Establishing an Association Foundation

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Many nonprofit Section 501(c)(6) organizations set up separate foundations to carry on certain charitable or educational activities for the parent organization. We have helped many nonprofit organizations set up subsidiary foundations--this is very common and can enhance the activities and fundraising options for the parent organization. Provided below is background information on setting up a foundation.

By establishing an affiliated foundation, a trade or professional association can attract charitable contributions to support charitable and educational activities in the field. Foundations are typically established as nonprofit corporations and obtain tax exempt status under Section 501(c)(3) of the Code.

Benefits: There are several benefits associated with Section 501(c)(3) status such as:

- The organization’s revenues will not be subject to income tax (unless they constitute unrelated business income).
- Contributions to Section 501(c)(6) organizations are not deductible as charitable donations, but contributions to 501(c)(3) organizations or the foundation will be tax deductible to the donors as charitable donations.
- Since many private foundations and other funding groups will only make grants to 501(c)(3) organizations, the foundation may have access to more sources of funds than the parent association.
- In certain situations, the foundation may be exempt from state and local sales tax and eligible for certain reduced postal rates.

Supporting Organizations: There are two basic types of Section 501(c)(3) organizations: public charities? (which are publicly supported) and private foundations? (which generally have a small number of donors, e.g., the Ford Foundation, or the Bill and Melinda Gates Foundation). The preferred status, and the status that most association-related foundations have, is to be a public charity, since private foundation status carries with it significant administrative and tax burdens, such
as expenditure guidelines and excise taxes for insufficient expenditures. The fact that an affiliated 501(c)(3) organization is called a "foundation" does not mean it is a private foundation, but "foundation" is a common term used for most association foundations.

Different Types of Public Charities: There are several ways that a 501(c)(3) organization can obtain a determination from the IRS that it is a public charity. Organizations can meet the public support test under Code Section 509(a)(1) (at least one third government or other public support) or Section 509(a)(2) (at least one third government or public support, such as grants, gifts, admission fees, etc., and not more than one third investment income or unrelated business income subject to tax). Another route is under Section 509(a)(3), establishing the foundation as a supporting organization. Most association foundations are supporting organizations.

Of course, this being the Internal Revenue Code, there are wrinkles to this approach. There are three types of supporting organizations:

- Type I is where at least a majority of the foundation's Board is appointed by the parent association.
- Type II is where there is at least a majority overlap of the parent and charitable organization boards.
- Type III involves more of a loose affiliation between the two entities.

Type III is not as preferred, because some funders do not want to give grants to Type III supporting organizations. Type I is the safest category, and also ensures that the foundation would be a publicly supported organization rather than a private foundation, whether or not it meets the public support tests. Further, we do not believe that contributions from the typical association or the association's directors to the foundation would jeopardize the Type I supporting organization status of the foundation.

As a result, we generally recommend that supporting organizations take the form of Type I.

How to Set Up Your Foundation

Outlined below are the basic steps required to establish a subsidiary foundation.

- Articles of Incorporation. The first step is to prepare Articles of Incorporation to incorporate the foundation. The Articles will have to be drafted to meet applicable state law requirements for nonprofit corporations, as well as the IRS rules for Section 501(c)(3) organizations.
- Bylaws. The foundation also must develop Bylaws to govern its operations. As indicated above, the Bylaws of many affiliated foundations provide that the 501(c)(6) association will appoint all or a majority of the directors of the foundation, or that some or all of the directors of the association will also be the directors of the foundation. The Bylaws of the foundation may also provide that the parent association must approve any amendments to the foundation's Bylaws. This type of relationship between the foundation and the parent association is permissible and assists in maintaining control of the foundation over the long term.
• **Organizational Resolutions.** Newly incorporated corporations are required by law to hold an organizational meeting, where initial corporate resolutions are approved. It is through these resolutions that the foundation typically adopts Bylaws, elects the first full Board of Directors and officers, and authorizes bank accounts to be set up, the tax exemption application to be filed, and the like.

• **Form SS-4.** An Employer ID Number (also called a Taxpayer ID Number) will be obtained from the IRS by filing Form SS-4. This serves as the foundation’s ID number for all communications with the IRS. The Form is fairly simple and filed after the foundation is incorporated. The EIN can nowadays be obtained in an on-line filing to the IRS.

• **Cost Sharing Agreement.** We also recommend a pro forma Cost Sharing Agreement between the parent association and the foundation to properly allocate expenses and avoid unrelated business income tax to the parent association for revenues that might otherwise be characterized as “management fees.” This agreement formalizes the arrangement for tax and management purposes, and also confirms the separateness of the corporations to help protect the association from liability for the foundation’s actions. (These might arise, for instance, from a contract dispute or a tort claim at the foundation level.) We often include provisions regarding licensing of intellectual property by the parent association to the foundation in this Agreement.

• **Tax Exemption Applications.** Once we have finalized these documents, a tax exemption application must be drafted and filed with the IRS via Form 1023. The application form requires information about the foundation, including a full description of the substantive proposed activities of the foundation and proposed budgets for the next two years. Copies of the Articles of Incorporation, Bylaws, Cost Sharing Agreement, and other relevant documents of the foundation, including a conflict of interest policy, will have to be included with the application filed with the IRS. Assuming the application is filed on a timely basis (within 27 months of the date of incorporation) and is approved, the foundation’s tax exempt status will be retroactive to the date of incorporation and all contributions received by the foundation after that date will be tax deductible to the donors.

The IRS generally responds with a determination letter within about three or four months of filing (depending on the IRS’s caseload), and also may ask additional questions or request more information. Therefore, the entire process usually takes six to eight months.

Once the IRS has granted tax-exempt status under federal law, an exemption under state income tax law should then be obtained. In some states, such as Virginia, income tax exemption is automatically granted. In other jurisdictions, however, such as Maryland and the District of Columbia, one must apply for state income tax exemption.
In sum, it is very common for membership organizations to set up Section 501(c)(3) charitable foundations, and we have done this many times for our client associations.