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To: Kelly Ryan and Dawn Vruwink
From: Melissa Auchard Scholz, Scholz Nonprofit Law LLC
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Re: Support for Informal Community Activities by Incourage Community Foundation

I was asked to answer the following question: can a community foundation that is recognized as a public charity under Section 501(c)(3) of the Internal Revenue Code (a "501c3"), such as the Incourage Community Foundation (Foundation), support projects of or give grants to organizations that are not formally recognized by the IRS as a 501c3? The short answer is "yes," as long as the 501c3's funds are spent to support legitimate 501c3 purposes.

The first question in this analysis is whether the Foundation's governing documents restrict Foundation distributions to only recognized 501c3s. In brief, based on my review of the articles of incorporation and bylaws, the Foundation is not limited to supporting recognized 501c3s. Specifically, Article 3.1 of the Articles, states that the purpose of the Foundation is to operate "exclusively for charitable, religious, literary, scientific, and educational purposes as set forth in Section 501(c)(3) . . . *including,* for such purposes, the making of distributions to organizations that qualify as exempt organizations under Section 501(c)(3)." I added emphasis to "including" because that indicates that distributions to recognized 501c3s is not the only way to fulfill its charitable purposes. Article 3.2(e) further provides that the Foundation may make distributions to "qualified charitable organizations" or for "charitable purposes in accordance with determinations made by the Board of Directors primarily for the benefit of the people of South Wood County, Wisconsin area." "Qualified charitable organizations" are defined in Article 10.2 as organizations that are recognized by the IRS as 501c3 public charities. "Charitable purposes" are defined in Art. 10.2 as *including* "educational, religious, scientific, public and other purposes for which contributions are deductible [under the tax code]." In other words, the distributions from the Foundation must be for purposes that would qualify as legitimate 501c3 purposes even if the recipient of the distribution is not officially recognized by the IRS. The Foundation's bylaws do not place any further limitations on its distributions.

As background on the general law governing 501c3s, a 501c3 is an organization that "is organized and operated exclusively for charitable, religious, scientific . . . or other educational purposes" and does not engage in substantial lobbying or any political activity. I.R.C. 501(c)(3). To operate "exclusively" means that all of the organization's resources must be used to further its tax-exempt mission (e.g., charitable or educational activities) and to fulfill a public rather than a private purpose. A public purpose is one that benefits a broad group of persons (e.g., the purpose of a 501c3 could be to provide job training to youth in a community but its purpose could not be to train the workers of one particular company). In general, an organization can fulfill its tax-exempt mission by providing services directly, purchasing services, or making a grant.

In fulfilling the requirement to engage "exclusively" in 501c3-permitted activities, it is commonly believed that 501c3s may only provide support to other 501c3s. That's not true. Here's what is true:

- 501c3s may only use their resources to fund expenditures that satisfy a tax-exempt purpose. That means that all amounts spent to provide service directly, purchase services or make a grant must further the cause. In other words, if a 501c3 gives someone money or something of value (e.g., shelter), that person must qualify under a "charitable class" (e.g., low income). Or if a 501c3 purchases a service, the organization must receive something of at least equal value in return (e.g., enough hours of work from that person furthering a tax-exempt cause to justify the payment).

- Private foundations, as a subset of 501c3s, have more restrictions on them to ensure that their funds are spent appropriately. Consequently, if a private foundation does not give to another 501c3, it must exercise "expenditure responsibility," which requires the private foundation to "exert all reasonable efforts" and establish specific procedures to ensure that the grant is spent only for its intended purpose, to receive detailed reports on how the funds are spent, and report to the IRS. These demanding rules do not apply to public charities in general; however, it is important to keep in mind that Donor Advised Funds (DAFs) that are held by public charities are subject to different rules. For purposes of this analysis of supporting informal arrangements, distributions from DAFs would be governed by the private foundation rules (e.g., grants to an organization that isn't formally recognized would be subject to "expenditure responsibility" and no grants could be made to individuals).

- Public charities, such as Incourage Community Foundation, have more flexibility than private foundations. While they do not have to fulfill the technical obligations of "expenditure responsibility," they still have to be sure that their money is being spent appropriately. This requirement translates into common "best practices" such as requiring receipts and explanations to reimburse an employee for an expense, obtaining a written agreement from a service provider, or asking for a copy of the 501c3 determination letter when making a grant to another 501c3.

- When a public charity wants to support activities that are not part of an already-recognized 501c3, it can do so as long as it has enough information to assure itself that the expenditures will be appropriate. In other words, if a group seeks funds to host a community event, the supporting 501c3 needs to know where it will be held, who is invited, how it is being publicized, and after it is over see documentation on how the money was spent (e.g., receipts for pizza). Of course, there is some risk in this situation that someone could abuse this opportunity by not actually using the funds to do what they planned or using them to pursue a non-charitable purpose (e.g., helping a political campaign), but these risks can be managed depending on the situation.

- The best way to minimize risk is rooted in common sense and will depend on a variety of factors. For example, issues to consider are the amount of money released at any point, familiarity with the players, the ability to verify expenditures (e.g., the event happened or it didn't), and the novelty of the idea.

In applying these general rules, there are various options for supporting community activities. Below is a summary of the most common options:

Independent 501c3 organization – An independent 501c3 organization, with an incorporated entity, an employer identification number (EIN), and its own formal recognition of 501c3 status from the IRS, is the most traditional model. It provides the least risk because of the presumption of validity of all transfers between 501c3s. It also has significant advantages for certain kinds of on-going projects: its ability to collect tax-deductible contributions from individuals and businesses and grants from private foundations that only give to officially-recognized 501c3 organizations.

Unincorporated Association with its own EIN – A group of people interested in doing something for the community may organize an unincorporated association (UA), which means: agreeing to some kind of governing document (e.g., a charter and/or bylaws) that outlines how the group of people will work together. UAs may obtain an EIN and use that number to establish a bank account. UAs are not eligible for tax-deductible donations or grants from private foundations that only give to 501c3s. However, a UA may be able to receive a sponsorship from a business that treats the contribution as a marketing or other business expense. A 501c3 public charity may choose to support a UA through a grant or agreement to cover a specific expense, but because it is not an official 501c3, it will want to gather specific information on how any funds will be and eventually are used, and take other necessary precautions as suggested above.

Project Support – An individual or a group of people interested in doing something for the community may organize a project or activity that is not part of a group structure. There are three basic ways for a 501c3 organization to support this kind of effort: i) pay for an individual to do the work of the project by hiring her/him as an independent contractor, under a written "agreement for services" that outlines specific expectations for use of the funds; ii) issue a grant to an individual who is working on behalf of a project along with a grant agreement or transmittal letter that outlines the allowable uses of the funds, requires reporting, and makes clear that the funds will have to be paid back if not used for the intended purpose; or iii) pay expenses of the project directly. For example, for a community movie night, a 501c3 could receive an invoice for and pay directly for the cost of the equipment and other agreed upon expenses.

Fiscal Sponsorship – Fiscal sponsorship is a formalized agreement by a recognized 501c3 to sponsor the charitable activities of another group. A sponsorship could be for an already incorporated organization (e.g., one that is seeking 501c3 status but hasn't received the letter yet), an unincorporated association or an individual or group of people undertaking a project. There are various ways to structure a fiscal sponsorship arrangement but, in general, the activities should be seen as a "project of" the sponsor.

Please let me know if you have questions or want to explore any of these options in more detail.