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MULTIPLE – ENTITY DONORS: HOW TO WORK EFFECTIVELY WITH TODAY'S SOPHISTICATED PHILANTHROPIST

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MULTIPLE – ENTITY DONORS: HOW TO WORK EFFECTIVELY WITH TODAY'S SOPHISTICATED PHILANTHROPIST[1]

I. INTRODUCTION

A. Scope of Discussion

Sophisticated active philanthropists have found that a single private charitable fund such as a private foundation often is not able to meet all of their charitable needs. These philanthropists have established multiple charitable funds such as a private foundation and a donor advised fund to accomplish all of their goals. Limitations impose by the Pension Protection Act on donor advised funds and supporting organizations have pushed more donors to establish multiple charitable entities to accomplish a range of charitable purposes. A gift planning officer who understands the capabilities and limitations of the various funds will be able to work more effectively with multiple entity donors. The first step in the analyses is to determine which of the entities can legally fund the donor's charitable interest. If multiple funds can provide the desired funding, then the donor will want to use the fund that is least effective for the donor's other philanthropic interests.

II. DONOR FUNDS

A donor fund is established by an outright gift to the sponsoring charitable organization, which has legal control over the fund. Treas Reg §1.170A–9(e)(11)(ii). The charitable organization agrees to separately account for the contribution in the donor fund and to allow the donor to offer advice regarding the fund. The sponsoring organization will usually honor donor recommendations that fall within the sponsoring organization's published guidelines.

Donor funds are simple to establish, and are usually created by a short agreement with the sponsoring charity. Because donor funds are maintained by public charities, donors receive the most favorable tax treatment for gifts to donor funds.

Other than donor-advised funds (as defined in IRC §4966 and discussed in more detail below), donor funds operate under the limitations applicable to public charities, not the more restrictive rules applicable to private foundations. Used creatively, donor funds can be powerful tools for accomplishing philanthropic goals.

A. Types of Donor Funds

1. Donor-Advised Funds

The most common type of donor fund is the donor-advised fund. A donor to a donor-advised fund may advise the sponsoring charity on use of the fund. Alternatively, the donor may name another person or group to advise the charity. The advice, however, is not legally binding on the charitable organization, which has ultimate control over the distribution of the funds. *See Lapham Found. v Commissioner* (6th Cir 2004) 389 F3d 606. However, while the donor's

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advice is not legally binding, a charity that maintains a donor-advised fund will almost always follow any advice to make a distribution for a legitimate charitable purpose. Charities that maintain donor-advised funds must have the trust of donors that the charity will follow their advice. A donor may make grants to any number of charitable organizations over almost any time frame from a donor-advised fund. A more detailed discussion on donor-advised funds is included below.

2. Field-of-Interest Funds

Another type of donor fund is the field-of-interest fund. A donor establishing a field-of-interest fund designates a charitable area such as cancer research, after-school programs, or performing arts to be supported by the fund. Periodically, the charity sponsoring the field-of-interest fund selects one or more charities that have programs within the donor's field of interest to receive distributions from the fund. These funds allow a donor to support a particular area of interest with the sponsoring charity selecting and reviewing charities that work in the area. This structure makes the field-of-interest fund flexible, allowing the sponsoring charity to select the best charities each year to meet the donor's objectives, with the option to include new charities formed after the donor's death.

Unlike the advice for a donor-advised fund, the designation of a field of interest can be legally binding on the charitable organization sponsoring the field-of-interest fund. Treas Reg §1.507–2(a)(8)(v), Example 3; s*ee* Cal Bus & Prof Code §17510.8. The charity may not distribute outside the designated field unless it becomes impossible or impractical for the charity to stay within the field of interest. If it becomes necessary for the charity to change the field of interest, the charity must find and select a field as close as possible to the donor's original designation. The extent of a charity's discretion in changing a field of interest and the procedure it must follow depend on the charity's governing instrument, which may expand its variance power.

3. Scholarship Funds

A donor interested in offering scholarships without being tied to a particular educational institution may form a scholarship fund. The donor can create the scholarship criteria applicable to a large enough group of students to constitute a charitable class and formulate objective criteria so that scholarships are awarded in a nondiscriminatory manner. The donor may be part of the selection committee if desired as long as the board of the sponsoring charity controls the membership of the selection committee and the donor and related parties do not control the committee.

Although scholarships should not be awarded to the donor's family members, relatives of employees of the charity sponsoring the fund may be eligible to receive scholarships. *See* IRS Letter Ruling 7945108.

4. Designated and Restricted Funds

A donor to a donor fund can impose the same legal limits on the donor fund as can be imposed on other gifts: either designating the fund for a particular purpose or restricting the spending of the fund to its income or annual return, or both. A designated fund is one that makes payments to one or more specific charities. When a fund is designated, the donor has specified a particular charitable purpose for which the fund is to be used.

The designated fund is useful when a donor wants to provide a long-term funding source to a charity but is concerned about the charity's ability to manage the funds. The sponsoring charity manages the designated fund with its pool of funds, generally distributing the earnings annually to the designated charity.

Similar to a field-of-interest fund, the designation of a specific charity to receive support is legally binding on the sponsoring charitable organization. *See* Cal Bus & Prof Code §18510.8. The charity may make distributions to other than the designated charity only if it becomes impossible or impractical to follow the donor's designation. The charity must choose a successor charity that is similar or related to the donor's original charity.

A restricted fund (also called endowment) is limited as to the amount that the charity may spend from the fund over time. A donor may restrict the spending of the fund to its income or annual return, or both. If a fund is restricted, the charity may spend only the income or earnings of the fund each year, but not the principal. Cal Prob Code §18502. If no other limitations are imposed, the charity is free to spend the income or earnings of the fund on any charitable purpose it chooses.

If a donor both restricts and designates the fund, then only the income or earnings of the fund may be spent each year, and that amount must be spent for the designated purpose.

B. Administrative Costs of Donor Funds

Organizations that offer donor funds need to recover the costs of operating the funds. Accordingly, a donor fund is generally subject to a fee of one to two percent of the value of the fund each year. The fee may be higher for a fund with a lot of grant-making activity or an administratively burdensome program like scholarships.

C. Control over Donor Funds

Initially, donor funds were governed by the community trust regulations applicable to community foundations. *See* Treas Reg §1.170A–9(e)(11). These regulations define whether a fund that is separately accounted for by a community trust will be treated as a component part of the community trust or as a separate trust that would be classified as a private foundation. Under these regulations, the sponsoring charity must control the fund's investments. The sponsoring charity also must have discretionary power to change the purpose of the fund if the original purpose becomes impractical or is no longer in accordance with community needs.

The lack of a donor's legal control over a donor-advised fund was confirmed in *Lapham Found. v Commissioner* (6th Cir 2004) 389 F3d 606. That case dealt with the qualification of a supporting organization. The court held that a donor to a donor-advised fund had no legal control over the funds, and, accordingly, a gift to such a fund is an undesignated gift that can be used by the receiving charity for any charitable purpose.

D. Definition and Characteristics of Donor-Advised Funds

The Pension Protection Act of 2006 (the "PPA") (Pub L 109–280, 120 Stat 780) defines the term "donor-advised fund" in the Internal Revenue Code and subjects donor-advised funds to certain excise taxes, among other changes, resulting in donor-advised funds being subject to several limitations. Because of these limits, it is important that the donor and charity determine whether a fund is a donor-advised fund under IRC §4966 or some other donor fund as described below. Under IRC §4966(d)(2)(A), a donor-advised fund is defined as a fund or account:

- Owned and controlled by a sponsoring organization;
- Which is separately identified by reference to contributions of a donor or donors; and
- With respect to which the donor, or any person appointed or designated by the donor ("donor advisor"), has, or reasonably expects to have, advisory privileges concerning the distribution or investment of the funds.

A sponsoring organization is defined as an IRC §170(c) organization that is not a governmental organization or a private foundation. IRC §4966(d)(1). The Bluebook prepared by the Joint Committee on Taxation indicates that an organization's general fund will not be treated as a donor-advised fund if they are not separately identified by a 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 at 342 (Aug. 3, 2006, JCX-38–06) ("Bluebook").

The term donor-advised fund does not include a fund or account (IRC §4966(d)(2)(B)):

- That makes distributions only to a single identified organization or governmental entity; or
- With respect to which a donor advises a sponsoring organization regarding grants for travel, study, or similar purposes if:
    - The donor's, or the donor advisor's, advisory privileges are performed in his or her capacity as a member of a committee whose members are appointed by the sponsoring organization,
    - No combination of donors or donor advisors (or related persons) directly or indirectly control the committee, and
    - All grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsoring organization's board of directors.

With respect to grants for travel, study or similar purposes, unlike a private foundation, the sponsoring organization is not required to have every scholarship program approved by the IRS before it can be implemented. Nevertheless, a sponsoring organization may consider seeking

IRS approval of its donor-advised funds' scholarship programs to ensure that the programs are consistent with the standards set forth in the Internal Revenue Code.

The Treasury has authority to exempt certain funds from treatment as donor-advised funds if either (IRC §4966(d)(2)(C)):

- The fund or account is advised by a committee not directly or indirectly controlled by the donor or donor advisor (and any related parties), or

- The fund or account benefits a single identified charitable purpose.

The Treasury has accepted certain employer-sponsored disaster relief assistance programs from the definition of a donor-advised fund. *See* IRS Notice 2006–109, 2006–51 Int Rev Bull 1129.

1. Taxable Distributions

Internal Revenue Code §4966 imposes an excise tax on a sponsoring organization for each taxable distribution it makes from a donor-advised fund. IRC §4966(a)(1). It also imposes an excise tax on any fund manager of the sponsoring organization who knowingly agrees to make a taxable distribution. IRC §4966(a)(2). The tax on taxable distributions applies to distributions occurring in taxable years beginning after August 17, 2006. Pub L 109–280, §1231(c), 120 Stat 780.

In general, a taxable distribution is any distribution from a donor-advised fund to (IRC §4966(c)(1)):

- An individual, or

- An organization/entity if:

    - The distribution is for any purpose other than one specified in IRC §170(c)(2)(B), or

    - The sponsoring organization maintaining the donor-advised fund does not exercise expenditure responsibility with respect to such distribution in accordance with expenditure responsibility requirements for private foundations.

It is important to note that, although a grant to an individual is a taxable expenditure, certain grants to individuals are excepted from the definition of a donor-advised fund and thus, not subject to the taxable expenditure rules. Specifically, these include certain scholarship funds and certain employer sponsored disaster relief assistance programs.

A taxable distribution does not include a distribution from a donor-advised fund to (IRC §4966(c)(2)):

- An organization described in IRC §170(b)(1)(A) (other than a disqualified supporting organization);

- The sponsoring organization of such donor-advised fund; or

- Any other donor-advised fund.

A "disqualified supporting organization" includes a (IRC §4966(d)(4)):

- Type III supporting organization that is not functionally integrated (*i.e.*, the activities of the supporting organization are related to performing the functions of, or carrying out the purposes of, the supported organizations); and

- Any Type I, Type II, or functionally integrated Type III supporting organization in which the donor or donor advisor (and any related parties) directly or indirectly controls a supported organization of the supporting organization.

Types of supporting organizations are discussed more fully below.

2. Prohibited Benefits

Internal Revenue Code §4967 imposes an excise tax of 125 percent if a donor, donor advisor, or a person related to a donor or donor advisor of a donor-advised fund provides advice as to a distribution from a donor-advised fund that results in any donor, donor advisor, or a person related to a donor or donor advisor receiving, directly or indirectly, a more than incidental benefit. IRC §4967(a)(1). The excise tax is imposed on any person who advises as to the distribution and any person who receives the benefit. IRC §4967(a)(1). A separate excise tax may be imposed on a fund manager who agreed to the making of the distribution. IRC §4967(a)(2). The excise tax under IRC §4967 applies to taxable years beginning after August 17, 2006. Pub L No 109–280, §1231(c), 120 Stat 780.

Based on the Bluebook, generally, a donor receives an incidental benefit if the donor receives any goods or services from the charity that would reduce the donor's income tax deduction for a payment to the charity. Accordingly, *e.g.*, if a donor is allowed to attend a charity dinner, the donor will have received an incidental benefit.

3. Excess Benefit Transactions

Under IRC §4958, certain transactions are automatic excess benefit transactions. These transactions include any grant, loan, compensation, or other similar payment from a donor-advised fund to a person who is a donor, donor advisor, or a person related to a donor or donor advisor. IRC §4958(c)(1). The *entire* amount paid to any such person is treated as the amount of the excess benefit. IRC §4958(c)(2). The requirement that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rules of IRC §4958, which provide that the excess benefit is the amount by which the value of the economic benefit exceeds the value of the consideration received. The Bluebook indicates that "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement.

Because an expense reimbursement is an automatic excess benefit transaction, a donor cannot be reimbursed from a donor-advised fund for out-of-pocket payments for fundraising event expense.

Donors who put funds for fundraising expenses into a donor-advised fund prior to the PPA have no way of pulling those funds out of the donor-advised fund. Donors who create a donor-advised fund after the PPA must be aware of this rule and reserve some of the funding to fund fundraising events, resulting in a potential trap for the unwary donor.

Additionally, donor-advised funds are subject to the generally applicable excess benefit transaction rules under IRC §4958 with respect to transactions with its disqualified persons, which include a donor, donor advisor, an investment advisor or a person related to such persons. IRC §4958(f)(1)(E), (f)(1)(F). The term "investment advisor" means, with respect to any 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 donor-advised funds (including pools of assets all or part of which are attributed to donor-advised funds) owned by the sponsoring organization. IRC §4958(f)(8).

4. Excess Business Holdings

Internal Revenue Code §4943 imposes excise taxes on the sponsoring organization for excess business holdings of a donor-advised fund. Generally, such a donor-advised fund's voting or profits interests in a business enterprise, when combined with the interests of related persons, may not exceed 20 percent. IRC §4943(c), (e). The excess business holdings rules apply to donor-advised funds for taxable years beginning after August 17, 2006. Pub L No 109–280, §1231(c), 120 Stat 780. A donor-advised fund can follow the transition rules that applied to private foundations when IRC §4943 was enacted in 1969. IRC §4943(e)(3).

5. Grants to Supporting Organizations

Grants from donor-advised funds are prohibited to (IRC §4966(c)(2)):

- Type III SOs that are not functionally integrated with the supported organization; and
- Any Types I, Type II or functionally integrated Type III SO if the donor or donor advisor controls a supported organization unless the sponsoring organization exercises expenditure responsibility.

Regulations may provide other circumstances under which a distribution from a donor-advised fund to a supporting organization is not allowed. The IRS has issued interim guidance for donor-advised fund grantors when determining (i) a supporting organization grantee's type, (ii) if it is a Type III supporting organization, whether it is functionally integrated and (iii) if it is a Type I, Type II or functionally integrated Type III supporting organization, whether it is controlled. IRS Notice 2006-109, 2006-51 Int Rev Bull 1121.

E. Creating a Donor Fund

One of the great attractions of a donor fund is the simplicity of creating it. Generally, donor funds are created with a two- to three-page agreement. The agreement should include the following information:

- The name of the fund;
- The identity of the advisor and successor advisors, if any;
- Procedures to be followed when there are no more advisors;
- An explanation of what fees the sponsoring charity will pass on to the fund;
- The legal status of the funds and whether designated or restricted;
- The means of reporting fund activity to the donor; and
- How the fund will be invested.

If the donor intends any binding designation or restriction on the fund, it is important to carefully review the fund agreement to ensure that the "boilerplate" provisions do not override the legal limits that the donor intends to impose. To avoid being treated as a donor-advised fund, the donor should meet the scholarship exception to the definition of a donor-advised fund.

F. Pooling Assets of Donor-Advised Funds

Typically, the assets of donor-advised funds are pooled for investment. The sponsoring charity may give the donor the right to give advice regarding asset allocation. For example, a donor who expects to recommend distribution of the donor-advised fund over one or two years would recommend the asset allocation for the fund be ten percent cash and cash equivalents like money markets to avoid the risk of short-term market swings. A donor who wished to advise distribution of a fund over long period of time, however, would recommend an asset allocation with a high percentage of equities for growth over time.

Generally, the sponsoring charity selects the fund managers for all the asset classes available to the donor-advised funds. In limited circumstances, a donor may be allowed to recommend a fund manager for a large donor fund. If the charity uses a donor-recommended fund manager, the charity should have the power to remove the manager at will, and the manager's activities must be coordinated with the overall investment strategy of the charity. However, this would also result in the fund being treated as a donor-advised fund and subject to certain excise taxes under the Internal Revenue Code.

1. Agency Funds

A smaller charitable organization sometimes places funds with a community foundation to take advantage of the community foundation's investment management expertise and ability to pool the funds. A fund held for another charity by a community foundation is often called an agency fund. While this arrangement can be beneficial, the charitable organization considering an agency fund should fully understand the legal implications of the arrangement.

In general, the transfer of funds to the community foundation is an outright gift. In creating the fund, the charitable organization relinquishes legal control over the funds. If the charity is using funds that were contributed subject to designations or restrictions imposed by the original donors, the transfer of the funds as an outright gift to another organization may not be permissible.

2. Quasi-Endowment Funds

If an agency fund is restricted as an endowment fund, the board of the charity creating the agency fund has accomplished something that it could not do internally—create an endowment by action of the board. When a board takes unrestricted funds and treats them as endowment, the funds are only a quasi-endowment, and future boards may invade the principal of the fund.

Distributions from an endowed agency fund are limited to income, and the endowed agency fund would be restricted in the hands of the community foundation. In theory, however, the community foundation and the original charity creating the restriction could agree to remove the restriction. Accordingly, creating an endowed agency fund is not a guarantee that a future board will not invade the principal of the fund.

G. Uses of Donor Funds

Donor funds can be used in many creative ways. For example:

- A donor who needs an income tax deduction in the current year but wants more time to consider which charitable organizations will ultimately benefit from the gift can obtain a current deduction by making a gift to a donor-advised fund. In subsequent years, the donor may advise which charitable organizations should receive gifts from the donor-advised fund.

- A donor fund can be used as a memorial fund to honor a deceased individual. If only family members contribute to the memorial fund, and it is advised by family members, such a fund will be a donor-advised fund. If many non-family members contribute, however, it will not be a donor-advised fund.

- A donor fund could be an alternative wedding gift for a couple that already has a well-established household. If only family members contribute to the wedding fund, it will be a donor-advised fund, but if a large number of non-family members contribute, it will not be a donor-advised fund.

- A newly formed charitable organization awaiting its determination letter can use a donor fund to accept gifts from donors concerned about the certainty of their charitable contribution deduction.

- A donor who is interested in providing scholarships can operate the program through a donor fund, taking advantage of the sponsoring community foundation's expertise and infrastructure for granting scholarships. Additionally, the fund agreement should make clear whether the fund will be considered a donor-advised fund under IRC § 4966(d)(2). For example, the agreement should indicate whether gifts will be separately tracked in the fund by reference to specific donor and whether the donor will have advisory privileges or merely make non-binding recommendations with respect to distributions and investments of the fund's assets.

III. PRIVATE FOUNDATIONS

A private foundation is the form of private charitable organization that offers the founder the greatest degree of legal control over the organization, but it also offers the most limited tax benefits and is subject to the greatest restrictions in its operations. Additionally, contributions to private foundations are given less favorable tax treatment than contributions to public charities. IRC §170(b)(1)(B).

All charitable organizations that are exempt from tax under IRC §501(c)(3) are private foundations unless the organization meets one of the definitions of a public charity. IRC §509. Public charities include charities that are charities based on their function, such as hospitals, churches and schools. IRC §509(a)(1). In addition, organizations that receive broad public support in the form of contributions or revenue from the exempt activity of the organization are public charities. IRC §509(a)(2). Finally, organizations with a close relationship to one or more public charities called supporting organizations are public charities. IRC §509(a)(3).

It should be noted that private foundations are not really "private" at all. Private foundations must annually file a Form 990-PF federal tax return. Form 990-PF includes detailed information about the foundation, including the names and addresses of its substantial contributors. The foundation must provide copies of its last three 990-PF's to anyone who requests them. They, along with other nonprofit information, are posted on the Internet by GuideStar, at http://www.guidestar.org.

The IRS has a Web-based information tool to assist private foundations comply with federal tax rules and requirements that occur through the life cycle of their organizations. It is available online at http://www.irs.gov/charities/foundations/index.html.

A. Limitations on Private Foundations

Private foundations are subject to a number of limitations and prohibitions that are designed to prevent the tax advantages they offer from being abused. To avoid the administrative difficulty of determining whether transactions between private foundations and their insiders are fair and appropriate, Congress prohibited a number of transactions and relationships between private foundations and their major contributors and managers. While these prohibitions may simplify the tax administration of private foundations, they significantly limit the flexibility of the private foundation for charitable planning.

1. Self-Dealing Transactions with Disqualified Persons

The limitations and prohibitions on private foundations apply to "disqualified persons." Disqualified persons include:

- Substantial contributors (IRC §4946(a)(1)(A));
- Foundation managers who are the foundation's officers and directors (IRC §4946(a)(1)(B));

- Any owner of more than 20 percent of a business that is a disqualified person (IRC §4946(a)(1)(B));

- Certain family members of disqualified persons (IRC §4946(a)(1)(D)), including ancestors, children, grandchildren, and great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren (IRC §4946(d)); and

- A corporation, partnership, or trust that is 35 percent owned by disqualified persons (IRC §4946(a)(1)(E)–(G)).

If a private foundation has a large board, it can be particularly challenging to determine the identity of all the disqualified persons. In particular, a private foundation board with a number of unrelated directors may not have complete information about each director's family members and business interests.

Private foundations are prohibited from entering into self-dealing transactions with disqualified persons. IRC §4941. Self-dealing transactions include any sale, lease, or use of property for the benefit of the disqualified person. IRC §4941(d)(1)(A). Any extension of credit between a private foundation and a disqualified person is a self-dealing transaction. IRC §4941(d)(1)(B). Under the self-dealing prohibitions, it does not matter whether the transaction was beneficial to the private foundation. If, for example, a disqualified person sells publicly traded securities to a private foundation for a price below the current trading price for the stock, the transaction is still a self-dealing transaction that is prohibited.

There are a number of specific exceptions to the prohibitions on self-dealing. Among the important exceptions are that a disqualified person can provide office space to a private foundation free of rent, and a disqualified person can loan funds to private foundation for exempt purpose activities free of interest. IRC §4941(d)(2)(B);(C). In addition, disqualified persons can perform services necessary for the exempt purpose of the private foundation and receive a reasonable compensation for those services. IRC §4941(d)(2)(E).

2. Minimum Annual Distributions

Private foundations are required to make minimum annual distributions. Generally, the amount that a private foundation is required to distribute is equal to five percent of the fair market value of the foundation's noncharitable assets. IRC §4942(e). A private foundation that obtains a private letter ruling from the IRS may accumulate funds for a specifically larger future grant for a period of up to five years. IRC §4942(g)(2). For those accumulations, the amount set aside for the larger grant will count each year toward the required five percent distribution. IRC §4942(g)(1)(A). The reasonable administrative expenses of the private foundation are included in the amounts that count towards the required five percent distribution. If the private foundation distributes more than the required five percent, it can reduce its required distribution in a future year by the excess distribution. IRC §4942(i). A private foundation can carry forward an excess distribution for up to five years. IRC §4942(i)(2).

3. Net Investment Income

Although private foundations are exempt from tax under IRC §501(c)(3), they are required to pay a two percent tax on their annual net investment income. IRC §4940. If the private foundation exceeds the required minimum distribution for a year, it can reduce the two percent tax down to a one percent tax. IRC §4940(e). The increased distribution in one year, however, sets the floor for the amount that the private foundation must distribute in the following year in order to take advantage of the one percent tax rate. Accordingly, a private foundation will not likely stay in one percent tax rate over several years.

4. Interests in Business Enterprises

Private foundations and disqualified persons are prohibited from together owning large interests in business enterprises. IRC §4943. Specifically, a private foundation is prohibited from owning an interest in a corporation or partnership if the ownership interest of the private foundation, when combined with the interests held by disqualified persons, exceeds 20 percent of the business enterprise. IRC §4943(c)(2)(A). If the business is in fact controlled by another person who is not a disqualified person, the percentage that the private foundation and disqualified persons may own increases to 35 percent. IRC §4943(c)(2)(B). There is also a de minimis exception that allows a private foundation to own two percent of any business regardless of the holdings of disqualified persons. IRC §4943(c)(2)(C).

A private foundation that receives an excess business interest as a contribution has five years to dispose of it. IRC §4943(c)(6). This is often done through a redemption at market value, which must be offered to all shareholders. IRC §4941(d)(2)(F). The redemption may not be desirable, as other shareholders also will tender their shares to the company. A private foundation may not dispose of an excess business holding by selling to a shareholder who is a disqualified person, except if the sale is through an administration of an estate. Treas Reg §53.4941(d)–4.

5. Jeopardy Investments

Private foundations are prohibited from holding jeopardy investments. *See* IRC §4944. Jeopardy investments are investments that cause the foundation to lose money, thereby jeopardizing its ability to carry out its charitable purpose. IRC §4944(a)(1). The regulations state that investments are viewed in the context of the foundation's whole portfolio, and the regulations specifically identify puts, calls, and working oil and gas interests as suspect investments. Treas Reg §53.4944–1(a)(2). However, a California nonprofit public benefit corporation are subject to the investment rules imposed by the California Corporations Code which are similar to the jeopardizing investment rules imposed on private foundations. *See* Cal Corp Code § 5240.

Modern hedging strategies often use investments on the suspect list contained in Treas Reg §53.4944–1(a)(2); it is not clear how losses on these investments would be treated.

6. Compensating Family Members

Private foundation governance tends to be dominated by the members of the family that founded the private foundation. It is not unusual for a private foundation board to consist of the initial donor husband and wife and their children with no outsiders. Nor is it uncommon for one or more of the family members to provide services to the private foundation and to be paid for that work.

Compensating a family board member is problematic if the foundation is organized under the California Public Benefit Corporation Law (Cal Corp Code §§5110–6910) because not more than 49 percent of the directors may be interested directors. Cal Corp Code §5227. The attribution rules of financial interest in the Corporations Code are broader than the Internal Revenue Code and include siblings. Accordingly, if the parents and siblings are the directors, and if any one child is receiving compensation, all of the directors are considered to be interested directors.

This limitation can be avoided by incorporating in Delaware or some other jurisdiction besides California, by forming as a trust, or, if applicable, forming as a California religious corporation.

7. Taxable Expenditures

There are a number of expenditures that are prohibited to private foundations called taxable expenditures. *See* IRC §4945. Taxable expenditures include expenditures for lobbying and for scholarships and grants to individuals for travel or study unless they are part of a program that has been pre-approved by the IRS. IRC §4945(d)(3), (e). These rules require a private foundation to have every scholarship program, as well as any changes in such a program, approved by the IRS before it can be implemented. IRC §4945(g).

8. Independent Audit Committee Requirement

The Nonprofit Integrity Act (Stats 2004, ch 919) (amending and adding sections to the Uniform Supervision of Trustees for Charitable Purposes Act (Cal Govt Code §§12580–12599.7)) requires an independent audit committee for corporations holding charitable assets in California with revenues over $2 million. Cal Govt Code §12586(e)(2). The composition and permissible members of the audit committee are specified in the statute. The Nonprofit Integrity Act thus poses challenges for families that wish to maintain management of their private foundation within the family. Sometimes, it is possible to name a trusted advisor to the family to serve on the audit committee, but some advisors may be professionals who are also rendering services to the corporation. Professional advisors providing services to the foundation will not be considered independent and able to act as the audit committee. *See* Cal Govt Code §12586(e)(2).

The Nonprofit Integrity Act also requires that any private foundation holding charitable assets in California, whether a corporation or a trust, must have an audit by a certified public accountant if its revenue exceeds $2 million. Cal Govt Code §12586(e)(1). A private foundation with simple operations and modest revenue may be subject to the audit requirement if it receives a contribution of $2 million or more in one year.

9. Grants to Supporting Organizations

Grants by private non-operating foundations to certain supporting organizations do not count as qualifying distributions under IRC §4942. IRC §4942(g)(4). These supporting organizations include (IRC §4942(g)(4)):

- Type III supporting organizations that are not functionally integrated with the supported organization (*i.e.*, the activities of the supporting organization are related to performing the functions of, or carrying out the purposes of, the supported organizations); and

- Any Type I, Type II, or functionally integrated Type III supporting organizations in which a disqualified person of the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organizations.

Furthermore, such grants are taxable expenditures for both private non-operating and private operating foundations under IRC §4945 unless the foundation follows the expenditure responsibility requirements. IRC §4945(d)(4)(A). Regulations may provide other circumstances under which a distribution from a private foundation to a supporting organization is not allowed. The IRS has issued interim guidance for private foundation grantors when determining (i) a supporting organization grantee's type, (ii) if it is a Type III supporting organization, whether it is functionally integrated and (iii) if it is a Type I, Type II or functionally integrated Type III supporting organization, whether it is controlled. IRS Notice 2006-109, 2006-51 Int Rev Bull 1121.

B. Private Operating Foundations

Most private foundations make grants to other charitable organizations. Some private foundations, however, carry out their own charitable activities, such as operating a museum. These private foundations are referred to as private operating foundations. Charitable contributions to private operating foundations are treated as gifts to public charities. IRC §170(b)(1)(A)(vii).

An operating foundation is not subject to the two percent excise tax imposed on net investment income that applies to regular private foundations. IRC §4940(d). In addition, other private foundations can make grants to private operating foundations in the same manner as to public charities. IRC §4945(d)(4)(A). No expenditure responsibility is required. In all other respects, a private operating foundation is subject to the same rules as a private foundation relating to reporting, record keeping, and restrictions on activities by disqualified persons.

To qualify as a private operating foundation, an organization must satisfy two tests: the income test and an alternative test.

1. Income test

All private operating foundations must satisfy the income test. To meet the test, a private foundation must make "qualifying distributions…directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated equal to substantially all of the lesser of (a) its adjusted net income…, or (b) its minimum investment return." IRC §4942(j)(3)(A). In general, this means that the private foundation cannot simply make grants and passively support its charitable purposes. Rather, it must use its income to engage in charitable activities directly. If the private foundation makes grants to individuals, the grants can count as direct distributions if the private foundation maintains significant involvement in the programs for which it is making the grant.

In addition to amounts that the private foundation would spend directly on its charitable activities, certain other distributions qualify as direct distributions. The following are considered direct distributions (*see* IRC §4942(g)):

- Amounts paid to acquire assets held for use by the foundation as operating assets in the exempt function;

- Reasonable administrative expenses necessary to conduct the exempt function are direct even though they are not directly for the active conduct of the exempt function; and

- Amounts properly set aside for the purpose of assets to be held for direct use in the exempt function (*e.g.*, funds accumulated over several years to construct a building to be used in the exempt purposes of the foundation).

"Substantially all" means 85 percent, and as a result, a private operating foundation can only retain (or make non-qualifying grants) of up to 15 percent of the lesser of (a) the private foundation's adjusted net income or (b) its minimum investment return. IRC §4942(j)(3)(A); Treas Reg §53.4942(b)–1(c). Adjusted net income is gross income less deductions allowable to a corporation. IRC §4942(f). Gross income does not include grants received by the private foundation, but would include income from a related business carried on by the private foundation. Minimum investment return equals five percent of its assets that are not used directly in carrying out it exempt function, less acquisition indebtedness with respect to such assets.

2. Alternative Test

In addition to the income test, private operating foundations must also satisfy one of the following tests:

- **The asset test** requires that 65 percent of the private foundation's assets must be devoted directly to either (i) the active conduct of activities constituting its exempt purpose or (ii) a functionally related business. IRC §4942(j)(3)(B)(i); Treas Reg §53.4942(b)–2(a). Assets used for an exempt function include real estate, facilities, equipment, and intangible assets. Securities are generally not counted as used for exempt purposes unless the private foundation owns 80 percent of the corporation's stock. There are special rules for valuing nonmarketable assets. This test is usually appropriate if the organization has invested substantial capital in assets, typically art or real estate, which it uses in its exempt activities.

- **The endowment test** requires that a private operating foundation make direct distributions of at least two-thirds of its minimum investment return (*i.e.*, 3–1/3 percent of its assets). IRC §4942(j)(3)(B)(ii); Treas Reg §53.4942(b)–2(b). Of the three tests, this is usually the easiest to satisfy.

- **The support test** requires that (i) at least 85 percent of the private operating foundation's support, other than investment income, be from a combination of the general public and five or more exempt organizations; (ii) not more than 25 percent of support other than investment income be from any one exempt organization; and (iii) not more than 50 percent of its support is received from gross investment income. IRC §4942(j)(3)(B)(ii); Treas Reg §53.4942(b)–2(c). This test rarely applies because organizations that can meet this test usually qualify as public charities.

C. Donor-Directed Funds

A donor-directed fund is a private foundation that maintains individual donor accounts similar to donor-advised funds. *See* IRC §170(b)(1)(F)(iii). Unlike a donor-advised fund, however, the donor's directions with respect to a donor-directed fund are legally binding. Donor-directed funds are required to distribute all income annually to public charities. IRC §170(b)(1)(F)(iii). On the death of the donor or the survivor of the donor and the spouse of the donor, the entire principal of the donor-directed fund for that donor must be distributed to a public charity. IRC §170(b)(1)(F)(iii). Donor-directed funds have fallen out of favor because donor-advised funds offer the same practical benefits to donors without the disadvantages of the required annual distribution and all the restrictions of operating as a private foundation.

IV. SUPPORTING ORGANIZATIONS

A. Definition

A supporting organization ("SO") is a charitable organization operated exclusively for the benefit of one or more public charities described in IRC §509(a)(1)–(2). IRC §509(a)(3)(A). Because of its close relationship with one or more public charities, an SO is treated as a public charity. Thus, donations to SOs receive the most favorable tax treatment. SOs are not subject to as many prohibitions as private foundations.

All SOs must satisfy certain basic requirements with respect to support of the public charities and the composition of their board. Each SO must also establish a close relationship with the supported public charities in one of three different ways. IRC §509(a)(3)(C). This relationship requirement distinguishes a Type I SO from a Type II SO or a Type III SO.

Supporting organizations must be operated exclusively for the benefit of the supported public charities. IRC §509(a)(3)(A). These charities can be identified by name or, in some instances, as a class. All of the SO's distributions must be to or for the benefit of the supported public charities. For example, an organization formed to support a university could either make grants directly to the university or distribute scholarships to the students at the university.

Community foundations play an important role in an SO's obligation to make distributions to or for the benefit of its supported charities. Because community foundations support a wide variety of causes, a community foundation SO has tremendous grant-making flexibility. If an SO supports only a specific purpose charity, such as a hospital and a university, it will be able to make only distributions related to those charities and purposes.

B. Directors

Supporting organizations must satisfy certain basic requirements with respect to the composition of their board. More than 50 percent of the directors of an SO must be persons who are not disqualified persons. IRC §509(a)(3)(C). For example, a board that had two disqualified persons and two persons who are not disqualified persons would not be a legal board, but a board with three nondisqualified persons and two disqualified persons would be a legal board.

C. Types of Supporting Organizations

The relationship between an SO and its supported public charities, as defined in IRC §509(a)(3)(B), may be structured in one of three ways (Treas Reg §1.509(a)–4(f)(2)):

- The SO is *operated, supervised, or controlled by* the supported public charities (Treas Reg §1.509(a)–4(g));
- The SO is *supervised or controlled in connection with* the supported public charities (Treas Reg §1.509(a)–4(h)); or
- The SO is *operated in connection with* the supported public charities (Treas Reg §1.509(a)–4(i)).

Since the enactment of the PPA, the IRS has issued a guide sheet with an explanation that sets forth the guidelines for a determination as a supporting organization. The guide sheet and explanation can be found on the IRS's Web site at http://www.irs.gov/charities/index.html.

1. Type I Supporting Organizations

An SO that is operated, supervised, or controlled by the supported public charities is a Type I SO. A public charity is considered controlling if it appoints a majority of the voting members of the SO's board, *e.g.,* four members of a seven-member board.

In a Type I SO, not every supported public charity is required to have the right to designate a director. One organization could designate all of the directors for the public charities, or several public charities could each designate one director. As long as the charities that are designating the directors can be reasonably expected to represent the interests of all the public charities supported by the SO, the board will meet the requirements for a Type I SO.

A Type I SO is sometimes viewed as having as a parent-child relationship with the supported public charities. Certainly in circumstances when one public charity appoints the majority of the directors of the SO, the SO functions very much like a subsidiary of the public charity.It is important to note that a public charity that appoints the majority of the board of directors of the SO will be required to consolidate its accounting with that of the SO under rules promulgated by the Financial Accounting Standards Board (FASB), available on the internet at http://www.fasb.org.

2. Type II Supporting Organizations

An SO supervised or controlled in connection with its public charities is a Type II SO. A Type II SO may have the same directors as the directors of its supported public charity, or a third entity may appoint the directors of both of the SO and the supported public charity. Type II SOs are referred to as brother-sister organizations. They are typically found in healthcare systems and are not generally used by donors.

3. Type III Supporting Organizations

An SO operated in connection with one or more public charities is a Type III SO. Generally, the public charities will appoint only a minority, if any, of the board members of a Type III SO.

Unlike Type I or Type II SOs, a Type III SO is not controlled by public charities or the same persons that control the public charities. Instead, the Type III SO must demonstrate a close relationship with the supported public charities. To show this relationship, a Type III SO must satisfy two tests: a responsive test and an integral part test. Treas Reg §1.509(a)–4(i)(1).

a. Responsiveness Test

An SO can satisfy the responsiveness test in two ways. The first way requires the officers or directors of the supported public charities to have a "significant voice" in the support organization's investment policies, disposition of assets and income, and grant-making activities. Treas Reg §1.509(a)–4(i)(2)(ii)(d). The SO can meet the significant voice requirement if:

- The public charities appoint one or more directors or officers of the SO (Treas Reg §1.509(a)–4(i)(2)(ii)(a));
- An officer or director of the public charity is a director or officer of the SO (Treas Reg §1.509(a)–4(i)(2)(ii)(b)); or
- The officers and directors of the SO and the public charity maintain a close working relationship (Treas Reg §1.509(a)–4(i)(2)(ii)(c)).

The IRS has argued that, one director named by the public charities may not be sufficient to meet the test. *Roe Found. Charitable Trust*, TC Memo 1989–566. The tax court has held that, generally, one director named by the public charities will satisfy this test. *Lapham Found.*, TC Memo 2002–293, aff'd *Lapham Found., v Commissioner* (6th Cir 2004) 389 F3d 606.

Prior to the PPA, the second way in which an SO could meet the responsiveness test required that the SO be a trust under state law, that the supported public charities be identified by name, and that the public charities have the right to enforce the trust and compel an accounting. Treas Reg §1.509(a)–4(i)(2)(iii). The PPA eliminated the ability to set up such a trust as a Type III SO. Pub L No 109-280, §1241(c), 120 Stat 780. The IRS has announced that it expects that it will issue proposed regulations in the future that require all charitable trusts to meet the responsiveness test under the existing Treasury Regulations. IRS Ann 2007-87. Thus, a charitable trust would be expected to show that its trustees have a close, continuous working relationship with the officers, directors, or trustees of the publicly supported organizations it supports and that through such relationship the officers, directors or trustees of its publicly supported organizations have a significant voice in the operations of the trust. *Id.*

b. Integral Part Test

A Type III SO may meet the integral part test by (Treas Reg §1.509(a)–4(i)(3)):

- Carrying out an exempt activity of a supported public charity; or
- Making material financial payments to the supported public charities.

If the SO is carrying out an exempt activity for the public charity, it must be an activity that the public charity would carry out itself “but for” the fact that the SO is carrying out the activity. Treas Reg §1.509(a)–4(i)(3)(ii). The “but for” test is not applicable to a grant-making organization.

If an SO is satisfying the integral part test based on its financial support of the public charities, it must meet three requirements (Treas Reg §1.509(a)–4(i)(3)(iii)):

- *First*, the support organization must distribute 85 percent of its income annually to the supported public charities. The support organization’s income includes dividends, interest, and short-term capital gains.
- *Second*, with respect to one of the supported public charities, the distributions from the support organization must represent ten percent of the revenue of the supported public charity or 50 percent or more of the revenue for an important program of the supported charity. The public charity that receives ten percent of its revenue or 50 percent of the support of an important program is the attentive charity.
- *Third*, most of the income of the support organization must be distributed to an attentive charity.

A grant-making SO will not qualify as carrying out the exempt purposes of a supported public charity under the integral part test. A grant-making support organization must pass the financial support tests to satisfy the integral part test. The required annual distribution of 85 percent of the income of the support organization may be unwelcome. In addition, the attentiveness test can be difficult to satisfy unless the donor is willing to focus primarily on one supported public charity. An SO that is large relative to its supported public charities will have the best chance of satisfying the attentiveness portion of the integral part test.

c. Advantages of Type III Supporting Organizations

Donors are attracted to Type III SOs because they appear to afford the donor the greatest degree of control. The donor will be able to select a majority, if not all, of the members of the board of directors. Although a majority of the directors will need to be individuals who are not family members or employees, close advisors and trusted friends may comprise the majority of the directors of a Type III SO.

d. Disadvantages of Type III Supporting Organizations

The main drawback of a Type III SO is that the IRS subjects exemption applications for Type III SOs to a great deal of scrutiny. For an SO that is satisfying the integral part test based on its financial support of the supported public charity, the IRS will require extensive documentation of the support organization's finances and the supported public charity's finances to confirm the significance of the SO's payments to the supported public charity. The IRS does not have the same concerns with respect to Type I SOs, and a determination letter for a Type I SO is obtained relatively easily.

Type III SOs are complicated to operate because of the tests that they must continue to satisfy. Additionally, these rules have been further complicated since the enactment of the PPA which is discussed more fully below.

D. Limitations on Supporting Organizations

Over the past several years, the IRS has expressed concerns that SOs in general, and Type III SOs in particular, have been abused by taxpayers. In response, Congress applied a number of the rules applicable to private foundations to SOs in the PPA.

1. Rules Applicable to Type III Supporting Organizations

a. Responsiveness Information

Type III SOs must provide to each of its supported organizations information that the IRS will require to ensure that the organization is responsive to the needs or demands of the supported organization. IRC §509(f)(1)(A).

b. Foreign Supported Organizations

Type III SOs cannot have a foreign supported organization. IRC §509(f)(1)(B)(i). Transition rules apply for existing SOs that support a foreign organization. *See* IRC §509(f)(1)(B)(ii).

c. Charitable Trusts

After the PPA, a charitable trust that is a Type III SO no longer qualifies as a Type III SO solely because it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting. Pub L No 109–280, §1241(c), 120 Stat 780.

d. Payout Requirements

The Department of the Treasury is required to issue regulations to require distributions of a percentage of either income or assets of the Type III SO to its supported organizations. Pub L No 109–280, §1241(d), 120 Stat 780. The intent is to require that a "significant amount" is paid to the supported organization. Bluebook at 360. There is an exception for "functionally integrated" Type III SOs. Pub L No 109–280, §1241(d), 120 Stat 780.

“Functionally Integrated” Requirements. The PPA distinguishes between functionally integrated and non-functionally integrated Type III SOs. Pub L No 109-280, §1241, 120 Stat 780 (2006). These two new categories appear to reflect the distinction drawn in the existing Treasury Regulations between those organizations that meet the integral part test by meeting the “but for” test and those that meet the integral part test by meeting the “attentiveness” test. IRS Ann 2007-87. Note that a grant-making Type III SO will not be considered functionally integrated with its supported organization because it cannot meet the “but for” test.

Recently, the IRS has announced that it expects that it will issue proposed regulations in the future that require all Type III SOs to meet the responsiveness test under the existing Treasury Regulations. *Id.* In addition, it also expects that Type III SOs that are functionally integrated will be required to meet (*Id.*):

- the “but for” test under the existing Treasury Regulations;

- an expenditure test that will resemble the qualifying distributions test for private operating foundations (*i.e.*, the SO must use substantially all of the lesser of (i) its adjusted net income or (ii) five percent of the aggregate fair market value of all its assets (other than assets that are used, or held for use, directly in supporting the charitable programs of the SOs) directly for the active conduct of activities that directly further the exempt purposes of its supported organizations); and

- an assets test that will resemble the alternative assets test for private operating foundations (*i.e.*, the SO must devote at least 65 percent of the aggregate fair market value of all its assets directly for the active conduct of activities that directly further the exempt purposes of its supported organizations).

Proposed Payout Requirements. Recently, the IRS issued a notice describing the contents of proposed regulations under the PPA that will include the payout requirements for Type III SOs that are not functionally integrated. Under the proposed regulations, the payout requirement for a non-functionally integrated Type III SO will be five percent of the fair market value of its assets, a methodology currently applicable to private foundations. IRS Ann 2007-87. Fair market value for this purpose is expected to be the average fair market value of the assets during the taxable year. *Id.* The private foundation rules provide that you take the monthly average fair market value of the assets for the year and distribute five percent of that amount within twelve months of year end. IRC §4942. In other words, you have up to one year after year end to make the required distributions. Distributions exceeding five percent can be carried forwarded for up to five years. *Id.* The IRS expects that amounts paid by an organization to accomplish the exempt purposes of its supported organizations will be considered as distributed to or for the use of its supported organization. IRS Ann 2007-87.

The proposed regulations will clarify that an organization that would otherwise be classified as a Type III SO, but either does not establish that it is functionally integrated or does not satisfy the payout requirement for non-functionally integrated organizations in a taxable year, will be classified as a private foundation. *Id.*

Note that an SO that is formed to holds assets for the supported public charity may find meeting the definition of a functionally integrated Type III SO difficult and the payout requirements onerous especially if it does not hold liquid or income-producing assets.

e. Limitation on Number of Supported Organizations

The IRS has indicated that the number of supported organizations that a non-functionally integrated Type III SO can support may be limited to five organizations in the future. IRS Ann 2007-87.

2. Contributions to Type I and III Supporting Organizations

Type I and III SOs may not accept any gifts or contributions from any person who directly or indirectly controls the governing body of a supported organization. IRC §509(f)(2). Additionally, no charitable contribution deduction is allowed for gifts to donor-advised funds operated by a Type III SO that is not functionally integrated. IRC §170(f)(18).

3. Excess Business Holdings of Type II and III Supporting Organizations

Existing private foundation excess business holdings rules apply to Type III SOs that are not functionally integrated with the supported organization, and to Type II SOs if the supported organization is controlled by the SO's donors. IRC §4943(f). Generally, such SOs voting or profits interests in a business enterprise, when combined with the interests of disqualified persons, may not exceed 20 percent. IRC §4943(c). The excess business holdings rules apply to taxable years beginning after August 17, 2006. Pub L No 109-280, §1243(b), 120 Stat 780. An SO can follow the same transition rules that applied to private foundations when IRC §4943 was enacted in 1969. IRC §4943(f)(7).

4. Rules Applicable to All Supporting Organizations

a. Excess Benefit Transactions

Any grant, loan, compensation, or other similar payment provided by an SO to a substantial contributor, a family member of the substantial contributor, or a business they control is treated as an automatic excess benefit transaction. IRC §4958(c)(3)(A)(i)(I). Furthermore, any loan to a disqualified person is an automatic excess benefit transaction. IRC §4958(c)(3)(A)(i)(II). The *entire* amount paid to any such person is treated as the amount of the excess benefit. IRC §4958(c)(3)(A)(ii).

The requirement that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rules of IRC §4958, which provide that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received. The Bluebook indicates that "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. There are exceptions for substantial contributors or other disqualified persons who are public charities. IRC §4958(c)(3)(C)(ii). *See* Bluebook at 342. The automatic excess benefit transactions rules are effective for transactions occurring after July 25, 2006 (with certain transition rules which are set forth in IRS Notice 2006–109, 2006–51 Int Rev Bull 1129). Pub L No 109–280, §1242(c)(2), 120 Stat 780.

Additionally, persons who are disqualified persons with respect to an SO are also disqualified persons with respect to the supported organizations under the general excess benefit rules. IRC §4958(f)(1)(D). Organization managers who knowingly participate in the transaction are subject to excise tax as well. IRC §4958(a)(2).

b. Distributions to Supporting Organizations

From Private Foundations. If distributions are made by a private non-operating foundation to (i) Type III SOs that are not functionally integrated with the supported organization, or (ii) any Type I, Type II, or functionally integrated Type III SO where a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization of the SO, then the foundation must exercise expenditure responsibility, IRC §4945(d)(4). Additionally, for all private foundations, distributions to such SOs will not count as a qualifying distribution under IRC §4942. IRC §4942(g)(4). Regulations may provide other circumstances under which a distribution from a private foundation to an SO is not allowed.

From Donor-Advised Funds. Grants from donor-advised funds are prohibited to (i) Type III SOs that are not functionally integrated with the supported organization, and (ii) any Type I, Type II, or functionally integrated Type III SO if the donor or donor advisor controls a supported organization or the Treasury determines by a rule that a distribution is inappropriate. IRC §4966(c)(2).

From a Retirement Plan. For 2006 and 2007, persons who reached 70½ years of age could exclude from income up to $100,000 per year in retirement plan assets if contributed to a qualifying charity. An SO was not a qualifying charity for this purpose. IRC §408(d)(8).

E. Reclassification as Public Charity

An SO can seek to change its public charity classification from an IRC §509(a)(3) organization to an IRC §509(a)(1) or (a)(2) organization for reasons related to changes made by the Pension Protection Act of 2006 (Pub L No 109–280, 120 Stat 780) by submitting a written request for reclassification to the IRS pursuant to Rev Proc 2006–4, 2006–1 Int Rev Bull 132.

V. ESTABLISHING AND MAINTAINING PRIVATE CHARITABLE ORGANIZATIONS

A. Pledge Agreements and Self-Dealing

Donors who enter into pledge agreements with charitable organizations must draft the agreements carefully if they wish to have the flexibility to satisfy the pledge with payments from a private charitable organization. If a private foundation satisfies a legally binding obligation to an individual donor who is a disqualified person under a pledge agreement, that will be an act of self-dealing by using the foundation's assets for the benefit of the disqualified person. IRC §4941(d)(1)(E).

It is likely a prohibited benefit for a donor-advised fund to satisfy the pledge because the individual donor would receive a more than incidental benefit. *See* IRC §4967. Alternatively, it could be considered an automatic excess benefit transaction because the donor is indirectly receiving a grant from the donor-advised fund. IRC §4958. It may be prohibited private inurement for an SO to satisfy the enforceable pledge of an individual donor. IRC §501(c)(3).

One option to consider is to have the private foundation, rather than the donor, make the pledge. In the situation of a donor-advised fund, a community foundation may be willing to make a pledge agreement if the donor has sufficient funds to satisfy the pledge in the donor-advised fund at the time the pledge is entered into. A donor can maintain maximum flexibility by drafting such an agreement as a statement of an intent to make a gift, not to pay as a legally binding pledge. Then, there is no economic benefit to the donor by having the donor-advised fund or the private foundation make a payment under that intent to make a gift.

B. Maintaining Multiple Private Charities

Some philanthropists find that their needs cannot be satisfied by any one of the private charitable organizations available to them. It is not uncommon for an active philanthropist to have more than one private charitable organization. The donor may form a donor-advised fund and private foundation. In some cases, the donor may even form a donor-advised fund, a private foundation, and a support organization.

Generally, overhead administration expenses of these multiple identities can be shared so that the cost of maintaining the structures remains reasonable. A donor might give the private foundation unrestricted publicly traded stock while contributing appreciated real estate to the donor-advised fund. The donor might make grants to established public charities from the private foundation while running a scholarship program in the donor-advised fund.

VI. COMPARISON CHART OF PRIVATE CHARITABLE ORGANIZATIONS

	Donor-Advised Fund	Private Foundation	Supporting Organization
Public Charity or Private Foundation?	Public Charity	Private Foundation	Public Charity
AGI Limit on Cash Gifts	50%	30% (if not an operating foundation)	50%
AGI Limit on Appreciated Property	30%	20% (if not an operating foundation)	30%
FMV Deduction for Gifts Other Than Public Stock?	Yes	No (limited to basis)	Yes
Form of Tax Return	None (Form 990 filed by supporting org.)	Form 990-PF	Form 990
Are Donors Private or Public on Tax Return?	Donors are private	Donors are public	Donors are private
Subject to Self-Dealing Limits?	No	Yes	No
Required Minimum Distribution	None	5%	None presently (but will likely have 5% if not functionally integrated Type III)
Limits on Business Holdings?	Yes	Yes	Yes

Subject to Prohibited Benefits Limits?	Yes	No	No
Subject to Automatic Excess Benefits Limits?	Yes	No	Yes
Distribution Requirements?	No	Yes	Yes-Type III

	Donor-Advised Fund	Private Foundation	Supporting Organization
Subject to Jeopardizing Investment Rules?	No	Yes (if not an operating foundation)	No
Funding Limitations Due to Charitable Contribution Deduction Exclusions?	Yes	No	Yes