



NATIONAL ASSOCIATION OF

Community Health Centers

Important Content Note:

This technical assistance resource was developed prior to the August 2017 release of the Health Center Compliance Manual by the Health Resources and Services Administration's (HRSA) Bureau of Primary Health Care (BPHC). The BPHC Compliance Manual, issued August 2017, indicates where PINS, PALs and other program guidance are now superseded or subsumed by the BPHC Compliance Manual.

See: <https://bphc.hrsa.gov/programrequirements/pdf/healthcentercompliancemanual.pdf>

RM

Information Bulletin #8

Updated January 2016

Note that in all Information Bulletins:

The term **“health center”** refers to public or private nonprofit entities that: (1) receive grants under Section 330 of the Public Health Service Act (Section 330), including Sections 330(e), 330(f), 330(g) and 330(h) (collectively “Health Center Program Grants”); and (2) entities that have been determined by the Department of Health and Human Services (DHHS) to meet the Section 330-Related Requirements to receive funding without actually receiving a grant (“health center look-alikes”).

The term **“Section 330-Related Requirements”** refers to requirements set forth in:

- Health Center Program Statute: [Section 330 of the Public Health Service Act \(42 U.S.C. §254b\)](#),
- Program Regulations: [42 CFR Part 51c](#) and [42 CFR Parts 56.201-56.604](#)
- Health Center Program Requirements: <http://www.bphc.hrsa.gov/programrequirements/index.html>

The term **“Grant Requirements”** refers to Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards: 2 CFR Part 200, as adopted by DHHS at 45 CFR Part 75.

This publication is designed to provide accurate and authoritative information in regard to the subject matter covered. It is published with the understanding that the publisher is not engaged in rendering legal, financial or other professional service. If legal advice or other expert assistance is required, the services of a competent professional should be sought.

This publication was supported by Cooperative Agreement No. U30CS16089 from the Health Resources and Services Administration, Bureau of Primary Health Care (HRSA/BPHC). Its contents are solely the responsibility of the authors and do not necessarily represent the official views of HRSA/BPHC.

Establishing a Related Foundation: Does It Make Sense for a Health Center?

Health centers that are private nonprofit corporations typically are charitable organizations that are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (“IRC”), and usually exempt from most state and local taxes. Another benefit is that gifts and contributions to the organization usually are tax deductible by the donor, thereby providing an economic incentive for the donor to make a contribution. As tax-exempt organizations, a number of health centers and other charitable organizations have established separate, but related, foundations that also are tax exempt under section 501(c)(3).

This Information Bulletin:

- ◆ Discusses the term “related foundation” and explores reasons for a health center to establish one.
- ◆ Addresses how a health center can establish a related foundation, including the measures that should be taken to minimize risk to the health center in doing so.

WHAT IS A FOUNDATION

Simply put, a foundation is:

1. **A nonprofit charitable organization**, that’s
2. **Tax exempt under section 501(c)(3) of the IRC**, and that

- 3. Carries out its charitable purposes by making grants to another organization,** as opposed to conducting a charitable activity directly, although some foundations, known as “operating foundations,” may actually conduct their own charitable programs.

In the case of a foundation established by a health center, grants typically are made by the foundation to the health center to support the center’s activities or, possibly, to another tax-exempt organization that supports the health center’s activities.

A foundation is already a section 501(c)(3) organization, so there are no legal requirements for forming a tax-exempt foundation. But to qualify for federal income tax exemption, a foundation, like all other section 501(c)(3) organizations, must be organized and operated exclusively for a charitable purpose. Fundraising for or otherwise supporting the activities of a section 501(c)(3) organization is a charitable purpose qualifying a foundation for tax exemption.¹

It should be noted, however, that federal tax law defines a class of section 501(c)(3) organizations as “private foundations.” These are organizations that derive a substantial portion of their revenue from only one or a few large donors, as opposed to the general public. The classification is based on the source of the organization’s income and has nothing to do with what the charity does, i.e., whether it makes grants or conducts a program of charitable activities.

Organizations classified as private foundations for federal tax purposes are subject to numerous burdensome restrictions and requirements. Therefore, tax classification as a private foundation should be avoided, if possible, even by an organization that identifies itself as a “foundation” and conducts grant-making activities. A foundation that is related to a health center or other charitable organization can avoid this classification if it is organized and operated as a “supporting organization” to the health center. This will be discussed in more detail below.

WHY ESTABLISH A RELATED FOUNDATION

Health centers might want to establish a related foundation for several reasons.

Risk Management

Segregating assets is a common risk management tool. Transferring assets, such as cash surpluses and even real estate, to a related foundation is a way of protecting those assets from health center creditors because they are then “owned” by a separate entity that is not legally responsible for the health center’s obligations. However, as is discussed more fully below, the foundation must be operated entirely independent of the health center (although under its control) in order to assure that this protection is maintained. Moreover, health centers should be cautious when transferring assets acquired with federal funds (or, in the case of real property, purchased or improved with federal funds). Federal property standards do not permit transfer without prior federal approval. Federal loans and loan guarantees may contain similar restrictions, as may state, local, or private funders.

Fundraising

Developing expertise in fundraising and development is a common reason why service provider organizations (including health centers, colleges and universities, and hospitals) establish separate fundraising foundations. The management and operational systems and structures necessary to operate programs efficiently and effectively are not necessarily the same as those required to operate an effective fundraising program. A related foundation

¹ See Rev. Rul. 67-149, 1967-1 C.B. 133.

can be a useful fundraising vehicle because gifts and contributions to a health center (as a section 501(c)(3) organization) are tax deductible. That raises a legitimate question as to why a health center would bother setting up a separate fundraising organization at all. Similarly, while a significant part of the job of a health center's board of directors is to support and promote fundraising efforts on behalf of the health center, individuals who have fundraising expertise or contacts with potential donors may not necessarily want that responsibility nor be able to make the commitment that service on the health center's governing board requires.

They may, however, be willing to serve on the governing board of a related foundation. Likewise, a health center may benefit from offering seats on the Board of its related foundation to "high profile" persons in the community who may be useful in attracting financial support for the health center through the related foundation.

Fiscal Planning

Setting aside resources for a proverbial rainy day may be a useful fiscal planning tool. The health center can transfer financial surpluses to the foundation to be set aside as reserves. While these reserves can be held directly by the health center in an appropriate investment account, there often is less temptation to use the funds to meet current operational needs if they are held by a separate entity. This is particularly so if the health center is seeking to establish an endowment fund, such as a fund that will produce investment income for the benefit of the health center while the principal sum remains intact.

Note also that, while federal rules require that a health center's excess program income derived from the Section 330-supported project must be spent to further program objectives and not for any purpose prohibited under Section 330 – there is no requirement that the funds remain in the health center's bank account.

HOW TO FORM A RELATED FOUNDATION

A related foundation is formed like any other charitable organization. The necessary documents required under state law must be filed, such as the Articles of Incorporation or a Certificate of Incorporation, a governing board must be seated, and Bylaws and other operational policies for the foundation must be adopted.

Establish the Board of Directors

Obviously, considerable thought should be given to who will serve on the foundation's governing body since board members will have responsibility for stewardship of foundation assets, which likely will include health center assets transferred to the foundation or fundraising proceeds that otherwise would be held directly by the health center. As noted below, the process for selecting foundation board members should be controlled by the health center through election or appointment powers, to assure that no less than a majority of the board seats are controlled by the health center.²

Selection criteria for board members might include expertise in managing investments, fundraising experience, and contacts in the community, such as the "high profile" board member who can attract contributions. Assuming the foundation is controlled by the health center, the foundation's governing board need not be particularly large. Nor does it have to meet Section 330 composition requirements. Many states require that a nonprofit organization

² Control does not necessarily require that health center Board members be selected for the foundation Board. The particular problems that can arise from cross-membership on the respective Boards are discussed in the following section of this bulletin.

have a minimum of three board members. Many organizations that have formed a related foundation have found between three and five members to be the optimum size for the governing board. If a larger body is desirable for public relations purposes, an “honorary” or “advisory” board can be established. Such bodies typically have no governance authority but provide an opportunity for the foundation to have influential community members formally associate themselves with the health center and its related foundation.

Preparing and Submitting Organizational Documents

Recognition of federal income tax exemption under section 501(c)(3) must be obtained by filing Form 1023 and supporting documents, such as Articles/Certificate of Incorporation and Bylaws. Importantly, the application for exemption must explain the rationale for the charitable exemption, which, in the case of a health center-related foundation would be to support, financially and otherwise, the health center’s mission of serving medically underserved communities. The application should also describe in some detail the foundation’s proposed activities in support of its charitable purpose.

The organizational documents of a related foundation and the foundation’s application for recognition of exemption under section 501(c)(3) are important legal instruments that should always be prepared by, or under the supervision of, a knowledgeable tax attorney or other tax professional.

PITFALLS TO AVOID

The benefits of establishing a related foundation will be negated if the health center fails to properly attend to certain organizational and operational matters. Several of the more common pitfalls in organizing a related foundation are discussed below.

Insufficient Health Center Control

A related foundation is useful to a health center only if it is responsive to a health center’s needs. The last thing a health center wants is for its related foundation, which may be holding significant funds derived from the health center’s operational reserves and from fundraising in the health center’s name, to embark on its own agenda. Accordingly, there must be mechanisms in place to assure the foundation’s responsiveness to the health center’s priorities and to eliminate the risk that the foundation will attempt to set its own course.

Approval of Foundation Board Membership

– Include provisions in the foundation’s Articles/Certificate of Incorporation and Bylaws that give the health center the right to appoint or elect at least a majority of the foundation’s governing body with broad authority to remove, with or without cause, the board members that it appoints or elects. Thus, the health center essentially maintains control of the foundation’s governance through its appointment/removal authority. Additionally, the organizational documents of the foundation can be structured to require approval of the health center’s board of directors for certain key decisions of the foundation, such as investment policies, change of mission, and dissolution, sale of assets, etc.

Keep in mind that appointment/ removal powers and health center approval authorities are really only a “fail safe” system to prevent the foundation board from taking the foundation in the wrong direction,

from the health center's point of view. They do not substitute for a careful process of selecting foundation board members, offering appropriate training for board members on the complementary missions of the health center and the foundation, and providing for constant and open discussion between the two governing bodies.

Approval of Key Decisions – Structure the organizational documents of the foundation to require the approval of the health center's board of directors for certain key decisions of the foundation, such as investment policies, change of mission, dissolution, sale of certain assets, etc.

Cross Membership on the Boards – Establish cross membership on the respective boards, but with no more than a majority of the foundation's board members also serving on the health center board. Cross membership encourages the foundation to respond to the health center's priorities.

As a legal matter, the foundation board could be comprised entirely of health center board members. However, it is important that the foundation operate independently of the health center and that the health center not become excessively involved in the foundation's day-to-day affairs. Failure to maintain appropriate independence may allow the IRS (and state courts if a liability claim is asserted against the health center) to treat the foundation as the alter-ego of the health center, thereby exposing foundation assets to the liabilities of the health center and vice versa. Structuring the foundation's board in that manner also will leave board seats for outside members who can bring different perspectives to the foundation's board.

Classification as a Private Foundation

As previously noted, **charitable organizations exempt under section 501(c)(3) run a risk of being classified as a private foundation as opposed to a public charity if they do not have a sufficient amount of public support, typically at least one-third of their total support** coming from contributions from the general public or through government grants. A health center that primarily funds its related foundation through transfers of operating reserves or other funds from the health center or that does not raise sufficient funds by way of donations from the general public through a foundation-sponsored fundraising program may well find the foundation classified as a private foundation.

Some of the numerous consequences that are particularly important with respect to being classified as a private foundation are:

- ◆ An excise tax of 2% of the foundation's net investment income for each tax year;
- ◆ A requirement to distribute annually, i.e., make grants or spend for administrative purposes, an amount equal to 5% of the assets held by the foundation for investment purposes, and to pay a tax of 15% of the amount that has not been distributed timely;
- ◆ A less generous tax deduction allowed for contributions as the deduction allowed for contributions to a public charity;
- ◆ Significant record keeping and reporting burdens.

Classification as a private foundation can be avoided by organizing a health center's related foundation as a supporting organization as described in Section 509(a)(3) of the IRC. This model is a common approach for avoiding private foundation classification in circumstances where a related foundation receives

most of its revenue from the parent organization, such as a health center, or from a few large contributors.

With respect to its related foundation, the health center would be designated as the “supported organization.” In order to qualify as a supporting organization, the Articles of Incorporation and Bylaws of a health center’s related foundation must limit its activities to:

- ◆ Supporting the health center, which, can be accomplished by providing financial support to the health center or carrying on other activities that support the health center;
- ◆ Working closely with its supported organization. Legally, it must demonstrate that it is:
 - Operated, supervised, or controlled by, OR
 - Supervised or controlled in connection with, OR
 - Operated in connection with its supported organization.

The first relationship is the most common of the three, amounting essentially to a parent-subsidiary relationship. Accordingly, if a health center’s board of directors retains the authority to appoint at least a majority of the related foundation’s governing board (as recommended above), which satisfies the “operated, supervised, or controlled by” test, the related foundation will qualify as a supporting organization.

Note also that organizing the related foundation as a supporting organization to the health center provides an additional level of assurance that the foundation will be responsive to the health center’s priorities in that the foundation is required by law to operate for the benefit of the health center.

Excessive Health Center Intrusion into Foundation Affairs

While it is important for a health center to maintain policy control of its related foundation through the techniques described above, it also is very important that the health center not become involved in the foundation’s day-to-day operations. In order to maintain the benefit of a separate organization (in particular, protection against foundation assets being made available to satisfy health center liabilities) and otherwise to prevent the activities of the foundation from being attributed to the health center, and vice versa, strict financial, management, and operational separation must be maintained at all times. As noted above, the IRS and the courts may well disregard the existence of separate corporations if, under the particular facts and circumstances, the affairs of the foundation are so extensively controlled by the health center that the foundation becomes an instrument of the health center.

Cross-membership on the governing boards and the sharing of corporate officers is easier to justify if the foundation is organized as a supporting organization. In that case, the foundation, by law, must be “operated, supervised, or controlled by” the health center, which would make it difficult for the IRS to argue that shared board members or officers cross the line. Corporate formalities must be observed to demonstrate that the two organizations are, indeed, separate entities.

At a minimum,

- ◆ The two organizations must keep **separate financial records and other corporate documents.**
- ◆ The respective boards of directors must hold **separate board meetings**, although the meetings can be held in conjunction with one another for the convenience of the shared board members.

- ◆ Operational separation must be maintained.
 1. **Time records** – Necessary staff can be shared with the parent health center, but in that case, staff should keep time records to document the time spent on foundation matters and on health center matters.
 2. **Facilities and supplies** – Maintain records to document facilities and supplies contributed to the foundation.
 3. **Administrative support** – Reflect in a written contract or memorandum of agreement the type and value of administrative support provided between the two organizations, with the foundation reimbursing the health center for the support costs. Such an agreement is important to establish that federal grant funds were not used to support the related foundation, as such expenditures are not an allowable cost under federal awards.

CONCLUSION

Establishing a related foundation can be an excellent way to raise substantial dollars for the health center, possibly with the help and good name of community luminaries who may or may not be interested or able to participate in the more demanding role of a health center board member. Further, forming a related foundation may be a useful risk management technique. However, health centers should keep in mind that they will derive all of the anticipated benefits from creating a related foundation only if they pay appropriate attention to proper structuring of the foundation at the outset.

This Information Bulletin was written for NACHC by:

Michael B. Glomb, Esq.
Feldesman Tucker Leifer Fidell LLP
Washington, D.C.

For information about these bulletins, contact:

Betsy Vieth at NACHC at bvieth@nachc.com



7501 Wisconsin Avenue, Suite 1100W

Bethesda, MD 20814

Telephone: 301-347-0400

Fax: 301/347-0459

Website: www.nachc.com