation's disqualified persons would include the company as the foundation's substantial contributor, as well as the directors and officers of the foundation, who may also have a personal stake in the company.[31] On receipt of a gift that results in the foundation, along with its disqualified persons, owning more than 20 percent of the stock of a company, the foundation would be required to dispose of the excess stock within five years to avoid having excess business holdings.[32] A private foundation is not treated as having excess business holdings in any corporation in which it (together with other related private foundations) owns not more than 2 percent of the voting stock and not more than 2 percent of the value of all outstanding shares of all classes of stock.[33]

Finally, if the company funds the company foundation with company stock, the sale of any of that stock by the company foundation back to the company generally will constitute an act of self-dealing under section 4941. An exception this general rule exists if the sale takes place under a liquidation, merger, redemption, recapitalization, or other corporate adjustment or reorganization; the terms of the foundation's sale are the same as the terms of other holders of the same class of stock; and the foundation receives at least fair market value for the stock.[34] This redemption exception is frequently used by company foundations.

If a company pledges stock options to a company foundation and the company foundation exercises the stock options, that will be an act of self-dealing under section 4941 because the company foundation will be paying cash to the company in exchange for the shares of stock. To avoid that situation, the company foundation can grant the stock options (rather than cash) to an unrelated charitable organization, which then can exercise the options.[35]

V. What to Fund Through the Company Foundation and What Not to Fund — Self-Dealing[36]

A. General

Perhaps a main consideration of what programs and charities to fund from the company foundation and what to fund from direct giving is the expected benefits the company desires to receive in return. Section 4941 imposes a penalty excise tax on disqualified persons who engage in prohibited transactions with the company foundation. Prohibited transactions include selling or

[26]Treas. reg. section 1.507-2(a)(8)(i).

[27]Under the Pension Protection Act of 2006 (P.L. 109-280) enacted on August 17, 2006, new standards have been adopted to determine if an appraiser is qualified to issue the appraisal. Furthermore, if the donee disposes of the gift within three years (two years before the adoption of the Pension Protection Act) of receipt from the donor, the donee must file an IRS Form 8282 with its annual information return. IRS Form 8282 will include the consideration received by the donee upon disposal.

[28]Treas. reg. section 1.170A-13(c)(7)(ix) and (x).

[29]Treas. reg. section 1.170A-13(c)(7)(xi)(A).

[30]The Pension Protection Act of 2006 doubled the excise tax penalty rates applicable to public charities, private foundations, and social welfare organizations. The new rates are effective for tax years beginning after August 17, 2006.

[31]Under section 4943(b), an additional tax of 200 percent may be imposed if the situation is not corrected within the allotted time.

[32]Section 4943(c)(6)(A). An extension may be available on application to the secretary of the Treasury. Section 4943(c)(7).

[33]Section 4943(c)(2)(C).

[34]Section 4941(d)(2)(F).

[35]LTR 200530008 (July 29, 2005).

[36]This section is adapted in part from the Nooney-Mehlman article.

leasing property; loaning assets; furnishing goods or services; using the foundation's facilities; or transferring the income or assets of a private foundation to a disqualified person.[37] As noted above, a disqualified person of the company foundation would include the company as a substantial contributor and would include officers and trustees of the company who also serve as officers and trustees of the company foundation.[38] As of tax years beginning August 17, 2006, the penalty tax rate is 10 percent of the amount involved.[39] A penalty tax of 5 percent of the amount involved may be imposed on a foundation manager if the manager participated in the act knowing that it was self-dealing, unless the manager's participation was not willful and was due to reasonable cause.[40] Additional penalties apply if the act of self-dealing is not corrected within the tax period the initial penalty was imposed.[41]

The question whether to fund a grantee from the company foundation or from the company itself may involve the question of the benefits that the company might derive or expect in return for the gift. If these benefits are more than incidental and tenuous, as discussed below, the gift must not be made from the company foundation to avoid violation of the self-dealing prohibitions contained in section 4941.

Section 4941(d)(1)(E) provides that the "transfer to or use by or for the benefit of a disqualified person of the income or assets of a private foundation" will constitute an act of self-dealing. An act of indirect self-dealing can occur when the transaction is between a private foundation and a party other than a disqualified person, but the disqualified person receives a benefit as a result of the transaction. Treas. reg. section 53-4941(d)-2(f)(2) provides that an incidental or tenuous benefit derived by a disqualified person from the use by a foundation of its income or assets will not by itself constitute self-dealing.

B. Naming Rights, Publicity, and Goodwill

Critically, public recognition received by a disqualified person as a result of charitable activities of the private foundation is generally considered an incidental or tenuous benefit derived from the use by a foundation of its income or assets.[42] In considering the potential self-dealing implications in the context of naming, publicity, and goodwill, it might help to think of this issue as a spectrum of risk, one that increases as the publicity moves from that of name recognition and goodwill or morale to recognition of products or industry line to that of actual business opportunities. The analysis of this issue involves the recognition of its very fact-specific nature, as the IRS's rulings demonstrate. To the extent that a given program or grant may fall outside the boundaries that have been articulated by the IRS as permissible in this regard, the program or grant should be funded by the company and not by the foundation.

A private foundation will typically choose to name the corporation after itself. Also, the corporate name may be affiliated with programs conducted by the foundation. The IRS generally has ruled that the benefits derived from naming opportunities are incidental and tenuous. The same is true of additional public recognition in the form of publicity and goodwill that the corporate donor might receive. For example, in Rev. Rul. 73-407, the IRS ruled that a contribution made by a private foundation to a public charity on the condition that the public charity change its name to that of the substantial contributor to the foundation was not an act of self-dealing because the public recognition that the disqualified person received qualified as incidental or tenuous within the meaning of the regulation.[43] In a private letter ruling from 1999, the IRS ruled that the additional public recognition that might accrue to a corporation as a result of the construction by a foundation of an institute named for the company, and the presentation by officers or employees at seminars presented by the institute, was held to be incidental and tenuous.[44] The institute was constructed by a donation of real estate received by several individuals from the company to the foundation, on whose board the individuals sat.

1. *Matching Gifts*

Can a company foundation pay the matching gifts of company employees under a company matching gift program? In one ruling, a company foundation engaged in three programs: matching gifts made by employees of the corporation to qualified educational programs; providing financial assistance to organizations for whom employees had volunteered their services for at least one year for use in programs related to the employee's volunteer activities; and granting funds to local charities with particular attention to those endorsed by an employee committee in each community in which the corporation maintains a plant or office. The IRS ruled that the public recognition and goodwill derived by the corporation (as well as any secondary intangible benefit pertaining to increased morale of the corporation's employees) as a result of these programs was incidental or tenuous within the meaning of Treas. reg. section 53.4941(d)-2(f)(2).[45]

2. *Product Publicity*

The issue becomes more sensitive in the context of publicity for a company's product. In one ruling, a foundation assumed a charitable program from a related corporation.[46] The foundation planned to advertise the program (including the fact that funding came from the corporation), adopted a logo that included the logo of the

[37]Section 4941(d).
[38]Section 4946.
[39]Section 4941(a)(1).
[40]Section 4941(a)(2). Regarding any one act of self-dealing, the penalty imposed on the foundation manager may not exceed $10,000. Section 4941(c)(2).
[41]Section 4941(b).
[42]Treas. reg. section 53.4941(d)-2(f)(2).
[43]Rev. Rul. 73-407, 1973-2 C.B. 383.
[44]LTR 199939049 (Oct. 4, 1999).
[45]LTR 8004086 (Oct. 31, 1979).
[46]LTR 9235062 (June 5, 1992).

for-profit corporation, and proposed to allow the corporation to present awards on behalf of the foundation. Also, the foundation represented that the corporation's products might be distributed as an incentive to the charitable recipients to complete the program, either by the corporation itself or by another corporation with which the corporation had a special relationship and thus was also presumed to be a disqualified person in regard to the foundation. The IRS found that these activities, including the distribution of the corporation's products, did not result in self-dealing because the benefit to the corporation was incidental and tenuous.

On a related front, a company foundation's primary mission may be related to the industry in which its corporate donor operates. The IRS considered this type of recognition in one ruling and found that the company foundation's grant to an organization to set up a museum dedicated to the industry to which the corporation belonged would not result in self-dealing. Even though the museum would indirectly increase public awareness of the corporation in its focus on the corporation's founder as a pioneer in the industry, the IRS ruled that the benefit to the corporation itself was incidental and tenuous.[47]

3. *Business Opportunities — No "Preferential Treatment"*

Under what circumstances might actual business opportunities fall within the protection of the incidental and tenuous standard? In one ruling, the key to the IRS's view was the absence of preferential treatment for the company. In that ruling, a company foundation founded by a mortgage broker to promote housing and community development undertook educational outreach programs designed to promote home ownership for low- and moderate-income families.[48] Those programs, which were similar to those that previously had been conducted by the corporation, would include the provision of counseling services (possibly provided as donated services by the corporation's employees) as well as lists of affordable housing lenders. The IRS ruled that the proposed program would give rise only to incidental benefits to the company because it would not result in any preferential treatment regarding any loans generated through the program. Moreover, the company did not originate mortgages but competed on the secondary market.

In another situation, the foundation received an additional favorable ruling to expand its activities to include home-buying fairs in which the corporation might participate but on the same terms as all other participants.[49]

C. Recruiting

Like the company foundation that sponsors activities related to its corporate donor's industry, what about a company foundation that makes grants to an educational organization from which its corporate donor recruits employees? The IRS addressed this question in Rev. Rul. 80-310, ruling that a company foundation that made a grant to an educational program from which the corporation, a disqualified person, sought to employ graduates and enroll some of its employees would not subject the corporation to an excise tax for self-dealing.[50] The program was considered to be of broad public benefit while the corporation was perceived to have only an incidental and tenuous benefit in benefiting from the skills acquired from the graduates of the program, because it represented that it would not receive any preferential treatment in recruiting.[51]

In another private letter ruling, the IRS addressed a situation in which a company foundation sponsored a minority internship for journalism school graduates to work for the newspaper funding the foundation.[52] It was represented to the IRS that the "cost of staff time at the newspaper which will be devoted to teaching the interns will far exceed the value of the newspaper stories written by the interns for publication." Moreover, the interns would not be eligible to work for the newspaper for two years after completing the program. On these facts, the IRS ruled that although there was some benefit to the newspaper as a disqualified person in the time and effort spent by the interns working for it, any benefit derived was incidental to the educational purposes and did not constitute self-dealing.

Several other private letter rulings have adopted a similar rationale. For example, in one ruling, a foundation proposed to make a series of grants to educational institutions from which its related corporation anticipated employing students both while they were in school and after their graduation.[53] The IRS concluded that the fact that the related corporation would not receive preferential treatment either in admissions for its employees or in recruiting the graduates supported the conclusion that any benefit derived would be incidental and tenuous to the corporation.

The lesson of these rulings is that for any benefit derived from an educational contribution to remain incidental and tenuous, the program must advance the educational goals of the company foundation and "not be utilized primarily as recruitment vehicles" for the corporation, and the corporation must not receive any preference in hiring or employee admissions.

D. Shared Facilities and Employees

As previously discussed, section 4941(d)(1) provides that the term self-dealing includes any direct or indirect sale or exchange, or leasing, of property between a private foundation and a disqualified person and any direct or indirect furnishing of goods, services, or facilities between a private foundation and a disqualified person. Section 4941(d)(2)(C) provides that the furnishing of goods, services, or facilities by a disqualified person to

[47]LTR 8202081 (Oct. 13, 1981).
[48]LTR 9614003 (Apr. 5, 1996).
[49]LTR 9702041 (Jan. 10, 1997).
[50]Rev. Rul. 80-310, 1980-2 C.B. 319.
[51]*See also* LTR 7913063 (1979).
[52]LTR 8418124 (Feb. 2, 1984).
[53]LTR 8237072 (June 17, 1982).

a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3). Thus, to ensure that the sharing of office space, employees, and other resources is not an act of self-dealing, the corporate donor, as a disqualified person, must either make these resources available at no charge to the foundation or the resources must be handled in such a manner that they are not considered to be furnished by the donor. This principle is clarified in LTR 9312022 (often referred to as the Road Map Ruling),[54] in which the IRS ruled that the proposed sharing of office space, supplies, and employees between a private foundation and a law firm controlled by two of the foundation's directors would not result in self-dealing. If a corporation and its company foundation want to share employees, facilities, or resources, a written agreement containing a set of guidelines based on the Road Map Ruling should be adopted. A critical component of the guidelines is proper record keeping of services rendered by shared employees (for example, by time diaries) and relative costs incurred. Another critical component is the need for separate payments to be made by the company and the foundation, respectively, to vendors, lessors, and others.

E. Fundraising Event Tickets, Admission Discounts, and Similar Benefits Received in Exchange for Charitable Contributions

On occasion, a company foundation will make a grant to another charity and in return will receive tickets to the charity's fundraising event, a discount on admission to the charity's facilities or events, or similar benefits. Can employees of the company attend or otherwise enjoy these benefits? According to a private letter ruling issued by the IRS, that activity might give rise to self-dealing. Specifically, the IRS ruled that the payment by a private foundation of a portion of a benefit event ticket for use by employees of a company that was a substantial contributor to the private foundation would constitute self-dealing.[55] The ruling states that the payment by the foundation "represents an amount that [the company] would have been expected to pay had it not been paid by [the private foundation]. Therefore, [the private foundation's] distribution of amounts on [the company's] behalf . . . would result in a direct economic benefit to [the company] since it would relieve [the company] of the obligation to pay these portions of the fund-raising events."[56]

The ruling concludes by stating that "the results would remain the same in any funding approach whereby [the foundation's] funds were used to permit [the company's] corporate executives to attend."[57] In the ruling, the IRS specifically stated that the benefits derived by the company could not be described as tenuous or incidental under Treas. reg. section 53.4941(d)-2(f)(2).[58]

The breadth and reach of this private letter ruling has been debated. Whether it stands for the proposition that the use by the corporation's employees of tickets is prohibited outright is unclear. The rules governing the substantiation of charitable contributions under section 170 may provide some basis for an argument that at least some benefits exercised by the company employees will not contravene section 4941. Specifically, Treas. reg. sections 1.170A-13(f)(8) and 1.170A-13(f)(9) provide that for purposes of substantiation, some annual membership benefits offered to the employees of a corporate donor may be disregarded. The membership benefits include any rights or privileges that the taxpayer can exercise frequently during the membership period, such as free or discounted admission to the organization's facilities or events; free or discounted parking; preferred access to goods or services; and discounts on the purchase of goods or services. Also, membership benefits include admission to events during the membership period that are open only to members of the donee organization and are reasonably expected to cost below a specified cost per person. It could be argued that benefits that can be disregarded for substantiation purposes should, by analogy, be characterized as incidental and tenuous for section 4941 purposes.[59]

Nevertheless, a foundation that transfers those benefits to company employees may be doing so at its peril. In particular, practitioners who have made informal inquiries of the IRS and Treasury have been informed that Treasury believes that even if benefits can be disregarded for purposes of section 170, they will not necessarily be considered incidental and tenuous for self-dealing purposes. Therefore, short of waiving any quid pro quo benefits, if employees who are not engaged in activities for the company foundation plan to attend a benefit on behalf of the company, the safer course of action is to have the company (and not the foundation) purchase the tickets.[60]

VI. Cause-Related Marketing: Commercial Coventure Relationships

How does a company involve its goods or products in its corporate philanthropy program? A traditional method has been gifts of inventory. Section 170 contains special income tax deduction provisions that apply to gifts by corporate taxpayers of ordinary income property in the form of inventory. Section 170(e)(3) provides for an

[54]LTR 9312022 (Dec. 28, 1992).
[55]LTR 9021066 (Mar. 1, 1990).
[56]*Id.*
[57]*Id.*
[58]*Id.*
[59]But note that the preamble to the Treasury regulations under section 170 refers to the difficulty of valuing membership benefits as a reason for disregarding them in determining the amount of a charitable contribution.
[60]For an in-depth discussion of this topic, *see* Robert C. Louthian III, "Attendance at Charitable Fundraising Events by Disqualified Persons: Self-Dealing or Incidental Benefit?" 15 *Exempt Org. Tax Rev.* 267 (Nov. 1996).

enhanced fair market value deduction of inventory contributions made to qualified organizations that use the inventory to care for the "ill, the needy, or infants." Section 170(e) also contains special provisions relating to contributions of food inventory, book inventory to public schools, scientific property, and computer technology or equipment. In general, the company foundation is either not eligible or not appropriate as the donee of inventory contributions by the company.

Another way that a company involves its products or services in its corporate philanthropy is cause-related marketing. While the term "cause-related marketing" is growing to encompass more longer-term relationships between a company and a charity (or cause), perhaps the most direct example of cause-related marketing is the advertisement by a company that proceeds from the sale of its products or services will benefit a charity or a charitable cause. Other examples include collections by a company for a charity or a charitable cause at its store locations. For example, a company ties the sale or promotion of its goods or services to a charitable cause; the consumer can make a charitable contribution at a collection point or on checkout.

A. Law of Commercial Coventure Arrangements

In the legal context, cause-related marketing programs can be a trap for the unwary. A cause-related marketing program that involves the advertisement by a company that all or a portion of the proceeds of the sale of its products or services will benefit a charity is legally referred to as a commercial coventure arrangement. New York state's charitable solicitation statute defines a commercial coventure arrangement as one in which a for-profit corporation that is regularly and primarily engaged in trade or commerce, other than raising funds for a charitable organization, advertises that the purchase or use of goods, services, entertainment, or any other thing of value will benefit a charitable organization.[61]

Historically, there has been a lack of awareness in the corporate community regarding the application of fund-raising laws to commercial coventure arrangements. The volume of commercial coventure arrangements in the wake of September 11, 2001 perhaps highlighted this lack of awareness.[62] Before implementing commercial coventure relationships as part of a corporate philanthropy program, it is important for a company to understand that most states regulate commercial coventure relationships and impose legal obligations on the company as the commercial coventurer. Because charitable organizations are a party to these arrangements and consumers may be more inclined to buy a product because of the arrangement, the laws and regulations regarding commercial coventure arrangements are ordinarily contained within the state's charitable solicitation statute. If a commercial coventure arrangement is conducted in a particular state, that state's charitable solicitation statute should be consulted.

1. *Commercial Coventure Agreement*

By way of example, under New York law, the charitable organization and the commercial coventurer must memorialize their commercial coventure arrangement in a written contract and maintain a copy of that contract for at least three years after the arrangement ends.[63] New York law also requires that an advertisement that a sale will benefit a charitable organization include the amount that will go to charity.[64] In other words, an advertisement stating that a portion of the proceeds will go to charity technically does not comply with the provisions of New York law. However, this requirement has been subject to challenge and scrutiny on First Amendment and free trade grounds, and many advertisements in connection with commercial coventure arrangements do not specify the exact amount that the company will donate to charity. Nonetheless, if only a small portion of *net* proceeds is expected to end up in the charity's hands, consideration should be given to whether a promotion that is not somewhat specific as to the amount to be donated is appropriate.

2. *Filing Requirements*

New York law also provides that within 90 days of the end of the sales promotion, the commercial coventurer must provide the charity with an accounting of the number of items sold, the dollar amount of each sale, and the amount paid or to be paid to the charity.[65] Charities must include information regarding their commercial coventure arrangements with their annual filings with the attorney general's office.[66] In addition to requirements similar to those noted above, at least four states (Alabama, Maine, Massachusetts, and Washington) require that the commercial coventurer be registered with the state.

3. *Registration by the Charity*

More than 40 states require registration of charities that conduct activities and solicit funds in their states. In New York, the definition of the term "solicit" includes commercial coventure arrangements. Therefore, a company that engages in a commercial coventure arrangement with a charitable organization in a particular state should confirm and contractually require that the charity is complying with the charitable solicitation laws in each state in which the arrangement is being conducted.[67]

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[61]N.Y. Exec. Law section 171-a.6.

[62]*See* David Barstow and Diana B. Henriques, "9/11 Tie-Ins Blur Lines of Charity and Profit," *The New York Times*, Feb. 2, 2002, at A3.

[63]N.Y. Exec. Law section 173-a.1.

[64]N.Y. Exec. Law section 174-c.

[65]N.Y. Exec. Law section 173-a.3.

[66]N.Y. Exec. Law section 173-a.4.

[67]N.Y. Exec. Law section 171-a. The definition of "solicit" is to directly or indirectly make a request for a contribution, whether express or implied through any medium. This includes any advertising that represents that the purchase or use of goods, services, entertainment, or any other thing of value will benefit a charitable organization.

4. *Internet Coventures*

What about a commercial coventure relationship that involves an Internet component? Is that considered to be fundraising activity conducted in every state? The law is unclear as to what level of Internet activity would require a charity to register in any particular state. In March 2001 the National Association of State Charity Officials (NASCO) set forth voluntary guidelines to help states develop their own regulatory approach to Internet solicitation activities by charities.[68] Under the so-called Charleston Principles, a charity or fundraiser that uses the Internet for charitable solicitations is required to register in a particular state if it uses its Web site to target people in that state, or if it receives contributions from the state on a repeated and ongoing basis or on a substantial basis through its Web site.[69] If a charity has no nexus with a state and does not target that state, it suffices that the charity be registered in the state in which it is domiciled (if required by that state). However, the Charleston Principles do not have the force of law, and not every state necessarily subscribes to the principles. Therefore, the legal boundaries of Internet fundraising are not entirely clear.

5. *No Mention of the Charity*

What if the promotion does not identify a specific charitable organization, but rather identifies a cause (for example, "50 percent of the company's proceeds derived in the month of December will benefit AIDS-related causes"). Arguably, the commercial coventure statutes would not be applicable, because no specific charitable organization has been named. That said, to best avoid later scrutiny, it would be appropriate for the company to maintain proper books and records to verify that it has complied with its public statements.

B. Involvement of the Company Foundation

How can the company foundation be involved in a cause-related marketing program? For example, could the foundation contribute toward the costs and administration of a commercial coventure promotion or an in-store collection campaign? Not without potentially running afoul of section 4941. The benefits to the company of an advertisement attracting consumers to its product because of the promise to donate a portion to charity, or attracting consumers to its store in part based on the existence of the in-store collection campaign, are likely more than incidental and tenuous. Therefore, cause-related marketing programs, generally, are more appropriately conducted solely with the company's financial resources. Of course, the company foundation can play a strategic role in terms of the charitable partners or causes to be benefited from the company's cause-related marketing programs.

[68]NASCO, *The Charleston Principles: Guidelines on Charitable Solicitations Using the Internet* (Mar. 14, 2001), *available at* http://www.nasconet.org. A full discussion of the Charleston Principles is outside the scope of this article.

[69]*Id.* section III(B)(1)(b).

VII. Employer-Related Grant Programs[70]

A common activity for company foundations is the awarding of grants or scholarships to employees of the related corporation or to their children. The relevant statutory authority is section 4945, which governs grants by private foundations to individuals, and the Treasury regulations and authority issued by the IRS as guidance under this section. In particular, company foundations or their counsel should be familiar with Rev. Proc. 76-47, which is discussed below.[71]

Section 4945 provides that a grant by a private foundation to an individual for travel, study, or other similar purposes is a taxable expenditure by the private foundation unless the grant satisfies requirements set forth in section 4945(g).[72] Under section 4945(g), a grant by a private foundation to an individual will not be a taxable expenditure if it is awarded on an objective and nondiscriminatory basis under a procedure approved in advance by the IRS and if it is demonstrated to the satisfaction of the IRS that the grant is a scholarship or fellowship grant that is excluded from the gross income of the recipient[73] and is to be used for study at a qualifying educational institution.[74]

One of the most significant issues raised by an employee grant or scholarship program — whether implemented by a corporation or by its related company foundation — is whether the grants or scholarships are being used as an inducement to employment or as compensation for employment. That is because an amount paid or allowed to or on behalf of an individual to enable the individual to pursue studies or research will not constitute an excludable scholarship or fellowship grant under section 117(a) if the amount represents either compensation for past, present, or future employment services or represents payment for services that are subject to the direction or supervision of the grantor.[75]

[70]This section is adapted from the Nooney-Mehlman Article.

[71]Rev. Proc. 76-47 1976-2 C.B. 670.

[72]Section 4945(d)(3). Specifically, a private foundation may not attempt to influence legislation, undertake any political campaign participation, grant funds to individuals for travel or study unless they are distributed under a policy preapproved by the IRS, or grant funds to another organization unless the foundation exercises expenditure responsibility to ensure that the grant is spent in accordance with charitable purposes.

[73]Section 117(a) defines when a scholarship grant is excluded from the recipient's gross income. Although that definition was limited when section 117 was amended by the Tax Reform Act of 1986, section 4945(g) references the definition of scholarship grant that appeared in section 117(a) before its amendment; therefore, a scholarship grant under a private foundation grant program may include amounts for tuition, enrollment fees, accommodations, and allowances for travel, research, clerical help, or equipment.

[74]A qualifying educational institution is an educational institution described in section 170(b)(1)(A)(ii)— in other words, one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at the place where its educational activities are regularly carried on.

[75]Treas. reg. section 1.117-4(c).

Rev. Proc. 76-47 sets forth specific guidelines for private foundations with employer-related grant programs. These guidelines apply on their face only to programs in which the group of employees, or children of employees, from which grantees are to be selected is sufficiently broad so that the awarding of grants to members of such a group could be considered consistent with the fulfillment of a purpose described in section 170(c)(2)(B) (in other words, religious, charitable, scientific, literary, educational, etc.) and the group could be considered to be a charitable class.[76]

Rev. Proc. 76-47 contains seven specific requirements, as well as a percentage test. Provided that a company foundation's grant program meets these requirements as well as either the percentage test or a facts-and-circumstances test, the IRS will assume that the grants made under the program are not compensation for employment and therefore will constitute scholarship or fellowship grants subject to the provisions of section 117(a). Thus, if the grants meet the requirements of Rev. Proc. 76-47 and are awarded on an objective and nondiscriminatory basis under a preapproved procedure, the grants will not be taxable expenditures under section 4945.[77]

The following is a summary of the guidelines set forth in Rev. Proc. 76-47:

1. *Inducement.* The employer and the foundation must not use the program to recruit employees or to induce employees to continue their employment, or otherwise follow a course of action sought by the employer.
2. *Selection Committee.* The committee must be made up entirely of independent individuals who are not connected to the employer, the foundation, or its creator; otherwise the grants made will be considered taxable expenditures.[78] For these purposes, even former employees will not be considered independent. Announcements of awards made under the program must be made by the foundation or the selection committee, not by the employer. Only the selection committee may vary the amounts of the grants, and the grants must be awarded solely in the order recommended by the selection committee. Although a foundation may reduce the number of grants to be awarded, it may not award more grants than the number recommended by the selection committee.
3. *Minimum Eligibility Requirements.* Any employer-related grant program must impose identifiable minimum requirements for grant eligibility that are related to the purpose of the grant. Scholarship applicants must meet the minimum admission standards of their respective educational institutions and must reasonably be expected to attend such an institution. If a minimum period of employment by the employee is required for eligibility, the time period may not exceed three years, and eligibility may not be related to any other employment-related factors, such as the employee's position, services, or duties.
4. *Objective Basis of Selection.* Selection of the recipients must be based solely on objective standards completely unrelated to the employment of the recipients, their parents, or to the employer's line of business. Permissible standards include academic performance, recommendation from instructors, and financial need.
5. *Employment.* Once a grant or scholarship has been awarded, it may not be terminated if the recipient's parent terminates employment. If the scholarship is awarded for more than one academic year, renewal must be based solely on nonemployment criteria.[79]
6. *Course of Study.* Courses of study for which scholarships are available must not be limited to those that would particularly benefit the foundation or the employer.
7. *Other Objectives.* The revenue procedure contains a catchall requirement that the terms of the grant and the courses of study for which grants are available must meet all other requirements of section 117 and the regulations thereunder, and must be consistent with a disinterested purpose of enabling the recipients to obtain an education for their own benefit, not for the benefit of or to accomplish any purpose for the employer or the foundation.

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[76]Neither the code nor Rev. Proc. 76-47 states what constitutes a sufficiently broad charitable class. In considering this issue in Rev. Rul. 75-196, 1975-1 C.B. 155, the IRS stated that the class benefited must be broad enough to warrant a conclusion that the educational facility or activity is serving a broad public interest rather than a private interest and is therefore exclusively educational in nature.

[77]Rev. Proc. 80-39, 1980-2 C.B. 772, sets forth guidelines for determining whether educational loans made by a private foundation under an employer-related loan program are taxable expenditures under section 4945. The guidelines contained in Rev. Proc. 80-39 are the same as the guidelines contained in Rev. Proc. 76-47.

[78]*See* LTR 8915002 (Dec. 16, 1988) (grants were taxable expenditures when the scholarship selection committee included an employee of the sponsoring company); TAM. 9825004 (June 19, 1998) (grants were taxable expenditures when the selection committee was composed of the director of human resources and chief financial officer of the sponsoring company and a director of the foundation).

[79]*See* LTR 8915002 (Dec. 16, 1988) (grants were taxable expenditures when the recipients were ineligible for future grants if the parent terminated employment with the sponsoring company); TAM 9825004 (June 19, 1998) (grants were taxable expenditures when the grant assistance would be continued only for two years or four semesters following the parent's termination of employment).

8. *The Percentage Test.* The grant program must satisfy a percentage test or will be reviewed by the IRS on the basis of a facts-and-circumstances test. If the grants are awarded to children of employees, the percentage test will be met if the number of grant recipients in any given year does not exceed 25 percent of those who were eligible, applied, and were considered by the selection committee for that year or 10 percent of the number of individuals eligible to receive grants in that year, regardless of whether they submitted applications.[80] If grants are awarded to employees, the percentage test will be met if the number of grant recipients in any given year does not exceed 10 percent of the number of employees who were eligible, applied, and were considered by the selection committee for that year.[81]
9. *The Facts-and-Circumstances Test.* If a private foundation cannot meet the percentage test, the IRS will determine whether the grants are scholarships or fellowship grants subject to the provisions of section 117(a) on the basis of all the facts and circumstances. In making this determination, the IRS will consider whether the primary purpose of the program is charitable (to educate recipients in their individual capacities) or simply to provide extra compensation or other employment incentives. Relevant factors that the IRS might consider include the following: the history of the program (for example, the source of its funding); courses of study for which the grants are available; any eligibility requirements imposed by the program (other than employment or age and grade prerequisites); publicity for the program; the degree of independence of the selection committee; the particular standards used for selection of grant recipients; the means used to determine whether those standards have been met; the nature of the employee limitation or preference; the number of grants available; the number of employees or children eligible for grants; the percentage of eligible recipients who normally receive grants; and whether and how many grants are awarded to individuals who are not employees or children of employees.[82]

[80]*See* LTR 8915002 (foundation did not satisfy the percentage test when scholarships were granted to all applicants (100 percent ratio)).

[81]In Rev. Proc. 94-78, 1994-2 C.B. 833, the IRS set forth a rounding convention for the percentage tests in Rev. Proc. 76-47 and Rev. Proc. 80-39. If, in applying any of the percentage tests, an organization determines that the maximum number of allowable grants is a mixed number with a fraction of one-half or greater, the organization may round upward the number of allowable grants to the nearest whole number.

[82]In TAM 9502010 (Nov. 10, 1994), the IRS ruled that a private foundation's grant program satisfied the facts-and-circumstances test because all children of employees meeting

(Footnote continued in next column.)

VIII. Emergency Disaster-Relief Programs[83]

At the time of the September 11, 2001 terrorist attacks, the future of employer-sponsored charitable assistance programs seemed bleak. The IRS had favorably addressed disaster-relief programs established by employer-sponsored private foundations in two private letter rulings issued in 1995. In 1999, however, the IRS reversed its position and revoked those rulings.[84] The IRS stated that it considered the disaster-relief programs similar to other types of employee-benefit programs that serve the private interests of the employer and its employees, rather than the interests of the broader public.

Then September 11 occurred. In response to the attacks, Congress enacted the Victims of Terrorism Tax Relief Act of 2001[85] (the Victims Relief Act), which changed the landscape for employer-sponsored assistance programs. Specifically, the act:

1. amended the code by inserting new section 139, which defines qualified disasters and provides that disaster relief payments for victims of qualified disasters are excluded from victims' gross income; and
2. directed the IRS to broaden the allowed activities of private foundations in regard to disaster relief for both the general public and employee beneficiaries of employer-sponsored foundations.[86]

A. Qualified Disaster Relief Payments

Section 111 of the Victims Relief Act amended the code by adding section 139, which governs the tax treatment of payments made to victims of some qualified disasters.[87] Specifically, section 139(a) excludes from gross income

the minimum time requirements were eligible for consideration; only a relatively small number of grants would be awarded; although the foundation would not meet the percentage test each year, it would meet the test in some years, and would meet it consistently on a rolling, five-year basis; and the grant program was only a small part of the foundation's total charitable program. For these reasons, the IRS determined that the grant program would not constitute an employment incentive.

[83]This section is adapted from *Disaster Relief by Employer Controlled Charities*, Simpson Thacher & Bartlett LLP (Oct. 15, 2002).

[84]LTR 199914040 (Apr. 12, 1999); LTR 199917077 (May 3, 1999).

[85]Victims of Terrorism Tax Relief Act of 2001, Pub. L. No. 107-134, 115 Stat. 2427 (2001).

[86]As set forth in more detail below, this direction was not included in the Victims Relief Act, nor was it added to the code. Instead, this direction was found in the technical explanation accompanying the Victims Relief Act and was further explained in the Disaster Relief publication.

[87]Section 139(c) defines qualified disaster as:
(1) a disaster that results from a terroristic or military action (as defined in section 692(c)(2));
(2) a presidentially declared disaster as defined in section 1033(h)(3) (generally, a disaster in an area that has been subsequently determined by the president to warrant federal assistance under the Disaster Relief and Emergency Assistance Act);

(Footnote continued on next page.)

any amount received by an individual as a qualified disaster relief payment.[88] A qualified disaster relief payment[89] includes payments of specific expenses incurred as a result of a qualified disaster. These qualifying payments may be from any source (including, as set forth below, an employer) to reimburse or pay reasonable and necessary expenses for the individual's repair or rehabilitation of a personal residence and its contents (to the extent attributable to the qualified disaster), and other personal, family, living, or funeral expenses.

The technical explanation of section 139 indicates that a qualified disaster relief payment can be from any source, including an employer.[90] The technical explanation goes on to note the uncertainty in the IRS's position regarding the treatment of disaster-relief payments made by employer-controlled private foundations to employees, and states that "clarification [by the IRS] of the appropriate treatment of the foundation and the payments may be helpful."[91] The legislative history sets forth the following guidelines for such clarification:

1. An employer-controlled private foundation that makes payments in connection with a qualified disaster to employees (and their family members) will be entitled to the presumption that it is acting consistently with the requirements of section 501(c)(3) and is not providing an inappropriate private benefit if:
   a. the class of beneficiaries is large or indefinite, and
   b. recipients are selected based on an objective determination of need by an independent committee of the foundation, a majority of the members of which are not persons who are in a position to exercise substantial influence over the affairs of the employer (determined under principles similar to those in effect under section 4958), or based on "adequate substitute procedures."[92]
2. Need-based payments from an employer-controlled private foundation to individuals for exclusively charitable purposes, including the relief of distress caused by a qualified disaster, are excludable from the recipients' income as gifts, regardless of whether the payments fall within the scope of section 139 and regardless of section 102(c), which provides that a transfer from an employer to an employee generally is not excludable from income as a gift.
3. Disaster-relief payments made by a private foundation that support a large or indefinite class of beneficiaries and are granted based on an objective determination of need (and that therefore qualify for the presumption that the foundation is acting consistently with the requirements of section 501(c)(3))
   a. will not be treated as an act of self-dealing under section 4941 merely because the recipient is an employee (or family member of an employee) of a disqualified person in regard to the foundation;
   b. will be treated as advancing the foundation's charitable purposes; and
   c. will be considered to meet the requirements of section 4945(g) (regarding grants to individuals by private foundations) to the extent that they apply.
4. Contributions to a section 501(c)(3) organization administering relief in the manner outlined above (including contributions made by employers and employees) are deductible for federal income-tax purposes under the generally applicable rules of section 170.[93]

In 2003 the IRS issued Rev. Rul. 2003-12.[94] This ruling further confirmed that section 139 allows employees to exclude from gross income qualifying payments received

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(3) a disaster resulting from any event that the Secretary determines to be of a catastrophic nature; or
(4) with respect to amounts described in section 139(b)(4), "a disaster that is determined by an applicable Federal, State, or local authority (as determined by the Secretary) to warrant assistance from the Federal, State, or local government or an agency or instrumentality thereof."

Section 139(c). A presidentially declared disaster is a disaster that occurred in an area determined by the president of the United States to be eligible for federal assistance. Section 1033(h)(3) defines the term "presidentially declared disaster" in reference to the Disaster Relief and Emergency Assistance Act, which uses as its operative concept the term "major disaster." A "major disaster" is defined, in part, as "any natural catastrophe . . . or, regardless of cause, any fire, flood, or explosion, *in any part of the United States.*" (Emphasis added.)

[88]Section 139(a) provides that gross income shall not include any amount received by an individual as a qualified disaster relief payment.

[89]Section 139(b) provides that a qualified disaster relief payment includes any amount paid to or for the benefit of an individual —

(1) to reimburse or pay reasonable and necessary personal, family, living, or funeral expenses (not otherwise compensated for by insurance or otherwise) incurred as a result of a qualified disaster, or
(2) to reimburse or pay reasonable and necessary expenses (not otherwise compensated for by insurance or otherwise) incurred for the repair or rehabilitation of a personal residence or repair or replacement of its contents to the extent that the need for such repair, rehabilitation, or replacement is attributable to a qualified disaster.

[90]Staff of Joint Comm. of Taxation, 107th Cong., Technical Explanation of the "Victims of Terrorism Tax Relief Act of 2001," as Passed by the House and the Senate on December 20, 2001, JCX-93-01 [hereinafter the "Technical Explanation" 15 (2001).

[91]*Id.* at 17.

[92]The Technical Explanation does not explain what "adequate substitute procedures" might be, except to note that such procedures would "ensure that any benefit to the employer is incidental and tenuous."

[93]*See id.* at 18.

[94]Rev. Rul 2003-12, 2003-3 C.B. 283.

from their employers. Specifically, the IRS ruled that grants received by employees through an employer's program to pay or reimburse certain reasonable and necessary medical, temporary housing, or transportation expenses they incur as a result of a flood could be excluded from such employees' gross income under section 139.

In this ruling, the IRS evaluated a disaster relief program created by an employer to assist employees affected by a flood. The grant program did not require individuals to provide proof of actual expenses to receive the grant payment and it contained requirements designed to ensure that the grant amounts were reasonably expected to be commensurate with the amount of unreimbursed reasonable and necessary expenses that employees incurred as a result of the flood. Also, the grants were available to all affected employees regardless of length or type of service, and the payments were not intended to indemnify all flood-related losses or to reimburse the cost of nonessential, luxury, or decorative items and services. The IRS ruled that the employer's grants were qualified disaster relief payments that could be excluded from the gross income of its employees, and, therefore, the grants were not subject to federal income, Social Security, Medicare, or FUTA tax reporting under section 6041 or any other information reporting requirements.[95]

As a result of both Rev. Rul. 2003-12 and the Victims Relief Act, taxpayers living in a presidentially declared disaster area — for example, those areas listed in President Bush's recent hurricane disaster declarations[96] — do not have to include in their income any grants made by their employers to cover medical, transportation, or temporary housing expenses.

B. IRS Publication on Disaster Relief

Following the enactment of the Victims Relief Act, the IRS released a revised version of Publication 3833, *Disaster Relief: Providing Assistance Through Charitable Organizations*.[97] The disaster relief publication describes the IRS's current position on disaster relief payments by employer-controlled charities. The IRS addresses employer-sponsored private foundations and employer-sponsored public charities in separate sections of the disaster relief publication.[98]

Specifically, the IRS has set forth three requirements that must be met for an employer-controlled private foundation to benefit from the presumption that disaster relief payments to employees (or their family members) in response to a qualified disaster are consistent with the foundation's charitable purposes:[99]

1. the class of beneficiaries must be large or indefinite;
2. the recipients must be selected based on an objective determination of need; and
3. the selection must be made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. The selection committee is considered to be independent if a majority of the committee members are persons who are not in a position to exercise substantial influence over the affairs of the employer.

If these criteria are met, payments by the foundation will be considered to be made for a charitable purpose, will not be an act of self-dealing, and employees may exclude the payment from income. This favorable presumption, however, applies to those payments made in response to a qualified disaster. This means that only those employees living in a presidentially declared disaster area may exclude from their income any grants made by their employers to cover medical, transportation, or temporary housing expenses.

The presumption also does not apply to payments that would otherwise constitute self-dealing, such as payments to directors of the foundation or to members of the foundation's selection committee. Also, the disaster relief publication notes that an employer-controlled foundation's program of disaster-relief payments may not be used to induce employees to follow a particular course of action (such as to continue their employment) or to relieve the employer of a legal obligation to provide employee benefits (such as an obligation under a collective bargaining agreement).

In addition, the IRS has made clear that a private foundation must also maintain adequate records demonstrating the victims' need for assistance and that the private foundation made qualified disaster relief payments to further the foundation's charitable purposes. The IRS has stated that the documentation should include a description of the following:

1. the nature of the assistance;
2. the purpose for which aid was given;
3. the charity's objective criteria for disbursing assistance under each program;
4. the process by which recipients were selected;

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[95] *Id.* at 283.

[96] A list of the presidentially declared disasters can be found at http://www.fema.gov or http://www.irs.gov/newsroom/index.html.

[97] IRS Pub. 3833 (2002).

[98] *See id.* at 15-19.

[99] Although the IRS has not formally revoked its 1999 rulings, statements in the disaster relief publication indicate that the IRS is not likely to follow its previous private ruling position and that, if the above-described guidelines are followed, an employer-controlled foundation may operate a program that provides disaster-relief payments to employees facing hardship after a qualified disaster.

5. the name, address, and amount distributed to each recipient; and
6. the relationship between recipient and officers, directors, or key employees of or substantial contributors to the charitable organization.

C. Guidelines for the Establishment of a Disaster Relief Assistance Program Funded by a Company Foundation That Benefits Company Employees

The following guidelines may be used by a company foundation that would like to establish a disaster relief assistance program for the benefit of the company's employees:

1. The foundation's certificate of incorporation should broadly define the purpose of the foundation, stating that the foundation will provide assistance to the company's employees and others who are victims of any civil or natural disasters, present and future, and that the foundation is able to accept contributions from interested individuals, corporations, and other organizations, including employees of the company.
2. A disaster relief distribution committee of at least three members should be established by the foundation. This committee will review the requests for assistance, select recipients on an objective basis, and disburse funds. No more than one member of the committee should be an executive officer or key employee of the company.
3. The foundation should create an application for relief that must be completed by each individual seeking assistance from the foundation and submitted to the committee for consideration.
4. The committee should select recipients by the affirmative vote of at least a majority of the committee members after considering various factors, including the extent to which the applicant is needy or distressed at the time of the request, the type of assistance sought (for example, short-term versus long-term), and the amount requested.
5. The committee should document all of its decisions and preserve a file containing documentation collected regarding each successful applicant.
6. The foundation may distribute funds to the selected recipients or provide goods or services to the selected recipients.

IX. Conclusion

Of course, not every legal issue pertinent to the arena of corporate philanthropy has been raised or addressed fully in this article. But we hope that it can serve at least as a guide for companies and company foundations to the fundamental legal and governance issues that require consideration.