

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

Health centers that are private nonprofit corporations typically are exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code (“IRC”) as a public charity. Aside from the exemption from income tax, another benefit is that gifts and contributions to the health center may be tax deductible by the donor, thereby providing an economic incentive for the donor to make a contribution. Notwithstanding that they enjoy these benefits, several health centers and other charitable organizations have established separate, but related, foundations that also are tax exempt under section 501(c)(3).

Issue Brief Objectives:

- Discusses the reasons that a health center may want to establish a “related foundation”.
- 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.

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What is a Foundation?

Simply put, a foundation is:

1. A nonprofit charitable organization, that is
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 conduct their own charitable programs.

In the case of a foundation established by a health center, the foundation typically makes grants to the health center to support the center’s activities or, possibly, to another tax-exempt organization that supports the health center’s activities, or conducts certain activities on behalf of the center, such as outreach and educational programs.

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 public. The classification is based exclusively on the source of the organization’s income and has nothing to do with how the organization identifies itself or 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 is potentially at risk for being classified as a private foundation depending on its source of income, but that classification can be avoided if it is organized and operated as a “supporting organization” to the health center.

Private foundations and supporting organizations are discussed in more detail below.

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

Why Establish a Related Foundation?

There are several reasons why a health center might want to establish a related foundation.

Risk Management

Fundraising

Fiscal Planning

Ask a Foundation Leader...

How has establishing a foundation impacted the health center's ability to raise funds?

In one word – “bandwidth.”

Health Centers are not set up to focus solely on fundraising nor do they have the capacity to cultivate sustainable relationships that go beyond a transaction.

Having a separate foundation board with aligning initiatives allows the foundation to maximize territory and to create awareness about health center programs and services.

In addition, the foundation:

- Is a secondary marketing tool.
- Builds relationships to bring new resources to the health center beyond money.
- Is flexible and can be called on when the health center has funding gaps with special projects but lacks the staff needed to go out and fill those funding gaps.

Ultimately, we are the resource that health centers need to grow and sustain programs beyond federal grant funding. We are burden alleviators when leveraged properly.

Misty Lewis

Chief External Affairs Officer & Foundation Executive Director

HealthNet (Indianapolis, IN)

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) 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 agreements with state, local, or private funders.

Fundraising

A related foundation can be a useful fundraising vehicle for a health center. As noted previously, gifts and contributions to a health center (as a section 501(c)(3) organization) may be tax deductible by the donor. That raises a legitimate question as to why a health center would bother setting up a separate fundraising organization at all.

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.

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 the responsibility, nor be able to make the commitment, that service on the health center's governing board requires. They may 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 quite effective 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 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.

Also note 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 specific 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. More details are discussed below.

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, 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. Some states require that a nonprofit organization 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.

Ask a Foundation Leader...

What are some examples of effective tactics for recruiting Foundation board members?

If you are just launching your foundation, consider creating an advisory group of people who have nonprofit board experience to provide guidance during the planning process. You will benefit from their insights and might be able to recruit a few participants for your inaugural board.

For established foundations, remember that board-building – like fundraising – is about relationships. Ask your governing and foundation board members, health center colleagues, and closest supporters to give you names and help with introductions. Review your donor lists to identify your most loyal supporters and volunteer leaders and find small ways to engage them in fundraising activities. The people who are already committed to your mission may be some of your best board prospects.

Melissa Hilton

VP Development & Foundation Executive Director

Erie Family Health Centers (Chicago, IL)

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.

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. Accordingly, the application should 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

Classification as a
Private Foundation

Excessive Health
Center Intrusion into
Foundation Affairs

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.

Solution: Mechanisms for Health Center Control

- Approval of Foundation Board Membership
- Approval of Key Decisions
- Cross Membership on Boards

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 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

Require a certain number of seats on the foundation's board to be held by health center board members. Cross membership on the respective boards 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 operates 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.

Therefore, if cross membership is provided, it is advisable that no more than a majority of the foundation's board members also be health center board members. 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 public through a foundation-sponsored fundraising program may well find the foundation classified as a private foundation.

Some of the undesirable consequences of being classified as a private foundation are:

- An excise tax of 1.39% 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 net assets held by the foundation for investment purposes, and to pay a tax of 30% of the amount that has not been distributed timely;
- A less generous tax deduction is allowed for contributions than the deduction allowed for contributions to a public charity;
- Significant record keeping and reporting burdens.

Solution: A Related Foundation as a Supporting Organization

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 community health center, or from a few large contributors.

A supporting organization is nothing more than a charitable organization that meets all the requirements for tax exemption under Section 501(c)(3) but is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of its supported organization. In relation to the foundation, the health center would be designated as the "supported organization."

To qualify as a supporting organization, the Articles of Incorporation and Bylaws of a health center's related foundation must limit its activities to those that support the health center. In addition, it must work closely with and be responsive to its supported organization by demonstrating 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, being operated, supervised, or controlled by the supported organization, is the most common approach, 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) 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. 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 always maintained.

Solution: Demonstrate Separate Entities

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 consecutively to one another for the convenience of the shared board members.
- Operational separation must be maintained.
 - Time records – Necessary staff for the foundation 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.
 - Facilities and supplies – Maintain records to document facilities and supplies provided to the foundation.
 - Administrative support – Execute a written contract or memorandum of agreement the type and value of administrative support provided to the foundation, 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.

[Join the NACHC Workgroup...](#)

Email us at partnership@nachc.org to find out more about the Health Center-based Foundations Executive Director workgroup. The meetings offer peer-to-peer sharing, external guest speakers, and networking.

Current Participants (as of July 2023):

- Affinia Healthcare (St. Louis, MO)
- Cherry Health (Grand Rapids, MI)
- Chiricahua Community Health Center (Douglas, AZ)
- El Rio Health (Tucson, AZ)
- Erie Family Health Centers (Chicago, IL)
- Golden Valley Health Centers (Merced, CA)
- HealthNet (Indianapolis, IN)
- Horizon Healthcare (Howard, SD)
- International Community Health Services (Seattle, WA)
- Neighborcare Health (Seattle, WA)
- Open Health Care Clinic (Baton Rouge, LA)
- Virginia Garcia Memorial Health Center (Aloha, OR)
- Zufall Health (Dover, NJ)

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 able to take on 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 the anticipated benefits from creating a related foundation only if they pay appropriate attention to properly structuring the foundation at the outset and continuing to operate it for the benefit of the center.

For information about this bulletin, contact NACHC at partnership@nachc.org.

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