RESPONSE TO GRAND JURY REPORT FORM

Report Title: *College Of Marin Foundation – What's Now? What's Next?*
REVISED

Report Date: June 11, 2013

Public Release Date: June 20, 2013

Response by: **September 20, 2013**

FINDINGS

- I (we) agree with the findings numbered:_____
- I (we) disagree wholly or partially with the findings numbered: F 1 – F 5

  (Attach a statement specifying any portions of the findings that are disputed; include an explanation of the reasons therefor.)

RECOMMENDATIONS

- Recommendations numbered R 3 have been implemented.

  (Attach a summary describing the implemented actions.)

- Recommendations numbered R 1 R 5 have not yet been implemented, but will be implemented in the future.

  (Attach a timeframe for the implementation.)

- Recommendations numbered R 2 R 4 require further analysis.

  (Attach an explanation and the scope and parameters of an analysis or study, and a timeframe for the matter to be prepared for discussion by the officer or director of the agency or department being investigated or reviewed, including the governing body of the public agency when applicable. This timeframe shall not exceed six months from the date of publication of the grand jury report.)

- Recommendations numbered_____ will not be implemented because they are not warranted or are not reasonable.

  (Attach an explanation.)

Date: 9-18-13 Signed: [signature]

Number of pages attached 7

COLLEGE OF MARIN FOUNDATION

P.O. Box 325
Kentfield, CA 94914

September 17, 2013

The Honorable Judge James Ritchie
Marin County Superior Court
P.O. Box 4988
San Rafael, CA 94913-4988

Rich Treadgold, Foreperson
Marin County Grand Jury
3501 Civic Center Drive, Room #275
San Rafael, CA 94904

Dear Judge Ritchie and Foreperson Treadgold:

The Grand Jury Report: ***College of Marin Foundation: What's Now? What's Next?*** reflects the thorough and conscientious efforts of the Grand Jury to understand complex issues associated with the current status of the College of Marin Foundation (Foundation) and the development/fundraising program administered by the Advancement Office at the College of Marin.

As members of the Board of Directors of the Foundation, we (Diana Conti and David Wain Coon) are working diligently to address the outstanding issues and challenges facing the Foundation. Our legal counsel had an initial meeting with Elizabeth Kim, Supervising Deputy Attorney General, Charitable Trusts Division, on August 13, 2013. Ms. Kim and her staff requested a substantial number of documents, which we have provided, and they are currently reviewing. They also requested a copy of this letter and a copy of the legal opinion memorandum provided with this letter as Attachment 1, which we are in the process of sending them. We have agreed to determine in early October when we should meet again. With regard to "what's next" for the Foundation, we cannot proceed with decisions until we have completed the process of conferring with the Attorney General's Office.

Certain aspects of the Grand Jury's report address issues related to the College of Marin ("College"), which is a part of the Marin Community College District ("District"). In order to make clear who is

responding and in what role the person or persons are responding, please be advised that the portions of the response below that address District matters come from the Superintendent/President of the College of Marin, Dr. David Wain Coon. Those portions of the response that address Foundation matters come from Foundation board members Diana Conti and David Wain Coon.

The Foundation's and District's responses to the Grand Jury Report's Finding and Recommendations are provided in ***italicized blue print.***

FINDINGS

The Foundation and/or District disagree with the findings numbered F2, F3, F4, and F5.

F2. As of the date of this report's finalization, the Advancement Office of College of Marin is neither a USC 501 (c)(3) nor a California State 23701e-designated non-profit organization and this creates potential problems for the acceptance of corporate donations.

Response by the District: This conclusion that the College's lack of 501(c)(3) status creates potential problems for the acceptance of corporate donations is incorrect. A tax attorney at Crowe Horwath LLP has provided the District with a legal opinion memorandum that addresses this and other related tax issues (Attachment 1). In pertinent part, the opinion memorandum provides the following conclusion:

> ***Corporate Charitable Contributions to the District:***
>
> ***Corporate donors who make contributions to the District are permitted a charitable deduction in the same manner as contributions to a section 501(c)(3) charitable organization. Corporate charitable deductions are limited to 10% of the corporation's annual net income. This 10% limit also applies to contributions by a corporation to section 501(c)(3) public charities.***

F3. As of the date of this report's finalization, The Foundation has not filed IRS Form 990 and California State Form RRF-1 since 2011. These forms are required to be submitted every fiscal year in order to renew an organization's tax-exempt status.

Response by the Foundation: The Foundation filed the 2012 IRS Form 990 in a timely fashion by the deadline on May 15, 2013 (Attachment2). The Foundation also filed its California State Form RRF-1 report, which was not delinquent (Attachment 3).

F4. The College is currently in charge of all Foundation assets and with that comes potential for a conflict of interest.

Response by the Foundation: The assertion that the College is in charge of all Foundation assets is incorrect. The Foundation Board of Directors is in charge of all Foundation assets. It is true that Foundation board member David Wain Coon is also the Superintendent/President of the College, and Foundation board member Diana Conti is also a member of the Board of Trustees for the District. The Memorandum of Understanding between the Foundation and the College, the Foundation By-Laws, and College of Marin Board policies all establish official dual roles for the College President and the College Board President in regard to the Foundation. These dual roles do not present an inherent conflict of interest.

First, both David Wain Coon and Diana Conti are keenly aware of the separation in their roles and responsibilities in regard to the two organizations. When conducting the business of the Foundation, they exercise and fulfill their duties of loyalty and care under the high standard called for in fulfilling their fiduciary responsibilities to the Foundation.

Second, the Foundation's Articles of Incorporation specify that its purposes are: (1) to raise money for the purpose of awarding scholarships and loans to assist students residing in Marin County to attend college; and (2) to afford and encourage the establishment of permanent collections, art endowments, research and educational projects, and otherwise provide aids to education that are supplementary to governmental support for the College of Marin. No part of their duties as College President and member of the District's Board of Trustees are in conflict with the purposes of the Foundation or their role as members of the Foundation Board of Directors.

F5. No source for emergency funds exists for students in immediate need of financial assistance since Restricted funds were repurposed.

Response from the Foundation: The former Foundation Executive Director had a relatively small discretionary fund (less than $10,000 annually) to assist students with emergency personal needs, such as bus fare or meal vouchers; not scholarships or book grants.

Response from the District: The District had and continues to have the authority to grant Board of Governors ("BOG") fee waivers to students with financial need. Currently 46% of all College students receive BOG waivers. In addition, the College Advancement Office is undertaking fundraising efforts to meet the needs of students for emergency financial assistance.

COMF disagrees partially with the findings number F1.

F1. Historically, there has been a lack of transparency regarding the Foundation's methods and financial circumstances and this has led to spending donor funds on non-donor designated purposes.

Response from the Foundation and the District: The Foundation has been a valued partner with the District providing support for the College's students and programs since 1964. While not without challenges along the way, the partnership between the Foundation and the District has worked well more often than not. There is no evidence of a lack of transparency regarding the Foundation's methods and financial circumstances prior to Fiscal Year 2012, the time period in which spending by the former Board of Directors members exceeded the Foundation Board's approved budget by $474,573. While the Foundation's Standard Operating Procedures perhaps lacked sophistication, they met the needs of the Foundation, donors, and the College until Fiscal Year 2012, when the former directors did not comply with the Foundation's fiscal policies. The former directors also failed to respond to the College's requests in 2012 for current financial information.

RECOMMENDATIONS

R1. The Board of Directors of the current Foundation and any successor organization collecting funds in support of College of Marin, its students, programs and departments, make public, on a quarterly basis, the status of the Foundation or its successor, its assets and plans for immediate future.

Response from the Foundation: The Foundation will provide financial statements on a quarterly basis, which will be available to the public. As to plans for the future, the Foundation directors are committed to transparent and regular communication with the public. We are currently working with the Attorney General's Office to determine next steps. Once this has been accomplished, we will make our next report to the public and media. While we cannot guarantee there will be new information available to report to the public on a quarterly basis, we will commit to reporting to the public in the most efficient and effective way possible as new information becomes available.

R2. College of Marin's Advancement Office file for USC 501 (c)(3) and State of California 23701e status.

Response from the District: As discussed above, we recently received a legal opinion memorandum on tax issues related to the District's fundraising program (Attachment 1). In pertinent part, the opinion memorandum provides information which follows. In light of the receipt of this information, President Coon will be providing the information in the opinion memorandum and the Grand Jury's recommendations (to file for USC 501 (c)(3) and State of California 23701e status) to the District's Board of Trustees for consideration. The Board of Trustees would need to decide if there is a benefit to pursuing this course of action; however, the College is authorized under federal tax law to receive tax-deductible donations without taking this step.

Tax Status of the District

For federal income tax purposes, the District is considered to be an instrumentality of the State of California. As such, any income accruing to the District is excluded from gross income under IRC section 115(1).

Individual Charitable Contributions to the District

Individual donors who make contributions to the District are permitted a charitable deduction in the same manner as contributions to section 501(c)(3) organizations for up to 30% of the donor's adjusted gross income. If capital gains property is contributed to the District, the charitable deduction is limited to 20% of the donor's adjusted gross income.

Corporate Charitable Contributions to the District

Corporate donors who make contributions to the District are permitted a charitable deduction in the same manner as contributions to a section 501(c)(3) charitable organization. Corporate charitable deductions are limited to 10% of the corporation's annual net income. This 10% limit also applies to contributions by a corporation to section 501(c)(3) public charities.

Grants by Charitable Organizations to the District

Section 501(c)(3) charitable organizations, including "public charities" and "private foundations," are permitted to make grants/contributions to the District without any restrictions or limits. Grants/contributions from private foundations will be treated as "qualifying distributions" under IRC section 4942 and will not require the private foundation to exercise expenditure responsibility over the grants.

Public Perception Issues

There is a public perception, one that is incorrect but nevertheless one that is somewhat ingrained in the public's thinking, that individual and corporate donors are not entitled to a charitable deduction for contributions made to a governmental unit or for the use of a governmental unit. There is also an incorrect perception on the part of private foundations that such grants either do not count as "qualifying distributions" or require the foundation to exercise expenditure responsibility over the grants. In fact, contributions to, or for the use of governmental units are common and even increasing as government budgets are squeezed, and they are treated as qualifying distributions with no expenditure responsibility required.

Tax Exempt Charitable Alternative

It should be possible for the District itself to obtain recognition of exemption as a section 501(c)(3) charitable organization. This would mean that the

District would have "dual status" as an instrumentality [of the State] and a section 501(c)(3) entity at the same time. Pursuant to Rev. Rul. 60-384, 1960-2 CB 172, the IRS ruled that a wholly owned state or municipal instrumentality which is a counterpart of an organization described in IRC section 501(c)(3) such as a separately organized school, college, or university may qualify for exemption under section 501(c)(3)...

R3. The Foundation immediately file IRS Form 990 Return of Organization Exempt from Income Tax and State Form RRF-1, Annual Registration Renewal Fee Report to Attorney General of California, for 2012 to renew the organization's registration as a public benefit corporation. These forms must be on file for the Foundation to collect money legally or to proceed with dissolution.

Response from the Foundation: As reported in F3, the Foundation has accomplished the recommended actions. The Foundation filed 2012 IRS Form 990 by the deadline on May 15, 2013 (Attachment 2). The Foundation also timely filed California State Form RRF-1 (Attachment 3).

R4. The College, immediately following the dissolution of the Foundation, create an independent body to collect and administer donations to benefit students and programs at the College.

Response from the Foundation: The Foundation Board of Directors has not reached a decision to dissolve the Foundation. Again, we are currently working with the State Attorney General's Office to determine the next steps.

Response from the District: Given that the College of Marin is within permitted by law to receive all types of personal and corporate gifts as well as grant funds, the creation of a separate independent body may not be necessary. However, the District is deferring its decision-making process on these issues until the Foundation completes its consultative process with the Attorney General's Office and makes a determination about the future of the Foundation.

R5. College of Marin's Office of Advancement contact outside sources, including service groups, to arrange for emergency funds for students in immediate need of financial assistance until a permanent program to address these needs is established.

Response from the District: The Foundation historically had a relatively small discretionary fund (less than $10,000 annually) to assist students with emergency personal needs, such as bus fare or meal vouchers; not scholarships or book grants. The College's Advancement Office is actively developing a comprehensive fund development program that will appropriately and effectively support the needs of students and College programs. In less than a year's time, the Advancement Office has raised in excess of $450,000.

Thank you for the opportunity to respond to the Grand Jury Report ***College of Marin Foundation: What's Now? What's Next?*** Please do not hesitate to contact us should further clarification be needed or desired.

Respectfully,

David Wain Coon, Ed.D.
Ex-Officio Director
College of Marin Foundation

Diana Conti
Ex-Officio Director
College of Marin Foundation

David Wain Coon, Ed.D.
Superintendent/President
College of Marin

Attachments

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MEMORANDUM

DATE: August 30, 2013

TO: Marin Community College District Tax Correspondence File

FROM: John V. Woodhull

RE: Charitable Deductions for Contributions to the Marin Community College District

CC: David Coon, Randy Parent, Kristin Ficker

Background Information

The Marin Community College District ("District") has asked Crowe Horwath LLP ("Crowe") to determine whether the College of Marin ("College") can, through its own development office, solicit contributions from the general public that would be eligible for a charitable deduction under Section 170(c)(1) of the Internal Revenue Code ("IRC") in the same manner as a section 501(c)(3) charitable organization. The District would like to determine for federal income tax purposes whether contributions made directly to the College enable individuals as well as corporations to claim charitable deductions. By way of background, neither the District nor the College has applied for, or received, recognition of federal tax exempt status under section 501(c)(3).

The District is one of 72 community college districts created by the state of California that operate a total of 112 community colleges. The District is part of the California Community Colleges, a post-secondary educational system, and maintains and oversees the operations of the College.

The California Community Colleges are governed by a seventeen person board, twelve of whom are appointed by the Governor. This board appoints the Chancellor, who serves as the system's chief administrative officer. According to California Education Code Section 71024, the Board of Governors has the duties, powers, purposes, responsibility and jurisdiction previously vested in the State Board of Education, Superintendent of Public Instruction and the California Department of Education.

Each year, the Board of Governors prepares and adopts a proposed budget for California Community Colleges and submits it to the State Department of Finance as part of the annual budget bill. A significant portion of the California Community Colleges' annual support comes from state funding. The Board of Governors allocates the appropriated funds to the 72 Community College Districts.

At the Community College District level, each district is under the control of a board of trustees elected at large from the district to serve terms of four years. According to the California Education Code, community college district governing boards consist of five to seven members. The District has seven governing board members and one non-voting student member ("Board of Trustees"). The Board of Trustees appoints the Superintendent/President who serves as the District's chief executive officer and provides overall administrative leadership to the College.

It should be noted that the College is not a separate entity for federal tax purposes. It is the District that obtained a federal employer identification number ("EIN") and it is the District that is the formal entity for our federal tax discussions. The District's primary activity is to operate the College of Marin – the District is essentially doing business as the College of Marin. Although contributions have been and can continue to be solicited in the name of the College, as noted above, it is the District that is the entity for federal tax purposes.

The District has asked Crowe to provide tax guidance on the following issues and transactions:

- Tax exempt status of the District.
- Tax deductibility of contributions to the District by individual donors.
- Tax deductibility of contributions to the District by corporate donors.
- Tax consequences of contributions to the District by tax exempt organizations
- The ability of the District to solicit gifts and grants from section 501(c)(3) organizations, for-profit corporations and governmental entities.

Conclusions

Tax Status of the District

For federal income tax purposes, the District is considered to be an instrumentality of the state of California. As such, any income accruing to the District is excluded from gross income under IRC section 115(1). However, because the District is considered an instrumentality, pursuant to IRC section 511(a)(2)(B), any unrelated business income earned by the District would be subject to unrelated business income tax.

Individual Charitable Contributions to the District

Individual donors who make contributions to the District are permitted a charitable deduction in the same manner as contributions to section 501(c)(3) organizations for up to 30% of the donor's adjusted gross income. If capital gains property is contributed to the District, the charitable deduction is limited to 20% of the donor's adjusted gross income.

Corporate Charitable Contributions to the District

Corporate donors who make contributions to the District are permitted a charitable deduction in the same manner as contributions to a section 501(c)(3) charitable organization. Corporate charitable deductions are limited to 10% of the corporation's annual net income. This 10% limit also applies to contributions by a corporation to section 501(c)(3) public charities.

Grants by Charitable Organizations to the District

Section 501(c)(3) charitable organizations, including "public charities" and "private foundations," are permitted to make grants/contributions to the District without any restrictions or limits. Grants/contributions from private foundations will be treated as "qualifying distributions" under IRC section 4942 and will not require the private foundation to exercise expenditure responsibility over the grants.

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There is a public perception, one that is incorrect but nevertheless one that is somewhat ingrained in the public's thinking, that individual and corporate donors are not entitled to a charitable deduction for contributions made to a governmental unit or for the use of a governmental unit. There is also an incorrect perception on the part of private foundations that such grants either do not count as "qualifying distributions" or require the foundation to exercise expenditure responsibility over the grants. In fact, contributions to, or for the use of governmental units are common and even increasing as government budgets are squeezed and they are treated as qualifying distributions with no expenditure responsibility required.

Tax Exempt Charitable Alternative

It should be possible for the District itself to obtain recognition of exemption as a section 501(c)(3) charitable organization. This would mean that the District would have "dual status", an instrumentality and a section 501(c)(3) entity at the same time. Pursuant to Rev. Rul. 60-384, 1960-2 CB 172, the IRS ruled that a wholly owned state or municipal instrumentality which is a counterpart of an organization described in IRC section 501(c)(3) such as a separately organized school, college, or university may qualify for exemption under section 501(c)(3) so long as it does not have the ability to exercise sovereign powers.

All of our conclusions are discussed in more detail below.

Tax Law

Tax Status as a Political Subdivision or Instrumentality

CA. Government Code Section 8557(b) describes a political subdivision as including any city, city and county, county, district or other local governmental agency or public agency authorized by law.

The IRS Exempt Organization Continuing Professional Education Text for FY 1990, "Instrumentalities" ("EO CPE") states that the term "governmental unit" generally includes a state; a possession of the United States; a "political subdivision" of a state or United States possession; the United States; or the District of Columbia.

Treas. Regs. Section 1.103-1(b) defines a "political subdivision" as either a municipal corporation, or a division of government that has been delegated the right to exercise part of the

government's sovereign power. There are three generally acknowledged sovereign powers: the power to tax, the power of eminent domain, and the police power. An entity is a "political subdivision" however, only if it has substantial sovereign power

In Rev. Rul. 77-165, 1977-1 C.B. 21, the IRS determined whether a state university qualified as a political subdivision under Treas. Regs. Section 1.103-1(b). The University was created pursuant to a state statute and was supported by annual legislative appropriations. It had formed a police force primarily to regulate traffic on campus and had used the state's power of eminent domain in very limited situations with prior legislative approval. The IRS concluded that the University did not possess a substantial right to exercise the sovereign powers of the state, and therefore, did not qualify as a political subdivision.

IRC section 115(1) provides, in part, that gross income does not include income derived from the exercise of any essential governmental function and accruing to a state or any political subdivision of a state. It should be noted that section 115 does not exempt governmental entities from federal taxes, it instead, excludes their income from federal income taxation.

Rev. Rul. 77-261, 1971-1 C.B. 28 concluded that IRC section 115(1) was intended to refer, not to the income of a State or municipality resulting from its own direct participation in industry, but rather to that part of the income of a corporation engaged in the performance of some governmental function that accrues to a State or municipality.

Rev. Rul. 57-128, 1957-1 C.B. 311, sets forth the factors to be taken into account in determining whether an entity is an instrumentality of one or more governmental units: (1) whether the organization is used for a governmental purpose and performs a governmental function; (2) whether performance of its function is on behalf of one or more states or political subdivisions; (3) whether there are any private interests involved, or whether the states or political subdivisions have the power and interests of an owner; (4) whether control and supervision of the organization is vested in a public authority or authorities; (5) whether express or implied statutory or other authority is necessary for the creation and/or use of the organization, and whether this authority exists; and (6) the degree of financial autonomy of the entity and the source of its operating expenses. Each of these factors must be evaluated in order to determine if the District is an instrumentality of the State of California.

In IRS PLR 201220005, the IRS ruled that an educational organization was an instrumentality of the state in which it was incorporated and contributions to it were deductible under IRC section 170(c)(1). According to the facts of the ruling, the organization was created by an act of the state legislature as a public corporation to support educational excellence in certain specified public schools operated by the State Department of Education which was considered as the administrative arm of the State Board of Education. The IRS concluded that the organization satisfied all the factors enumerated in Rev. Rul. 57-128 and therefore was an instrumentality of the state for purposes of section 170(c)(1).

Based on our review of the six factors listed in Rev. Rul. 57-128 and the analysis in IRS PLR 201220005, it is clear that the District does not qualify as a political subdivision, but is an instrumentality of the state of California.

Charitable Contributions

IRC section 170(a)(1) provides, subject to certain limitations, a deduction for contributions or gifts to or for the use of organizations described in section 170(c), payment of which is made within the taxable year.

IRC section 170(c)(1) provides, in part, that the term "charitable contribution" means a contribution to or for the use of a state, a possession of the United States, or any political subdivision of the foregoing, but only if the contribution or gift is made for exclusively public purposes.

IRC section 170(c)(2) provides, in part that the term "charitable contribution" means a contribution to or for the use of a corporation, trust, or community chest, fund, or foundation-

> (A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;
>
> (B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;
>
> (C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and
>
> (D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

For individual contributors, IRC section 170(b)(1)(A) provides, in part, that any charitable contribution to churches, educational institutions, hospitals, governmental unit described in section (c)(1) (state and local governments and their political subdivisions) and publicly supported organization shall be allowed a deduction to the extent that the aggregate of such contribution does not exceed 50 percent of the taxpayer's contribution base for the taxable year.

Under IRC section 170(b)(1)(B), deductions for contributions "for the use of" governmental units described in section 170(c)(1) may not exceed 30 percent of the taxpayer's "contribution base" for the taxable year.

Pursuant to Rev. Rul. 75-359, 1975-2 CB 79, a contribution to an instrumentality of a governmental unit described in section 170(c)(1) does not qualify as a contribution "to" an organization described in section 170(c)(1) and therefore does not qualify for the 50 percent deduction. However, because the organization is an instrumentality of state government, contributions to the instrumentality are deductible as contributions "for the use" of such a governmental unit, rather than a contribution "to" such a governmental unit.

We would note that although IRC section 170 and the regulations thereunder provide a significant amount of discussion on the qualifications and distinctions between contributions eligible for a charitable deduction up to 50% of individuals' adjusted gross income and 30% of adjusted gross income, very few individual contributors reach, much less exceed, the 30% threshold.

IRC section 170(b)(1)(G) provides that for purposes of this section, the term "contribution base" means adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172).

IRC section 170(b)(2)(A) provides that in the case of a corporation, the total deductions under subsection (a) for any taxable year (other than for contributions to which subparagraph (B) applies) shall not exceed 10 percent of the taxpayer's taxable income. For corporate donors, the type of charitable or governmental donee does not matter; the maximum charitable deduction for corporations is 10% of their annual taxable income, whether the donee is a section 501(c)(3) organization, a state government, a political subdivision of a state government or an instrumentality of a state government , like the District.

Private Foundation Grants To Governmental Entities and Affiliates

Treas. Regs. Section 53.4942(a)-3(a)(2) provides that a qualifying distribution means any amount (including program-related investments, as defined in section 4944(c), and reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in section 170(c)(1) or (2)(B), other than any contribution to-

(a) A private foundation which is not an operating foundation (as defined in section 4942(j)(3)), except as provided in paragraph (c) of this section,

IRC section 4945(d) imposes on each taxable expenditure (as defined in subsection (d)) a tax equal to 20 percent of the amount thereof. The tax imposed by this paragraph shall be paid by the private foundation.

IRC Section 4945(d)(4) defines the term "taxable expenditure" to mean any amount paid or incurred by a private foundation as a grant to an organization unless such organization is:

- Described in paragraph 1 or 2 of section 509(a)
- An organization described in section 509(a)(3)
- Is an exempt operating foundation, or
- The private foundation exercises expenditure responsibility with respect to such grant in accordance with subsection (h)

Treas. Regs. Section 53.4945-5(a)(4)(ii) provides that for purposes of this section, an

organization will be treated as a section 509(a)(1) organization if:

(i) It qualifies as such under paragraph (a) of §1.509(a)-2 of this chapter;

(ii) It is an organization described in section 170(c)(1) or 511(a)(2)(B), even if it is not described in section 501(c)(3); or

(iii) It is a foreign government, or any agency or instrumentality thereof, or an international organization designated as such by Executive order under 22 U.S.C. 288, even if it is not described in section 501(c)(3).

However, any grant to an organization referred to in this subparagraph must be made exclusively for charitable purposes as described in section 170(c)(2)(B).

Treas. Regs. Section 53.4945-5(h) provides that a private foundation will be considered to be exercising "expenditure responsibility" under section 4945(h) as long as it exerts all reasonable efforts and establishes adequate procedures-

(i) To see that the grant is spent solely for the purpose for which made,

(ii) To obtain full and complete reports from the grantee on how the funds are spent, and

(iii) To make full and detailed reports with respect to such expenditures to the Commissioner.

In cases in which pursuant to paragraph (a)(6) of this section a grant is considered made to a secondary grantee rather than the primary grantee, the grantor foundation's obligation to obtain reports from the grantee pursuant to section 4945(h)(2) and this section will be satisfied if appropriate reports are obtained from the secondary grantee. For rules relating to expenditure responsibility with respect to transfers of assets described in section 507(b)(2), see section 507(b)(2) and the regulations thereunder.

(2)Pregrant inquiry.

(i) Before making a grant to an organization with respect to which expenditure responsibility must be exercised under this section, a private foundation should conduct a limited inquiry concerning the potential grantee. Such inquiry should be complete enough to give a reasonable man assurance that the grantee will use the grant for the proper purposes. The inquiry should concern itself with matters such as: (a) The identity, prior history and experience (if any), of the grantee organization and its managers; and (b) any knowledge which the private foundation has (based on prior experience or otherwise) of, or other information which is readily available concerning, the management, activities, and practices of the grantee organization. The scope of the inquiry might be expected to vary from case to case depending

upon the size and purpose of the grant, the period over which it is to be paid, and the prior experience which the grantor has had with respect to the capacity of the grantee to use the grant for the proper purposes. For example, if the grantee has made proper use of all prior grants to it by the grantor and filed the required reports substantiating such use, no further pregrant inquiry will ordinarily be necessary. Similarly, in the case of an organization, such as a trust described in section 4947(a)(2), which is required by the terms of its governing instrument to make payments to a specified organization exempt from taxation under section 501(a), a less extensive pregrant inquiry is required than in the case of a private foundation possessing discretion with respect to the distribution of funds.

IRC section 511(a)(2)(B) describes colleges and universities which are agencies or instrumentalities of any government or any political subdivision thereof, or which are owned or operated by a government or any political subdivision thereof, or by any agency or instrumentality of one or more governments or political subdivisions.

Discussion and Analysis

Characterization of the District as an Instrumentality of the State of California

Based on the above federal tax statutes, regulations and IRS rulings, the District is considered to be an instrumentality of the state of California for federal income tax purposes, although for state law purposes, it is considered a political subdivision of the State of California This means that for federal income tax purposes, contributions made directly to the College (As noted above, for federal tax purposes, the College and the District are considered the same) will be considered "charitable contributions" as described in IRC section 170(c) and that both individual and corporate donors will be entitled to claim charitable deductions on their respective tax returns subject to the limits listed in section 170(b).

Although it is clear from IRC section 170(c)(1) that contributions to governmental units and contributions for the use of governmental units are charitable contributions in the same manner as contributions to section 501(c)(3) organizations, most potential donors are either unaware of this code section or if they are aware, are confused by the terms "to governmental units" and "for the use of governmental units". Neither of these terms are defined in the Internal Revenue Code and neither have the preciseness that a section 501(c)(3) classification brings to the discussion nor the simplicity of an official letter from the IRS stating that the organization is recognized as exempt from federal income tax under section 501(c)(3).

Part of the uncertainty with the term "governmental unit" aside from the fact is that it is not defined anywhere in the Internal Revenue Code is the additional fact that there are multiple terms used to describe governmental units, including a state, a political subdivision of a state, an integral part of a state or a political subdivision of a state, as well as an instrumentality of a state or local government. Further compounding the situation is the fact that state and local governments often use different names to describe these entities. For example, it is common to see terms like municipal corporations, public corporations, authorities, districts, etc. without ever

having them defined relative to the federal tax code. All of this makes it very difficult for a donor to be certain that the potential recipient of its contribution is described in IRC section 170(c)(1) unless it receives a formal determination letter from the IRS ruling on the entity's tax status or a separate analysis like one we are doing is conducted.

As noted above, the definition of a "political subdivision" is not found in IRC section 170 or in section 501(c)(3), but is instead found in the tax exempt bond regulations. Treas. Regs. Section 1.103-1(b) defines a political subdivision as either a municipal corporation, or a division of government that has been delegated the right to exercise part of the government's sovereign power. Sovereign powers include the power to tax, the power of eminent domain, and police power.

In Rev. Rul. 77-165, 1977-1 C.B. 21, a transaction with facts very similar to the those of the District, a state university that was established under state statutes and that was supported primarily by legislative appropriations from the state's general funds based on budgets submitted by the University and which had the power to create a police force for purposes of regulating traffic on campus, was considered to have an insubstantial amount of sovereign powers and thus, did not qualify as a political subdivision under Treas. Regs section 1.103-1(b). According to the IRS' ruling, financial support through legislative appropriations did not equate to the power of taxation nor did the creation of a police force that regulated traffic and secured the safety of the campus constitute a sufficient exercise of police power. Based on the above analysis and the conclusions reached in this revenue ruling, it is unlikely that the District would meet the definition of a political subdivision for federal tax purposes.

However, notwithstanding its inability to qualify as a political subdivision, the District is considered to be an "instrumentality" of the state of California for purposes of IRC section 170(c)(1), and contributions made to the District are deductible by a donor as described in section 170(b)(1)(B) (30% and 20% of contribution base).

A review of the factors listed in Rev. Rul. 57-128 and PLR 201220005 support the College's designation as an instrumentality of the state of California, which means that donations made to the College by individual and corporate donors are deductible under IRC section 170(c)(1).

Deductibility of Charitable Contributions to the District

As noted in PLR 201220005, an organization that satisfies the criteria of Rev. Rul. 57-128 is considered an instrumentality for purposes of IRC section 170(c)(1). Accordingly, contributions made to the College are deductible to the extent permitted under section 170(b)(1)(B) Although individual donors will be limited in the amount of charitable deductions they can claim as a percentage of their adjusted gross income as reported on their Form 1040, very few donors exceed 30% of the adjusted gross income. In very general terms, it means that an individual earning $100,000 would be able to contribute up to $30,000 to the College and have that amount deducted from his or her gross income for federal tax purposes. If the College were considered a political subdivision for federal tax purposes or a section 501(c)(3) public charity, the contribution limit would be 50% or $50,000 in our example above.

For corporate donors, the only limitation that would apply is the same limitation that would apply with regard to contributions to a section 501(c)(3) charitable organization. Corporations are limited to no more than 10 percent of their taxable income whether the donee is a section 501(c)(3) charitable organization, a state government, a political subdivision of a state government or an instrumentality of a state government, which is what the District is considered.

Private Foundation Grants to the District

Private foundations are often reluctant to make grants to organizations that are not "public charities", i.e.; section 509(a)(1) and section 509(a)(2) organizations. There are several other types of charitable organizations that are also eligible to receive qualifying distributions without requiring private foundations to exercise expenditure responsibility over the issuance of the grants. Included within these other organizations are private operating foundations and Type I and Type II Supporting Organizations under section 509(a)(3).

The regulations in IRC section 4945 expand the types of organizations that are considered section 509(a)(1) organizations by including organizations described in 170(c)(1) (states, political subdivisions, etc.) and section 511(a)(2)(B) (college or university which is an agency or an instrumentality of any government or political subdivision) even if it is not described in section 501(c)(3). It is clear under these definitions that for private foundation grant making purposes, the District is considered a section 509(a)(1) public charity.

As noted above, private foundations are especially reluctant to make grants to any entity other than a section 501(c)(3) public charity or a private operating foundation. There are two concerns that private foundations face. The first is that if the grant is not considered a "qualifying distribution", it may impact the private foundation's ability to meet its annual "minimum distribution" requirement and be subject to a 30% excise tax on the difference between the amounts distributed that count as qualifying distributions and the minimum distribution amount.

The second concern relates to the "expenditure responsibility" that private foundations must exercise over the grant process if the grant recipient is not a section 501(c)(3) public charity or a private operating foundation. As Treas. Regs. Section 53.4945-5(h) illustrates, if the grantee is not a public charity, private foundations are required to conduct a significant investigation of the potential grant recipient, secure signed agreements and promises as to how the grant will be spent, and obtain detailed reports from the grant recipient as to how the grant was spent, and prepare detailed reports on its own annual Form 990-PF. Because none of this is required if the grant recipient is a section 501(c)(3) public charity or private operating foundation, private foundations try to limit their grants to these types of organizations. Since, as the revenue rulings above indicate, an instrumentality of state government is treated as a section 509(a)(1) organization for purposes of the expenditure responsibility provisions, private foundations will be able to make grants to instrumentalities like the District without any additional responsibilities.

Section 501(c)(3) Charitable Status for the District

Public entities such as the District that qualify for exemption as organizations described in IRC section 501(c)(3) become "dual status organizations" They do not relinquish their status as

governmental entities, but add the additional status of section 501(c)(3). An added advantage as a section 501(c)(3) organization is that these public entities are not required to file a Form 990 like most charitable organizations.

To qualify for tax exemption, the entity must be a separately organized entity and its powers must be limited to those permitted to a section 501(c)(3) organization. One of the biggest hurdles for an instrumentality is in meeting the organizational test, including a determination of whether the instrumentality is a separate entity. Unless it is considered a separate entity by the IRS, it will not be able to qualify for exemption under IRC section 501(c)(3).

According to the IRS in 1996 EO CPE Text, "State Institutions-Instrumentalities", the separately organized entity requirement is met if an instrumentality is incorporated under a state non-profit corporation law. When an instrumentality is created through state statutes and is neither a corporation nor a trust, the IRS has stated in the 1996 CPE Text that "even if not incorporated under state law, any entity that is considered a 'corporation' for federal tax law purposes will be considered a separately organized entity. IRC section 7701(a)(3) provides that the term 'corporation' includes associations. Treas. Regs. Section 301.7701-2 lists six major characteristics that are ordinarily found in a pure corporation, which, taken together, distinguish it from other organizations. Since some of these corporate characteristics are not relevant to unincorporated nonprofit bodies, they have been administratively adapted to cases involving classification of nonprofit organizations. As adapted, the characteristics are: (i) associates, (ii) an objective by the associates to carry on the activity for which the organization was formed, (iii) continuity of life, (iv) centralized management, (v) limited liability, and (vi) free transferability of interests. An instrumentality will be treated as an association if it has a sufficient number of the corporate characteristics such that the instrumentality more nearly resembles a corporation than a partnership, trust or mere aggregation of individuals. If so, it will be considered a separately organized entity for purposes of IRC section 501(c)(3) and Rev. Rul. 60-384."

A review of IRS materials indicates that the IRS has made an extra effort to find ways for instrumentalities to qualify as section 501(c)(3) organization. Based on the above analysis, it would appear that the District can qualify as a separate entity for section 501(c)(3) exemption purposes.

Under Treas. Regs. Section 1.501(c)(3)-1(b), an organization is, in part, organized exclusively for one or more exempt purposes only if its articles of incorporation limit the purposes of the organization to one or more exempt purposes and its assets are dedicated to exempt purposes so that in the event of dissolution, the assets can only be used for exempt purposes. Because most legislation that creates instrumentalities does not contain any "exclusive purpose" or proper "dissolution clause" language, this also can be a difficult test to satisfy.

However, once again the IRS in the 1996 EO CPE Text provides an approach that should enable the District to meet the "organizational test". According to the IRS, "if a careful reading of an instrumentality's enabling document clearly shows that it will operate exclusively for exempt purposes, it will be deemed to have met that portion of the organizational test. Further, if an enabling document, or in the alternative, a state law, provides that, upon dissolution, all of an instrumentality's assets will be transferred to the state or any political subdivision thereof, it will be deemed to have met that portion of the organizational test. In those cases, absent any clear