SELECTING THE BEST CHARITABLE DONEE: PUBLIC CHARITY, DONOR ADVISED FUND, OR PRIVATE FOUNDATION

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I. INTRODUCTION.

A. Changes Affecting Charitable Organizations and Charitable Giving.

1. For several years, charitable organizations have been the subject of various reform proposals as well as actual legislation included as part of the Pension Protection Act of 2006 (the "2006 Act"). Of particular interest to advisors assisting clients achieve their philanthropic objectives have been changes affecting supporting organizations, and in particular Type III supporting organizations, and donor advised funds (discussed in detail below).

2. Congressional activity has also led the Internal Revenue Service to increase enforcement and compliance activity and actively promote good governance practices (on the assumption that a well governed organization is more likely to be a tax compliant organization).

3. This new legislation and increased Internal Revenue Service enforcement activity has led charitable organizations to heighten their efforts to ensure compliance with the federal tax laws and to adopt policies and procedures designed to comply with good governance practices.

4. This focus on charitable organizations has been accompanied by a number of reforms that affect charitable giving, including new rules affecting gifts of partial interests in tangible personal property, stricter rules for recordkeeping and substantiation of charitable contributions, more stringent penalties for valuation overstatements associated with charitable contributions of property, and new rules regarding qualified appraisers and qualified appraisals.

B. Effects of Change on Planning Charitable Gifts.

1. The 2006 Act was intended to promote charitable giving but to eliminate a number of perceived abuses involving the use of certain types of charitable entities for personal benefit with limited direct charitable benefit.

2. As is often the case with legislation intended to correct abuses, the application of the new rules is broad and affects the operation of private foundations, donor-advised funds, and supporting organizations.

3. Selecting the appropriate vehicle to implement a client's philanthropic plan and goals requires an understanding of the rules

(including the recent changes) applicable to the various types of charitable entities.

4. Maximizing the tax benefits associated with a particular charitable contribution requires an understanding of the income tax charitable deduction rules that apply to gifts to particular types of charitable entities.

II. CLASSIFICATION RULES UNDER INTERNAL REVENUE CODE SECTION 509.

A. Presumed Classification as Private Foundation.

1. **Types of 501(c)(3) Organizations.** There are essentially four types of section 501(c)(3) organizations: (1) private foundations; (b) organizations engaging in inherently public activity; (c) publicly supported organizations; and (d) supporting organizations.

2. **Presumed Classification.** A charitable organization is presumed to be a private foundation unless it can establish to the satisfaction of the Internal Revenue Service that it meets the requirements of one of the categories of public charities. I.R.C. § 509(a).

B. Advantages of Public Charity Classification.

B. Advantages of Public Charity Classification. As a general rule, status as other than a private foundation is preferred because of a multitude of rules that apply to private foundations, including, but not limited to:

1. Limitations on the income tax charitable deduction for contributions to a private foundation. I.R.C. § 170(b)(1)(B)(i), (D)(i).

2. A two-percent excise tax on net investment income. I.R.C. § 4940.

3. Excise taxes on self-dealing transactions, jeopardy investments, excess business holdings, and taxable expenditures. I.R.C. §§ 4941, 4943, 4944, 4945.

4. A prohibition against any lobbying activities. I.R.C. § 4945.

5. A mandatory charitable distribution requirement in each year. I.R.C. § 4942.

III. INHERENTLY PUBLIC CHARITIES AND PUBLICLY SUPPORTED CHARITIES.

A. Inherently Public Charities. Inherently public charities are those that are considered public by virtue of the type of activity they conduct and include churches, qualified educational organizations, such as colleges,

universities, and private schools, qualified hospitals, and foundations and other organizations that support a public college or university.

B. Publicly Supported Organizations. There are two types of publicly supported organizations under Internal Revenue Code section 509(a).

1. Publicly Supported Organizations under Internal Revenue Code Sections 509(a)(1) and 170(b)(1)(A)(vi).

a. An organization described in sections 509(a)(1) and 170(b)(1)(A)(vi) is treated a publicly supported if the total amount of support that it normally receives from governmental units or the general public is at least one-third of the total support received by the organization. For purposes of this support test, support does not include amounts received by the charitable organization for services rendered or "gross receipts."

b. The one-third support test is computed over a five-year period on the organization's annual information return (Form 990).

c. Gifts from "disqualified persons" (generally persons or businesses contributing $5,000 or more and officers and directors of the organization) are counted in full in the denominator of the support fraction. In determining public support, public support includes support from governmental units and contributions from other publicly supported organizations described in section 170(b)(1)(A)(vi) and certain other section 170(b)(1)(A) organizations. Direct or indirect contributions from any other source, such as an individual, trust, business entity, or private foundation, are included within public support (i.e., the numerator) only to the extent that those contributions do not exceed two percent of the organization's total support. Treas. Reg. § 1.170A-9(e)(6). This limitation insures that support will come from a broad cross-section of the general public rather than from a few substantial donors.

d. The public support test under section 170(b)(1)(A)(vi) can be met on either the objective basis of actual public support or a more subjective facts and circumstances test.

e. Public Support Test. "An organization will be treated as a 'publicly supported' organization if the total amount of support which the organization 'normally'…receives from

governmental units…, from contributions made directly or indirectly by the general public, or from a combination of these sources, equals at least 33 1/3 percent of the total support 'normally' received by the organization." Treas. Reg. § 1.170A-9(e)(2).

f. Facts and Circumstances Test. Even if an organization cannot meet the public support test, it can still be treated as a publicly supported organization under section 170(b)(1)(A)(vi) if it can meet the facts and circumstances test. To meet the facts and circumstances test, the organization must establish that it normally receives a substantial part of its support from governmental units, from direct or indirect contributions from the general public, or from a combination of these sources. There are two facets of meeting this test.

(1) The organization must show that, under the facts and circumstances, it normally receives a substantial part of its support from these sources.

(a) Under this requirement, the required public support under the public support test can be as low as 10 percent.

(b) In addition, the organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis, which requires a continuous and bona fide program for solicitation of funds from the general public. Treas. Reg. § 1.170A-9(e)(3)(i) & (ii).

(2) And, the organization must establish that it is in the nature of a "publicly supported" organization taking into account certain factors set forth in the regulations. Treas. Reg. § 1.170A-9(e)(3). Relevant factors for consideration include:

(a) Percentage of financial support from public or governmental units.

(b) Sources of support.

(c) Representative governing body.

(d) Availability of public facilities or services and public participation in programs or policies.

g. Definition of Support.

(1) The following items are included in the organization's total support as used in the denominator of the support calculation:

(a) Gifts, grants (including governmental grants), and contributions.

(b) Membership fees.

(c) Gross income from interest, dividends, amounts received from payments on securities loans, rents, royalties, and unrelated business taxable income.

(d) Net income from unrelated business activities to the extent not included in item (3) above.

(e) Tax revenues levied for the organization's benefit and paid to or expended on behalf of the organization.

(f) The value of services or facilities (exclusive of services or facilities furnished to the public without charge) furnished by a governmental unit to the organization without charge.

(2) Total support does not include contributions of services for which a deduction is not allowable, exempt function income, the value of any exemption from any federal, state, or local tax, capital gains, loan repayments, and unusual grants.

2. Publicly Supported Charities under Internal Revenue Code Section 509(a)(2).

a. These are organizations that meet two support tests.

(1) Investment income cannot exceed one-third of the organization's total support.

(2) Over one-third of the organization's total support must be received from one or more of the following sources:

(a) Gifts, grants, contributions, and membership dues from nondisqualified persons.

(b) Admission fees to exempt function facilities or performances.

(c) Fees for the performance of exempt function services.

(d) Sales of goods related to the organization's activities.

b. An organization that receives the majority of it support from activities related to its exempt functions (such as a museum charging admission fees) rather than from contributions from the general public will usually try to qualify under section 509(a)(2).

c. Rules similar to those described for the section 170(b)(1)(A)(vi) test described above also apply under section 509(a)(2) with the exceptions noted.

IV. SUPPORTING ORGANIZATIONS.

A. General Overview of Supporting Organizations. A supporting organization is a tax-exempt organization described in Internal Revenue Code section 501(c)(3) that supports one or more tax-exempt organizations described in Internal Revenue Code sections 509(a)(1) or 509(a)(2) (hereinafter referred to as "public charities" or "publicly supported organizations"). For tax purposes, the supporting organization receives the favorable tax treatment afforded to public charities without being required to meet the strenuous public support tests that must be met by some section 509(a)(1) organizations and all section 509(a)(2) organizations because of the close relationship between the organizations. *Roe Foundation Charitable Trust v. Commissioner*, T.C. Memo 1989-566.

B. Avoidance of Private Foundation Limitations.

1. An organization that is classified as a supporting organization avoids the rules and limitations that are imposed on private foundations. For example, the income tax charitable deduction for contributions to a supporting organization is not subject to the limitations that apply to the deduction for contributions to a private foundation. In addition, certain types of supporting organizations

are not subject to the private foundation prohibited transactions rules under Internal Revenue Code sections 4941 through 4946, which if violated can subject the private foundation and certain persons to substantial penalty taxes. Furthermore, a supporting organization is not subject to the excise tax on net investment income imposed on private foundations under Internal Revenue Code section 4940.

2. Supporting organizations have often been used when a person who might otherwise choose to create a private foundation finds that some aspect of the private foundation environment makes that impractical.

C. **Requirements to Establish a Supporting Organization.** To be classified as a supporting organization, an organization must meet three tests: (a) the organization must be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more public charities; (b) the organization must be operated, supervised, or controlled by or in connection with one or more public charities; and (c) the organization must not be controlled directly or indirectly by one or more disqualified persons (other than foundation managers) within the meaning of Internal Revenue Code section 4946. I.R.C. § 509(a)(3)(A)-(C); Treas. Reg. § 1.509(a)-4(a)(1).

1. **Organizational Test.** The organizational test requires that the organization be organized for the benefit of, to perform the functions of, or to carry out the purposes of one or more public charities.

a. To meet the organizational test, the organization's articles of organization must limit the purposes of the organization to benefiting, performing the functions of, or carrying out the purposes of one or more public charities; not expressly empower the organization to engage in any activities which are not in furtherance of benefiting, performing the functions of, or carrying out the purposes of one or more public charities; designate by class or purpose or by name the public charities on whose behalf the organization is to be operated; and not expressly empower the organization to operate to support or benefit any organization other than those specified in the articles of organization. Treas. Reg. § 1.509(a)-4(c)(1)(i)-(iv).

b. The degree of specificity with which the supported organization must be designated depends upon the type of relationship between the supporting organization and the

supported public charity or charities. The permissible types of relationships are described below in more detail.

c. Generally, if the organization is "operated, supervised, or controlled by" or "supervised or controlled in connection with" the supported public charity or charities, the supported public charity or charities can be specified by name, by class or purpose. Treas. Reg. § 1.509(a)-4(d)(2).

d. If the supporting organization is "operated in connection with" one or more public charities, the supported organization as a general rule must be specified by name. Treas. Reg. § 1.509(a)-4(d)(4)(i).

e. As a general rule, the safest method of ensuring compliance with the organizational test is to designate the supported public charity or charities by name in the supporting organization's governing documents.

2. **Operational Test.** The operational test requires that the organization be "operated exclusively" to support one or more specified public charities. An organization will meet this operational test only if it engages solely in activities that support or benefit the specified public charity or charities.

a. Permissible activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the supported public charities. Treas. Reg. § 1.509(a)-4(e)(1).

b. The organization will not meet the operational test if any part of its activities is not in furtherance of a purpose other than supporting or benefiting the specified public charity or charities. Treas. Reg. § 1.509(a)-4(e)(1).

c. It is not necessary to meet the operational test that the organization pay over its income to the supported public charity or charities. Instead, it may meet the operational test by using its income to carry on an independent activity or program that supports or benefits the specified public charity or charities. Treas. Reg. § 1.509(a)-4(e)(2).

3. **Relationship Test.** The organization must have one of three types of relationships with the public charity or charities it is to support. The organization must be either (a) operated, supervised, or controlled by the public charity or charities it supports, (b) supervised or controlled in connection with the public charity or charities it supports, or (c) operated in connection with the public

charity or charities it supports. Treas. Reg. § 1.509(a)-4(f)(2). Any relationship must insure that the organization will be responsive to the needs or demands of the public charity or charities it supports and will constitute an integral part of, or maintain a significant involvement in, the operations of the public charity or charities it supports. Treas. Reg. § 1.509(a)-4(f)(3).

a. Operated, Supervised, or Controlled by Test (Type I Supporting Organization). The distinguishing feature of a Type I supporting organization is 'the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization." Treas. Reg. § 1.509(a)-4(f)(4).

(1) This relationship test is the one most commonly used to establish supporting organization status and is most appropriate for donors that have a close, primary relationship with the public charity to be supported.

(2) The operated, supervised, or controlled by test "presupposes a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations." Treas. Reg. § 1.509(a)-4(g)(1)(i).

(3) Essentially, this type of relationship is comparable to that of a parent and subsidiary in which the subsidiary is under the direction of and accountable or responsible to the parent.

(4) The operated, supervised, or controlled by test is met if a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more public charities. Treas. Reg. § 1.509(a)-4(g)(1)(i).

b. Supervised or Controlled in Connection With Test (Type II Supporting Organization). The distinguishing feature of a Type II supporting organization is "the presence of common supervision or control among the governing bodies of the organizations involved, such as the presence of common directors...." Treas. Reg. § 1.509(a)-4(f)(4).

(1) The Type II relationship is usually used by an existing public charity that for fundraising or other reasons desires to establish another charitable organization to carry out certain activities.

(2) To meet the supervised or controlled in connection with test, "there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations." Treas. Reg. § 1.509(a)-4(h)(1).

(3) This relationship test is met by establishing that the control or management of the supporting organization is vested in the same persons that control or manage the public charity or charities it supports. Treas. Reg. § 1.509(a)-4(h)(1).

(4) This type of relationship is similar to that of "brother-sister" corporations in the for profit corporate context.

c. Operated in Connection With Test (Type III Supporting Organization). The distinguishing feature of a Type III supporting organization is "that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization." Treas. Reg. § 1.509(a)-4(f)(4).

(1) The operated in connection with test is the most flexible type of relationship that can exist between the supporting organization and the public charity or charities it supports. But, it is also the most subjective test, and therefore it can be more difficult to establish that the requirements of the test are met.

(2) Generally, the Type III relationship is more appropriate when the donor and the donor's family have close relationships with multiple publicly supported charities.

(3) Under this test, it is not necessary that the supporting organization be controlled by the supported public charity or charities. Rather, there must be sufficient ties between the supporting

organization and the public charity or charities it supports.

(4) To meet this relationship test, the supporting organization must establish that it satisfies a responsiveness test and an integral part test. Treas. Reg. § 1.509(a)-4(i)(1)(i).

(a) Responsiveness Test. The responsiveness test is designed to ensure that the supporting organization will be responsive to the needs or demands of the supported public charity or charities. Treas. Reg. § 1.509(a)-4(i)(2)(i). Essentially, the supported public charity or charities must have the ability to influence the activities of the supporting organization. *Roe Foundation Charitable Trust v. Commissioner*, T.C. Memo 1989-566. See also *Nellie Callahan Scholarship Fund v. Commissioner*, 73 T.C. 626 (1980). The responsiveness test is satisfied if: (1) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations; (2) One or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or (3) The officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and (4) By reason of either (1), (2), or (3) above, the officers, directors, or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants, and the selection of recipients by the supporting organization, and in otherwise directing the use of the income or assets of the supporting organization. Treas. Reg. § 1.509(a)-4(i)(2)(ii). Because of the changes made by

the 2006 Act, the responsiveness test can no longer be met solely by the supporting organization being a charitable trust under state law, where each specified publicly supported organization is a named beneficiary under the terms of the charitable trust's governing instrument and the beneficiary organization has the power to enforce the trust and compel an accounting under applicable state law.

(b) Integral Part Test. To meet the integral part test, the supporting organization must maintain a significant involvement in the operations of one or more publicly supported organizations. Furthermore, the publicly supported organizations must be dependent upon the supporting organization for the type of support the supporting organization provides. Treas. Reg. § 1.509(a)-4(i)(3)(i). Under the current regulations (which have not yet been modified to reflect changes made by the 2006 Act), the integral part test can be satisfied in one of two ways. The first alternative contemplates that the supporting organization will carry on its own activities in furtherance of the purposes of the publicly supported organization or organizations it supports. The integral part test will be satisfied if "[t]he activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves." Treas. Reg. § 1.509(a)-4(i)(3)(ii). This is often referred to as the "but for" alternative. Alternatively, the integral part test will be satisfied if "[t]he supporting organization makes payments of substantially all of its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly

supported organizations is sufficient to insure the attentiveness of such organizations to the operations of the supporting organization." Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a). This is often referred to as the "substantially all income" prong. For purposes of this alternative, "substantially all" means 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161. Also, a substantial amount of the total support of the supporting organization must go to those publicly supported organizations that meet this attentiveness requirement. As a general rule, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support so as to insure such attentiveness.

4. **Limitations on Control.** An organization cannot qualify as a supporting organization if it is controlled directly or indirectly by disqualified persons within the meaning of Internal Revenue Code section 4946.

5. **Additional Requirements for Type III Supporting Organizations under the 2006 Act. The 2006 Act imposed additional requirements on Type III supporting organizations.**

   a. Disclosures. For each tax year beginning after August 17, 2006, a Type III supporting organization must provide each supported organization with such information as the Secretary of the Treasury may require to ensure that the supporting organization is responsive to the needs of the supported organization. This information is intended to include a copy of the supporting organization's governing documents and any amendments thereto, the Form 990, the Form 990-T if any, and an annual report. These requirements will become effective upon issuance of final regulations.

   b. Foreign Organizations. A Type III supporting organization cannot support an organization that is not organized in the United States. (This rule does not apply until the first day of the organization's third tax year beginning after August 17, 2006 for existing organizations operated in connection with a foreign organization.)

c. Limits on Contributors. Type I and Type III supporting organizations cannot receive contributions from certain persons. These persons include (a) a person who directly or indirectly controls (either alone or with other persons described in (b) or (c) following) the governing body of the supported organization, (b) a family member of a person described in (a), and (c) a 35-percent controlled entity.

d. Minimum Distribution Requirements. The Internal Revenue Service is required to issue new regulations on payments required by Type III supporting organizations that are not *functionally integrated* Type III supporting organizations that will require these organizations to make distributions of either a percentage of either income or assets to supported organizations in order to ensure that a "significant amount" is paid to such organizations. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required under regulations to be issued by the Internal Revenue Service to make payments to supported organizations because the activities of the organization are related to performing the functions or, or carrying out the purposes of, such supported organizations.

6. **Proposed Regulations on Type III Supporting Organizations.** On September 23, 2009, the Internal Revenue Service issued proposed regulations regarding the changes made to Type III supporting organizations under the 2006 Act. The proposed regulations address the changes made by the PPA and provide guidance regarding functionally integrated and non-functionally integrated Type III supporting organizations.

a. The proposed regulations set forth the types of information that a Type III supporting organization must provide to the organization(s) it supports.

b. The proposed regulations confirm the elimination of the special rule that allowed certain charitable trusts to meet the responsiveness test for classification as a Type III supporting organization, but retain the transitional rule allowing certain supporting organizations in existence before November 20, 1970, to qualify as Type III supporting organizations.

c. The proposed regulations set forth the criteria that must be satisfied by a "functionally integrated" Type III supporting organization.

(1) To be considered a functionally integrated organization, the organization must engage in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive. Additional guidance is provided on the types of activities that are considered to "directly further" the exempt purposes of a supported organization.

(2) Alternatively, an organization may be considered functionally integrated if it is the parent of, and exercises a substantial degree of control over, each of its supported organizations.

d. The proposed regulations impose a minimum distribution requirement on "non-functionally integrated" Type III supporting organizations. Non-functionally integrated organizations must meet a distribution requirement and an attentiveness test. The proposed regulations retain the transitional rule for trusts established before November 20, 1970.

e. The new regulations, when finalized, will be particularly relevant to organizations that conduct certain activities on behalf of their supported organizations, such as fundraising, investment and management of non-exempt-use assets, and grant making. Organizations that support colleges or hospitals, as well as charitable trusts with institutional trustees, will likely be affected by the proposed regulations.

V. DONOR ADVISED FUNDS.

A. New Regulatory Structure.

1. In recent years, donor advised funds have proliferated, becoming a popular alternative to private foundations and supporting organizations. Until the 2006 Act, however, neither the Internal Revenue Code nor the Regulations provided a definition of a donor advised fund or any specific rules governing their establishment or administration. The absence of specific rules lead to confusion and some abuses although the vast majority of donor advised fund programs were not involved in such abuses and have been only minimally affected by the changes made by the 2006 Act.

2. A donor advised fund is not a separate charitable entity for federal tax purposes. It is normally a type of program or fund offered by a public charity to facilitate charitable gifts by individual donors.

The public charity is referred to under the new rules as the "sponsoring organization." The sponsoring organization may be a community foundation or other public charity with an independent charitable program of its own, or it may have no program aside from the donor advised fund operation (the so-called commercial donor advised fund).

B. Definition of Donor Advised Fund under 2006 Act.

1. A donor advised fund is a fund or account (1) which is separately identified by reference to contributions of a donor or donors, (2) which is owned and controlled by a sponsoring organization, and (3) with respect to which a donor (or any person appointed or designated by the donor (called a "donor advisor")) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the assets of the separately identified fund or account by reason of the donor's status as donor.

a. To be a donor advised fund, the fund or account must meet all three of the requirements listed above.

b. To be a donor advised fund, the fund or account must reference the contribution of a specific donor or donors. A general fund or account or one that receives contributions from multiple donors whose contributions are not separately accounted for within the fund will not be a donor advised fund.

c. The Internal Revenue Service will look to the actual manner of operations of the fund in determining if it is separately identified by reference to contributions of a donor or donors.

d. Advisory privileges do not include enforceable rights or obligations under a gift agreement.

e. Advisory privileges may be set forth in a written agreement, but, even in the absence of written agreement, may be inferred from the conduct of the donor and the sponsoring organization. But, the donor does not have advisory privileges if the donor provides advice without some sort of reciprocity on the part of the sponsoring organization.

f. It is not necessary that the donor actually provide advice, if the donor reasonably expects to have advisory privileges with respect to the fund or account and that expectation is

reciprocated by some action on the part of the sponsoring organization.

g. Advisory privileges do not include privileges based upon the donor's position as an officer, employee, or director of the sponsoring organization in the absence of other factors, unless such position resulted from the establishment of the fund.

2. A donor advised fund does not include any fund or account that (a) makes distributions only to a single identified organization or governmental entity, (b) with respect to which the donor recommends to the sponsoring organization the selection of the committee members that will provide investment and distribution advice if the recommendations are based on objective criteria related to the expertise of the member, or (c) with respect to which a donor or person appointed or designated by the donor advises as to which individuals receive grants for travel, study, or other similar purposes if (i) the advisory committee for such fund is composed only of members that are appointed by the sponsoring organization and is not controlled by the donor or persons appointed or designated by the donor and (ii) grants are awarded on an objective and nondiscriminatory basis in accordance with procedures meeting the requirements for similar grants by private foundations and these procedures have been approved in advance by the board of the sponsoring organization.

3. The Internal Revenue Service also is granted the authority to exempt other funds or accounts from the definition (a) if the fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by the donor or (b) if such fund benefits a single identified charitable purpose.

4. A sponsoring organization is any organization that is described in section 170(c) (other than section 170(c)(1) and without regard to section 170(c)(2)(A)), is not a private foundation, and maintains one or more donor advised funds.

VI. PRIVATE FOUNDATIONS.

A. General Characteristics of Private Foundations.

1. While some publicly supported organizations or supporting organizations will convert to private foundation status if they fail to meet the public support test or the requirements for continuing qualification as a supporting organization, many charitable

organizations are established as private foundations because of their limited sources of support.

a. Most family and corporate foundations are private foundations.

b. As a general rule, private foundations are endowed by a single individual or family, a corporation, or a small group of private donors who wish to retain control over the use and management of donated assets.

c. The private foundation's endowment may initially be established through outright contributions or distributions from a trust, such as a charitable lead trust. Ongoing funding is usually derived primarily from investment income and growth in the foundation's underlying assets and not from fundraising activities.

2. Unlike many public charities, a private foundation generally makes grants to other charitable organizations rather than actively conducting charitable programs and services.

3. In the case of family foundations, the donor and the donor's family usually control all decisions. This allows participation by younger family members and perpetuates family control.

4. Because of the lack of public oversight and participation in these foundations, they are closely regulated under the Internal Revenue Code to safeguard against operation for private benefit and ensure operation in furtherance of charitable purposes.

5. Private foundations, like public charities, are exempt from federal income tax because they are organizations described in Internal Revenue Code section 501(c)(3). Thus, private foundations are subject to all of the rules applicable under section 501(c)(3) including the private inurement prohibition and limitations on impermissible private benefit.

B. **Tax on Net Investment Income.** The Internal Revenue Code imposes an excise tax of two percent on the net investment income of a tax-exempt private foundation in each tax year. I.R.C. § 4940(a). The two percent excise tax may be reduced to one percent for certain tax years in which the foundation's payout rate is increased. I.R.C. § 4940(e).

C. **Self-Dealing.**

1. Internal Revenue Code section 4941 prohibits acts of direct or indirect "self-dealing" between a private foundation and a

disqualified person. It does not matter whether the act of self-dealing results in benefit or detriment to the foundation. Treas. Reg. § 53.4941(d)-1(a).

2. **Definition of Disqualified Persons.** Under Internal Revenue Code section 4946, disqualified persons are defined as:

   a. Substantial contributors (generally, anyone contributing more than $5,000 to the foundation).

   b. Foundation managers (officers, directors, or trustees of the foundation).

   c. Any 20-percent owner of a business that is a substantial contributor to the foundation.

   d. Any family member of the persons described above (a spouse, ancestors, and children, grandchildren, and great grandchildren, and a spouse of any child, grandchild, or great grandchild).

   e. Any corporation, partnership, trust, or estate in which persons described above have more than a 35 percent interest.

   f. Any government official.

3. **Self-Dealing Defined.** Although there are a number of statutory and regulatory exceptions, acts of self-dealing generally are defined as:

   a. Any sale, exchange, or leasing of property, between a private foundation and a disqualified person.

   b. Any lending of money or other extension of credit between a private foundation and a disqualified person.

   c. Any furnishing of goods, services, or facilities by a private foundation to a disqualified person.

   d. The payment of compensation or expenses by the private foundation to a disqualified person.

   e. Any transfer to, or use by or for the benefit of, a disqualified person of the private foundation's income or assets.

f. Any agreement to make any payment of money to a government official. I.R.C. § 4941(d)(1).

4. **Direct v. Indirect Self-Dealing.** Internal Revenue Code section 4941 applies to any "direct" or "indirect" act of self-dealing. Direct self-dealing occurs when the private foundation is a party to the transaction with the disqualified person. An act of indirect self-dealing occurs when a disqualified person engages in a transaction with an organization controlled by the private foundation or by the foundation managers.

   a. The indirect self-dealing rules can apply to transactions between an estate of which a private foundation is a beneficiary and a disqualified person.

   b. Indirect self-dealing can arise with respect to an organization controlled by the private foundation or the foundation managers. If the private foundation or its managers can use their votes or authority to cause another organization to engage in a transaction that would be self-dealing if engaged in directly by the private foundation, that transaction constitutes indirect self-dealing and is subject to the excise tax on self-dealing. Treas. Reg. § 53.4941(d)-1(b)(5).

5. **Exceptions to Acts of Self-Dealing.**

   a. Certain Loans. The lending of money by a disqualified person to a private foundation is not an act of self-dealing if the loan is interest-free and the proceeds of the loan are used exclusively for exempt purposes. I.R.C. § 4941(d)(2)(B).

   b. Certain Leases. The leasing of property by a disqualified person to a private foundation is not an act of self-dealing if the lease is without charge (although the foundation can pay for janitorial services, utilities, or other maintenance costs it incurs for use of the property as long as such payments are not made to the disqualified person (directly or indirectly). Treas. Reg. § 53.4941(d)-2(b)(2).

   c. Certain Furnishing of Goods, Services, or Facilities.

      (1) The furnishing of goods, services, or facilities by a disqualified person to a private foundation is not an

act of self-dealing if the furnishing is without charge and the goods, services, or facilities are used exclusively for an exempt purpose. I.R.C. § 4941(d)(2)(C).

(2) The furnishing of goods, services, or facilities by a private foundation to a disqualified person is not an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public. I.R.C. § 4941(d)(2)(D).

d. Reasonable Compensation for Personal Services. Self-dealing does not include the payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services that are reasonable and necessary to carrying out the exempt purpose of the private foundation if the compensation or reimbursement is not excessive. I.R.C. § 4941(d)(2)(E).

(1) Whether compensation is reasonable is determined in accordance with the standards for reasonableness under Internal Revenue Code section 162. Treas. Reg. § 53.4941(d)-3(c). Reasonable compensation is "only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. Treas. Reg. § 1.162-7(b)(3).

(2) In general, "the making of a cash advance to a foundation manager or employee for expenses on behalf of the foundation is not an act of self-dealing, so long as the amount of the advance is reasonable in relation to the duties and expense requirements of the foundation manager." Treas. Reg. § 53.4941(d)-3(c)(1). Such an advance should not ordinarily excess $500 unless the advance is to "cover extraordinary expenses anticipated to be incurred in fulfillment of a special assignment (such as long distance travel)." Treas. Reg. § 53.4941(d)-3(c)(1).

e. Certain Corporate Transactions. An act of self-dealing does not include any transaction between a private foundation and a corporation that is a disqualified person pursuant to any liquidation, merger, redemption,

recapitalization, or other corporate adjustment if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for the receipt by the foundation of no less than fair market value. I.R.C. § 4941(d)(2)(F).

f. Preexisting Business Relationships. The regulations under Internal Revenue Code section 4941 provide an exception to the definition of indirect self-dealing for certain preexisting business relationships that meet the following three-part test:

(1) The transaction results from a business relationship that was established before such transaction constituted an act of self-dealing;

(2) The transaction was at least as favorable to the organization controlled by the foundation as an arm's-length transaction with an unrelated person; and

(3) Either (a) the organization controlled by the foundation could have engaged in the transaction with someone other than a disqualified person only at severe economic hardship to the organization, or (b) because of the unique nature of the product or service being provided by the organization controlled by the foundation, the disqualified person could not have engaged in the transaction with anyone else, or could have done so only by incurring severe economic hardship. Treas. Reg. § 53.4941(b)-1(b)(1).

g. Estate Administration Exception. There is a regulatory exception for certain transactions that occur during the administration of an estate (or revocable trust). This exception specifically provides that an act of indirect self-dealing does not include a transaction with respect to a foundation's interest or expectancy in property held by an estate (or revocable trust), regardless of where title to the property vests under state law, if:

(1) The administrator of the estate (or trustee of the revocable trust) has the power of sale with respect to the property or the power to reallocate the property to another beneficiary or is required to sell

the property under the terms of any option subject to which the property was acquired by the estate (or revocable trust);

(2) Such transaction is approved by the probate court having jurisdiction over the estate (or revocable trust);

(3) The transaction occurs before the estate is terminated for federal income tax purposes;

(4) The estate (or revocable trust) receives an amount that equals or exceeds the fair market value of the foundation's interest or expectancy; and

(5) Either, the foundation receives an asset at least as liquid as the one it gave up, the transaction results in the foundation receiving an asset related to its exempt purpose, or the transaction is required under the terms of an option binding on the estate (or revocable trust). Treas. Reg. § 53.4941(d)-1(b)(3).

h. Corporate Redemption Exception. A corporation that is a disqualified person can redeem stock held by the foundation without engaging in an act of self-dealing if certain requirements are met. The exception is available if all securities of the same class as that held by the foundation are subject to the same terms and those terms provide that the foundation shall receive no less than fair market value for its stock.

6. The penalty imposed on an act of self-dealing is a two-tier excise tax that can be imposed on a foundation manager as well as the disqualified person. There is no self-dealing tax imposed on the private foundation. An additional and confiscatory tax is imposed if the act of self-dealing is not corrected within the statutorily defined correction period.

a. Section 4941(a) imposes an initial tax pursuant to which any disqualified person who participates in an act of self-dealing must pay a tax of 10 percent of the amount involved with respect to the act of self-dealing. In addition, any foundation manager who participated in an act of self-dealing is liable for a tax of five percent of the amount involved (up to $20,000 per act for all managers) unless

such participation was not willful and was due to reasonable cause. I.R.C. § 4941(a), (c)(2).

b. In addition to paying the initial tax, the disqualified person must correct the self-dealing by undoing the transaction and restoring the foundation to the position it would have been in had there been no self-dealing. I.R.C. § 4941(e)(3).

c. If the act of self-dealing is not corrected, an additional tax of 200 percent of the amount involved is imposed on the disqualified person, and an additional tax of 50 percent of the amount involved is imposed on foundation managers who refused to agree to part or all of the correction with an aggregate cap of $20,000. I.R.C. § 4941(b), (c)(2).

d. For purposes of these rules, if the self-dealing transaction results from a payment of excessive compensation, the tax applies only to the amount of such excess and not to the entire payment.

D. Minimum Distribution Requirements.

1. A private foundation must make minimum distributions of income annually for its exempt purposes to avoid an excise tax on undistributed income under Internal Revenue Code section 4942.

a. If the foundation fails to meet the minimum distribution requirements, it is subject to an excise tax equal to 30 percent of the amount of the underdistribution. I.R.C. § 4942(a).

b. If the foundation does not make the required distributions after a certain correction period, an additional excise tax is imposed equal to 100 percent of the amount remaining undistributed at the close of the correction period. I.R.C. § 4942(b).

2. To avoid an excise tax, a private foundation must distribute at least five percent of the average fair market value of its noncharitable assets (cash, securities, other investment assets, etc.) each year. I.R.C. § 4942(d), (e).

a. The minimum distributable amount is calculated each year on the foundation's annual Form 990-PF.

b. The foundation essentially has two years in which to make the required minimum distribution: the year for which the

minimum distribution amount is calculated and the subsequent tax year. I.R.C. § 4942(a).

c. A foundation may carry forward any excess qualifying distributions for five additional years. I.R.C. § 4942(i).

3. The distributions that count towards this minimum distribution requirement are referred to as "qualifying distributions." Qualifying distributions are defined under Internal Revenue Code section 4942(g)(1) as:

a. Any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more exempt purposes.

b. Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more exempt purposes.

4. Distributions to other private foundations (nonoperating) or controlled organizations do not count as qualifying distributions. Under changes made by the 2006 Act, distributions are not qualifying distributions if made to a non-functionally integrated Type III supporting organization or a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. I.R.C. § 4942(g)(1)(A), (4).

E. Excess Business Holdings.

1. Internal Revenue Code section 4943(a)(1) imposes a 10 percent excise tax on the excess business holdings of any private foundation in a business enterprise during any tax year. The tax is imposed upon the value of the excess business holdings. There is an additional tax of 200 percent if the foundation does not dispose of the excess business holdings within the statutorily prescribed correction period after the imposition of the initial 10 percent tax. I.R.C. § 4943(b).

2. While the term "business enterprise" is not expressly defined, it does not include:

a. A functionally related business.

b. A trade or business at least 95 percent of the gross income of which is derived from passive sources. I.R.C. § 4943(d)(3).

3. The permitted holdings of a private foundation in an incorporated business are 20 percent of the voting stock of such business enterprise, reduced by the percentage of voting stock owned by all disqualified persons. I.R.C. § 4943(c)(2)(A). In the case of a partnership or joint venture, reference is made to the profits interest held by the foundation rather than voting stock. I.R.C. § 4943(c)(3)(B). In all other cases, reference is made to the beneficial interests owned by the foundation and disqualified persons. I.R.C. § 4943(c)(3)(C).

4. "Excess business holdings" are the amount of stock or other interests that the private foundation would have to dispose of to a person other than a disqualified person in order for the foundation's holdings in the business enterprise to be "permitted holdings." I.R.C. § 4943(c)(1).

5. Under a de minimis rule, a foundation will not be treated as having an excess business holding if it does not own more than two percent of the voting stock and not more than two percent in value of all of the outstanding shares of all classes of stock in a business enterprise. I.R.C. § 4943(c)(2)(C).

6. Permitted holdings in a corporation also include any share of nonvoting stock in the business enterprise if disqualified persons hold, actually or constructively, no more than 20 percent of the voting stock of the corporation. Treas. Reg. § 53.4943-3(b)(2)(i).

7. The percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors. Treasury stock and stock that is authorized but not issued is ignored as are higher voting requirements for extraordinary corporate actions. Treas. Reg. § 53.4943-3(b)(1)(ii). Equity interests do not include evidences of indebtedness (including convertible indebtedness) and warrants or other options or rights to acquire stock. Treas. Reg. § 53.4943(b)(1)(i).

8. Special holding periods apply if the private foundation receives holdings in a business enterprise by gift or bequest. Under Internal Revenue Code section 4943(c)(6), if a private foundation acquires holdings in a business enterprise other than by purchase by the private foundation or disqualified persons with respect to the foundation and the acquisition causes the foundation to have an excess business holding, the foundation has five years to dispose of sufficient holdings to eliminate the excess business holdings.

During this five-year period, the excess business holdings are deemed to be held by a disqualified person instead of the private foundation. The five-year grace period can be extended for an additional five years at the discretion of the Internal Revenue Service.

9. In certain circumstances the permitted holdings is increased from 20 percent to 35 percent. This increase is available if (a) the foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and (b) the foundation establishes to the satisfaction of the Internal Revenue Service that "effective control" of the corporation is in one or more persons who are not disqualified persons with respect of the foundation. I.R.C. § 4943(c)(2)(B).

F. **Jeopardy Investments.** The jeopardy investment rules of Internal Revenue Code section 4944 impose an excise tax if a private foundation invests its assets in manner that jeopardizes the accomplishment of the foundation's exempt purposes. The foundation is subject to a tax of 10 percent of the amount invested. I.R.C. § 4944(a)(1). Any foundation manager who participated in making the investment knowing that it jeopardized the foundation's exempt purposes if subject to an excise tax equal to 10 percent of the amount invested unless such participation was not willful and was due to reasonable cause. I.R.C. § 4944(a)(2).

G. **Taxable Expenditures.**

1. Internal Revenue Code section 4945 prohibits private foundations from making "taxable expenditures." Taxable expenditures are defined as:

a. Expenditures to carry on propaganda or otherwise to attempt to influence legislation.

b. Expenditures to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive.

c. Grants to an individual for travel, study, or other similar purposes unless the grant is awarded on an objective and nondiscriminatory basis and is approved in advance by the Internal Revenue Service.

d. Grants to an organization other than one that is a public charity described in Internal Revenue Code section 509(a)(1), (2), or (3) (other than a non-functionally integrated Type III supporting organization) or an exempt

operating foundation (as defined in Internal Revenue Code section 4940(d)(2)).

e. Expenditures for any purpose other than a charitable, religious, scientific, literary, or educational purpose. I.R.C. § 4945(d).

2. Any taxable expenditure made by a private foundation is subject to a 20 percent initial excise tax and foundation managers who agreed to the making of the taxable expenditure knowing that it was a taxable expenditure is subject to an initial tax of five percent (capped at $10,000 in the aggregate) unless such agreement is not willful and is due to reasonable cause. I.R.C. § 4945(a)(1), (2), (c)(2). If the taxable expenditure is not corrected, an additional 100 percent tax is imposed on the foundation and a 50 percent tax (capped at $20,000) is imposed on foundation managers who refused to agree to the correction. I.R.C. § 4945(b)(1), (2), (c)(2).

3. Certain taxable expenditures are permitted, such as grants to another private foundation, if the private foundation exercises "expenditure responsibility" with respect to the grant. I.R.C. § 4945(h).

a. Expenditure responsibility requires the foundation to:

(1) Assure that the grant is spent only for the purpose for which it is made;

(2) Obtain full and complete reports on how the funds are spent; and

(3) Make full and detailed reports on the expenditures to the Internal Revenue Service. I.R.C. § 4945(h)(1).

b. The foundation should also conduct a pre-grant inquiry to determine the identity, past history, and experience, management, and activities of the grantee organization. Treas. Reg. § 53.4945-5(b)(2)(i).

c. The foundation must also require the pre-payment submission of a written commitment signed by an appropriate officer or director of the grantee organization, which agreement must clear specify the purposes of the grant as well as reporting and accounting requirements necessary from the grantee and should stipulate that the

grant may not be used for any noncharitable purpose. Treas. Reg. § 53.4945-5(b)(3).

d. The private foundation can make grants that are earmarked for one or more charitable purposes under Internal Revenue Code section 170(c)(2)(B) to political subdivisions and certain other organizations that do not hold determination letters under Internal Revenue Code sections 501(c)(3) and 509(a)(1), (2), or (3). Treas. Reg. § 53.4945-5(a)(4).

VII. PRIVATE OPERATING FOUNDATIONS.

A. Generally. A private operating foundation operates its own charitable programs rather than making grants to public charities. For income tax charitable deduction purposes, a private operating foundation is treated the same as a public charity, meaning that the limitations normally applicable to contributions to private foundations do not apply.[*] Private operating foundations continue to be subject to the excise tax provisions applicable to private foundations.

B. Tests Applicable in lieu of Minimum Distribution Requirements. Because private operating foundations actually conduct charitable activities, they are not required to meet the minimum distribution requirements imposed on private foundations under Internal Revenue Code section 4942. Instead, to maintain classification as a private operating foundation, the foundation must meet an income test and either an assets test, endowment test, or a support test.

1. Income Test. A private operating foundation must use substantially all (at least 85%) of its adjusted net income or its minimum distribution amount (ordinarily 5%), whichever is less, directly for the active conduct of its exempt charitable activities. Grants to other organizations do not count as direct expenditures.

2. Assets Test. The assets test requires that substantially more than one-half (at least 65%) of the private operating foundation's assets are actually used for the active conduct of its exempt charitable activities or functionally related businesses. Stock in a corporation that the foundation controls and of which substantially all of the assets are devoted to charitable purposes will also qualify under the assets test.

[*] "Conduit" or "pass-through" private foundations also receive favorable income tax charitable deduction treatment under Internal Revenue Code section 170(b)(1)(F). While these foundations are beyond the scope of this outline, a conduit private foundation is essentially a private foundation that distributes an amount equal to 100 percent of all contributions it receives in such year not later than the 15th day of the third month after the close of the taxable year in which such contributions are received. Treas. Reg. § 1.170A-9(h)(1)(i).

3. **Endowment Test.** A private operating foundation must normally expend at least two-thirds of its minimum distribution amount directly for the active conduct of exempt charitable activities to meet this test.

4. **Support Test.** This test requires:

   a. Substantially all of a private operating foundation's support must be normally received from the general public and at least five exempt organizations that are not disqualified persons with respect to each other or the private operating foundation.

   b. Not more than 25% of a private operating foundation's support may be normally received from any one of the five exempt organizations.

   c. Not more than half of a private operating foundation's support may be normally received from gross investment income.

VIII. NEW SUPPORTING ORGANIZATION RULES.

A. Changes Made by 2006 Act affecting Supporting Organizations.

1. Excess Benefit Transactions.

a. Because they are not private foundations, supporting organizations are subject to the intermediate sanctions rules, which provide penalty excise taxes on "excess benefit transactions" under Internal Revenue Code section 4958.

b. The 2006 Act expands the application of these taxes to supporting organizations and provides that an excess benefit transaction automatically includes (i) any grant, loan compensation, or other payment, such as an expense reimbursement, made by a supporting organization to a substantial contributor or his family members and entities 35 percent controlled by such persons and (ii) any loan provided by a supporting organization to a disqualified person (which would include a director of the organization).

c. A person who is a disqualified person with respect to a supporting organization will also be a disqualified person with respect to the supported organization.

d. These rules apply to all types of supporting organizations.

2. Application of Excess Business Holdings Rules to Supporting Organizations.

a. Formerly, supporting organizations were sometimes used as a vehicle to hold family business interests in situations where the private foundation excess business holdings rules would have prevented a family foundation from doing so.

b. The 2006 Act applies the private foundation excess business holdings rules of section 4943 to certain supporting organizations, including non-functionally integrated Type III supporting organizations and Type I or Type II supporting organizations if the supported organization is controlled by the supporting organization's donors.

c. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons, cannot exceed 20 percent. Any holdings in excess of this amount are subject to an excise tax. These rules apply the broader definition of disqualified person, however, that is found under the excess benefit transaction rules of section 4958.

d. The 2006 Act offers some relief from the application of these rules. The Secretary of the Treasury may exempt any qualified supporting organization from the application of these rules if the Secretary determines that the excess business holdings of such organization are consistent with the purpose or function constituting the basis for its exemption under section 501. In addition, in the case of a Type III supporting organization (such as the Hershey Trust), excess business holdings do not include any holdings in any business enterprise if, as of November 18, 2005, the holdings were held (and at all times thereafter are held) for the benefit of the community pursuant to the direction of a State attorney general or a State official with jurisdiction over the Type III supporting organization.

e. The provisions also adopt certain transitional rules that had applied to private foundations after the enactment of section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are extraordinarily complex, it appears that existing

holdings of a supporting organization holding 95 percent or more of the voting stock in the business enterprise may be held for up to 20 years without imposition of an excise tax.

3. **Distributions from Nonoperating Private Foundations to Supporting Organizations.**

a. The 2006 Act excludes from the definition of a "qualifying distribution," for purposes of the minimum distribution rules applicable to private foundations, any amount paid by a private foundation that is not an operating foundation to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. The Internal Revenue Service may determine, by regulation, that other distributions to supporting organizations should be excluded from the definition of qualifying distributions as well.

b. Conforming changes are made to the taxable expenditure rules applicable to private foundations under section 4945. Under these changes, a private foundation that makes distributions to a Type III supporting organization that is not functionally integrated must exercise expenditure responsibility over the grant.

B. **Practical Implications.** The foregoing rules do not provide a complete listing of the changes with regard to supporting organizations under the 2006 Act, but they are the rules most likely to be encountered by the typical planner. Obviously, the result is an entirely different climate. The following are among the practical issues planners must now be prepared to face:

1. **Existing Supporting Organizations May Need Attention.**

a. Clients with existing supporting organizations created before 2006 may not be aware of the 2006 Act changes. Consider the following situations:

(1) The supporting organization was created to hold business interests, perhaps as an important part of the client's estate plan.

(2) The founders' family members serve as paid employees of the supporting organization.

(3) The supporting organization has loans outstanding to disqualified persons (including related business interests).

(4) The Board of Directors of the supporting organization is designed to give the donor(s) a measure of influence that approaches control.

b. The Type III supporting organization structured to support a large number of public charities is now a nonfunctionally integrated Type III supporting organization.

2. Some Supporting Organization Clients May Want Out. Clients in the situations described above, and others, many now find that they do not want to continue as a supported organization. The following alternatives are available:

a. Devise a public fundraising plan and achieve sufficient public support to qualify the organization as publicly supported under Internal Revenue Code section 509(a)(1) and 170(b)(1)(A)(vi).

b. Terminate by transferring all assets to a fund at a public charity, which fund may be a donor advised fund.

c. Terminate by distributing all assets to other charities and go out of business.

d. Become a private foundation. Consider whether local law, the Attorney General, or the Internal Revenue Service may object if the organization seeks to abandon its form as a supported organization. *See, e.g.,* PLR 9052055.

3. Planning for the New Supporting Organization. Planners will have to consider afresh the utility of a supporting organization for many client situations, such as the transfer of business interests, employment of family members, and desire to avoid minimum distribution requirements.

4. Is the Supporting Organization Still a Viable Alternative to the Family Foundation?

a. Since 1969, there have been only two types of organizations, public charities and private foundations. There were strict rules for private foundations that did not apply to public charities. Supporting organizations were public charities that resembled private foundations in that they contemplated some donor involvement in their

charitable programs, but the private foundation restrictions did not apply. This made the supporting organization an attractive alternative in many situations.

b. The 2006 Act changed those dynamics and singled out the supporting organization (and the donor advised fund, discussed below) for treatment that is, in some respects, less favorable than either the public charity or the private foundation. As a result, the planner must re-examine traditional attitudes and planning approaches in selecting the appropriate charitable vehicle to achieve the client's philanthropic and tax objectives.

IX. NEW DONOR ADVISED FUND RULES.

A. New Regulatory Structure. Recent years have seen the proliferation of donor advised funds, with such funds becoming a popular alternative for a person considering a private foundation. Even though there were a number of changes under the 2006 Act that affect donor advised funds, including the addition of a definition of a donor advised fund, the vast majority of donor advised fund programs have been only minimally affected by the changes.

B. Tax on Taxable Distributions.

1. The 2006 Act imposes a 20 percent excise tax on a sponsoring organization that makes a taxable distribution. The tax is imposed on the amount of the taxable distribution.

2. There is also a five percent excise tax imposed on any fund manager of the sponsoring organization who agreed to the making of the distribution (but the maximum tax in the aggregate that can be imposed on fund managers is $10,000).

3. A fund manager is defined as an officer, director, or trustee of the sponsoring organization or an individual having similar powers or responsibilities and, with respect to any act or failure to act, the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).

4. A taxable distribution is any distribution from a donor advised fund to (a) an individual or (b) any other person if the distribution is for other than an exempt purpose under section 170(c)(2)(B) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to such distribution.

5. A taxable distribution does not include a distribution to any organization described in section 170(c)(2)(B) (other than a grant to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if the donor or anyone appointed or designated by the donor for the purpose of advising the donor advised fund directly or indirectly controls a supported organization). It also does not include any grant to the sponsoring organization or any other donor advised fund.

C. **Taxes on Prohibited Benefits.** The 2006 Act enacted a new section 4967 that imposes significant excise taxes on certain transactions that result in prohibited benefits.

1. That section imposes a 125 percent excise tax if any donor, donor advisor, or related person provides advice to a sponsoring organization causing a distribution from a donor advised fund that results in that person or any other donor, donor advisor, or related person receiving, directly or indirectly, a more than "incidental benefit." The tax is paid by any such person who advises as to the distribution or who receives a benefit as a result of the distribution.

2. Any fund manager who agrees to the making of the distribution, knowing that it would confer a prohibited benefit, is also subject to a 10 percent excise tax (with a cap on the total tax for fund managers of $10,000).

3. A more than incidental benefit is any benefit that would have resulted in a reduction of the income tax charitable deduction had the person made a direct contribution to the charitable recipient.

4. These taxes do not apply if the transaction results in a tax under the excess benefit transaction rules of section 4958.

D. **Application of Excess Benefit Transaction Rules to Donor Advised Funds and Sponsoring Organizations.**

1. The 2006 Act modifies the excess benefit transaction provisions of section 4958 to treats donors, donor advisors, and investment advisors to donor advised funds and family members of such persons or entities 35 percent controlled by them or family members as disqualified persons with respect to the sponsoring organization under the excess benefit transaction rules of section 4958. An investment advisor is any person compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds owned by the sponsoring organization.

2. The new rules treat any grant, loan, compensation, or other similar payment, such as an expense reimbursement, distributed to a donor, donor adviser, or person related to a donor or donor adviser as an *automatic* excess benefit transaction. The entire amount distributed to such person is treated as an excess benefit for purposes of section 4958. Any correction amount cannot be held in or credited to the donor advised fund.

3. Amounts paid under a bona fide sale or lease of property are not subject to this special rule, but will instead be subject to the general arm's-length rules of Internal Revenue Code section 4958, with the special disqualified person definition described above applicable. The technical explanation of the 2006 Act makes it clear that a substance-over-form analysis will apply to determine whether a purchase is made from a donor advised fund (in which case the full amount involved will be deemed the excess benefit) or from the sponsoring organization (in which case an arm's-length standard will apply).

4. For example, if a donor contributes securities to a donor advised fund, the donor advised fund distributes them to the sponsoring organization, and the donor then purchases the securities from the sponsoring organization, the distribution to the sponsoring organization will be ignored so that the purchase from the sponsoring organization will be subject to tax under Internal Revenue Code section 4958.

E. **Application of Excess Business Holdings Rules to Donor Advised Funds.** The 2006 Act applies the private foundation excess business holdings rules of section 4943 to donor advised funds.

1. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons, cannot exceed 20 percent. Any holdings in excess of this amount are subject to an excise tax. A disqualified person includes any person who is a disqualified person for purposes of the new rules imposing an excise tax on prohibited distributions from a donor advised fund, as well as family members of such individuals and 35-percent controlled entities.

2. The provision also adopts certain transitional rules that had applied to private foundations after the enactment of section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are extraordinarily complex, it appears that existing holdings of a donor advised fund holding 95 percent or more of the voting stock in the business

enterprise may be held for up to 20 years without imposition of an excise tax.

F. Charitable Contributions to Donor Advised Funds.

1. An income, estate, or gift tax charitable deduction is denied for any contribution to a donor advised fund if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization), a Type I or Type II supporting organization if the donor or an advisor controls a supported organization, or a private foundation.

2. No income, gift, or estate tax deduction is available for a contribution to a donor advised fund maintained by a veterans' organization or fraternal society and no income tax deduction is available for such a gift to a cemetery company.

3. Further, no deduction is allowed for a contribution to a donor advised fund unless the donor obtains a contemporaneous written acknowledgement from the sponsoring organization that states that the sponsoring organization has exclusive legal control over the assets contributed.

G. Annual Returns and Exemption Applications for Sponsoring Organizations.

1. The 2006 Act requires disclosure on the exemption application of an organization that intends to maintain donor advised funds and detailed information regarding the manner of operating these funds.

2. A sponsoring organization is also required to include certain information on its Form 990 including the total number of donor advised funds owned by it at the end of the taxable year, the aggregate value of assets held in such funds at the end of the taxable year, and the aggregate contributions to and grants made from such funds during the taxable year.

H. Practical Implications.

1. Most responsible donor advised funds operate in basically the matter dictated by the new rules. For example, donors to traditional funds were not given an opportunity to receive grants, loans, or compensation, or to contribute business interests or other problematic assets prior to the Act.

2. Despite this, there are several important points for the planner to consider, including the following:

a. Private Benefit – Be Cautious! Private benefit rules can have some unexpected effects. For example, some community foundations allow donors to bifurcate some contributions, such as the cost of tickets to a fund-raising dinner or other event. In such instances, the donor may advise a grant from his/her donor advised fund account to pay the portion of the ticket cost that would be deductible if paid directly, but write a personal check for the value of the non-deductible part. Unless and until the Internal Revenue Service clarifies this, such a practice should be approached with caution.

b. Donors -- Check Your Receipts. The receipt for a contribution to a donor advised fund now must include language warning that the sponsoring organization has exclusive legal control over the assets contributed.

c. More Rules on the Way! The 2006 Act directed the Treasury Department to conduct a study of donor advised funds. When that report is released, it could result in an additional legislation that may establish additional restrictions on donor advised funds and their contributors.

d. Donor Advised Fund vs. Family Foundation. Just as the new rules imposed under the 2006 Act affect the viability of supporting organizations as alternatives to donors considering a private foundation, the new donor advised funds may have some impact on donors as well. However, the typical donor is not as intimately involved with the operations of the donor advised fund, and is thus not as likely to encounter disappointment under the new rules. In fact, many clients who formerly chose a supporting organization may wish to terminate that and distribute the remaining assets to a donor advised fund.

X. PRIVATE FOUNDATIONS MAY BE LOOKING BETTER.

A. **2006 Act Changes the Balance.** Private foundations formerly had more restrictive operating rules and limitations on donors' deductions than any other category of charity. The Act changes this balance, and some donors may find that private foundation status is preferable to continued existence as a supporting organization, while others may find that a donor advised fund brings restrictions they would rather avoid.

B. Most Changes Did Not Affect Family Foundations.

1. **Doubled Penalties.** This shouldn't be a problem, since the goal always is to avoid the penalties in the first place.

2. **Watch Out for Grants to Supporting Organizations.** Under the pre-Act system, grants to public charities were always qualifying distributions for purposes of the minimum distribution requirement of section 4942. Now, however, foundations must make further inquiries in the case of one category of public charity -- supporting organizations. It will first be necessary for a foundation to determine whether a prospective supporting organization grantee is a Type I, Type II, or Type III supporting organization. From there, the rules get somewhat complicated.

3. **Type I, II, and Functionally Integrated Type III Supporting Organizations.** Private foundations may make distributions to Type I, Type II, or functionally integrated Type III supporting organizations; these distributions count as part of the foundation's qualifying distribution amount for the year. However, if a disqualified person to the foundation controls the Type I, Type II, or functionally integrated Type III supporting organization, or if that disqualified person controls a supported organization of that supporting organization, the foundation must exercise expenditure responsibility.

4. **Type III Nonfunctionally Integrated Supporting Organizations.** Private foundations may also make distributions to Type III supporting organizations that are not functionally integrated so long as they exercise expenditure responsibility. However, these distributions are not considered qualifying distribution for the purposes of the foundation's annual required distribution amount, and are considered a taxable expenditure if the foundation does not engage in expenditure responsibility.

XI. IMPACT OF INCOME AND TRANSFER TAX CHARITABLE DEDUCTION RULES ON CHOICE OF DONEE.

A. Overview.

1. **No One Gives to Charity Solely to Get a Tax Deduction.**

   a. A person may refuse to make a gift if he cannot obtain a charitable deduction for tax purposes, but under today's tax rates, no one gives solely to get a deduction.

b. Some charitable motivations must be present before a person will give.

c. A charitable gift is unlikely to be made if it does not fit the donor's overall estate and financial planning objectives.

2. The Complexity of the Tax Laws Discourage Many Donors.

a. Gifts in kind frequently require qualified appraisals and reporting requirements.

b. Predicting the exact taxes to be saved through a charitable gift is almost impossible.

c. More complex substantiation rules further complicate the availability of a charitable deduction for even the simplest gifts.

d. Rules which reduce the itemized deductions (including the charitable deduction) of certain higher income taxpayers further discourage charitable gifts by limiting the tax benefits associated with the gift.

B. Overview of the Tax Rules.

1. Applicable Internal Revenue Code Sections.

a. Section 170 – Income tax charitable deduction rules and percentage limitations.

b. Section 501 – Enumeration of categories of exempt organizations, for example, section 501(c)(3).

c. Section 509 – Rules classifying section 501(c)(3) organizations as private foundations or public charities.

d. Section 2055 – Estate tax charitable deduction rules.

e. Section 2522 – Gift tax charitable deduction rules.

f. Section 4940 through 4947 – Private foundation excise tax rules that apply to private foundations and in some cases to supporting organizations and donor advised funds.

2. Income Tax Charitable Deduction for Individuals.

a. Donor Must Itemize Deductions. A donor who itemizes deductions is entitled to an income tax charitable deduction

for contributions to qualified charitable organizations. I.R.C. § 170(a).

b. Overall Limitation on Itemized Deductions. Certain taxpayers with income above a certain amount ($166,800 (or $83,400 for a separate return filed by a married individual) in 2010) must reduce their itemized deductions by the lesser of three percent of the excess of their adjusted gross income over this certain amount or 80 percent of the amount of itemized deductions otherwise allowable for the tax year. I.R.C. § 68(a).

c. Not all tax-exempt organizations qualify as charitable organizations.

d. 50 Percent Limitation. For a gift of cash or unappreciated property to a "50 percent-type" organization (generally 509(a)(1), (2), or (3) organizations and private operating foundations, but not private foundations), the donor is generally entitled to deduct the full amount of the contribution up to 50 percent of the donor's contribution base (essentially adjusted gross income) (the "50 percent ceiling"). I.R.C. § 170(b)(1)(A).

e. 30 Percent Limitation. For a gift of cash or unappreciated property to a "30 percent-type organization (a private foundation, other than a private operating foundation) and gifts *for the use of* a 50 percent-type organization, the donor is generally entitled to deduct the full amount of the contribution up to 30 percent of the donor's contribution base.

f. Limitations for Gifts of Capital Gain Property. For gifts to a 50 percent type organization of long-term capital gain property that has appreciated, the donor may deduct the full fair market value of the gift only up to 30 percent of the donor's contribution base. I.R.C. § 170(b)(1)(C). For gifts of such property to a private foundation, the deduction is limited to 20 percent of the donor's contribution base. I.R.C. § 170(b)(1)(D).

g. Five-Year Carryover. A five-year carryover generally applies to any portion of a charitable deduction that cannot be deducted because of the percentage limitations. I.R.C. § 170(b)(1)(D).

h. Special Rules for Gifts to Private Foundations.

(1) In addition to the deduction limitation discussed above, the contribution deduction for gifts of appreciated property to a private foundation is further limited. If an individual contributes capital gain property, such as real estate held for more than one year, the amount of the deduction is limited to the lesser of the property's basis and its fair market value. I.R.C. § 170(e)(1)(B)(ii).

(2) There is a special rule, however, that allows a deduction at fair market value (rather than tax basis) for a contribution of "qualified appreciated stock," which is stock for which market quotations are readily available on an established securities market. The value of such gifts for purposes of a charitable contribution deduction is the fair market value of the stock. I.R.C. § 170(e)(5).

i. Contributions of Related Use Tangible Personal Property.

(1) A donor is entitled to a charitable deduction equal to the greater of fair market value or basis for a contribution of tangible personal property the use of which is related to the donee's exempt purpose. If the property is not related, the donee's deduction is limited to the property's basis (or fair market value if less).

(2) The 2006 Act treats as unrelated use tangible personal property that is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the donor made the contribution and with respect to which the donee has not in a written statement signed by an officer of the donee under the penalties of perjury either (1) certified that the use of the property was related to the donee's exempt purpose or function and described how the property was used and how such use furthered such purpose or function of the donee or (2) stated the intended use of the property by the donee at the time of contribution and certified that such use has become impossible or infeasible to implement.

(3) If the property is disposed of after the close of the taxable year of the contribution and within three years of the date of the contribution (unless the

donee makes the certification described above), the Act requires the recapture of the charitable deduction in an amount equal to the difference between the amount claimed as a deduction and the property's basis. The donor must include this amount in ordinary income in the year in which the disposition occurs.

(4) The rule applies to property that was identified as related use property by the donee on Form 8283 and for which a deduction of more than $5,000 is claimed by the taxpayer.

(5) The 2006 Act also imposes a $10,000 penalty (in addition to any criminal penalties) on any person who identifies property as exempt use property knowing that the property is not intended for such a use.

j. Limitations for Gifts of Ordinary Income Property. The amount of the charitable deduction for gifts of property, the sale or exchange of which would produce a gain, other than a long-term capital gain, is reduced by the amount of the non-long-term gain. § 170(e).

(1) Included in this category are: inventory, crops, dealer property and works created by the donor. In the case of a painting donated by the artist, for example, the deduction is limited to the artist's cost of materials.

(2) Note: This applies to property that would yield a short-term capital gain, as well as to property that would yield ordinary income.

(3) Normally, this means that if the asset is not a long-term capital asset, a charitable deduction is limited to basis (fair market value, less potential non-long-term capital gain).

(4) Capital Gain/Ordinary Income Property, e.g., personal property with section 1245 recapture potential. Both the capital gain and the ordinary income rules apply. This is the one situation in which the deduction may be more than basis, since it would be basis plus the potential capital gain, but

without the potential recapture income. See Treas. Regs. § 1.170 A-4(d) (ex. 2).

3. **Estate and Gift Tax Charitable Deductions.** Generally, contributions to organizations that qualify for the income tax charitable deduction also qualify for the estate and gift tax charitable deductions. For estate and gift tax purposes, there are no limitations on the amount of the deduction for qualifying contributions and the classification of the charity as a public charity or private foundation is not relevant. I.R.C. §§ 2055(a), 2522(a).

   a. The estate tax charitable deduction is allowed for an amount that becomes or is added to a charitable bequest or transfer as a result of a "qualified disclaimer" under Internal Revenue Code section 2518. In addition, Internal Revenue Code section 2055(a) provides that the complete and timely termination of a power to consume, invade, or appropriate property for the benefit of an individual before such power has been exercised is treated as a qualified disclaimer.

   b. Property includible in the gross estate of a decedent by reason of a general power of appointment and received by a qualified recipient is considered a bequest made by the decedent.

   c. The estate tax charitable deduction is reduced by the amount of any death taxes that are, either by the terms of the will or by local law, assessed against an otherwise deductible bequest or other transfer.

   d. The amount of the deduction may not be more than the value of the transferred property that is required to be included in the gross estate.

4. **Substantiation Requirements.**

   a. No income tax charitable deduction is available for a separate contribution of $250 or more unless the taxpayer has a written receipt or other acknowledgment from the charity (which must be received before the tax return claiming the deduction is filed) of the contribution (including a good faith estimate of the value of any goods or services provided to the taxpayer in exchange for making the gift). Taxpayers may not rely on a canceled

check as substantiation for a donation of $250 or more. I.R.C. § 170(f)(8)(A).

b. Modified Recordkeeping Requirements for Cash Gifts.

(1) A taxpayer may not claim a deduction for any cash or other monetary gift (even if under $250) unless the taxpayer maintains as a record of the contribution a bank record (such as a cancelled check or credit card record) or other written communication from the donee showing the name of the donee, the date of the contribution, and the amount of the contribution. This provision applies to contributions made in taxable years beginning after August 17, 2006. Thus, calendar year taxpayers will be subject to these rules beginning in 2007.

(2) IRS Notice 2006-110 sets forth guidance for the new recordkeeping requirements in the case of charitable gifts made through payroll deductions.

c. To claim an income tax deduction for a contribution of property (other than cash) valued at $500 or more, the donor must obtain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a description of the property in reasonably sufficient detail. The donor must also complete and file Section A of Form 8283 with the Internal Revenue Service. Treas. Reg. § 1.170A-13(b)(3).

d. If the contributed property (other than cash or publicly traded securities) has a value in excess of $5,000 ($10,000 in the case of nonpublicly traded stock), the donor must obtain a qualified appraisal of the property. In addition, the donor must complete the appraisal summary on Form 8283. Treas. Reg. § 1.170A-13(c).

e. In the case of a gift of artwork with an aggregate value of $20,000 or more, a complete copy of the signed appraisal must be submitted with Form 8283. An 8 x 10-inch color photograph of the artwork must be provided upon request.

5. Property Contributions after the 2006 Act.

a. Overvaluation Abuses. Excessive valuation claims for charitable contributions of property has been a potential problem since the creation of the charitable deduction.

Despite tightening of the valuation rules over the years, particularly with the imposition of the qualified appraisal requirement, notification to Internal Revenue Service on disposition of contributed property by the donee (so-called "tattletale" rule), and ever-increasing penalties, this subject remains a point of concern for the Internal Revenue Service.

b. Appraisers and Valuations. The 2006 Act created new qualification rules for appraisers and increases penalties for valuation misstatements.

(1) The threshold for imposing accuracy-related penalties for overstatement of the value of property contributions is lowered from 200% (of the true value) to 150%, the gross valuation misstatement threshold is lowered from 400% to 200%.

(2) Penalties on understatement of values for estate tax against tax purposes are similarly beefed up. In general, there is a substantial penalty if the valuation reported is 65% (formerly 50%) or less of the correct value, and a gross understatement is present, if the value is 40% (formerly 25%) or less.

(3) The accuracy-related penalties formerly did not apply if the taxpayer showed there was reasonable cause and he or she acted in good faith. The Act eliminates this exception for gross misstatements.

(4) Appraisers are subject to increased oversight under the Act. A civil penalty of the greater of $1,000 or 10% of the understatement resulting from a valuation misstatement (up to a maximum of 125% of the gross income derived from the appraisal) applies to a person who prepares an appraisal that results in a valuation misstatement. The disciplinary rules for appraisers also were expanded. The IRS no longer needs to apply a civil penalty before it can discipline appraisers by suspending or barring them from appearing in tax matters.

c. Qualified Appraisers. In addition, the definition of qualified appraiser was expanded to require verifiable education and experience in valuing that type of property for which the appraisal is being performed.

d. Cash Contributions. Even a simple thing like a charitable contribution of money was made more complicated by the Act. Formerly, a canceled check, a receipt, or "other reliable written records" were sufficient, but under the Act," other written records" alternative is repealed. Thus, if a donor does not get a receipt, it will be necessary to obtain a bank record substantiating a cash contribution.

XII. FACTORS FOR CONSIDERATION IN CHOICE OF CHARITABLE DONEE.

A. Donor's willingness to relinquish control over management, investments, or grantmaking.

B. Donor's relationship (or lack thereof) with one or more public charities.

C. Amount of assets to be contributed to charitable donee.

D. Availability of investment management.

E. Nature of assets to be contributed to charitable donee.

F. Limitations on income tax charitable deduction associated with gifts of certain types of property to private foundation.

G. Potential application of excess business holdings rules to assets to be contributed.

H. Donor's desire to have family involvement on board and length of time of involvement.

I. Donor's desire for charitable donee to employ family members.

J. Donor's current need for an income tax charitable deduction without certainty of ultimate charitable donee.

K. Donor's desire to use the charitable donee as a vehicle for coordinated family philanthropy.

L. Donor's desire to use the charitable donee as a training vehicle to promote good stewardship and investment management among younger generations of the family.

M. Donor's expectation that funds may be raised from third parties (i.e., the general public).

N. Donor's desire for future generations to have a vehicle to continue the family's philanthropic tradition.

O. Donor's desire for anonymity or privacy (in connection with funding or in connection with grants awarded).

P. Tax on investment income.

Q. Minimum distribution requirements.

R. Donor's expectations that charitable donee will carry on a direct charitable activity, such as operation of an art museum.

S. Donor's desire to defer funding until death.

T. Donor's desire to use planned giving vehicles, such as charitable remainder trusts or charitable lead trusts to fund the charitable donee.

U. Donor's willingness to bear cost and burden of administration, tax filings, and management of charitable organization.

V. Nature and location of anticipated grantees of charitable donee.

W. Donor's desire for charitable donee to make scholarship grants to individuals.

X. Donor's desire for grantmaking support and advice.

XIII. INTERESTING IDEAS FOR DISCUSSION AND COMMENT.

A. **General Comments.** The following discussion deals with several kinds of charitable planning concepts. In each, a transaction is proposed which, the authors believe, most estate planning practitioners would agree is effective to achieve the purposes intended. The transaction is then progressively (regressively?) modified until a point at which the authors believe most estate planning practitioners would agree is not effective to achieve the purposes intended. In reviewing the transactions the authors believe it is helpful to consider two questions:

1. To what degree, if any, does a private benefit taint a transaction? Conversely, to what degree, if any, does benefit to charity protect a transaction which also has non-charitable benefits?

2. To what degree, if any, is a charity's independent ability to act or refrain from acting relevant to determining the application of the Federal income and transfer tax laws to a transaction? If a transaction creates an economic incentive for a charity to take a certain action when will the law conclude the charity is not truly independent?

B. Assumptions. In the transactions described, unless stated otherwise, the reader should assume that each of the parties is independently represented, to the extent required or suggested by applicable state law, that none of the parties control or influence, in any official capacity, the charity involved, and all appraisals are independent and are qualified appraisals for section 170 purposes.

C. Gifts To and Sales By Charitable Organizations.

1. Basic Transaction.

a. Client owns all 10,000 shares, all the same class, of a C corporation which is an operating business worth $10,000,000. In 2006 client gives 1,000 shares to client's two children, equally, and gives 1,000 shares to a local charity. Client retains an independent appraiser who determines each share is worth $600. Client reports a $600,000 gift to children, and a $600,000 charitable gift, for gift and income tax purposes.

b. Two years pass without any additional gifts by client and without any material change in the operations of the business. At such time, the corporation contacts the charity and offers to purchase the shares for then current appraised value. The charity agrees and obtains an appraisal that the shares are worth $600 each, for a total of $600,000. The corporation redeems the shares from the charity for $600,000.

c. After the transaction, there are 9,000 outstanding shares of the corporation. The corporation is worth $9,400,000 ($10,000,000 - $600,000) thus each share is worth $1,044.44. Client's children have value of $1,044,444 and client only made a taxable gift of $600,000.

2. First Refinement.

a. Suppose the client gave 1,000 shares to the children and 3,000 shares to each of three charities. Because all the interests were minority interests the appraisal for the shares remained $600 per share. After two years the shares were reappraised, remained $600 per share, and each charity was redeemed for $1,800,000 for a total of $5,400,000. The 1,000 shares owned by the children now have a value of $4,600,000 ($10,000,000 - $5,400,000 = $4,600,000). Any difference if it is 1,000 shares to nine different charities?

b. Suppose the corporation were recapitalized with 1,000 voting shares and 9,000 non-voting shares. The voting shares were given to the children and the non-voting shares were given to the charity. The appraiser valued the voting shares at $1,000 per share and the non-voting at $600 per share.

3. Second Refinement.

a. Suppose the corporation were a family limited partnership owning $10,000,000 in marketable securities with 100 general partnership units and 9,900 limited partnership units. Client gives the GP units to the children at appraised value ($100,000; no discount) and 9,900 LP units to charity at appraised value of $5,940,000 (40% discount) and takes an income tax deduction for that amount.

b. Two years later the client's children offer to purchase from the charity the 9,900 LP units. The market has been flat and there is no change in the values of the securities or the discount. Thus the children pay $5,940,000. The children now own a partnership with $10,000,000 in assets for which they paid $5,940,000 through a gift by client of $100,000.

c. Suppose the appraised value of the GP included a voting premium and the LP units were valued at only a 25% discount?

d. Suppose the partnership sold the securities during the two year period, and reinvested in other securities. The charity owns 99% of the partnership; does 99% of the gain escape income tax?

e. If the partnership owned rental real estate would that affect the analysis?

4. Third Refinement.

a. Suppose the corporation's shares were subject to a stock restriction agreement which creates special rights with respect to shares owned outside the client's family. Specifically, any non-family owner has a put to the corporation at a value equal to 20% of the value of the entire corporation.

b. Suppose the agreement gives the corporation a call right at a value less than appraised value (ignoring the call right).

c. Does the agreement effect the transaction whether or not the charity exercises the put or the corporation the call?

D. Transfer of Remainder Interests by Charity.

1. Basic Transaction.

a. Client creates a charitable remainder annuity trust for the life of the client with the remainder passing to a charity. Worthy National Bank is trustee. No one may change the identity of the charitable remainderman.

b. Two years after the trust is created and funded, the client's children approach the charity and offer to purchase the remainder interest at a fair value. The children furnish the charity with the client's health records. The charity reviews the then current value of the trust, makes a determination of the likely investment performance of the trust assets and the likely performance of the charity's investments, has a professional review the health records, and names a price. Client's children accept and the sale occurs.

c. Worthy National Bank as trustee continues to operate the trust as a charitable remainder trust under section 664.

d. Five years later client unexpectedly dies. The trust is included in the client's estate but the estate takes a full charitable deduction because the remainder interest passes to charity. Charity, in turn, informs the trustee that the trust assets should actually be distributed to the client's children. In Estate of Blackford v. Commissioner, 77 T.C. 1246 (1981) the decedent in her Will granted a life estate in her personal residence to her husband with the residence to be sold at his death and the proceeds given to certain charities. At issue was whether that was the transfer of a remainder interest in a personal residence (§170(f)) and the Tax Court held that it was. The opinion went on to state:

> There is no statutory requirement that the charity must somehow use the property as a personal residence in order for the gift to give rise to a deduction. In fact, there is nothing to prevent a charity from selling its remainder interest long before the life tenant dies and in that manner transforming its interest into cash.

2. **First Refinement.** Client's children's offer is based on the value of the remainder using section 7520 to determine value, using the IRS interest rate and actuarial tables for life expectancy.

3. **Second Refinement.** The trust involved is a charitable remainder unitrust. Does it matter for this purpose whether it is a straight unitrust or a net income (with makeup) unitrust?

4. **Third Refinement.** Client is trustee and client's children are the successor trustees.

5. **Fourth Refinement.** Charity sells all of the remainder interest but the sales price contains a future payment equal to 20% of any excess appreciation in the trust. That is, if the trust appreciates at a rate greater than the parties assume, the charity shares in the upside; charity accepts no downside risk.

6. **Fifth Refinement.** The transaction is not a charitable remainder trust but a remainder interest in a personal residence or farm.

7. **Sixth Refinement.** Client may change the identity of the charitable remainderman during client's lifetime. Taking into consideration the possibility that client might make a change, charity agrees to sell the remainder interest for 50% of the value determined above.

8. **Seventh Refinement.**

   a. Client creates a grantor retained income trust. Client is 60 years old and will receive the income from the trust for 10 years. If client dies during the 10 year term client has a general power of appointment over the trust assets. If client outlives the 10 year term charity receives the trust assets. Client makes a taxable gift of 49.3% of the value of the trust, determined pursuant to section 7520 . After two years, client's children approach charity about purchasing the remainder interest either on the basis of the section 7520 rate or as independently determined by the charity so long as the charity takes into consideration the chance that client may die during the term.

   b. Suppose the trust for a 60 year old is for a 40 year term. The amount of the taxable gift under section 7520 is almost zero ($2030 per million).

9. **Eighth Refinement.**

a. Client, a billionaire, executes a Will which provides for 90% of client's assets to pass to charity. Sometime later client's children approach charity noting that client is notoriously fickle and that the chances charity will actually receive "the billions" is remote. Client's children offer to purchase charity's expectancy for half a billion dollars today. Charity concludes that half a billion today is worth lots of billions later on and sells. Sometime later client dies and client's personal representative wires billions to the charity, taking a full estate tax charitable deduction for the interest. Charity in turn wires billions to the children. Question: do the children have income?

b. Suppose the children do not have half a billion dollars today. Instead children promise to pay charity when client dies, whether or not client has left anything to charity, half a billion dollars plus interest at 8% between today and whenever client dies.

E. Termination of Charitable Remainder Trusts.

1. **Basic Transaction.** Client created, is trustee, and is the only non-charity beneficiary of a charitable remainder trust. Client and charity desire to terminate the trust which was created 10 years previously. Client and charity agree as to the value of the trust assets and the application of the section 7520 actuarial factors. Under applicable state law the termination may occur by agreement of the trustee, lifetime beneficiary, and remainder beneficiary. The calculations are made, the trust is terminated, and the assets divided. The client reports the assets received as capital gain.

2. **First Refinement.**

a. On January 1, 2007, several years after the trust was created, client purchases the remainder interest from the charity, at section 7520 actuarial value. Because the client is now the only beneficiary of the trust the trust terminates by operation of law and client receives all the assets. Reasoning that the trust is not a charitable remainder trust at the moment of termination the client reports no income at the termination of the trust and takes the assets with the basis the trust would have had.

b. Suppose the trust had $1.00 of unrelated business income in the year in which the trust terminated. Does that affect the analysis.

3. **Second Refinement.** On January 1, 2007, several years after the trust was created, client's children purchase the client's interest and the charity's remainder interest. Client pays capital gains tax on the transfer. Do Client's children receive the trust assets without capital gains tax and with the same basis as the trust would have had?

F. Assignment of Income Issues.

1. **Basic Transaction.**

   a. Client gives 100% of a limited liability company to charity. The LLC owns a warehouse leased to a national tenant on favorable terms (long-term lease, excellent rent, appropriate escalator clauses). Under applicable state law the charity has minimal liability due to the nature of the asset and the LLC structure.

   b. The charity considers whether to hold the warehouse because of its income potential but determines to sell. Client lists the warehouse with a leading real estate agent and some time later sells the warehouse for 90% of the asking price.

2. **First Refinement.**

   a. Along with the LLC transfer documents client gives charity a letter from the national tenant offering to purchase the warehouse for a stated price.

   b. Suppose the charity consults a real estate agent and obtains an appraisal and sells the warehouse to the national tenant without placing it "on the market."

3. **Second Refinement.** The warehouse is a single-use property and the lease will expire in 18 months. The value of the warehouse to the national tenant is much greater than its value to any local company. As client gives offer letter to charity client remarks "I have been waiting for those folks to buy this for years and am finally glad they are going to."

4. **Third Refinement.**

a. Client gives 60% of the LLC to charity which is the controlling interest.

b. Suppose client gives 45% to charity but gives charity the right to control a sale.

5. **Fourth Refinement.**

a. The LLC actually owns a tract of undeveloped land.

b. Suppose the LLC is given in exchange for a gift annuity.

6. **Fifth Refinement.**

a. Client owns the majority of a C corporation which, client hopes, will soon be bought by a national company although there is no legal obligation today. Last year client turned down an offer from another national company but knows that company remains interested.

b. Client transfers the C corporation stock into an LLC and gives 99% to charity retaining a 1% interest, which controls all the vote. The LLC will dissolve in one year (purpose of which is the limit the discounts taken by the appraiser when valuing the gift for income tax purposes). Client negotiates with the national company knowing that if this sale falls through the offer from the previous company can be pursued. Either way, client can sell the company.

7. **Sixth Refinement.** Client wants a charitable remainder trust to own certain securities if the company is acquired but not if the acquisition does not occur. Client knows the acquisition is "in the works" but has no control over that transaction. Client has charity prepare a charitable remainder trust and client's attorney prepare a revocable trust naming charity as a 1% beneficiary of the trust after client has died. Client is trustee of each trust and asks for each trust to be called the CLIENT'S 2006 TRUST FOR NAMED CHARITY. Client has securities in certificate form and assigns them to client as trustee of the CLIENT'S 2006 TRUST FOR NAMED CHARITY. Within a few weeks client knows whether the acquisition has occurred and thus knows which trust was actually funded. If the acquisition did not occur, client has lawyer remove the 1% charitable interest from the revocable trust.

PLANNING CHART

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS	PREFERRED TYPE OF CHARITY
Outright Gift of Undiscounted Assets	Full income tax deduction. No payments to donor.	-0-	Charity receives income and appreciation on the contributed assets from the date of gift.	For cash and marketable securities differences are minimal. For closely-held and real estate assets, private foundation gifts are less desirable.
Outright Gift of Discounted Assets followed by family purchase or redemption	Full income tax deduction. No payments to donor. Note that the restrictions on the gift could create a future interest thus eliminating the income tax deduction	Potential value received by the family through the purchase or redemption of assets that are discounted from pro rata value.	Charity receives income and appreciation on the contributed assets from the date of gift. However, enjoyment may be postponed if the assets are illiquid.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good donee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules.
Defined value / charitable allocation clause transfer	Full income tax deduction. No payments to donor.	Potential for discounted assets to pass to the family transferring additional value.	Charity receives income and appreciation on the contributed assets from the date of gift. However, enjoyment may be post-poned if the assets are illiquid.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good donee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules.
Bequest	No income tax deduction. No payments to donor.	-0-	Assets available at an undetermined future date.	No substantial differences. Bequests to a private foundation may be "bought out" by the family using the Probate Exception.
Disclaimer to a Charitable Fund	No income tax deduction. No payments to donor.	Potential for discounted assets to pass to the family transferring additional value.	Assets available at an undetermined future date.	Donor advised fund or some supporting organizations are most desirable. Public charity is a good transferee but may lack experience to handle the gift efficiently. Private foundation is undesirable because of self-dealing rules regardless of the probate exception.

TYPE OF GIFT	DONOR BENEFITS	FAMILY BENEFITS	CHARITY BENEFITS	PREFERRED TYPE OF CHARITY
Gift Annuity	Partial income tax deduction. Annuity payments to donor.	-0-	Assets available immediately, subject to an obligation to make annuity payments.	Public charity is almost always the best choice.
Charitable Remainder Trust	Partial income tax deduction. Annuity or unitrust payments to donor.	-0-	Assets available in the future, date may or may be fixed. Asset may be monetized through a fair market value sale.	The income tax deduction for gifts to private foundations is limited and monetizing the interest of a private foundation may be difficult.
Remainder interest in house or farm	Partial income tax deduction. Donor may use the house or farm for life.	If remainder interest is purchased by the family, potential for value to transfer depending on the appreciation rate of the asset and the length of the donor's life.	Assets available in the future at a date that is not fixed. Asset may be monetized through a fair market value sale.	Private foundations are undesirable recipients.
Charitable Lead Trust - - Constant Annuity	Typically no income tax deduction but income is removed from the donor's taxable income base. No payments to donor.	Assets available in the future, date may or may not be fixed.	Annuity or unitrust payments to charity.	Any charitable donee. Private foundations do not have to include the assets of the lead trust when calculating the annual 5% distribution.
Charitable Lead Trust - - Increasing Annuity or Shark-Fin CLAT	Typically no income tax deduction but income is removed from the donor's taxable income base. No payments to donor.	Assets available in the future, date likely to be fixed at the end of a specified term.	Annuity payment to charity largely deferred until the end, or close to the end, of the trust term. Minimal payments until then.	Private foundations less desirable because the charitable donee must be free to challenge the investment of trust assets during the term, and to ensure that all trustee actions are independent.

Shark-Fin CLATs with Chief Brody Option.

A. I Create a 50 year CLAT.

Suppose I create a CLAT within the window to use a 7520 rate of 1.4%. I fund the CLAT with $1,000,000. The term is 50 years. During the first 49 years the CLAT pays $1,000 per year to Worthy Charity at the end of the year. In year 50 the CLAT pays $2,000,000 to Worthy Charity and pays whatever amount remains to my children. My children are the trustees.

I have not made a gift to my children because the IRS believes that $2,000,000 in 50 years is worth $1,000,000 this year. [1.014^50 = 2.004]. Actually the $2,000,000 balloon may be somewhat lower taking into consideration the $1000 per year payments.

The IRS sample forms specifically allow back-loaded annuities, unlike with, say a Grantor Retained Annuity Trust. If you were to graph payments that started low and went up at the end it would look like a shark's fin, hence the common name of these, Shark-Fin CLAT.

B. My Children Approach the Charity.

My children, being clever souls, look at the calendar and conclude that - - despite excellent health habits - - they might not survive 50 years and thus are unlikely ever to see a benefit from my largesse. They are not encouraged by my reminder that half the people must die prematurely. Being extra-clever souls they hit upon a plan. They do not discuss the plan with me and I know nothing of it until it is completed.

My children approach Worthy Charity with calculator in hand and inquire of its development and finance department what they think the present value of $2,000,000 will be worth in 50 years. Worthy Charity expects that it can earn 5.5% a year over the next 50 years so in fact it believes that $2,000,000 then is worth a paltry $137,533 now. [$2,000,000/ (1.055^50) = $2,000,000/14.54196 = $137,533]

My children do not want to take advantage of Worthy Charity. They decide to make Worthy Charity an offer it cannot refuse: $225,000 today for Worthy Charity's interest in the CLAT. That is an assumed earnings rate of about 4.466% a year over the term. Every bit Worthy Charity earns above 4.466% is profit on the deal. For instance, if Worthy Charity actually earns 5.5% then at the end of 50 years it would have $3,272,000 versus the original $2,000,000. After a few minutes of cogitation, Worthy Charity takes the offer and transfers its interest to my children.

My children are elated: they have bought $1,000,000 for $225,000. Ought they to be elated or is there something faulty here? Does the trust terminate with the purchase of the interests from Worthy Charity? That would seem desirable and, depending on the wealth of my children, may be necessary.

C. Is Anyone Going To Jail, Metaphorically or Actually?

Has Worthy Charity done anything wrong? Given the numbers, might Worthy Charity do something "wrong" if it does not agree to sell? (Does that mean a charity that is the beneficiary of a CLAT ought be seeking buyers for its interest?)

Is this a prohibited transaction, perhaps self-dealing. CLTs are subject to the self-dealing rules. Do those prohibit a charity from selling its interest in a CLT?

Is this a commutation and if so is it prohibited? Rev. Rul. 88-27 prohibits the trustee from having the power to commute the charitable interest. The Ruling states:

> If the trustee has the discretion to commute and prepay the charitable "lead" annuity interest prior to the expiration of the specified term of the annuity, the interest does not qualify, as a guaranteed annuity interest

> under section 2522(c)(2)(B) of the Code, and under section 2522(a), no deduction is allowed for the amount of the transfer to charity.
>
> The result would be the same even if the trust instrument provided that the prepayment amount were to be calculated using the discount rate and methodology used to calculate the present value of annuity payments under the Code and regulations in effect on the date the annuity was established, because the exact amount payable to charity can not be determined as of the date of the gift.

Treas. Reg. §25.2522(c)-3(c)(2)(vi)(a) states in part:

> An amount is determinable if the exact amount which must be paid under the conditions specified in the instrument of transfer can be ascertained as of the date of gift. For example, the amount to be paid may be a stated sum for a term of years, or for the life of the donor, at the expiration of which it may be changed by a specified amount, but it may not be redetermined by reference to a fluctuating index such as the cost of living index. In further illustration, the amount to be paid may be expressed as a fraction or percentage of the cost of living index on the date of gift.

If the trust terminates by operation of law - - the children who have the remainder interest purchasing the charitable lead interest - - is that a commutation? The trustee would not be involved in the transaction.

D. Going Forward.

The point of this illustration is not necessarily to inspire you to go out and create 50 year Shark-Fin CLATS but rather that you begin to think about the low section 7520 rate versus the likely experience of charitable investments. The longer the term the more leverage that exists. However, prudence suggests that overly long terms not be used.

E. **Don't Some People Suggest That Life Insurance Be Owned in a Shark-Fin CLAT? Any other planning tips?**

Yes. Folks who sell life insurance. The theory is that if I have a 25 year life expectancy the life insurance will pay off and furnish the money to make the balloon payment. Life insurance in this context is an investment and it is either good or bad. However, it limits your ability to pay-off the charity early.

A CLAT may either pay its own income taxes - - and receive an income tax deduction only for distributions it makes to charity - - or all the income can be taxed every year to the grantor in which case the grantor gets an income tax deduction in the first year for the amount with which the CLAT is funded (e.g. $1,000,000 in my example). The first is more typical. Consideration should be given to having mini-balloon payouts every few years to "clear out" accumulated capital gains.

F. **What's In A Name?**

Why the name? Jaws. Chief Brody goes out to get the shark. His boat sinks, he's bloodied, heck he's almost eaten, but he survives and paddles back to shore. If music helps you think like it does me … Flatt & Scruggs and The Beverly Hillbillies...

hum along the first verse and then choose whichever second verse makes you happier

Come and listen to my story about a man named Fred,
He wasn't 'specially poor but he sure hated the Feds.
Then one day when his broker said he's flat,
Someone came along and suggested he try a CLAT.

(Not Just Any CLAT. A Shark-Fin CLAT With Chief Brody Option)

Well the next thing you know ole Fred's passed all his wealth,
And he's done it, with almost total stealth.
Along come his children who say they're all grateful,
And in fact they promise always to be faithful.
(The kids will visit. Bring mac & cheese. Occasionally Sudoku.)

OR

Well the next thing you know ole Fred's passed all his wealth,
And he's done it, with almost total stealth.
He's pretty pleased until one day when he picks up his mail,
And Fred finds ou,t he's gonna spend some time in jail.
(The kids will visit. Bring mac & cheese. Occasionally Sudoku.)