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BEYOND THE PRIVATE FOUNDATION

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I. INTRODUCTION.

"I need a foundation" is the classic refrain from a donor who wants to fund and operate a long-term charitable goal. A foundation, or more correctly, a private foundation is not the only option to consider, however, and may not be the most appropriate. This outline will review the tax consequences of establishing a private foundation and the tax rules that apply to its operation. It will then compare alternatives that enable the activities of the entity to operate in an environment that, for the most part, will be free of income tax liability. None of these options imposes any tax liability upon funding by the donor. All but one provides the donor with tax benefits in the form of a deduction that may be claimed in the year of contribution against the donor's taxable income, in each case on terms more generous than those applicable when funding a private foundation.

II. PRIVATE FOUNDATIONS.

A. Overview.

1. **Definition**. Private foundations are defined in the Internal Revenue Code through an exclusionary definition. I.R.C. § 509(a). A private foundation means a domestic or foreign organization described in Internal Revenue Code section 501(c)(3) other than:

   a. Certain status-based organizations defined in Internal Revenue Code section 170(b)(1)(A)(i) through (v), namely, churches; schools and other educational organizations; hospitals and medical research organizations; organizations supporting state universities and colleges; and governmental units.

   b. Organizations that are publicly supported with gifts, grants and contributions, as defined in Internal Revenue Code section 170(b)(1)(A)(vi).

   c. Organizations that are publicly supported with exempt purpose gross receipts, as defined in Internal Revenue Code sections 509(a)(2) and 509(d).

   d. Supporting organizations ("SOs"), as defined in Internal Revenue Code section 509(a)(3) and 509(f).

   e. Organizations operated exclusively for testing for public safety.

   f. Organizations described in these five categories are commonly referred to in federal tax parlance as "public charities." This nomenclature should not be confused with terminology used in other contexts. For example, state regulation of public charities ordinarily covers the otherwise mutually exclusive subsets of public charities and private foundations under the federal tax system.

2. **General Characteristics**. A typical private foundation has the following three characteristics:

   a. A single or concentrated source of contributions, in the guise of a single individual or corporate donor, one family of individual donors, or a discreet group of individual donors.

   b. Reliance from income earned by an endowed fund to support the charitable activities of the organization, as opposed to annual fundraising.

   c. Carrying out its charitable purposes through grantmaking as opposed to the direct operation of specific charitable programs.

3. **Time Horizon**. Private foundations are ideal charitable planning vehicles for donors who want to commit significant funds to charity now (and thereby obtain immediate tax benefits), but who are not ready to relinquish control over the eventual charitable use of the property. Property contributed to a private foundation may be retained by the private foundation and put to charitable uses in subsequent years.

4. **Enhanced Regulation**. Since the Tax Reform Act of 1969, private foundations have been subject to more stringent regulatory oversight than public charities, namely, with regard to self-dealing, minimum distributions requirements, investments and business holdings. These restrictions aim to prevent abuse of the private foundation system by ensuring that an organization does not receive the benefit of tax-exempt status if it is primarily operating for a non-charitable purpose. See General Explanation of the Tax Reform Act of 1969, prepared by the Staff of the Joint Committee on Internal Revenue Taxation, December 3, 1970 (Joint Committee Explanation), 30-41.

B. Organization, Operation and Administration.

1. **Formation**. Private foundations may be formed as corporations, trusts or unincorporated associations. The corporate and trust forms are the most common because they offer the directors or trustees of the foundation liability protection. Because corporations are generally required to register with the state in which the corporation is formed and to make annual filings, trusts may provide additional benefits of privacy and lower organizational and administration expenses.

2. **Funding**. A private foundation funded by an individual can be funded during the individual's lifetime or at his or her death. A private foundation may also receive support from other donors.

   a. Private foundations can be funded with many different types of property, including cash, marketable or unmarketable securities, real estate, artwork and other property.

   b. Certain assets, such as business interests and property subject to debt, may create administrative and tax issues for the private foundation.

3. **Filing Requirements**.

   a. Private foundations obtain tax-exempt status by filing with the IRS a Form 1023, Application for Recognition of Exemption under Code section 501(c)(3) of the Internal Revenue Code. The private foundation must file before the end of the 15th month (or, in many cases, extended to the 27th month by an automatic statutory extension) from its date of organization if tax-exempt status is to be retroactive to the date of organization. Treas. Reg. §§ 1.508-1(a)(2) and 301.9100-2(a)(2)(iv).

   b. Private foundations must file a Form 990-PF with the IRS annually, on or before the 15th day of the fifth month after the close of the private foundation's taxable year. This filing requirement is applicable even if the private foundation's application for tax exemption is pending. Treas. Reg. § 53.6011-1(e).

   c. Private foundations may have state-specific filing requirements, such as filing requirements with the Secretary of State's office (typically, in the case of a corporation) and with the Attorney General's office or other state agency that oversees charitable organizations.

C. Income Tax Treatment of Contributions.

1. **Income Tax Charitable Contribution Deduction – General**. A donor to a private foundation is entitled to an income tax charitable contribution deduction for her contribution to the entity. I.R.C. § 170. Furthermore, a contribution of appreciated assets to a private foundation is treated no differently from any other gift to charity; it does not constitute a sale or exchange and thus does not give rise to gain or loss that is recognized for regular tax purposes. Campbell v. Prothro, 209 F.2d 331, 335 (5th Cir. 1954).

2. **Limitations**. The calculation of the deduction and the amount that may be deducted in the year of contribution varies based on the type of property contributed and the income tax character (i.e., capital gain or ordinary income) of the property. Deductions for contributions of cash and property are subject to percentage limitations, which are more restrictive than those permitted for contributions to public charities. Contributions to public charities are counted first before contributions to private foundations in applying overall deduction limits.

   a. Gifts of cash and ordinary income property are limited to the lesser of 30 percent of the donor's contribution base or 50 percent of the contribution base reduced by cash gifts to public charities. I.R.C. § 170(b)(1)(B).

   b. Gifts of appreciated long-term capital gain property are limited to the lesser of 20 percent of the donor's contribution base or 30 percent of the contribution base reduced by such gifts to public charities. I.R.C. § 170(b)(1)(D).

      (1) The income tax deduction for gifts of appreciated real estate or personal property is limited to the donor's basis in the property. I.R.C. § 170(e)(1)(B)(ii).

      (2) A full fair market value deduction is available only for gifts of qualified appreciated stock (QAS). I.R.C. § § 170(e)(5).

   c. Deductions in excess of the percentage limitations may be carried forward and utilized to offset income over the five years succeeding the year in which the contribution is made. I.R.C.§§ 170(b)(1)(B) and 170(b)(1)(C)(ii).

3. **Gifts of Long-Term Capital Gain Property**. Gifts to private foundations of appreciated property are generally deductible only to the extent of the donor's cost basis. I.R.C. § 170(e)(1)(B)(ii). The full fair market value of a gift of QAS may be deducted, however, subject to the 20 percent limitation described above. I.R.C. § 170(e)(5)(A).

   a. QAS is stock for which market quotations are readily available on an established securities exchange and which has been held by the donor as long-term capital gain property (i.e., for more than one year). I.R.C. § 170(e)(5)(B).

   b. Stock traded on an over-the-counter bulletin board but not listed on NASDAQ or on an exchange is not QAS, nor is stock that is convertible into a marketable security but is not currently marketable. Priv. Ltr. Rul. 9504027; Priv. Ltr. Rul. 9915053.

   c. QAS does not include stock to the extent that the donor and the donor's family have contributed, in the aggregate, in excess of 10 percent of the issuer's shares to private foundations. I.R.C. § 170(e)(5)(C).

   d. Stock subject to restrictions on transfer (imposed either by securities laws or the issuer) might not be QAS, unless it is clear that the stock can be sold by the donor and the donee at its market price on the date of the gift. Priv. Ltr. Rul. 9247018; Priv. Ltr. Rul. 9320016. But see Priv. Ltr. Rul. 9435007 (stock restricted in the hands of the donor but unrestricted once in the ownership of the donee foundation is treated as QAS).

4. **Pass-Through Contributions**. If a private foundation promptly pays out all of its contributions received in a given year together with its income for the year, a donor to that foundation may treat her contributions as if they had been made to a public charity for purposes of Internal Revenue Code section 170. In other words, cash contributions will qualify for the 50 percent contribution base limit and long-term capital gain property contributions for the 30 percent limit, without application of other cutback rules under Internal Revenue Code section 170(e). I.R.C. §§ 170(b)(1)(A)(vii) and 170(b)(1)(e). The status of the foundation itself is not changed, however, and it remains subject to all provisions of Chapter 42.

a. **Distribution Requirements**. In order to qualify as a private distributing foundation, the status of which is determined individually for each taxable year, the foundation must distribute, no later than the 15th day of the third month after the close of its taxable year, 100 percent of all contributions that it received in such taxable year. Such distributions must be qualifying distributions as defined in Internal Revenue Code section 4942(g), which are treated as distributions out of corpus in accordance with Internal Revenue Code section 4942(h). Distributions to a commonly controlled organization or to another private foundation do not qualify. Treas. Reg. 1.170A-9(h)(1). In order for a distribution to be from corpus, a foundation must generally distribute its income first from the immediately preceding tax year and then the income from the current year, unless a special election is made. I.R.C. § 4942(h).

b. **Property Transfers**. While the general rule is that a private foundation must make corpus distributions of all contributions in whatever form received in the year in question to be treated as a distributing foundation for that year, a special rule – provided solely for the cutback rule under Internal Revenue Code section 170(e)(1)(B)(ii) – requires it only to distribute all contributions of property received in the taxable year. This special rule permits a foundation whose donor is only interested in avoiding the cost basis limitation on the amount of the income tax deduction (and is not seeking the more generous percentage limitations) to make a flow-through distribution of property contributions only. For this purpose, distributions are treated as made first out of the property contributions and then out of the contributions of cash. Treas. Reg. § 1.170A-9(h)(2).

c. **Valuation**. In general, the fair market value of contributed property determined on the date of contribution must be used for purposes of the 100 percent distribution requirement. Accordingly, if contributed property declines in value, the loss must be made up by distributing from other assets. However, if the foundation either sells or makes an in-kind distribution of contributed property within 30 days after the date of the contribution, the foundation is permitted to elect to treat the gross sales price (less reasonable expenses of sale) or the fair market value at the date of distribution as the fair market value for purposes of the distribution requirements. Treas. Reg. § 1.170A-9(h)(2)(iv).

d. **Deferral**. One of the uses for private distribution foundation status is to delay the ultimate distribution of a contribution to a public charity. By careful selection of fiscal years for newly created entities or careful timing of the contribution to an existing foundation, the private distributing foundation can provide up to 14 months in which to make a distribution to a public charity. This feature permits a donor to obtain a current deduction while continuing to control the contributed property and potentially complete the negotiation of the terms of a gift to a public charity that the donor may not have otherwise had time to negotiate.

e. **Election**. An election into private distributing foundation status is made on the foundation's Form 990-PF for the affected taxable year.

5. **Common Fund Foundations**. Contributions made by an individual to a special type of nonoperating foundation, referred to as a common fund foundation, are also treated for income tax deduction purposes as if made to a public charity. The entity itself, however, is subject to all other regular private foundation rules.

a. **Structure**. A common fund foundation is an organization that would otherwise qualify as an SO (as defined in section 509(a)(3) of the Internal Revenue Code), except for the fact that any donor (or the spouse of any donor) who is a substantial contributor has the right to designate annually the public charities that are to receive the income from the donor's contribution to the fund and to direct (by deed or by will) the payment to public charities of the corpus in the common fund that is attributable to the donor's contribution. I.R.C. § 170(b)(1)(F)(iii); Treas. Reg. 1.170A-9(i)(1).

b. **Distribution Requirement**. To qualify, the private foundation must be required by its governing instrument to distribute, and it must actually distribute (including administrative expenses), (1) all of the adjusted net income of the common fund to one or more public charities by the 15th day of the 3rd month after the close of the tax year in which the income is realized by the fund, and (2) all the corpus from any donor's contribution to the fund to one or more public charities not later than one year after the donor's death or after the death of the donor's surviving spouse if the surviving spouse has the right to designate the recipients of the corpus. Treas. Reg. 1.170A-9(i)(2). A private foundation will not fail to qualify for this exception if a substantial contributor or spouse fails to exercise the right to designate the recipients of income or corpus of the fund, as long as the income and corpus from the contribution are distributed as required. Treas. Reg. 1.170A-9(i)(3).

6. **Appraisal and Substantiation Issues**.

a. **Appraisal**. Any gift of property other than cash or marketable securities having a value in excess of $5,000 ($10,000 in the case of securities that are not publicly traded) must be appraised pursuant to the regular appraisal rules that apply to all charitable contributions. I.R.C. § 170(f); Treas. Reg. §§ 170A-13. If a donor's deduction is limited to her cost basis but that amount exceeds the $5,000 (or $10,000) threshold, she must obtain an appraisal to support her deduction since the gift is of assets other than cash or marketable securities and the deduction may never exceed fair market value.

b. **Substantiation**. In general, no charitable contribution deduction is allowed for income tax purposes for contributions of $250 or more without contemporaneous written acknowledgement of the contribution by the charitable recipient. I.R.C. § 170(f)(8). The acknowledgement must state (i) the amount of cash or a description of any property contributed; (ii) whether any goods or services were provided by the charity in exchange for the contribution; and (iii) if so, a description and estimate of the value of any goods or services that were provided. The substantiation rules apply to all gifts, even when made by a donor to a private foundation that is controlled by the donor.

7. **Gifts of Ordinary Income Property**. If a donor contributes property that would generate ordinary income tax if sold by the donor, such as inventory, the donor's income tax charitable deduction will be limited to the donor's cost basis in the property. I.R.C. §§ 170(e)(1)(A) and 1221. In the case of property created by the donor, such as works of art, this may eliminate the donor's deduction entirely. Treas. Reg. § 1.170A-1(c)(4). This rule is no different from the rule applicable to such gifts when made to public charities.

8. **Gifts of Partial Interests in Property**. The income tax deduction for contributions to a private foundation is limited in the same way as the deduction for contributions to public charity where the contributed property consists of a partial interest in the asset. I.R.C. §§ 170(f).

9. **IRA Qualified Charitable Distributions**. A qualified charitable distribution (QCD) is an otherwise taxable distribution from an IRA (other than an ongoing SEP or SIMPLE IRA) owned by an individual who is age 70½ or over that is paid directly from the IRA to a charity. I.R.C. § 408(d)(8). If certain requirements are all satisfied, the distribution, which can be up to $100,000 for each individual taxpayer in any calendar year, does not constitute taxable income to the taxpayer. At the same time, however, the distribution counts towards the taxpayer's required minimum distribution for the year. Notice 2007-7, 2007-5 I.R.B. 400, Q&A-42.

a. In order to qualify for this rule, the entire amount of the distribution must otherwise qualify for the charitable income tax contribution deduction, even though the distribution does not generate such a deduction and is not counted as part of the donor's aggregate contributions in determining current year deductibility. I.R.C. § 408(d)(8)(C). Accordingly, there can be no quid pro quo in connection with the contribution, such as a table at a fund-raising event or preferential seating in a college athletic stadium.

b. In addition, the contribution must be made to an organization described in Internal Revenue Code section 170(b)(1)(A) (other than an SO and a donor advised fund**)**. I.R.C. § 408(d)(8)(B)(ii). Since that provision of the Internal Revenue Code generally excludes private foundations, private foundations are for the most part outside the ambit of the QCD rule. However, Internal Revenue Code section 170(b)(1)(A) does describe certain private foundations, namely private operating foundations, foundations that make a pass-through contribution election as described above, and common fund foundations, also described above. Accordingly, QCDs can be made to these limited classes of private foundation.

D. Estate and Gift Tax Treatment of Contributions.

1. Deductions. A donor who makes a contribution to a private foundation during life is generally entitled to a gift tax charitable deduction equal to the full fair market value of the property contributed in computing taxable gifts for the year. I.R.C. § 2522. Likewise, if a decedent makes a contribution to a private foundation at death, the decedent's taxable estate is determined by deducting the full fair market value of the property contributed. I.R.C. § 2055. The gift and estate tax charitable deductions are not subject to percentage limitations. However, they are both subject to the partial interest rule. I.R.C. §§ 2055(e)(2) and 2522(c)(2).

2. Estate Inclusion. If a donor funds a private foundation during her lifetime and retains control over the disposition of the foundation's assets as a trustee, officer or director, whether alone or in conjunction with others, the foundation's assets will be includable in the donor's adjusted gross estate at death for estate tax purposes. I.R.C. § 2036 (a); Rev. Rul. 72-552, 1972-2 C.B. 525. Although the charitable deduction will offset the property that is treated as includable in the donor's estate, estate tax inclusion of such assets could nevertheless have an impact on the estate tax treatment of the decedent's estate. For example, it may mean that the estate is not eligible to claim relief for estate taxes attributable to closely held business interests, because such interests (after taking into account the inclusion of the foundation's assets) do not exceed 35 percent of the decedent's adjusted gross estate. I.R.C. § 6166.

E. Entity Level Taxation.

1. Tax on Net Investment Income. A private foundation is subject to an annual two percent tax on its net investment income, including interest, dividends, rents and royalties, and long- and short-term net realized capital gain. I.R.C. § 4940(a). The tax rate can be reduced to one percent if the foundation's current year qualifying distributions, discussed below, exceed its average distributions over the past five years plus one percent of its current year net investment income. I.R.C. § 4940(e). In effect, if the foundation's payout ratio in the current year exceeds its average payout ratio over the past five years, the foundation has the option to either pay a two percent tax on net investment income or pay a one percent tax on net investment income and make additional qualifying distributions equal to one percent of its net investment income.

2. Unrelated Business Taxable Income. Private foundations are subject to the tax on unrelated business taxable income in much the same way as other charitable and tax-exempt entities. The tax is assessed on income (i) from a trade or business that is (ii) regularly carried on and (iii) is not substantially related to the private foundation's performance of its tax-exempt purpose. I.R.C. §§ 512 and 513.

a. Certain forms of passive income are exempt from this tax, such as dividends, interest, royalties, rents from real property, long- and short-term capital gains and gains from options to buy or sell securities. I.R.C. § 512 (b). This exception does not apply, however, to debt-financed income generated by assets or activities unrelated to the organization's exempt purpose. I.R.C. § 514.

b. Income from a partnership that a private foundation invests in that is passive will pass through and retain its character as such and not be subject to the tax. However, if the partnership invests in debt-financed assets or engages in an active trade or business, such as operating an hotel, the income that passes through will not be considered passive income and will instead be treated as unrelated business taxable income and subject to taxation.

F. Regulatory Restrictions and Excise Taxes.

1. **General**. In addition to the excise tax on net investment income, chapter 42 of the Internal Revenue Code contains an annual distribution requirement for private foundations and a number of behavioral rules that apply to the administration of private foundations, which except in some limited circumstances are not applied to public charities. Certain of these rules can be described as no-fault, in the sense that the foundation or a foundation insider may be sanctioned for what might otherwise be fair and reasonable behavior that does not violate a fiduciary duty.

2. **Minimum Distribution Requirement**. Perhaps the single most significant restriction on private foundations is the requirement to use a percentage of its investment assets each year for charitable purposes. This is commonly referred to as the "minimum distribution requirement." I.R.C. § 4942(a). The policy reason for the requirement is that Congress wanted to make certain that funds set aside for charitable purposes in a private foundation are not held by the private foundation indefinitely, but are put to charitable use instead. The minimum distribution requirement has two main components: first, the private foundation must compute the amount that it is required to put to charitable use (the "distributable amount"); and second, the private foundation must determine whether or not a particular distribution counts toward the requirement.

   a. **Distributable amount**. The distributable amount is calculated each year on the foundation's Form 990-PF. It is equal to the private foundation's minimum investment return, less taxes paid on investment income and unrelated business taxable income. I.R.C. § 4942(e). A private foundation's minimum investment return for a given year is equal to five percent of the average value of the private foundation's investment assets (with certain specific exceptions) during the prior year, net of any indebtedness incurred to acquire investment assets. I.R.C. § 4942(e)(1).

      (1) Cash and marketable securities must be valued by taking the average of their monthly values in accordance with any reasonable method that is consistently applied. Treas. Reg. § 53.4942(a)-2(c)(4)(i).

      (2) Other assets must be valued annually using commonly accepted methods of valuation, such as those utilized for estate tax purposes. Treas. Reg. § 53.4942(a)-2(c)(4)(iv). The valuation can be made on any day during the taxable year, provided that the foundation follows a consistent practice of valuing the particular asset on the same day each year. Treas. Reg. § 53.4942(a)-2(c)(4)(vi). Real estate may be valued on a five-year basis. Treas. Reg. § 53.4942(a)-2(c)(4)(iv)(b).

   b. **Qualifying distributions**. The private foundation must make qualifying distributions equal to or in excess of the distributable amount by the end of the year following the year for which the distributable amount is computed. I.R.C. § 4942. The foundation essentially has two years in which to make the required minimum distribution: the taxable year for which the minimum distribution amount is calculated and the immediate following taxable year. I.R.C. § 4942(a).

      (1) Qualifying distributions include (a) reasonable administrative expenses of the private foundation, (b) amounts distributed to private operating foundations and public charities, (c) amounts spent to acquire exempt-function assets or the value of any investment asset converted to an exempt-function use, (d) qualified set-asides, and (e) program-related investments. I.R.C. § 4942(g).

      (2) However, grants to Type III non-functionally integrated SOs cannot be counted as qualifying distributions towards a private foundation's annual minimum distribution requirement, nor can grants to any type of SO where disqualified persons of the private foundation control the SO or one of the SO's supported

charities. I.R.C. § 4942(g)(4). In Notice 2006-109, 2006-2 C.B. 1121, the IRS provided private foundations with standards on which they could rely to determine whether a potential grantee is a Type III non-functionally integrated SO. Because of the possibility of excise taxes for private foundations and DAFs that fail to identify non-functionally integrated SOs, it is critical for private foundations and DAFs to be sure that their grant-making review process enables them to identify public charities that are classified as SOs and, specifically, Type III non-functionally integrated SOs. Notice 2006-109 was modified by Rev. Proc. 2011-33, 2011-1 C.B. 887, which provided that grantors may rely on an organization's classification in the IRS Business Master File. More recent guidance, contained in Notice 2014-4, explains that private foundations and DAFs can continue to rely on the grantor reliance standards described in Notice 2006-109; however, for grants to Type III functionally integrated SOs, the grantor must obtain a written representation and documents demonstrating that the SO meets the requirements for Type III functionally integrated status.

(3) An amount treated as a qualifying distribution in a given year may not be treated as a qualifying distribution in a subsequent year. I.R.C. § 4942(h).

c. **Excise Taxes Imposed**. If a private foundation's qualifying distributions are less than the distributable amount, the private foundation will be subject to an excise tax on the difference between those two amounts (called the private foundation's "undistributed amount"). The initial first tier tax is equal to 30 percent of the undistributed amount. I.R.C. § 4942(a). If the undistributed amount is not then distributed after a certain correction period, a second tier tax of 100 percent of the undistributed amount is imposed at the close of the correction period. I.R.C. § 4942(b).

3. **Self-Dealing**. Internal Revenue Code section 4941 prohibits acts of direct or indirect "self-dealing" between a private foundation and a disqualified person. The concept of self-dealing is broadly drawn and 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).

a. **Disqualified Persons**. The following individuals and entities are treated as disqualified persons. I.R.C. §§ 4946 and 507.

(1) A substantial contributor to the private foundation, namely (i) a person who has contributed more than $5,000 to the foundation if the amount contributed is more than two percent of the total contributions to the foundation before the end of the taxable year in which the contribution was made, and (ii) in the case of a private foundation that is organized as a trust, the creator of the trust;

(2) A private foundation manager, meaning the officers, directors and/or trustees of the foundation, or any employees having the authority to exercise powers typically held by such persons;

(3) An owner of more than 20 percent of (i) the total combined voting power of a corporation, (ii) the profits interest of a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the private foundation;

(4) A member of the family of any of the aforementioned individuals, meaning such individual's spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren and great-grandchildren (but not including the siblings of the individual;

(5) A corporation, partnership or trust or estate of which any of the aforementioned individuals owns more than 35 percent of the combined voting power, profits interest or beneficial interest, respectively; and

(6) A "government official," meaning, among other things, a person holding elective public office in the executive or judicial branch of the United States, a state or a political subdivision of the United States; a presidential appointee to any executive or judicial branch office; other persons holding high Civil Service positions; positions under the House of Representatives, Senate and others. I.R.C. § 4946(c).

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

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

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

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

(4) The payment of compensation or expenses by the private foundation to a disqualified person.

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

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

In addition, if a disqualified person uses private foundation assets to satisfy a personal pledge, such use will be an act of self-dealing. See Priv. Ltr. Rul. 97-03-020.

c. **Incidental Benefits**. The fact that a disqualified person receives an incidental or tenuous benefit from the use by the foundation of its income or assets does not by itself make such use an act of self-dealing. Accordingly, the public recognition that a person may receive arising from the charitable activities of a private foundation to which such person is a substantial contributor does not result in itself in an act of self-dealing, since the recognition is an incidental or tenuous benefit.

d. **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.

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

(2) 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).

e. **Exceptions to Acts of Self-Dealing**. There are a number of exceptions to the breadth of the self-dealing rule.

(1) **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).

(2) **Property Subject to Certain Debt.** A transfer by a disqualified person to a private foundation of property subject to indebtedness is not self-dealing if, but only if, the indebtedness was acquired at least 10 years prior to the transfer. I.R.C. §4941(d)(2)(A).

(3) **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).

(4) **Certain Furnishing of Goods, Services, or Facilities.**

(a) 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).

(b) 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).

(5) **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).

(a) 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).

(b) 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 exceed $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).

(6) **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:

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

(b) 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

(c) Either (i) 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 (ii) 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).

(7) **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:

(a) 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);

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

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

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

(e) 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).

(8) **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. I.R.C. § 4941(d)(2)(F).

(9) **Transaction that Causes Donor to Become Disqualified Person.** There is no self-dealing when the transaction itself causes the individual to become, for the first time, a disqualified person with respect to the foundation. Thus, a disqualified person who engages in a bargain sale of real estate that is favorable to the private foundation is an act of self-dealing. However, if the donor of the real estate had no prior relationship with the private foundation and became a

substantial contributor and disqualified person only as a result of the bargain sale transaction, the transaction is not treated as self-dealing.

f. **Excise Taxes Imposed**. The penalty for 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 as an entity. An additional and confiscatory tax is imposed if the act of self-dealing is not corrected within the statutorily defined correction period.

(1) 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).

(2) 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).

(3) 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).

(4) 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.

4. **Excess Business Holdings**. Private foundations are limited as to the extent to which they can own interests in business enterprises. I.R.C. § 4943.

a. **Business Enterprise**. Although not expressly defined, a business enterprise includes the active conduct of a trade or business, including any activity that is regularly carried on for the production of income from the sale of goods or the performance of services and which constitutes an unrelated trade or business under Internal Revenue Code section 513. There are certain exceptions from the term “business enterprise”:

(1) The rule does not apply to a business at least 95 percent of the gross income of which is derived from passive sources. I.R.C. § 4943(d)(3). Passive sources include dividends, interest, annuities, royalties, certain incidental rental income and income from the sale of goods other than stock in trade or property held primarily for sale to customers in the ordinary course of business if the seller does not manufacture, produce, physically receive or deliver, negotiate sales of, or maintain inventories in such goods. Treas. Reg. § 53.4943-10(c).

(2) Business enterprise does not include a functionally related business, meaning a business that is substantially related to the exercise or performance by the foundation of its charitable, educational or other exempt purposes, or which otherwise meets the requirements of Internal Revenue Code section 513(a) or section 4942(j)(4). Treas. Reg. § 53.4943-10(b).

(3) Business holdings do not include program-related investments (such as investments in small businesses in city centers or in corporations to assist in neighborhood renovation). Treas. Reg. § 53.4943-10(b).

b. **Permitted Holdings**. 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). 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). In the case of a partnership or joint venture, the rule refers to the profits interest held by the foundation rather than voting stock. I.R.C. § 4943(c)(3)(A). 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). Any business holdings beyond such permitted holdings are considered "excess business holdings." I.R.C. § 4943(c)(1).

c. **Exceptions to the General Rule**.

(1) There is a two percent *de minimis* rule, which permits a private foundation always to hold up to two percent of the voting and two percent of the value of all outstanding shares of all classes of stock without regard to the holdings of disqualified persons. I.R.C. § 4943(c)(2).

(2) 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).

(3) The 20 percent overall limitation may be raised to 35 percent in certain circumstances. This increase is available if (i) the foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and (ii) 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).

d. **Special Rule for Gifts and Bequests**. 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.

e. **Excise Taxes Imposed**. 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).

5. **Jeopardy Investments**. Private foundations are prohibited from participating in any investment that would jeopardize the fulfillment of its charitable purposes. I.R.C. § 4944. A foundation manager must exercise ordinary care and prudence, under the facts and circumstances prevailing at the time of making the investment, and determine that the investment should provide for the long- and short-term financial needs of the private foundation.

a. **Meaning**. No particular type of investment is prohibited per se, but the following investments or investment strategies will be closely scrutinized: commodity futures, interests in oil and gas wells, options, trading on margin and short-selling. Treas. Reg. § 53.4944-1(a)(2). Whether or not a particular investment is a jeopardy investment is determined on a case-by-case basis, considering the private foundation's investment portfolio as a whole and the care and prudence with which the investment was selected. Treas. Reg. § 53.4944-1(a)(2).

b. **Exclusion of Program-Related Investments**. A program-related investment, meaning an investment in furtherance of the private foundation's charitable purposes, is not a jeopardy investment. An investment qualifies as a program-related investment if (i) the primary purpose of the investment is to accomplish the private foundation's charitable purposes and (ii) no significant purpose of the investment is the production of income, the appreciation of property or lobbying or political activities. I.R.C. § 4944(c). If the investment would not be made but for the desired charitable purpose, the investment will be outside the jeopardy investment rules. Treas. Reg. § 53.4944-3.

c. **Contribution**. The rule does not apply to investments originally made by the person who later contributes them as a gift without any consideration to the foundation. Treas. Reg. § 53.4944-1(a)(2)(ii).

d. **Excise Taxes Imposed**. Failure to comply with the jeopardy investment rules results in a first-tier penalty tax of 10 percent of the amount involved. The tax is imposed on the foundation. In the event that any amount invested in such a manner as to jeopardize the carrying out of the foundation's exempt purposes is not removed from jeopardy within the taxable period, a second-tier tax of 25 percent of the amount involved is imposed on the foundation. Foundation managers who knowingly agreed to the investment are also subject to both first and second tier excise taxes of 10 percent and five percent, respectively, subject to maximum amounts on any one investment. I.R.C. § 4944(a), (b) and (d)(2).

6. **Taxable Expenditures**. Private foundations are prohibited from making "taxable expenditures." I.R.C. § 4945.

a. **Definition**. Taxable expenditures are defined as amounts distributed:

(1) to carry on propaganda, or otherwise to attempt to influence legislation;

(2) to influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter registration drive;

(3) as a grant to an individual for travel, study, or other similar purposes unless the grant is awarded on an objective and nondiscriminatory basis and in accordance with a plan that is pre-approved by the Internal Revenue Service;

(4) as a grant to an organization, unless the organization is a public charity or an exempt operating foundation, or the private foundation exercises expenditure responsibility with respect to the grant; or

(5) for purposes other than religious, charitable, scientific, literary or education, to foster national or international amateur sports competition, or for the prevention of cruelty to children and animals. I.R.C. § 4945(d).

For purposes of (4) above, public charities do not include Type III non-functionally integrated SOs and any type of SO where disqualified persons of the private foundation control the SO or one of the SO's supported charities. Consequently, grants to any such entities are considered taxable expenditures unless the private foundation exercises expenditure responsibility.

b. **Expenditure Responsibility**. Certain distributions that would be considered 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). 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).

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). In addition, it must also require the pre-payment submission of a written agreement signed by an appropriate officer or director of the grantee organization, which agreement must clearly 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).

c. **Excise Taxes Imposed**. Any taxable expenditure made by a private foundation is subject to a 20 percent initial excise tax. Foundation managers who agreed to the making of the taxable expenditure knowing that it was a taxable expenditure are 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), (b)(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).

7. **Termination of Private Foundation Status**. As outlined above, violation of the Chapter 42 behavioral rules is sanctioned by two levels of tax. The initial tax must be paid when there is a violation; an additional tax is then levied when the matter is not corrected in a timely fashion. There is a potential third level of tax called the involuntary termination tax. I.R.C. § 507(a)(2). This tax applies when a private foundation is terminated by the Internal Revenue Service because there have either been willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), that gives rise to liability under chapter 42.

a. **Termination Tax**. The amount of the tax imposed is equal to the lesser of (i) the amount established by the foundation as the aggregate tax benefit that has resulted from its tax-exempt status under Internal Revenue Code section 501(c)(3) or (ii) the value of the net assets of the foundation. The aggregate tax benefit includes the aggregate increase in income, estate and gift taxes that would have been imposed on substantial contributors to the foundation, as well as the income tax that would have been imposed on the foundation itself had it not been tax-exempt. I.R.C. § 507(d); Treas. Reg. § 1.507-5.

b. **Abatement**. The Internal Revenue Service may abate the termination tax if the foundation distributes all of its remaining assets to one or more public charities described in section 509(a)(1) (thereby excluding gross receipts organizations and all forms of SOs), each of which has been in existence for at least 60 months. I.R.C. § 507(g). In addition, the tax may be abated if the Internal Revenue Service and appropriate state authorities ensure that corrective steps are taken to assure the preservation of the foundation's assets for exempt purposes. Treas. Reg. § 1.507-9.

III. 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. In addition, a donor can make QCDs from her IRA to a private operating foundation. Private operating foundations continue, however, 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 one of three alternative tests – the assets test, the endowment test, or the support test. I.R.C. § 4942(j)(3).

1. Income Test. A private operating foundation must use substantially all (at least 85 percent) of its adjusted net income or its minimum distribution amount (ordinarily five percent of the average market value of its investment assets), whichever is less, directly for the active conduct of its exempt charitable activities. I.R.C. § 4942(j)(3)(A). Grants to other organizations do not count as expenditures directly for the active conduct of exempt activities. Treas. Reg. § 53.4942(b)-1(b)(1).

2. Alternative Tests. One of these three tests must also be satisfied:

a. Assets Test. The assets test requires that substantially more than one-half (at least 65 percent) 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. I.R.C. § 4942(j)(3)(B)(i); Treas. Reg. § 53.4942(b)-2(a).

b. 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. I.R.C. § 4942(j)(3)(B)(ii); Treas. Reg. § 53.4942(b)-2(b).

c. Support Test. This test has the following elements:

(1) Substantially all (85 percent) of a private operating foundation's support (other than gross investment income) is 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;

(2) Not more than 25 percent of a private operating foundation's support (other than gross investment income) is normally received from any one of the five exempt organizations; and

(3) Not more than half of a private operating foundation's support is normally received from gross investment income. I.R.C. § 4942(j)(3)(B)(iii); Treas. Reg. § 53.4942(b)-2(c).

3. Compliance. A foundation may satisfy the income test and either one of the alternative tests under one of two methods:

a. The Three-out-of-Four Year Method. Under this method, the foundation may satisfy the applicable tests for any three taxable years during a four-year period, consisting of the taxable year in question and the three immediately preceding taxable years.

b. **The Aggregation Method**. Under this method, the foundation may satisfy the applicable tests on the basis of an aggregation of all pertinent amounts of income, assets held, received or distributed during the four-year period consisting of the taxable year in question and the three immediately preceding taxable years. Treas. Reg. § 53.4942(b)-3(a).

C. **Exempt Operating Foundations**. If a private operating foundation also qualifies as an exempt operating foundation, it does not have to pay the private foundation excise tax on investment income. I.R.C. § 4940(d). In addition, grants made to such an entity by another private foundation are not subject to expenditure responsibility in order to be removed from the taxable expenditure rule. I.R.C. § 4945(d)(4)(A). To be an exempt operating foundation in any given year, a private operating foundation (i) must have been publicly supported for at least 10 years within the meaning of Internal Revenue Code section 509(a)(2), (ii) its governing body must consist of individuals who are broadly representative of the general public and at least 75 percent of whom are not disqualified individuals (namely, substantial contributors and certain related persons), and (iii) at no time during the year should any officer of the foundation be a disqualified individual. I.R.C. § 4940(d)(2). These special provisions are of limited value in the planning stage of establishing a charitable entity. Rather, they are designed to give certain organizations – including various libraries and museums – that have been existence for some time and that are otherwise classified as private foundations (albeit operating foundations) further attributes of a public charity.

IV. DONOR ADVISED FUNDS.

A. Overview.

1. **Basic Description**. A Donor Advised Fund ("DAF") is not a separate charitable entity for federal tax purposes. Instead, the term describes a segregated fund or account maintained by an existing section 501(c)(3) public charity to which a donor or small group of donors can make contributions. What distinguishes the fund is that, while its assets belong legally to the public charity, the donor, or a person designated by the donor, retains an advisory role with respect to the distribution and/or the investment of assets held in the fund.

2. **Brief History**.

a. **Federated Charities and Community Foundations**. The modern concept of DAFs can be traced back to the late nineteenth century, when Jewish leaders in Boston established the first federated charity, the Jewish Federation. The Jewish Federation accumulated donations in a single, undifferentiated account and then disbursed those funds based on decisions made by its leaders. At the beginning of the twentieth century, this concept was developed into the first community chest organization and then the first community foundation, both established in Cleveland. The latter was based on the premise that only investment earnings would be distributed by a board of community leaders and that donations would be maintained as an endowment fund. The next milestone occurred in 1931, when the New York Community Trust offered individual donors the opportunity to name funds held as part of the Community Trust endowment and to suggest charitable uses for the earnings and assets of the particular fund.

b. **Tax Reform Act of 1969**. With the passage of the 1969 legislation, private foundations were required to contend with many new regulatory requirements and restrictions, with the goal of boosting accountability to the public and limiting tax incentives. This development boosted the relative value of channeling philanthropic funds through public structures and creating endowments that were not subject to the same level of rigor. Subsequent rulings that confirmed the public charity status of community foundations and federated entities, including for assets that were held in accounts over which donors could make recommendations or provide advisory guidance, confirmed the advantages of the donor advised fund model.

c. **The "Commercials"**. In 1987, the Internal Revenue Service lost its attempt to deny tax-exempt status to a public charity that existed almost exclusively to maintain DAFs and other donor-recommended charitable projects. National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987). Several years later, in 1991, the Internal Revenue Service issued a private letter ruling granting tax-exempt status to a non-profit organization established to maintain DAFs and affiliated with Fidelity Investments, namely, the Fidelity Charitable Gift Fund. Since then, DAFs have flourished. In 2015, there were reported to be almost 270,000 DAF accounts holding assets worth nearly $80 billion.

3. **Statutory Definition**. Until 2006, neither the Internal Revenue Code nor Treasury Regulations provided a definition of a DAF or any specific rules governing their establishment or administration. This caused confusion and arguably some abusive practices. The Pension Protection Act of 2006 (the "PPA") corrected this situation and introduced the following definition: a fund or account –

   a. which is separately identified by reference to contributions of a donor or donors,

   b. which is owned and controlled by a sponsoring organization, and,

   c. with respect to which a donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor." I.R.C. §4966(d)(2)(A).

4. **Requirements of Definition**. All three requirements of the definition must be satisfied. The first element is met either by naming the fund after a donor or by separately accounting for a fund on the books of a sponsoring organization as attributable to contributions from a specific donor. See Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006 (JCX-38-06) (Aug. 3, 2006) at 342 (hereinafter, "Technical Explanation of H.R. 4"). The second is failed to the extent that the donor owns or controls the asset contributed to the sponsoring organization. Under the third element, advisory privileges are retained when the fund agreement indicates that the donor or a donor-advisor may provide advice regarding the investments or distributions, or the conduct of the donor and the sponsoring organization indicates that the donor can provide such recommendations.

5. **Exceptions**. There are two primary exceptions to the statutory DAF definition:

   a. A fund that makes distributions only to a single identified organization or governmental entity. I.R.C. § 4966(d)(2)(B)(i).

   b. A fund that makes distributions to individuals for travel, study, or "other similar purposes" if (i) the donor's advisory privileges are exercised in his or her capacity as a member of a committee that consists entirely of members appointed by the sponsoring organization; (ii) no combination of donors or donor-advisors (or persons related to them) controls the committee either directly or indirectly; and (iii) all grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that the grants satisfy the expenditure responsibility requirements applicable to private foundations making grants to individuals. I.R.C. § 4966(d)(2)(B)(ii).

   c. In addition, the Internal Revenue Service is granted authority to exempt other funds or accounts from the definition (i) 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 (ii) if such fund benefits a single identified charitable purpose. I.R.C. § 4966(d)(2)(C).

B. Organization, Operation and Administration.

1. **Formation**. As stated above, DAFs are not separate charitable entities. Instead they are separate accounts established by contributions from identified donors held and owned by a sponsoring

organization. Ordinarily, forming a DAF requires nothing more from the donor than a completed account application form and a contribution check or asset transfer. The account application form will address, among other things, the scope of the donor's advisory privileges, who will serve as donor-advisors to the DAF, and what will happen to the DAF upon the death of the donor or donor-advisor.

a. Sponsoring organizations are organizations described in Internal Revenue Code section 170(c) (other than section 170(c)(1) (governmental units) and without regard to section 170(c)(2)(A) (foreign incorporation or formation**)**. I.R.C. § 4966(d)(1)(A).

b. A private foundation cannot be a sponsoring organization. I.R.C. § 4966(d)(1)(B).

c. A sponsoring organization may be a community foundation or other public charity, such as a college or university, with an independent charitable program of its own, or it may have no program at all apart from its operation of DAF accounts. When DAFs are maintained by charities with their own programs, it is common for the DAF agreement to specify that a certain proportion of the DAF be used to recommend grants to the sponsoring organization, while grants may be recommended to unrelated organizations from the remaining balance of the account.

2. **Funding**. DAFs are funded by a contribution of cash, securities, or other assets to a sponsoring organization. Some sponsoring organizations limit the type of assets that they are prepared to receive into the DAF. While the Internal Revenue Code does not provide for a minimum required contribution, many sponsoring organizations have minimum funding limits.

3. **Investment**. As mentioned above, the assets contributed to a DAF belong to the sponsoring organization. However, the sponsoring organization may permit a variety of different investment approaches.

a. Many sponsoring organizations allow donors to recommend how funds contributed to a DAF are invested.

(1) The donor may be permitted to express preferences regarding the investment of his or her donated funds among options provided by the sponsoring organization, but not outside of them.

(2) Donors may be able to recommend that the sponsoring organization engage a specific investment manager to manage investments for their DAF.

b. Others may permit no donor involvement and may require that funds donated to a DAF be managed by an advisor selected by the sponsoring organization.

4. **Grant-making**. A donor must transfer control over the amount donated to a DAF to the sponsoring organization in order to get a current deduction for the amount donated.

a. However, the donor (or the donor's designee) is permitted to provide advice to the sponsoring organization with respect to grants (both as to the amount and the recipient) made from a DAF.

b. The sponsoring organization should never promise to act entirely in accordance with each recommendation made by the donor or her designee. Such a promise would, in effect, cede control over the donated funds to the donor, and take the account outside the ambit of the DAF rules.

c. With certain limitations, as described more fully below, grant recommendations can be made with respect to any charitable organization.

d. DAFs are not subject to minimum distribution requirements. However, some sponsoring organizations have imposed requirements on the types of grants, the frequency of grants and the amount of grants DAFs may make, and may require DAFs to distribute a certain percentage of the account value each year, or make at least one grant in a minimum amount at a certain frequency.

5. **Filing Requirements**.

a. **DAF account.** No IRS forms need to be filed by the donor when establishing the account, and there are no ongoing filing requirements with respect to each individual account. This flows from the fact that the DAF account is not treated as a separate entity, but as part of the assets of the sponsoring organization.

b. **Sponsoring Organization Reporting and Disclosures.** A sponsoring organization is required to disclose the following information pertaining to its DAFs on its IRS Form 990 (Schedule D): (i) the total number of DAFs it owns; (ii) the aggregate value of assets held in those funds at the end of the organization's taxable year; and (iii) the aggregate contributions to and grants made from those funds during the year. I.R.C. § 6033(k). The Form 990 also asks if the organization informed all donors and donor-advisors in writing that the assets held in DAFs are the organization's property, subject to the organization's exclusive legal control, and if the organization informed all grantees, donors and donor-advisors in writing that grant funds can be used only for charitable purposes and not for the benefit of the donor or donor-advisor, or for any other purpose conferring impermissible private benefit. In addition, a new organization that intends to maintain DAFs must disclose that intention on its exemption application and must provide detailed information on the application regarding the manner in which it plans to operate those funds.

C. **Income Tax Treatment of Contributions**.

1. **Charitable Contribution Deduction**. A donation made to a DAF is eligible for a current year income tax deduction, even though there is no requirement that the donor make grant recommendations and that grants actually be made from the DAF with respect to the contribution in the same calendar year. The donation may be deducted subject to the same rules that apply to all gifts to public charities. I.R.C. § 170(f)(18)(A)(i) and (ii).

a. The amount of the deduction is the amount of cash or the fair market value of the assets donated to the DAF, unless the donor receives a quid pro quo from the sponsoring organization, in which case the deduction will be reduced by the amount of the quid pro quo.

(1) Gifts of cash and ordinary income property may be deducted up to 50 percent of the donor's contribution base in the year of contribution. I.R.C. § 170(b)(1).

(2) Gifts of appreciated long-term capital gain property may be deducted up to 30 percent of the donor's contribution base in the year of contribution. I.R.C. § 170(b)(1)(C).

(3) Deductions in excess of the percentage limitations may be carried forward and utilized to offset income over the next five years succeeding the year of the contribution. I.R.C. § 170(d)(1)(A).

b. The deduction is subject to the usual rules with respect to appraisals. The standard partial interest rules also apply.

2. **Denial Based on Character of Sponsoring Organization**. No income tax deduction is permitted for a contribution to a DAF if:

a. The sponsoring organization is a Type III SO (other than a functionally integrated Type III SO).

b. The sponsoring organization is a veteran's organization, a fraternal society or a cemetery company, as defined in Internal Revenue Code sections 170(c)(3), (4), and (5). I.R.C. § 170(f)(18)(A).

3. **Special Acknowledgement Rule**. In order to be eligible for a charitable deduction, all donations made to a DAF must not only be acknowledged in writing by the sponsoring organization, but the acknowledgement must state that the organization has exclusive control over the contributed assets. I.R.C. § 170(f)(18)(B).

4. **IRA Distributions**. A distribution from an IRA will not qualify as a QCD and be excluded from the donor's taxable income in the year of the distribution if the distribution is made directly to a DAF. I.R.C. § 408(d)(8)(B)(ii).

D. Estate and Gift Tax Treatment of Contributions.

1. **Deductions**. A donor who makes a contribution to a DAF during life is generally entitled to a gift tax charitable deduction equal to the full fair market value of the property contributed in computing taxable gifts for the year. I.R.C. § 2522. Likewise, if a decedent makes a contribution to a DAF at death, the decedent's taxable estate is determined by deducting the full fair market value of the property contributed. I.R.C. § 2055. The gift and estate tax charitable deductions are not subject to percentage limitations. However, they are both subject to the partial interest rule. I.R.C. §§ 2055(e)(2) and 2522(c)(2).

2. **Denial Based on Character of Sponsoring Organization**. A gift or estate deduction is denied based on the tax character of the sponsoring organization in comparable circumstances to the income tax deduction rules. I.R.C. §§ 2055(e)(5)(A) and 2522(c)(5)(A).

3. **Acknowledgement**. Interestingly, both the gift and estate tax deduction rules require that the sponsoring organization provide an acknowledgement for the transfer which states that the sponsoring organization has exclusive control over the contributed or bequeathed assets. I.R.C. §§ 2055(e)(5)(B) and 2522(c)(5)(B).

4. **Includability of DAF Assets in Estate**. The assets held in a DAF at the time of the donor's death are not includable in the donor's estate under Internal Revenue Code section 2036. This is because the donor does not retain control of the DAF assets; the donor merely has advisory privileges with respect to the account.

E. Taxation of DAFs.

1. **DAF account**. Since the DAF is not a separate entity, there are no tax considerations at the DAF account level.

2. **Sponsoring Organization**. There are no special taxes that apply to a sponsoring organization that maintains DAFs. Sponsoring organizations must, however, vet assets transferred to the DAF to ensure that the assets will not produce unrelated business taxable income, and ordinarily limit investments that may be made in a DAF so that no unrelated business taxable income is generated by such investments.

F. Regulatory Restrictions and Excise Taxes.

1. **General**. The PPA introduced a number of new behavioral rules that apply to the administration of DAFs. Failure to comply with these rules leads to the imposition of excise taxes on a variety of different individuals and entities associated with the particular DAF.

2. **Taxable Distributions**. An excise tax is imposed on any taxable distribution made by a DAF. I.R.C. § 4966(a).

a. **Definition**. In general, a "taxable distribution" is any distribution from a DAF to

(1) A natural person, or

(2) Any other person, if the distribution is for any purpose other than one specified in Internal Revenue Code section 170(c)(2)(B) or the sponsoring organization does not exercise expenditure responsibility with respect to such distribution. I.R.C. § 4966(c)(1).

b. **Exceptions**. A taxable distribution does not include any distribution to:

(1) An organization described in Internal Revenue Code section 170(b)(1)A), unless the organization is a disqualified SO,

(2) The sponsoring organization of the DAF, or

(3) Another DAF. I.R.C. § 4966(c)(2).

c. **Exception to the Exceptions**. A disqualified SO is defined as a section 509(a)(3) SO that meets the requirements for the so-called Type III or "operated in connection with" category and that is not a "functionally integrated" Type III SO. For further details concerning such organizations, see Section V below.

(1) A SO (regardless of type) is also treated as a disqualified SO if the DAF donor controls a charity supported by the SO. I.R.C. §4966(d)(4).

(2) If a DAF makes a distribution to a disqualified SO, it must exercise expenditure responsibility with regard to the distribution to prevent it from constituting a taxable expenditure. Since expenditure responsibility can be cumbersome, many sponsoring organizations have a policy that prohibits DAF distributions to disqualified SOs.

d. **Excise Taxes Imposed**.

(1) A sponsoring organization that makes a "taxable distribution" is subject to an excise tax equal to 20 percent of the amount of the distribution. I.R.C. § 4966(a)(1).

(2) An excise tax of five percent is imposed on any fund manager (i.e., officers, directors, and certain employees) of the sponsoring organization who knowingly approved the distribution, up to a cap of $10,000 per distribution on the manager. I.R.C. § 4966(a)(2).

3. **Prohibited Benefits**. There is a prohibited benefit whenever a distribution made from a DAF results in a donor, a donor-advisor, or family member or a 35 percent-controlled entity of a donor or donor-advisor receiving, directly or indirectly, a "more than incidental benefit." I.R.C. § 4967(a)(1).

a. **Definition**. Internal Revenue Code section 4967 does not provide guidance on the meaning of "more than incidental benefit." The legislative history indicates that there is a "more than incidental benefit" if, as a result of a distribution from a DAF, a donor, donor-advisor, or related person with respect to the DAF receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit were received as part of the contribution to the sponsoring organization. See Technical Explanation of H.R. 4 at 350.

(1) The permissibility of satisfying a legally binding pledge entered into by the donor and binding herself individually only through a distribution from the donor's DAF is not addressed in either Internal Revenue Code section 4967 or the legislative history of the PPA. Most sponsoring organizations have, however, adopted a policy that prohibits DAFs from being used to satisfy an enforceable pledge to another organization.

(2) This policy is derived from rulings that consider the payment of a personal pledge by a private foundation an impermissible act of self-dealing; by extension, it is thought that such payment may constitute a prohibited benefit in the DAF context.

b. Excise Taxes Imposed.

(1) Where a prohibited benefit results from a DAF distribution, an excise tax of 125 percent of the amount of such benefit is imposed on the person who advised as to the distribution, and on the recipient of the benefit.

(2) If a manager of the sponsoring organization agreed to make the distribution knowing that the distribution would confer a more than incidental benefit, the manager is subject to an excise tax of 10 percent of the amount of such benefit, not to exceed $10,000, which may be imposed in addition to the taxable distributions penalty described above. I.R.C. § 4967(a)(2).

(3) No excise tax is imposed, however, under this provision if a tax has been imposed under Internal Revenue Code section 4958, as described below. I.R.C. § 4967(b).

4. Automatic Excess Benefit Transactions. A version of the so-called "intermediate sanctions" or "excess benefit transaction" rules that apply to all public charities is also imposed on DAFs. I.R.C. § 4958(c)(2). These excess benefit rules are designed generally to penalize disqualified persons who engage in transactions with a charitable organization and receive a benefit in excess of the fair market value of goods or services provided in return. In the context of distributions from a DAF, however, the rules are made more onerous.

a. Definition. Under the specific DAF rules, any grant, loan, compensation, or other similar payment from a DAF to certain disqualified persons is automatically treated as an "excess benefit transaction" under section 4958, with the entire amount paid to any such person treated as the excess benefit. I.R.C. § 4958(c)(2). The rule is invoked regardless of whether the payment is reasonable.

b. Disqualified Person Covered. For purposes of the DAF automatic excess benefit transaction rules, a disqualified person is defined to include the donor, donor-advisor, or a family member or 35 percent-controlled entity of the donor or donor-advisor. I.R.C. § 4958(f)(7). Consequently, all payments from a DAF, including reimbursement of expenses, to the donor, donor-advisor and members of their families should be avoided.

c. Excise Taxes Imposed.

(1) As stated above, the entire amount paid under an automatic excess benefit transaction is treated for these purposes as the excess benefit. The disqualified person is subject to a 25 percent excise tax on the full amount. I.R.C. § 4958(a)(1). If an excess benefit payment is not corrected, a 200 percent excise tax may be imposed on the disqualified person. I.R.C. § 4958(b). Any amount repaid as a result of correcting an excess benefit transaction may not be returned to the DAF. I.R.C. § 4958(f)(6).

(2) If a manager (director, officer, trustee or employee exercising functions ordinarily held by persons in such positions) of the sponsoring organization

participated in the excess benefit transaction, knowing that it was such a transaction, the manager is subject to an excise tax of 10 percent of the amount of the excess benefit, unless the participation is shown not to be willful and is due to reasonable cause. I.R.C. § 4958(a)(2).

d. **Additional Excess Benefit Issues**. Internal Revenue Code section 4957 also provides a special rule for purposes of assessing excess benefit transactions that involve the sponsoring organization of a DAF. Under that rule, the term "disqualified person" is extended to include an investment advisor (as well as persons related to the investment advisor). I.R.C. § 4958(f)(1)(F). The term "investment advisor" is in turn defined to mean, with respect to a sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in DAFs (including pools of assets all or part of which are attributed to DAFs) owned by the sponsoring organization. I.R.C. § 4958(f)(1)(F). The effect of this extension is that it is critical that all payments made by a sponsoring organization to an outside investment advisor be reasonable under the standard excess benefit rules. To the extent that such payments are found not to be reasonable, they will involve an excess benefit at the level of the sponsoring organization.

5. **Excess Business Holdings**. The excess business holdings rule under Internal Revenue Code section 4943, applicable generally to private foundations, was also made applicable by the PPA to DAFs. I.R.C. § 4943(e). For purposes of this rule, a disqualified person includes a donor to the DAF, a donor-advisor, family members of the donor or donor-advisor, and any entities that are more than 35 percent-controlled by the DAF or its disqualified persons. I.R.C. § 4943(e)(2). Transitional rules, comparable to those that applied to private foundations that were in existence at the time of the passage of the Tax Reform Act of 1969, apply to DAFs that were in existence prior to January 1, 2007, and that held excess business holdings at that time. These rules are quite complex but may still be applicable for DAFs and their disqualified persons that held high levels of voting stock in business enterprises.

V. SUPPORTING ORGANIZATIONS.

A. Overview.

1. The Tax Reform Act of 1969 provided special status to a group of organizations that were closely associated with public charities but formed as separate entities. As defined by the Code, an SO is a type of public charity described in Internal Revenue Code section 509(a)(3).

2. SOs are classified as public charities, but are not required to meet the strenuous public support tests that must be met by most section 509(a)(1) organizations and by all section 509(a)(2) organizations. Instead, an SO derives its public charity status from a close relationship with one or more public charities described in those provisions. In many cases, SOs perform functions or provide services that are integral to the conduct of the exempt purpose of the public charity or charities supported.

3. Examples of SOs include trusts established to provide scholarships to students attending a particular college or university, fundraising foundations for a school or hospital, and endowment management entities. Many non-profit healthcare systems and other large non-profit organizations also use SOs in their structures, sometimes as parent entities.

4. Concern about potential abuses by founders of SOs and insufficient ties to supported organizations caused Congress, as part of the PPA, to strengthen the accountability of SOs generally and to impose additional restrictions on certain SOs.

B. Organization, Operation and Administration

1. **Formation**. To qualify as an SO, an organization must satisfy an organizational test, an operational test, a control test and a relationship test. There are three types of SOs – Type I, II, and III – described in the Internal Revenue Code and Treasury Regulations. All three types of SOs must satisfy the same organizational, operational and control tests. The requirements for the relationship test vary based on SO type, as described in more detail below.

2. **Organizational Test**. An SO 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 publicly supported organizations. I.R.C. § 509(a)(3)(A).

   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 that 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 SO and the supported public charity or charities. The permissible types of relationships are described below in more detail. 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 by purpose. Treas. Reg. § 1.509(a)-4(d)(2). If the SO is "operated in connection with" one or more public charities, the supported organization as a general rule must be specified by name, unless there has been an "historic and continuing relationship" between the SO and the supported charity, and by reason of such relationship, there has developed "a substantial identity of interests" between the organizations. Treas. Reg. §§ 1.509(a)-4(d)(4)(i) and 1.509(a)-4(d)(2)(iv). 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 SO's governing documents.

3. **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. 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).

   b. 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).

   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).

4. **Control Test**. An SO may not be controlled, directly or indirectly, by "disqualified persons," including substantial donors, entities in which they own more than a 35 percent interest and their family members. I.R.C. § 509(a)(3)(C).

   a. The organization will run afoul of the control test if disqualified persons either constitute a majority of the trustees or directors or if any disqualified person may veto decisions of the governing board.

b. The control requirement does not preclude, however, disqualified persons from serving as trustees or directors of the SO. Treas. Reg. § 1.509(a)-4(j).

5. **Relationship Test**. An SO must establish the required relationship with the public charities it supports. An SO falls into one of three types based on the nature of the relationship it establishes with its supported charity or charities. The relationship test will be satisfied if the SO is (i) operated, supervised or controlled by its supported charities (Type I); (ii) supervised or controlled in connection with its supported charities (Type II); or (iii) operated in connection with its supported charities (Type III). I.R.C. § 509(a)(3)(B). Type I and Type II SOs meet the relationship test by virtue of being effectively controlled by the charities they support, either through control of the SOs' governing boards by representatives of the supported charities or through substantial overlap of governing boards.

a. **Type I SO**. Treasury Regulations indicate that the distinguishing feature of the Type I relationship 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 SO 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) The Regulations compare the Type I relationship to that of a parent corporation and its subsidiary, and indicate that the requisite relationship exists where the majority of officers, directors or trustees of the SO 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. **Type II SO**. The distinguishing feature of a Type II SO 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 SO 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). IRS guidance suggests that the critical factor in establishing the Type II relationship is that a majority of the persons who control the SO must perform the same functions at public charities that are actually supported by the SO. See, e.g., Priv. Ltr. Rul. 9530008 (4/21/95); Priv. Ltr. Rul. 9238041 (6/24/92); Gen. Couns. Mem. 39508 (5/28/86).

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

c. **Type III SO**. A Type III SO is not required to demonstrate the same degree of supported charity involvement in governance as the other two types of SOs, but must satisfy three additional tests – a "responsiveness test," a "notification test," and an "integral part test" – to establish the required relationship with its supported charities. This type of SO must be responsive to, and significantly involved in the operations of, the publicly supported organization." Treas. Reg. § 1.509(a)-4(f)(4).

(1) **General**. The operated in connection with test is the most flexible type of relationship that can exist between the SO and the public charity or charities it supports. It is also, however, the most subjective test, and therefore it can be more difficult to establish that its requirements are met. Generally, the Type III relationship is more appropriate when the donor and the donor's family have close relationships with multiple publicly supported charities.

(2) **Responsiveness Test**. A Type III SO must demonstrate that it is responsive to the needs or demands of the public charities it supports, which can be accomplished if the public charity's officers, directors or trustees have a "significant voice" in the SO's investment policies, the timing of grants, the manner of making grants, the selection of grant recipients, and in directing the use of the SO's income or assets.

(a) The "significant voice" requirement may be met if one or more of the SO's trustees, directors or officers are elected or appointed by the supported charities; one or more members of the governing bodies of the supported charities are also trustees, directors or officers of the SO, or hold other important offices in the SO; or if the trustees, directors or officers of the SO maintain a close, continuous working relationship with the supported charities' trustees, directors or officers. Treas. Reg. § 1.509(a)-4(i)(3).

(b) In Treasury Regulations proposed in February 2016 (the "2016 Proposed Regulations"), the responsiveness test was clarified to provide that a Type III SO must be responsive to the needs and demands of each of its supported organizations. Prop. Treas. Reg. § 1.509(a)-4(i)(3)(i). Since there is no numeric limit on the number of public charities a Type III SO may support, the practical effect of this rule may be to limit the number of charities that can be supported. The 2016 Proposed Regulations provide an example of how an SO may meet the responsiveness test with respect to 10 supported organizations. Prop. Treas. Reg. § 1.509(a)-4(i)(3)(iv), ex. 3.

(c) Prior to the PPA in 2006, the responsiveness test could be satisfied by an SO that was established as a trust under state law where each specified publicly supported organization was a named beneficiary under the terms of the trust's governing instrument and the beneficiary organization had the power to enforce the trust and compel an accounting under applicable state law. Now, to meet the responsiveness test, an SO structured as a charitable trust is also required to establish a close and continuous relationship with its supported charities such that the trust is responsive to the supported charities' needs or demands. Examples set forth in Treasury Regulations illustrate how a charitable trust can meet or fail the relationship obligation. Treas. Reg. § 1.509(a)-4(i)(3)(iv) ex. 1 and 2.

(3) **Notification Test**. A Type III SO must provide each of its supported charities certain information annually. I.R.C. § 509(f)(1)(A).

(a) A written notice addressed to a principal officer of the supported organization identifying the amount and type of support provided by the SO to the supported organization in the past year;

(b) A copy of the SO's Form 990 (or 990-EZ) that was most recently filed; and

(c) A copy of the SO's governing documents, and any amendments to such documents (once initially provided, governing documents need only be provided again if amended). Treas. Reg. § 1.509(a)-4(i)(2)(i).

(d) The required documents must be postmarked or electronically transmitted by the last day of the fifth month following the close of the SO's taxable year. Treas. Reg. § 1.509(a)-4(i)(2)(iii). If an SO's Form 990 is on extension at the time of the notification deadline, the SO will provide a copy of the Form 990 for its second preceding taxable year.

(4) **Integral Part Test**. The integral part test involves the degree of involvement that the SO maintains in the operations of the supported organizations. The test was changed significantly by the PPA and regulations promulgated after that legislation was passed. There are now two subcategories of Type III SOs based on this test: "functionally integrated" and "non-functionally integrated." I.R.C. §§ 4942(g)(4)(C) and 4943(f)(5)(B).

(a) **Functionally Integrated Type III SOs.** An organization is treated as a functionally integrated Type III SO if it engages in activities (i) substantially all of which "directly further" the exempt purposes of its supported organization to which it is responsive, and (ii) that, but for the involvement of the SO, would normally be engaged in by the supported organization. Treas. Reg. §§ 1.509(a)-4(i)(4)(i)(A) and 1.509(a)-4(i)(4)(ii).

i. Holding title to and managing exempt-use property is treated as directly furthering the exempt purposes of a supported organization. Treas. Reg. § 1.509(a)-4(i)(4)(ii)(C).

ii. Awarding grants, scholarships, and other payments to individual beneficiaries that are members of the charitable class benefitted by the supported organization will directly further the exempt purposes of an SO if (i) the individual recipients are selected on an objective and nondiscriminatory basis, (ii) the officers, directors, or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making them, and the selection of recipients and (iii) the awarding of such payments is part of an active program of the SO that directly furthers the exempt purposes of the supported organization and in which the SO maintains significant involvement. Treas. Reg. § 1.509(a)-4(i)(4)(ii)(D).

iii. In contrast, fundraising, investing and managing non-exempt-use assets, such as endowment assets, and making other types of grants (whether to the supported organization or third parties) are not activities that directly further the exempt purposes of a supported organization. Treas. Reg. § 1.509(a)-4(i)(4)(ii)(C).

iv. In addition, a Type III SO that is the parent of each of its supported organizations can qualify as a functionally integrated SO (a structure that is frequently used for health care systems), as can an SO that supports a governmental entity. Treas. Reg. § 1.509(a)-4(i)(4)(i)(B) and (C).

(b) **Non-functionally integrated Type III SOs.** All other Type III SOs, the focus of which is usually grant-making activities, are treated as non-functionally integrated entities. As such, they must meet a distribution requirement and an attentiveness test in order to maintain their status as SOs. Treas. Reg. § 1.509(a)-4(i)(5)(i). If these requirements are not met, the organization will be treated as a private foundation.

i. Distribution requirement. A non-functionally integrated SO must distribute its "annual distributable amount" to or for the use of its supported organizations each year, equal to the greater of 85 percent of the SO's adjusted net income or 3.5 percent of the fair market value of all non-exempt use assets (e.g., stocks, bonds, certain real estate) calculated based on the immediately preceding taxable year. Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F).

ii. The annual distributable amount must be distributed on or before the last day of the taxable year and may include reasonable and necessary administrative expenses if paid to accomplish the exempt purposes of the supported organization (i.e., such expenses do not include expenses incurred in the production of investment income). Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F).

iii. If a non-functionally integrated SO has made excess distributions, it is permitted to carry forward the excess amounts for the five taxable years immediately following the taxable year in which the excess amount is created. Treas. Reg. § 1.509(a)-4(i)(7)

iv. There is no distribution requirement for the first taxable year in which an organization is treated as a non-functionally integrated Type III SO. Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F).

v. There is a reasonable cause exception for an organization that fails to satisfy the distribution requirement if the organization establishes to the satisfaction of the Secretary of the Treasury that (i) the failure was due "solely to unforeseen events or circumstances that are beyond the organization's control, a clerical error, or an incorrect valuation of assets," (ii) the failure was due to reasonable cause and not to willful neglect, and (iii) the distribution requirement was met within 180 days after the organization is first able to make its required payout, notwithstanding the unforeseen event or circumstances, or 180 days after the date the incorrect valuation or clerical error was or should have been discovered. Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F).

vi. Attentiveness Requirement. Non-functionally integrated SOs are also required to meet an attentiveness requirement and must distribute one-third or more of their annual distributable amount to one or more supported organizations (i) that are attentive to the operations of the SO, and (ii) to which the SO is responsive. Treas. Reg. § 1.509(a)-4(i)(5)(iii).

vii. In order to demonstrate that the supported organizations are attentive to the operations of the SO, an SO must meet at least one of the following requirements: (i) the SO distributes annually to the supported organization an amount that is 10 percent or more of the supported organization's total support; (ii) the amount of support received from the SO is necessary to avoid the interruption of the carrying on of a particular function or activity, even if such program or activity is not the supported organization's primary program or activity so long as such program or activity is a substantial one; or (iii) based on consideration of all of the pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and SO and the purpose to which the funds are put, the amount of support is a sufficient part of a supported organization's total support. Treas. Reg. § 1.509(a)-4(i)(5)(iii)(B).

viii. Treasury Regulations indicate that the attentiveness of a supported organization generally is motivated by the amounts received from the SO. The more substantial the amounts involved, in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. The proposed regulations note that evidence of actual attentiveness by the supported organization is almost of equal importance. Treas. Reg. § 1.509(a)-4(i)(5)(iii)(B)(3).

ix. The regulations provide that the attentiveness requirement will not be met with respect to any amount received from the SO that is held by the supported organization in a DAF. Treas. Reg. § 1.509(a)-4(i)(5)(iii)(C).

6. Filing Requirements.

a. To secure tax-exempt status, a new SO must file a Form 1023 with the Internal Revenue Service in much the same way as a new private foundation. However, there are more questions for the founders of the SO to address in Schedule D. These questions are designed to establish the typing of the SO.

b. Each year, an SO must file a Form 990, Return of Organization Exempt from Income Tax. The scope of reporting required on the annual Form 990 has expanded significantly in recent years. In addition to stating its type (I, II or III functionally integrated or non-functionally integrated), an SO must list the entities it supports, the public charity status of its supported organizations, whether the supported organizations are listed in the SO's governing documents and the amount of monetary and other support provided. Beginning with the 2014 Form 990, Schedule A included a new Part IV, that must be completed by all SOs, regardless of type, and a new Part V that must be completed by Type III non-functionally integrated SOs. Part IV includes sections that are specific to each type of SO. The new Parts seek to clarify and confirm that the SO is meeting the required organizational and operational tests described above.

C. Income Tax Treatment of Contributions.

1. Public Charity Rules Apply. A donation to a qualified SO, of whatever type, is treated for income tax purposes as a donation to a public charity. Accordingly, a donor is entitled to claim an income tax deduction based on the higher percentage limits of the donor's contribution base in the year of the gift. In addition, appreciated long-term capital property can be deducted at full fair market value. There are no special substantiation or appraisal rules for transfers to SOs.

2. Potential for Application of Private Foundation Rules. Of course, if the SO defaults into private foundation status, due to its failure to meet the requirements of the various tests or, in the case of Type I and Type III SOs, the control of any of its supported charities by contributors to the SO, their family members or controlled entities, the deduction for a gift to such an SO will instead be governed by the rules applicable to private foundations.

3. IRA Distributions. A distribution from an IRA will not qualify as a QCD and be excluded from the donor's taxable income in the year of the distribution if the distribution is made directly to an SO, regardless of type. I.R.C. § 408(d)(8)(B)(ii).

D. Estate and Gift Tax Treatment of Contributions.

1. Deductions. The standard rules apply for contributions to SOs. A donor who makes a contribution to an SO during her lifetime is entitled to a gift tax charitable deduction equal to the full fair market value of the property contributed in computing taxable gifts for the year. I.R.C. § 2522. Likewise, if a decedent makes a contribution to an SO at her death, the decedent's taxable estate is determined by deducting the full fair market value of the property contributed. I.R.C. § 2055. There are no special deduction rules based on the type of SO to which the gift or bequest is made, or the nature or type of the charities that the SO is formed to support. There are also no acknowledgement requirements for a gift or bequest to any type of SO.

2. Estate Inclusion of SO assets. Notwithstanding the control test for qualification of the entity as an SO, assets contributed during a donor's lifetime may be brought back into the donor's estate at death under Internal Revenue Code section 2036. That provision does not require that the donor retain the sole right to designate who or what shall enjoy the property gifted or the income earned by that property. It merely requires that the donor retain such right "in conjunction with any person." If the donor serves as a trustee or director of the SO, this provision would seem to be applicable, notwithstanding the fact that the SO rules prohibit the donor (or any disqualified person) from retaining a veto power and prohibit disqualified persons, including the donor and members of the donor's family, from constituting the majority of the board of directors or trustees of the SO.

E. Taxation of SOs. SOs are subject to the standard tax provisions that apply to public charities. Specifically, this includes the tax assessed on unrelated business taxable income. I.R.C. §§ 512 and 513.

F. Regulatory Restrictions and Excise Taxes.

1. Support for Foreign Charities. Type III SOs are prohibited from supporting any charity that is not a U.S. domestic entity. The responsiveness test is automatically failed if any supported organization of such an SO is organized outside the U.S. I.R.C. § 509(f)(1)(B); Treas. Reg. § 1.509(a)-4(i)(10).

2. Contributions by Persons Who Control Supported Charity. To qualify as an SO, a Type I and a Type III SO must not accept any contributions from persons (other than publicly supported charities) who directly or indirectly control the governing board of a charity supported by the SO, from family members of such persons, or from entities controlled by such persons. I.R.C. § 509(f)(2). If a Type I or Type III SO accepts such a contribution, it loses its status as a public charity and will be treated as a private foundation.

3. Excess Benefit Transactions. Like other public charities, SOs are subject to the so-called intermediate sanctions rules of Internal Revenue Code section 4958 that impose excise taxes in the event the charity confers an excess benefit on a disqualified person (generally, its insiders, such as officers, directors, trustees and substantial contributors). SOs are also subject to more onerous excess benefit transaction rules.

a. Automatic Excess Benefit. Under these provisions, introduced in 2006 by the PPA, any loan provided by an SO to a disqualified person is automatically considered an excess benefit transaction. I.R.C. § 4958(c)(3)(A)(i)(II). In addition, any grant, loan, compensation or other "similar payment" from an SO to a substantial contributor (or to such person's family members or 35-percent controlled entities) is an automatic excess benefit transaction. I.R.C. § 4958(c)(3)(A)(i)(I). For these purposes, the legislative history states that "similar payments" include expense reimbursements, but not, for example, a payment made pursuant to a bona fide sale or lease of property. See Technical Explanation of H.R. 4 at 358.

b. **Persons Covered**. For these purposes, a disqualified person means, with respect to any transaction, (i) any person who was in a position to exercise substantial influence with the organization at any time in the five years immediately preceding the transaction, (ii) a member of the family of such an individual (including siblings and their spouses), and (iii) a 35 percent-controlled entity. I.R.C. § 4958(f)(1). A substantial contributor is any party (excluding public charities other than SOs) who contributes more than $5,000 to the organization, if that amount exceeds two percent of the total contributions received by the organization before the close of the taxable year of the contribution. If the SO is formed as a trust, the creator of the trust is also considered a substantial contributor. I.R.C. § 4958(c)(3)(C).

c. **Excise Taxes Imposed**.

(1) Under the automatic excise benefit provisions, the entire amount involved in the transaction is treated as an excess benefit, regardless of whether the payment was reasonable. The disqualified person (including a substantial contributor) is subject to a 25 percent excise tax on the full amount. I.R.C. § 4958(a)(1). If an excess benefit payment is not corrected, a 200 percent excise tax may be imposed on the disqualified person. I.R.C. § 4958(b).

(2) If an organization manager (director, officer, trustee or employee exercising functions ordinarily held by persons in such positions) of the SO participated in the excess benefit transaction, knowing that it was such a transaction, the manager is subject to an excise tax of 10 percent of the amount of the excess benefit, unless the participation is shown not to be willful and is due to reasonable cause. I.R.C. § 4958(a)(2).

4. **Excess business holding rule**. This rule has also been extended to SOs in certain circumstances.

a. **SOs Covered**. Non-functionally integrated Type III SOs are subject to the excess business holding rule applicable to private foundations and DAFs. I.R.C. § 4943(f)(3)(A). In addition, the excess business holdings rule applies to a Type II SO that accepts a gift or contribution from a person (other than a public charity that is not an SO) (i) who controls, directly or indirectly, the governing body of a supported organization, or (ii) who is related to a person described in category (i). I.R.C. § 4943(f)(3)(B).

b. **Permitted Holdings and Exceptions**. The rule applied to affected SOs is comparable to the rule applied to private foundations. Basically, an SO and its "disqualified persons" may not hold, in the aggregate, more than 20 percent of the ownership control interests in a business enterprise. I.R.C. § 4943(f)(1). Disqualified person means (i) a substantial contributor to the SO, (ii) certain persons related to a substantial contributor, (iii) entities that are more than 35 percent-controlled by a substantial contributor and/or her family members, (iv) an entity that is effectively controlled by the same persons who control the SO, and (v) an organization substantially all of the contributions to which were made by a substantial contributor to the SO or an owner of more than 20 percent of the beneficial interests in an entity that is a substantial contributor to the SO. I.R.C. § 4943(f)(4). Among the applicable exceptions, a safe harbor permits the SO to own up to two percent of the voting stock and two percent of all outstanding classes of stock without regard to the holdings of disqualified persons. In addition, SOs that held business interests as of November 18, 2005 for the benefit of the community pursuant to a direction of a state official having jurisdiction over the SO were exempted from the rule with respect to such holdings. I.R.C. § 4943(f)(6). Transactional rules apply to other SOs that were in existence before January 1, 2007 and held as of that date holdings that would be considered excess business holdings. I.R.C. § 4943(f)(7).

c. **Excise Tax Imposed**. An SO covered by this rule is subject to the same first and second tier excise taxes as apply to a private foundation. I.R.C. § 4943(a) and (b).

VI. 501(C)(4) ORGANIZATIONS

A. Overview.

1. **Definition**. Section 501(c)(4) of the Internal Revenue Code embraces two general classifications of tax-exempt organizations:

a. civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare ("social welfare organizations"); and

b. local associations of employees.

2. **History of Provision**. The predecessor of this provision was enacted as part of the Tariff Act of 1913. Tariff Act of 1913, ch.16, § II(G)(a), 38 Stat. 172. While there is little history surrounding its inclusion, it is generally assumed that its enactment was the result of a request by the U.S. Chamber of Commerce to exempt "civic and commercial" organizations from the ambit of the Tariff Act. Local associations of employees were added in 1924 because they had otherwise been denied exempt status on the basis that they provided services to a limited group of beneficiaries. Revenue Act of 1924, ch. 234, § 231(8), 43 Stat. 282.

3. **Social Welfare Organizations**. This outline will focus on social welfare organizations. An organization is operated exclusively for the promotion of social welfare if "it is primarily engaged in promoting in some way the common good and general welfare of the community" and is operated primarily "for the purpose of bringing about civic betterments and social improvements." Treas. Reg. §1.501(c)(4)-1(a)(2)(i). Note that "exclusively" in the definition means "primarily" and not solely.

a. The promotion of social welfare does not include activities that primarily constitute "carrying on a business with the general public in a manner similar to organizations which are operated for profit." Treas. Reg. §1.501(c)(4)-1(a)(2)(ii).

b. While the concept of social welfare is inherently abstruse and the categorization somewhat of a catch-all for non-profit organizations that resist classification under other parts of Internal Revenue Code section 501(c), the organization "must be a community movement designed to accomplish community ends" to fall with in its ambit. Erie Endowment v. United States, 316 F.2d 151, 156 (2d Cir. 1963).

c. Examples of section 501(c)(4) organizations include homeowners associations, veterans organizations, volunteer fire departments, parks associations, community service organizations such as Rotary Clubs, Kiwanis Clubs and Lion Clubs and public recreational facility organizations.

d. In addition, many advocacy organizations are operated as section 501(c)(4) social welfare organizations. Well-known examples include American Association of Retired Persons (AARP), American Civil Liberties Union (ACLU) and National Rifle Association of America (NRA). Section 501(c)(4) social welfare organizations can engage in unlimited legislative and lobbying activities, so long as the primary purpose for these activities is the achievement of the organization's exempt purposes. Rev. Rul. 61-177, 1961-1 C.B. 117. In addition, section 501(c)(4) social welfare organizations are not prohibited from engaging in political campaign activities; however, those activities must be secondary to their primary focus on the promotion of social welfare. Rev. Rul. 81-95, 1981-1 C.B. 332.

e. The promotion of social welfare is also included within the meaning of charitable purpose under Internal Revenue Code section 501(c)(3**)**. Treas. Reg. §1.501(c)(3)-1(d)(2). Consequently, there is overlap between sections 501(c)(3) and 501(c)(4), and many organizations could qualify for exempt status under either Code section. It is unclear whether the Internal Revenue Service could reclassify a section 501(c)(4) organization as a section 501(c)(3) organization of its own volition. To the best of the author's knowledge, no precedent for such reclassification exists.

B. Organization, Operation and Administration.

1. Formation. Social welfare organizations have historically been organized as non-profit corporations or unincorporated associations. However, there does not appear to be any reason why such an entity could not be established as a trust. State law considerations will generally govern the appropriateness of one form over another.

2. Funding. While the classic concept of a social welfare organization would seem to contemplate that the organization would be funded through the contributions or membership payments of many individuals, there is no such requirement – akin to the public support test in Internal Revenue Code section 501(c)(3) – written into the tax law. It may, therefore, be possible for one contributor, or one family of individual contributors, or a small group of individual contributors to establish and fund a section 501(c)(4) social welfare organization. There would also appear to be few restrictions of the type of assets that may be contributed to a section 501(c)(4) social welfare organization.

3. Filing Requirements.

a. Prior to 2016, there were no formal filing requirements with the Internal Revenue Service for a section 501(c)(4) social welfare organization to obtain tax-exempt status. As such, the organization could "self-declare." A section 501(c)(4) social welfare organization could choose to file a Form 1024, Application for Recognition of Exemption under section 501(a). An organization might take this course to receive a formal determination letter of IRS recognition of section 501(c) status in order to obtain certain incidental benefits, such as public recognition of its tax-exempt status, exemption from certain state and local taxes and other charges, and non-profit mailing privileges.

b. Section 506 of the Internal Revenue Code was added by the Protecting Americans from Tax Hikes Act of 2015 ("PATH Act**")**. Pub. Law 114-113. This provision requires an organization to notify the IRS no later than 60 days after the organization is established of its intention to operate as a section 501(c)(4) organization. Failure to submit the notification results in a penalty of $20 per day for each day that the failure continues, up to a maximum penalty of $5,000.

c. Notice is provided by filing Form 8976, Notice of Intent to Operate under section 501(c)(4**)**. The notice must be filed electronically using the Form 8976 Electronic Notice Registration System. A fee of $50 must be submitted to Pay.gov within 14 days after submitting Form 8976 to complete the registration process. Failure to pay results in rejection of the filing of the notice.

d. The organization must provide the following information on its notice: the name of the organization; the address of the organization; its employer identification number (EIN); the date it was organized; the state or other jurisdiction in which it was organized; the month end of the organization's annual accounting; and a statement of the purpose of the organization. The organization must also have an email address.

e. The notice is not open to public inspection under Internal Revenue Code section 6104(a)(1) and (d) because it is not considered an application for tax exemption within the meaning of that section.

f. The notice only has to be filed once; there is no annual notice requirement. If an organization chooses to submit a Form 1024, the submission of such form does not relieve the organization of the requirement to file the Form 8976.

g. There are certain exceptions to the notification requirement based on when the organization was formed and prior filings made. Specifically, organizations that filed a Form 990 or a Form 1024 on or before July 8, 2016 are not required to file the Form 8976. Rev. Proc. 2016-41, I.R.B. 2016-30. If a pre-existing organization had not made such a filing, however, it was required to file its notice no later than September 6, 2016.

h. A section 501(c)(4) organization is in all events required to file annual information returns or notices (e.g., Form 990, Form 990-EZ, or Form 990-N), depending on the size of its total assets and gross receipts. A failure to file these forms for three consecutive years results in an automatic revocation of the organization's tax-exempt status.

C. Income Tax Treatment of Contributions.

1. **Income Tax Charitable Contribution Deduction**. A donor to a 501(c)(4) organization is not entitled to a charitable contribution income tax deduction, regardless of the type of property contributed. The deduction is only available for contributions to organizations that meet the requirements of Internal Revenue Code section 170(c).

2. **Income Tax Consequences of Donating Appreciated Assets**. If a donor makes a contribution of appreciated assets to a 501(c)(4) organization, the transfer is not treated as a realization event. Instead, the organization receiving the gift takes the donor's cost basis in the asset. I.R.C § 1015(a). If the donor's cost basis is greater than the fair market value of the asset on the date of contribution, the organization's basis is, however, limited to fair market value on the date of the contribution. Id.

   a. In contrast, if a gift of appreciated property is made to a political organization as defined by Internal Revenue Code section 527(e)(1), the transferor is treated as having sold such property on the date of contribution and as having realized an amount equal to the fair market value of the property on the date of contribution. I.R.C. § 84.

   b. The basis of the property in the hands of the political organization is the donor's basis increased by the amount of gain recognized by the donor. I.R.C. § 84(b).

3. **IRA Distributions**. A distribution from an IRA will not qualify as a QCD and be excluded from the donor's taxable income in the year of the distribution if the distribution is made directly to a 501(c)(4) organization. I.R.C. § 408(d)(8)(B)(ii). QCDs can only be made to organizations described in Internal Revenue Code section 170(b)(1)(A), namely most public charities, governmental units and some private foundations. Other tax-exempt entities described in Internal Revenue Code section 501 are not embraced by the rule.

D. Gift Tax Treatment of Contributions.

1. Prior to 2015, there was controversy surrounding the federal gift tax consequences of contributing to a 501(c)(4) organization. The Internal Revenue Service took the position that such donations were subject to the federal gift tax. Rev. Rul. 82-216, 1982-2 C.B. 220 ("The Service continues to maintain that gratuitous transfers to persons other than organizations described in section 527(e) of the Code are subject to the gift tax absent any specific statute to the contrary, even though such transfers may be motivated by a desire to advance the donor's social, political or charitable goals."). Enforcement, however, was lax, until audit activity commenced in 2011. CRS Report R42655, 501(c)(4)s and the Gift Tax: Legal Analysis, by John R. Luckey and Erika K. Lunder (2012).

2. The PATH Act resolved the gift tax issue. It amended the Internal Revenue Code to exclude from the federal gift tax all transfers of money or other property made after December 18, 2015 "to an organization described in paragraphs (4), (5) or (6) of section 501(c) and exempt from tax under

section 501(a), for the use of such organization." I.R.C. § 2501(a)(6). Interestingly, the Joint Committee of Taxation Report that accompanied the legislation stated that no inference was to be drawn that transfers to such organizations were previously considered as "transfers of property by gift for purposes of chapter 12 of such Code." Technical Explanation of the Protecting Americans from Tax Hikes Act of 2015, House Amendment #2 to the Senate Amendment to H.R. 2029 (Rules Committee Print 114-40), Joint Committee of Taxation JCX-144-15, December 17, 2015, at 247.

a. The approach of the PATH Act – to exclude such transfers from the ambit of the federal gift tax – follows the approach taken with respect to transfers made to political organizations defined under Internal Revenue Code section 527(e)(1**)**. I.R.C. § 2501(a)(4).

E. **Estate Tax Treatment of Contributions**.

1. The changes made by the PATH Act were limited to the federal gift tax. The legislation did not introduce an exclusion to the federal gross estate definition under Internal Revenue Code section 2031 for bequests to section 501(c)(4) organizations, and there is no deduction for federal estate tax purposes for such bequests. Accordingly, the general view is that a transfer to a section 501(c)(4) organization is taxable for federal estate tax purposes.

2. The real significance of this issue does not necessarily lie in the potential tax liability for bequests. Instead it lies in the possibility of estate tax inclusion under Internal Revenue Code section 2036 coupled with no offsetting deduction. If a donor funds a section 501(c)(4) organization during the donor's lifetime and retains the right to control, either alone or in conjunction with others, the making of distributions from the organization, the organization's assets that are attributable to the donor's contributions will be included in the donor's gross estate. I.R.C. § 2036(a)(2). As such, they will be part of the taxable estate, because there is no statutory deduction to remove the value of the assets from the tax base. Cf. Rev. Rul. 72-552, 1972-2 C.B. 525.

F. **Gifts of Partial Interests in Property**. The partial interest rules, that limit the deductibility of certain property interests when transferred to a charitable organization under income, gift and estate tax rules in Internal Revenue Code sections 170(f)(3), 2055(e)(2) and 2522(c)(2), are not carried over to the gift tax exclusion rule under Internal Revenue Code section 2501(a)(6). Accordingly, a gift of an income interest to a 501(c)(4) organization, or a gift to such an organization of common stock, with the voting rights reserved to the donor, would appear to be excluded transfers not subject to federal gift tax.

G. **Entity Level Taxation**.

1. **Tax Exemption**. As a general matter, a section 501(c)(4) organization is exempt from income tax. I.R.C. § 501(a).

2. **Unrelated Business Taxable Income**. It is, however, subject to the tax on unrelated business taxable income in the same way as other tax-exempt entities under section 501.

3. **Political Campaign Activity**. Notwithstanding the fact that political campaign activity by a section 501(c)(4) organization may be permissible from the standpoint of its tax exemption, expenditures associated with such activities may be taxable. I.R.C. § 527(f). The taxable amount is equal to the lesser of the organization's net investment income for the taxable period (including net realized capital gains) and the amount expended for the political activity. I.R.C. § 527(f)(1).

H. **Regulatory Restrictions and Excise Taxes**.

1. **Private Inurement**. Since 1996, Internal Revenue Code section 501(c)(4) has expressly prohibited the inurement of the net earnings of any organization described under that provision for the benefit of any private shareholder or individual. I.R.C. § 501(c)(4)(B). This is the same concept that applies to section 501(c)(3) organizations; its existence results in the loss of, or failure to qualify for, tax-exempt status.

2. **Excess Benefit Transactions**. Section 501(c)(4) organizations are subject to the excise tax on excess benefit transactions between a disqualified person and the organization. I.R.C. § 4958(e)(1).

   a. **What is Covered**? The term "excess benefit transaction" means any transaction in which an economic benefit is provided by the organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

   b. **Disqualified Persons**. I.R.C. § 4958(f) defines the following individuals and entities as disqualified persons:

      (1) Any person who was, at any time during the five-year period ending on the date of such transaction, in a position to exercise substantial influence over the affairs of the organization;

      (2) A member of the family of anyone described in (a) above. The members of an individual's family are determined under the principles of Internal Revenue Code section 4946(d), with the addition of brothers and sisters (whether by the whole or half blood) of the individual and their spouses; and

      (3) A corporation, partnership or trust or estate of which any of the aforementioned individuals owns more than 35 percent of the combined voting power, profits interest or beneficial interest, respectively. The constructive ownership rules of Internal Revenue Code section 4946(a) apply in this context.

   c. **Excise Taxes Imposed**. An initial or first-tier excise tax of 25 percent of the amount of the excess benefit is imposed on the disqualified person. I.R.C. §4958(a)(1). If the act is not corrected, in timely fashion, an additional or second-tier tax of 200 percent of the amount involved is imposed. I.R.C. §4958(b). If a first-tier tax is imposed on a disqualified person, any organization manager – meaning an officer, director or trustee, or person having equivalent powers or responsibilities – who knowingly participated in the excess benefit transaction is also subject to an excise tax equal to 10 percent of the excess benefit, unless such participation is not willful and is due to reasonable cause. I.R.C. §4958(a)(2).

3. **Other Restrictions**. Section 501(c)(4) organizations are not subject to the self-dealing, minimum distribution, excess business holding, jeopardy investment and taxable expenditure rules that apply to private foundations and that apply, to a limited extent, to SOs and DAFs.

4. **Disqualified Person Definition**. It would also appear that a section 501(c)(4) organization is not itself within the definition of a disqualified person under Internal Revenue Code section 4946(a), even if the organization is controlled by individuals who are themselves disqualified persons with respect to another tax-exempt entity. Consequently, it may be permissible for transactions to be entered into between a section 501(c)(4) organization and a private foundation that would ordinarily be treated as self-dealing transactions by the private foundation. It may also be possible for a business to be owned by a combination of a private foundation and a section 501(c)(4) organization without violating the excess business holdings rule applicable to the private foundation.

VII. COMPARATIVE ANALYSIS.

The following section will highlight the key differences between the entities described above, together with a discussion of practical considerations that may guide the choice of entity adopted by the charitable donor. Statutory and regulatory citations will not be repeated where already referenced in the prior sections of this outline. Citations will be given where the discussion expands on the prior analysis or where new subject matter is raised.

A. Deductibility of Contributions.

1. **Private Foundations**. A donor to a private foundation is entitled to an income tax charitable contribution deduction for her contribution to the entity. The calculation of the deduction and the amount that may be claimed as an offset in the current year is, however, generally not as generous as for gifts to other classes of charitable organization and can lead to complex decisions that involve the operation of the foundation itself.

   a. **General Rules**.

      (1) Cash gifts. In the year of contribution, the amount deductible is limited to the lesser of 30 percent of the donor's contribution base or 50 percent of the contribution base reduced by cash gifts to public charities.

      (2) Long-term capital gain property gifts. The donor's deduction is determined by reference to the donor's cost basis (not full fair market value) of the property unless the property contributed qualifies as qualified appreciated securities. Accordingly, all contributions of real estate, partnership assets, closely held business interests, and the like may produce only a limited income tax benefit to the donor. Contributions that may be deducted based on fair market value may then only be claimed in the year of gift up to the lesser of 20 percent of the donor's contribution base or 30 percent of the contribution base reduced by such gifts to public charities.

   b. **Special Rules**. These limitations do not apply if the private foundation can be treated as a public charity for donor contribution purposes. This occurs if the private foundation is a private operating foundation, a common fund foundation or a pass-through foundation. As to the latter, pass-through status may be elected on a year-to-year basis and will require careful planning and consideration of its effect on other contributions made that year to the foundation.

2. **SOs and DAFs**. Both of these types of entity qualify as public charities for the income tax charitable contribution deduction rules applicable to the individual taxpayer. In other words:

   a. **Gifts of cash**. In the year of contribution, the amount deductible is limited to 50 percent of the donor's contribution base.

   b. **Gifts of appreciated assets**. As long as the asset would produce long-term capital gain income to the donor if sold, the deduction generated by the contribution is generally determined with reference to the fair market value of the property. There are some special exceptions. For example, if a gift of tangible personal property is made to a charity and it is not reasonable to anticipate that the charity will use it for a related purpose, the donor's deduction is limited in all cases to cost basis. I.R.C. § 170(e)(1)(B)(i). In addition, gifts of appreciated assets may be deducted in the year of contribution up to 30 percent of the donor's contribution base.

3. **501(c)(4) Organizations**.

   a. **No Income Tax Deduction**. Contributions to such organizations generate no income tax benefit to the donor. This consequence must be carefully weighed when considering this type of organization. It is a plausible option, however, if the donor cannot use the deduction that might otherwise be generated because the donor is already running up against the contribution base limits each year. In addition, some donors are not motivated by tax consequences, as hard as that may sometimes be to believe.

   b. **Gift and Estate Tax Considerations**. The gift tax consequences have been recently settled; there is no liability for a transfer to such an organization since the transfer is excluded entirely from the gift tax system. But that is not the case for estate tax purposes. There is no exclusion and no deduction for transfers to social welfare organizations. Consequently, bequests to such organizations should be avoided, unless the donor is prepared to either use some or all of the donor's remaining lifetime exemption on such a bequest or pay estate taxes. And, when a donor contributes to a social welfare organization during her lifetime, she has to be mindful of her retained control, whether alone or with others, of the organization. Such control will come with a price if it still pertains at the donor's death - an unplanned for estate tax liability.

B. Formation and Operation.

1. Creating the Vehicle.

a. Private Foundations and 501(c)(4) organizations. A donor who wants her own private foundation or 501(c)(4) organization must establish a new entity, generally a not-for-profit corporation or a trust. Although model forms exist, the donor is still likely to need specialized legal services to create the entity in the manner in which the donor desires. This may come at a significant cost. If formed as a corporation, the donor will also need to comply with the corporate formalities of the governing jurisdiction, which at a minimum will require certain filings with the secretary of state's office for the applicable state.

b. SOs. Given the role that supported organizations must play in the day-to-day operation of an SO and given that the donor and members of the donor's family are not permitted to control the SO, the documents required for establishment are inevitably more complicated and require input from and negotiation with other parties. This can add significantly to the cost of forming the SO.

c. DAFs. One of the distinct advantages of a DAF – and one frequently mentioned in marketing materials from sponsoring organizations – is that there are no upfront costs associated with its formation. A DAF is not a separate entity. All that is required is the completion and submission of a new account application form with the sponsoring entity.

2. Initial IRS Filings Requirements.

a. Private Foundations. To obtain tax-exempt status from its inception, a private foundation must file with the IRS a Form 1023 before the end of the 15th month (or, in many cases, extended to the 27th month by an automatic statutory extension) after the date that it was organized, and pay a user fee. Treas. Reg. §§ 1.508-1(a)(2) and 301.9100-2(a)(2)(iv). If any organization fails to meet the timing requirement, tax-exempt status is only effective from the date that the application is filed (assuming that such status is granted). Delay can, therefore, have very negative implications on contributions that were made before filing, in addition to the taxation of pre-filing activity within the foundation. A Form 1023 is a complex form, which requires legal or accounting assistance with its completion. The first eight parts of the form cover basic identification information, a description of the organizational structure, confirmation that the governing documents prohibit certain activities, a description of planned activities, questions about specific activities and details concerning compensation arrangements with trustees and/or directors. The form then requires the outline of a three year budget, which for a new organization means that the creator must have given at least some thought to what the foundation plans to raise and spend in the immediate years ahead.

b. SOs. A new SO must likewise file a Form 1023 to obtain tax-exempt status. In this case, the form's requirements are even more exacting. Schedule D must be completed, which asks for information about the supported organizations and the nature of the relationship with those organizations. This information substantiates the type of SO that the new entity claims to be.

c. DAFs. There is no requirement of an initial filing with the IRS, since the DAF is not a separate legal entity. The sponsoring organization is already a qualified tax-exempt entity and nothing further is required to ensure a tax deduction and tax-exempt status at the outset.

d. **501(c)(4) Organizations**. A new 501(c)(4) organization does not have to file an application for tax-exempt status. It is allowed to self-declare as a tax-exempt entity. It may file an application for tax exemption, and if it does, it files a Form 1024. As of 2016, any new 501(c)(4) organization is required to electronically file a Form 8976 no later than 60 days after the organization is established to notify the IRS of its intention to operate as a section 501(c)(4) organization.

3. **Ongoing Administrative Costs and Management Fees**.

a. **Private Foundations/SOs/501(c)(4) Organizations**. As separate entities, each of these will have ongoing care-and-feeding expenses. The level of these expenses will depend on the complexity of the entity's activities. In addition to legal, accounting and audit expenses, and annual filing fees that may be required for corporate entities, each type of organization is likely to employ staff or incur third–party fees to assist with the investment of assets. Additionally, the organization may incur similar expenses in connection with the grant-making process, from review of applicants through to the monitoring of grants made. Each type of entity may need office space to accommodate its staff. Given that directors or trustees have full fiduciary responsibility for the entity's assets and activities, compensation may need to be paid, at least to those outside the family, and directors and officers liability insurance provided. With all of this in mind, the scale of overall funding needs to be considered. Although there are no hard and fast rules on minimum size, such separate entities are rarely started or continued in operation where the funds held are less than several million dollars.

b. **DAFs**. DAFs are not the "free-lunch" of the charitable world. However, DAFs generally pay a lower percentage of asset value in ongoing administrative expenses than any of the separate entity forms of charitable vehicles. The lowered expense level is attributable largely to the fact that expenses are incurred by the sponsoring organization and are, therefore, shared among all the DAFs that are housed within that organization. Sponsoring organizations pass along these costs to each DAF in the form of an administrative fee, but that fee, as stated previously, is typically much smaller than the amount a similarly sized private foundation, SO or social welfare organization would pay. In addition, since the fee is based on the size of the fund, it is feasible to have a DAF with a relatively modest value. In fact, most of the "commercial" DAFs require a minimum initial contribution of only $3,000 - $5,000.

4. **Ongoing Tax Filings Requirements**.

a. **Private Foundations/SOs/501(c)(4) Organizations**. Each of these separate entities must file an annual form – a Form 990-PF for private foundations and a Form 990 in other cases – providing the IRS with the information that is required of the entity under Internal Revenue Code section 6033. These are detailed filings, which are often accompanied by sizable accounting fees. In particular, SOs are subject to expanded annual reporting requirements on Form 990, as well as notice requirements requiring information and documentation be provided annually to each of its supported charities. Private foundations have enhanced accounting obligations because of the annual tax on net investment income. In addition, private foundations and some types of SO also have to deal with minimum distribution requirements and a scrutiny of activity to ensure that no breach of applicable behavioral rules under chapter 42 of the Internal Revenue Code has occurred. If any of these entities has $1,000 or more of unrelated business taxable income during its tax year, the organization must also file a Form 990-T, Exempt Organization Business Income Tax Return.

b. **DAFs**. In contrast, a donor has no annual tax filing requirements with respect to her DAF. Instead, the sponsoring organization, on Schedule D of its Form 990, provides information about each of the DAFs that it maintains in its program. The sponsoring organization must also handle any reporting of unrelated business taxable income.

5. **Enhanced Vigilance During Administration**.

a. **Distribution Requirements**.

(1) **Private Foundations and Type III Non-functionally Integrated SOs.** These entities are subject to annual distributions requirements. Failure to comply leads to excise taxes, in the case of private foundations, and loss of public charity status and default into private foundation status, with its enhanced minimum distribution requirements and excise taxes, in the case of the Type III SOs.

(2) **Other SOs.** These entities do not have minimum distribution requirements per se. However, SOs must be supportive of their supported organizations and will by definition be financing programs or providing grant support to those entities.

(3) **DAFs.** DAFs do not have a required minimum distribution amount. However, the sponsoring organizations of many DAF programs require a certain minimum activity level.

(4) **501(c)(4) Organizations.** 501(c)(4) organizations are not subject to minimum distribution requirements. The board of directors or trustees will set the distribution policy and could, without penalty, make limited or no distributions in any given year. Consistent failure, however, to make distributions or finance programs run by the entity itself may lead to an IRS challenge to the entity's classification as a social welfare organization.

b. **Self-Dealing, Automatic Excess Benefit and Prohibited Benefit Transactions**.

(1) **Private Foundations, SOs and DAFs.** Each of these entities and, in the case of DAFs, the DAF sponsoring organization, must guard carefully against a wide variety of transactions between the entity/DAF and the donor and other disqualified persons. These rules are for the most part absolute. Failure to correct can lead to punitive excise taxes on those involved in the transaction. The scope of these rules is discussed in detail above.

(2) **501(c)(4) Organizations.** In contrast, 501(c)(4) organizations are subject only to the general rule concerning excess benefit transactions with donors and other disqualified persons. This requires that it be demonstrated that the disqualified person has received a benefit from the transaction beyond what is reasonable. Transactions that involve arm's length payments of consideration or that are otherwise on arm's length terms are not prohibited.

c. **Business Holdings**.

(1) **Private Foundations and DAFs.** Private foundations and DAFs are limited in their ability to own business interests. There is a two percent de minimis exception to the rule, but otherwise these vehicles cannot own, in conjunction with all persons who are treated as disqualified, more than 20 percent of the voting stock or controlling interests in the business enterprise. Foundation managers and sponsoring organizations must carefully scrutinize what is held to avoid this rule.

(2) **SOs**. This rule also applies to all non-functionally integrated Type III SOs and Type II SOs that accept a business interest gift from someone who controls the governing body of a supported organization, or who is related to such a person.

Other SOs are not, however, limited by this rule and can own more significant stakes in businesses.

(3) **501(c)(4) Organizations.** 501(c)(4) organizations are not subject to the excess business holdings rule in any respect. In theory, therefore, a 501(c)(4) organization can own controlling interest in a business.

d. Jeopardy Investments.

(1) **Private Foundations.** Private foundations must exercise greater scrutiny of their investment holdings and investment managers since they are prohibited from participating in investments that would otherwise jeopardize the fulfillment of their charitable purposes. No investments automatically fall within this prohibition, but option strategies and margin trading will be subject to enhanced review and probably should be avoided.

(2) **DAFs/SOs/501(c)(4) Organizations.** None of these vehicles is subject to the same prohibition. However, while sponsoring organizations of DAFs frequently allow donors to select their own investment managers, managers that employ complex or high risk investment strategies are generally not permitted by the terms of the DAF program.

6. Entity Level Taxation.

a. Private Foundations. A private foundation is subject to an annual two (or in some cases, one) percent tax on its net investment income, including interest, dividends, rents and royalties, and long and short-term net realized capital gain. It will also pay regular tax on unrelated business taxable income. While the tax is minor, its application and the accounting costs of its calculation must be considered when a donor is considering entity choice.

b. DAFs. DAFs are not subject to any form of taxation at the account level. However, sponsoring organization will generally be reluctant to accept assets that generate unrelated business taxable income, since tax on such income will be paid by the sponsoring organization.

c. SOs and 501(c)(4) Organizations. SOs, of all types, and social welfare organizations do not pay entity level tax on passive income. Both forms of entity are subject only to tax on unrelated business taxable income.

7. Privacy and Anonymity.

a. Private Foundations. It is difficult to maintain privacy with a private foundation, or for an individual to make an anonymous gift through a private foundation. The private foundation's application for tax-exempt status is subject to public inspection, as are the foundation's annual Forms 990-PF. I.R.C. § 6104. With respect to the latter, a private foundation is required to provide identifying information about its contributors and that information is included within the ambit of what is subject to public inspection. I.R.C. § 6104(d)(3). Public inspection has been made all the easier in recent years by such services as GuideStar, which describes itself as the "world's largest source of information on nonprofit organizations." Among the information provided by GuideStar is each organization's application for tax-exempt status and annual tax filings. See www.guidestar.org.

b. DAFs. In contrast, a donor to a DAF may request the sponsoring organization not to disclose her identity to the organization receiving the distribution from the DAF. The receiving organization simply knows that the contribution has been made from a DAF at the particular sponsoring organization. Moreover, while sponsoring organizations are generally required to include information about individuals who contribute to DAFs on

Schedule B to the sponsoring organization's Form 990, that schedule is not subject to public disclosure. I.R.C. § 6104(d)(3).

c. **SOs**. An SO's application for tax-exempt status is subject to public disclosure. However, while an SO's Form 990 generally provides detailed information about compensation to insiders and grants, its Schedule B is also not subject to public disclosure. I.R.C. § 6104(d)(3). Given the close relationship with the supported organizations and the participation of those organizations on the board of the SO, donor anonymity is not generally a sought after characteristic when a decision is made to establish an SO.

d. **501(c)(4) Organizations**. A 501(c)(4) organization is required each year to file a Form 990 and include a Schedule B listing certain contributors. However, as in the case of DAF sponsoring organizations and SOs, the Schedule B is not subject to public disclosure. I.R.C. § 6104(d)(3). In addition, although a new social welfare organization must file a Form 8976, that form does not require information about contributors and is also not open to public inspection because it is not considered an application for tax exempt status within the meaning of Internal Revenue Code sections 6104(a)(1) and (d).

C. Scope of Philanthropic Mission.

1. Overview: What are the donor's objectives?

a. Each of the aforementioned charitable entities affords the donor the option to achieve certain objectives in her philanthropy. Each permits many decisions to be delayed, if necessary.

b. What is important to acknowledge is the limitations that are inherent in certain structures, since those limitations may guide a donor away from its use.

2. General Limitations on Activities.

a. **Private Foundations**. Although the taxable expenditure rule imposes limits on certain types of activity and distributions, as discussed generally above and in certain cases further highlighted below, private foundations can have a very broad remit and a very long life. A general mission statement outlining its area or areas of focus may be adopted and may later be changed in light of shifting circumstances and societal needs, or simply because the donor wishes to reorient her philanthropy. A foundation may confine itself to grant making activity to other organizations, run its own programs, or adopt a combination of grantmaking and separate activity. A foundation can last in perpetuity; alternatively, a donor can impose a term limit on the existence of her foundation or can choose to bring it to closure by distributing out its funds in full to other charities. The options are many and varied, which helps explain why the regulatory scheme imposed is more onerous than that applicable to other charitable structures and why the income tax deduction rules are somewhat more miserly.

b. **DAFs**. In contrast, DAFs are grantmaking structures. The contributor to a DAF cannot run programs directly through grants requested and approved by the sponsoring organization. Instead, a donor can request distributions that enable programs organized and operated by other public charities to function. In addition, depending on the sponsoring organization, a donor may have limitations on the breadth of her grantmaking advice. Some community foundations and most colleges, universities, and other public charities not solely formed or focused on running DAF programs may require that grant recommendations from some part of the account benefit the sponsoring organization itself or a particular area of focus.

c. **SOs**. A donor who establishes an SO generally has a clear objective in mind – to support a definite charity or group of charities named in the document or to support a clearly defined class of charities or a particular charitable purpose. The intended supported charities must be engaged in the process of formation of the entity and must in most cases control the entity. In all situations, the donor and her family cannot be in control; they can influence, but no more. Accordingly, this type of entity requires a degree of initial commitment and a willingness not to second-guess that commitment, which is not a requirement of certain other options. In return, the donor achieves most of the tax benefits that are available when a gift is made directly to a public charity and all control and influence is ceded. In addition, an SO is not limited to granting out funds to its supported charities. It may use its resources to carry on an independent activity or program that supports or benefits the supported charities. Accordingly, a donor or members of the donor's family can become directly involved in programmatic activities should they so wish.

d. **501(c)(4) Organizations**. While overlapping in many respects, a social welfare organization inevitably has a broader remit. The definitional and behavioral rules that apply to private foundations, donor advised funds and SOs are not carried over. The entity can do anything that ultimately acceptable as social welfare activity.

3. Geographic Limitations.

a. **Private Foundations**. There is no provision in the Internal Revenue Code or Treasury Regulations that prohibits a private foundation from making a grant to an overseas charity. So long as the grant does not constitute a taxable expenditure, it should constitute a qualifying distribution under Code section 4942 and count towards required minimum annual distributions. As outlined above, a taxable expenditure is any amount paid for purposes other than charitable purpose, or as a grant to another organization, unless the latter is a public charity (including an operating foundation), or unless expenditure responsibility (ER) is exercised with respect to the grant.

(1) **Definition of ER**. When required, ER has five basic elements:

(a) The foundation must conduct a pre-grant inquiry complete enough to give "reasonable man assurance" that the foreign charity will use such grant for charitable purposes. The pre-grant inquiry includes questions regarding the character/tax status of the grantee, the names of officers and managers, the suitability of the grantee for funds and the mechanisms to satisfy accountability.

(b) The foundation and grantee must sign a written grant agreement, which includes provisions for the return of grant funds to the extent that the grant is not used for the stated purpose. The foundation must pay close attention to any restrictions that might apply in the country where the foreign organization is located that would prevent the return of funds.

(c) The grantee must maintain full and clear record keeping. This may be challenging, based on either customs in the country of operation or physical constraints present in the locale.

(d) The grantee must provide at least annual reports on the use of the funds, its compliance with the grant terms and its progress towards fulfilling the purposes of the grant.

(e) Finally, the foundation must report any ER grant on its Form 990-PF. Treas. Reg. § 53.4945-5(b).

(2) **When not required**. ER is not required in the following circumstances. Rev. Proc. 2017-53, 2017-40 I.R.B., superseding Rev. Proc. 92-94, 1992-1 C.B. 507.

(a) If the grant is made to the foreign governmental entity. The focus must then be upon documenting and ensuring that the grant is for a charitable purpose. Treas. Reg. § 53.4945-5(a)(4)(iii).

(b) If the foreign grantee has an IRS determination letter that it is a publicly supported charity. I.R.C. § 4945(d)(4)(A).

(c) If, in the reasonable judgment of the foundation manager, the foreign grantee has established that it is the equivalent of a publicly-supported organization and the supporting data in favor of such determination is generally in the form of a current opinion from a qualified tax practitioner, including a CPA or an enrolled agent. Treas. Reg. § 53.4945-5(a)(5).

b. **DAFs**. Sponsoring organizations may approve grant recommendations to U.S. charities that perform work overseas, to U.S. charities that are established to support a certain foreign charity (frequently referred to as a "friends of" organization) and foreign charities. Sponsoring organizations must, however, exercise ER with respect to grants to foreign charities or make an equivalency determination in the same manner as a private foundation to avoid an excise tax. I.R.C. § 4966(c)(1)(B)(ii); Notice 2006-109, 2006-51 IRB 1121; and Rev. Proc. 2017-53, 2017-40 I.R.B. Sponsoring organizations that permit overseas grant recommendations ordinarily require an additional administrative fee to cover their overhead in satisfying these requirements. It should be noted that some sponsoring organizations will not undertake the additional administrative overhead and will not permit grants to overseas charities. In contrast, other sponsoring charities focus on their ability to facilitate grants outside the U.S.

c. **SOs**. Type I and Type II SOs are not precluded from supporting foreign charities that have received IRS determination letters as a public charity or that otherwise meets the requirements of Internal Revenue Code section 509(a)(1)-(2). Internal Revenue Manual 7.20.7.2.4.1(1)(D). However there is a delicate balance between the required close relationship with a foreign supported organization and independence (i.e., the discretion and control of the funds) to avoid the argument that the SO functions as an inappropriate conduit to the foreign supported organization. In all events, Type III SOs are prohibited from supporting any charity that is not a U.S. domestic entity.

d. **501(c)(4) Organizations**. There are no geographic limitations on the grantmaking from a social welfare organization.

4. **Grants to Individuals**.

a. **Private Foundations**.

(1) **Grants for travel, study and other similar purposes.** Private foundations may not make a grant to an individual for "travel, study or other similar purposes" unless the grant meets certain requirements and the foundation's grant procedures have been approved in advance by the IRS. For example, a private foundation that wants to award scholarships to students for college tuition, grants to scholars to conduct academic research or prizes to artists or writers to improve or enhance their artistic or literary skills or talent must establish specific procedures for the grant program and obtain the approval of the IRS for such procedures before awarding any such scholarships, grants or prizes. To obtain IRS approval, the grant procedures must be objective and nondiscriminatory and must meet the following requirements:

(a) Grantees must be selected from a group large enough to constitute a charitable class.

(b) The criteria for selection of grantees must be reasonably related to the purposes of the grant.

(c) Persons selecting grant recipients must not be in a position to derive a private benefit, directly or indirectly, from the selection of grantees.

(d) Grants must be made according to a procedure that is reasonably calculated to result in performance by grantees of the activities that the grants are intended to finance.

(e) The foundation must obtain reports from the grantees to determine whether they have performed the intended activities.

(f) A grant to an individual may be renewed if the grantor has no information indicating that the original grant was used for any purposes other than the purpose for which it was made, all reports required at the time of renewal have been submitted and any additional criteria and procedures for renewal are objective and nondiscriminatory.

(g) Furthermore, the foundation is required to file reports with the IRS on its annual Form 990-PF concerning its grantmaking activities. In summary, appropriate grant procedures require the foundation to establish selection procedures, monitor the recipients, and report to the IRS.

(2) **Other grants to individuals**. Advance IRS approval of grant procedures is not required for other types of grants, such as grants to indigent individuals to enable them to buy basic necessities or for prizes that (i) are awarded in recognition of past achievements, (ii) are not intended to finance any future activities of an individual grantee and (iii) do not impose any conditions upon the manner in which the prize funds may be expended by the grantee. For example, a foundation may award prizes to accomplished writers in recognition of their literary achievements without advance IRS approval so long as the writers may use the prize funds in any way they desire. Grant procedures not subject to advance IRS approval still must be objective and nondiscriminatory, and the grants must not run afoul of other restrictions on private foundations, such as the prohibition against self-dealing, or the general prohibitions against private benefit and inurement applicable to all Internal Revenue Code section 501(c)(3) organizations.

b. **DAFs**. DAFs are not permitted to make distributions to individuals. Sponsoring organizations may only approve and make grants to other charitable organizations. Of course, those organizations can make grants to individuals in furtherance of the organization’s charitable purpose.

c. **SOs**. SOs can be organized to run programs for their supported organizations and those programs can make grants to individuals who are members of the charitable class benefitted by the supported organization. Following the general rule applicable to all public charities, the class of individuals must either be large or indefinite, so that aid to members of the class is viewed as aid to the community as a whole. If the persons potentially aided do not constitute an adequate charitable class, both the SO and the supported organization are at risk of losing their charitable status, as they would not be organized and operated exclusively for charitable purposes. Where SOs support programs to grant scholarships, the private foundation rules, while not legally applicable, provide useful guidance in how the scholarship program should be administered.

d. **501(c)(4) Organizations**. Again, there is nothing inherent in the concept of social welfare that would inhibit appropriate direct grants to individuals.

5. **Political Distributions and Grants**.

a. **General**. This is a controversial area. The rules seem straightforward in theory and in word, but can be convoluted and obscure in practice. They require an appreciation of the difference between political campaigning, lobbying and advocacy.

b. Political Campaign Activities.

(1) All section 501(c)(3) organizations are prohibited absolutely from directly or indirectly participating in, or intervening in, any political campaign on behalf of (or in opposition to) any candidate for elective public office. Violating this prohibition may result in denial or revocation of tax-exempt status and the imposition of excise taxes under Internal Revenue Code section 4955. Contributions to political campaign funds or public statements of position (verbal or written) made on behalf of the organization in favor of, or in opposition to, any candidate for public office violate the prohibition. Certain activities or expenditures may not be prohibited depending on the facts and circumstances. For example, certain voter education activities (including presenting public forums and publishing voter education guides) conducted in a non-partisan manner do not constitute prohibited political campaign activity. In addition, other activities intended to encourage people to participate in the electoral process, such as voter registration and get-out-the-vote drives, would not be prohibited political campaign activity if conducted in a non-partisan manner. On the other hand, voter education or registration activities with evidence of bias that would favor one candidate over another, oppose a candidate in some manner or have the effect of favoring a candidate or group of candidates, are likely to constitute prohibited participation or intervention. See generally Rev. Rul. 2007-41, 2007-1 C.B. 1421.

(2) 501(c)(4) organizations are not similarly constrained. However, the organization's primary activity cannot be partisan political activity; if it is, the organization will lose its status as a social welfare organization. Rev. Rul. 81-95, 1981-1 C.B. 332. In addition, a 501(c)(4) organization that has investment income may be subject to tax on expenditures for its partisan political activities under Internal Revenue Code section 527.

c. Lobbying.

(1) Section 501(c)(3) organizations may, in general, engage in some lobbying activities. In general, lobbying is any attempt to influence legislation by stating a position on specific legislation to legislators or other government employees who participate in the formulation of legislation or urging the general public or a specific group to contact their legislators with a position on specific legislation. Public charities may engage in a limited amount of legislative lobbying under either the substantial part test or by electing to operate such activities under an expenditure test set forth in Internal Revenue Code section 501(h). The substantial part test is evaluated on the basis of the facts and circumstances, such as the time and the expenditures devoted to lobbying by the organization.

(2) This general rule applies to SOs and the sponsoring organization of a DAF program, in addition to other forms of public charity.

(3) It does not apply, however, to private foundations. Any amount paid or incurred by a private foundation for lobbying purposes is considered a taxable expenditure under Internal Revenue Code section 4945.

d. Advocacy.

(1) All 501(c)(3) organizations, including private foundations, can engage in advocacy. In theory, there are no limits on how much can be spent on advocacy activities.

(2) What distinguishes advocacy from lobbying? Here is a list of activities that are generally considered to fall on the side of advocacy: influencing the adoption of agency regulations that interpret existing laws; developing relationships with

legislators or assisting grantees to build and sustain such relationships; educating legislators about a broad range of issues, without referencing a specific legislative proposal; meeting with legislators to discuss the scope and impact of the foundation's work; offering technical assistance to legislators in response to a written request for oral or written testimony from a legislative body; convening other nonprofits and individuals to discuss a broad topic (e.g., how to address climate change); participating in an amicus brief, filing a lawsuit to challenge or enforce a law, or funding litigation that challenges a law's constitutionality; influencing special purpose bodies with limited jurisdiction (e.g., school boards or housing authorities); conducting public education campaigns that do not include calls to action or mention specific legislation; producing non-partisan analysis studies or research reports that are widely distributed and provide adequate information to permit the reader to draw her own conclusions, even if the report contains specific legislative conclusions; and attempting to influence legislation that impacts the private foundation's existence, its tax-exempt status, or the deductibility of contributions.

D. Control and Intent

1. Private Foundations.

a. A private foundation allows the donor to retain complete control over the management and investment of assets contributed. The donor can determine the identity of grant recipients. The donor can decide how the foundation board (if there is to be a board) should be structured and may retain authority over the appointment and tenure of directors or trustees, in addition to defining the scope of their powers with respect to particular decisions. In addition, the donor can take steps to memorialize and institutionalize intentions and mission by setting forth a clear mission statement or other set of guiding principles. And the donor can also change her mind.

b. This autonomy and flexibility is a double-edged sword. The flexibility that the donor has during lifetime may be exercised by those who succeed as trustees or directors after her death to undermine her mission and intentions.

c. Facilitating control while locking in mission or intent requires consideration of the appropriate structure for the foundation as either a trust or a non-profit corporation. In general, a trust can be more restrictive, limiting the activities of the foundation to those enumerated in the trust instrument. The trust instrument can specify the circumstances, if any, in which changes may be made. Otherwise, a formal departure from the terms of the trust will usually require court involvement and oversight, and perhaps the participation by the state attorney-general. In such circumstances, changes may require a showing that the original purpose for the foundation has become impracticable or impossible to perform.

d. Alternatively, a private foundation may be structured as a corporation, with a charter or bylaws and a board of directors. This structure allows for greater flexibility. Such a charter or bylaws are not set in stone; in fact, all that may be required under state law to amend a foundation's charter or bylaws is a vote by the majority of the board. This may be detrimental to the long-term preservation of the donor's intent. To address that concern, a donor could establish a corporate structure with members and permit the members in turn to elect and remove directors. Of course, the members themselves may decide to veer away from the donor's goals, but the focus on a smaller and more select group of influencers may work to sustain the original mission. Alternatively, a donor could think more expansively and require, for example, that a percentage of the foundation's board members be made up of individuals from third-party organizations selected by the donor. The donor could cement her philanthropic vision by selecting organizations that share the vision. This may be particularly effective if there is concern that younger generation family members are not as invested in the donor's goals.

2. **DAFs**.

a. Once a donor contributes to a DAF, the donor no longer has legal control over the funds. The funds belong to the sponsoring organization. The role retained by the donor is advisory only; the donor cannot exert further influence. This means that a sponsoring organization could disregard a donor's recommendation for a grant recipient. Such disregard is, however, rare and probably arises only when the advice proffered would lead to a sanctioned distribution or would violate the terms of the gift agreement.

b. Many DAF programs extend the scope of the donor's advisory reach into the area of investments. A donor may be allowed to select any manager of her choice to run the account. Alternatively, the donor may be presented with a range of options and be asked to express a preference as to which approach should be adopted for her account.

c. Not all DAF programs are alike, particularly when it comes to the donor's ability to appoint successor advisors and the successor advisors' ability to perpetuate their succession. A donor who wants a DAF account to continue in existence long after her passing with input from family or other individuals needs to review carefully what a particular program permits.

3. **SOs**.

a. To qualify as an SO, the organization must meet one of the three legal tests as described above in Section V, each of which ensures that the public charity receiving the support from the SO has control or influence over the responsiveness of the SO to its needs, and each of which requires that the donor and members of the donor's family do not maintain such control. It is unavoidable, therefore, that the supported organizations will guide the grantmaking and philanthropic mission of the SO, and will have a controlling voice in day-to-day operations and the investment of the SO's assets.

b. However, the other side of this fact can work in favor of a donor looking to maintain control over her philanthropic intent. Choosing an organization to support which has a philanthropic mission in line with a donor's intent may solidify the donor's big picture goal and maintain that intent.

c. If a supported organization itself takes a different course, contrary to the donor's goals, the donor may be able to protect her mission by inserting some type of fallback strategy. For example, the governing documents might provide for the funds to support an alternative organization in the same field if the current supported organization changes its focus.

4. **501(c)(4) Organizations**.

a. Consideration of the use of social welfare organizations to fulfil the philanthropic goals of a single donor or a small group of donors is a recent phenomenon, attributable in large measure to the clarifying legislation enacted at the end of 2015 concerning gift tax treatment of contributions to 501(c)(4) organizations. That said, many of the considerations expressed above will be applicable to these entities, which can be established not only as corporations but also as trusts.

E. Business Interests and Charitable Planning.

1. **Excess Business Holdings**.

a. Private foundations, DAFs and certain types of SO are severely constrained with respect to the amount of a business they may own due to the excess business holdings rule. Unless the amount transferred is relatively modest (less than two percent of the voting or control interest), it may not be possible to use any of these entities for a charitable gift of a business interest that will be retained by the organization where the donor or members of her family otherwise control the business.

b. Therefore, in the case of a family controlled business, the options will be as follows:

(1) Donate, but plan to redeem or otherwise dispose of the interest within five years of the gift (ten years, if an extension is granted, which is discretionary and accordingly should not be assumed).

(2) Use a Type I or Type III functionally-integrated SO to receive the gift (or in appropriate circumstances a Type II SO), although control over the gifted stock is then ceded to the supported charities. A donor may not want outside scrutiny of her business operations.

(3) Forego the income tax deduction and use a 501(c)(4) social welfare organization to hold a larger than de minimis interest in the business.

c. A donor may wish to consider a combination of entities for gifts of business interests, particularly where ongoing control is critical. Consider the following approach:

(1) Structure the business so that its share capital or ownership interests consist of both voting and non-voting stock or interests. Have a significant majority of the economic value of the business tied-up in the non-voting stock or interests.

(2) Contribute a significant block (80 percent) of the voting stock to a 501(c)(4) organization controlled by the donor or members of her family. That entity does not appear to constitute a disqualified person for purposes of the excess business holdings rule when analyzing the aggregate holdings of an entity subject to the rule. Remember, however, that the donor should not remain in control of the social welfare organization (at least with respect to the closely held business interest) or be a member of the board (unless she is excluded from participating in decisions that affect property that she has contributed) as of the date of her death to avoid an estate tax problem.

(3) Contribute all the non-voting stock and the remaining voting stock to a private foundation. Such a transfer could be made during lifetime – producing potential income tax benefits – or be made at the donor's death. Such an arrangement would appear to be viable and not sanctioned by chapter 42 of the Internal Revenue Code.

2. **Program Restraints**. In addition, certain sponsoring organizations of DAF programs have limitations on the type of property that they will accept into a DAF account. Some will take only cash and marketable securities. This may limit even a de minimis gift of a business interest to a DAF. Others will want to ensure that there is a clear exit strategy for the sale of the business interest, again even if the interest transferred is de minimis and does not present an excess business holdings issue.

3. **Unrelated Business Taxable Income**. All tax-exempt organizations are subject to tax on unrelated business taxable income. This can be particularly problematic where a business is organized as a pass-through entity such as a partnership. If a tax-exempt organization is a partner in a partnership that regularly carries on a trade or business that is unrelated to the exempt purpose of the organization, the organization must include its share of partnership gross income from the unrelated trade or business and its share of partnership deductions directly connected with such income in its calculation of unrelated business taxable income. Passive income not earned in connection with the unrelated trade or business at the partnership level does not generally fall within this rule, however, and retains its tax-free character when attributed through to the tax-exempt partner.

a. **Earnings from S corporations**. The passive income exception outlined above does not apply when the business is organized as an S corporation. The charitable shareholder's entire share of S corporation earnings and gains is automatically treated as unrelated business taxable income subject to the unrelated business income tax, even if the income would otherwise be nontaxable under regular rules (such as passive dividend, interest, rental, or capital gain income). IRC § 512(e). The charitable shareholder will be subject to income tax on its share of S corporation income without regard to actual distributions, if any, from the corporation.

b. **Sale of S Corporation stock**. Capital gain realized on the sale of the S corporation stock is also taxable as unrelated business taxable income. IRC § 512(e)(1)(B)(ii). There is an exception if all of the stock is sold in a transaction (such as to a public company) that terminates the S election. In that case, the election is deemed terminated on the day before the sale, and because gain on the sale of C corporation stock is not treated as unrelated taxable business income under the usual rules, there is no tax.

c. **Minimizing the tax liability**. Given the breadth of potential tax liability when S corporation stock is donated, the usual inquiry focuses on limiting the tax (as opposed to its avoidance). Such an analysis may involve little more than the consideration of whether it would be better to organize the charity in trust or corporate form. Charitable corporations and charitable trusts are now subject to income tax at roughly the same top bracket, but trusts reach the top bracket much quicker (at taxable income of $12,700). However, charitable trusts are entitled to the same maximum rate on capital gain income as individual taxpayers, whereas corporations must pay income tax on capital gain at the standard corporate rate. For these reasons, the conventional wisdom is that a charitable trust is preferable for income tax purposes only if it is expected that the stock will be sold relatively soon. Otherwise, so the conventional wisdom goes, it is usually better to use a corporation.

d. **Can an SO help**? Suppose the donor wants to contribute S corporation stock not to her own charity but to a public charity organized as a corporation. The public charity and the donor agree that the stock will be redeemed over time. Both are looking for ways, however, to reduce the tax-exempt organization's tax liability, and therefore have a larger fund to effect the intended charitable objectives, particularly given that the donor's basis in the stock is almost zero. In this instance, the charity and the donor might consider establishing an SO in trust form. If the SO receives the gift and then makes sales of the stock, the SO will be entitled to claim a deduction for unrelated taxable income purposes for its upstream grants made from the sale proceeds to the supported organization under Internal Revenue Code section 512 (b)(11). Under that provision, the trust form SO can claim a deduction in the current year up to 50 percent of its adjusted gross income. Accordingly, it can effectively reduce its tax liability – already at the preferential capital gain rate – by up to half. In contrast, if the SO were formed as a corporation under this technique, the capital gain would not be subject to preferential rates and the SO would be limited under Internal Revenue Code section 512(b)(10) to a deduction for the upstream grant of no more than 10 percent of its unrelated business taxable income in the year of realization.