

CHOOSING AMONG THE PRIVATE FOUNDATION, SUPPORTING  
ORGANIZATION AND DONOR-ADVISED FUND <sup>1</sup>

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This outline focuses on factors a donor should consider in choosing among the private foundation, supporting organization and donor-advised fund. The outline also examines current developments regarding private foundations, supporting organizations, and donor-advised funds.

The emergence of the donor-advised fund in the 1990s marks a dramatic change in the American charitable-giving paradigm. Now virtually every exploratory conversation between an advisor and a prospective donor includes discussion of the donor-advised-fund option. The donor-advised fund focuses on values important to contemporary donors: involvement and efficiency<sup>2</sup> and all with significantly lower operating costs than would apply to a private foundation or supporting organization. Part of donor-advised funds' appeal is their ease of use: donors can open a gift account without any advice of counsel or legal instruments. Many accounts can easily be opened online.

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<sup>1</sup> Copyright © 2003 Victoria B. Bjorklund. This outline builds upon "The Emergence of the Donor-Advised Fund," presented at Georgetown University's 15th Annual Conference on Representing and Managing Tax-Exempt Organizations and reprinted at 3 Paul Streckfus' EO Tax Journal 15 (May 1998), prior outlines on this topic published by ALI-ABA, and a paper delivered at the October 1999 meeting of The National Center on Philanthropy and the Law at NYU Law School, which was published in 27 E.O.T.R. 107 (Jan. 2000).

<sup>2</sup> See, e.g., "'Wired': Giving With a Bottom Line," Chronicle of Philanthropy, p. 37 (Sept. 9, 1999) ("A new breed of donors is trying to reinvent the art of philanthropy, matching generosity with the no-nonsense rules of business, Wired Magazine writes..."); "The Radical Philanthropist," Forbes p.114 (May 1, 2000).

In 2000, the Fidelity Charitable Gift Fund achieved another DAF milestone: It raised \$1.1 billion in charitable contributions, a sum which propelled it into the number two position behind only the Salvation Army on the Chronicle of Philanthropy 400.<sup>3</sup>

The principal donor-advised fund stories in 2002 were (i) replication of the donor-advised fund model by colleges, existing public charities, and religious organizations and (ii) “private label” funds run by existing charities.<sup>4</sup> In 2003, there are no major donor-advised fund stories. Instead, the supporting organization seems to be attracting attention, as discussed below.

The absolute number of sponsoring charities of donor-advised funds remains relatively small: There are probably about 800 sponsoring charities of donor-advised funds in the United States today, with the vast majority of sponsoring charities being community foundations (about 550 community foundations offer DAFs). (Of course, each sponsoring charity may administer dozens or hundreds or thousands of individual donor-advised fund accounts.)

By way of comparison, there were 56,582 private and community foundations in existence at the end of 2000<sup>5</sup> (up from 2,000 in 1950). As of December 31, 2002, there were 29,843 organizations qualified as supporting organizations under section 509(a)(3), up from 25,962 in 1999.<sup>6</sup>

#### **I. CHOOSING AMONG A PRIVATE FOUNDATION, A DONOR-ADVISED FUND, A SUPPORTING ORGANIZATION, AND A PUBLIC CHARITY**

The main advantage of a private foundation over the alternatives can be summarized in one word: Control. Generally, determining the degree of control that the donor requires will determine whether the donor must have a private foundation. If the donor is willing to give up some or all control over her gift, she can gain other advantages, including greatly reduced administrative responsibilities and costs. For a donor who is committed to becoming a philanthropist, no alternative other than the private foundation may provide a degree of control

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<sup>3</sup> Tamar Lewin, “Charity Fund for Investors Moves Higher on Philanthropy List,” NY Times (Oct. 28, 2001).

<sup>4</sup> See Debra Blum, “Tailor-Made for Charity: Private-Label Gift Funds are Growing in Popularity,” Chronicle of Philanthropy (May 30, 2002).

<sup>5</sup> I thank John Edie of the Council on Foundations for providing this update, which is drawn from The Foundation Center’s 2002 edition of Foundation Growth and Giving Estimates.

<sup>6</sup> Telephone conversation with Ron Williams, IRS Employee Plans and Exempt Organizations Division, July 7, 1999. By way of comparison, there were 501,268 organizations classified as §509(a)(1) public charities and 223,731 §509(a)(2) public charities as of December 31, 2002.

sufficient to allow the donor to achieve her goals. See Appendix A for a comparison of control by type of entity. This broadest latitude is the reason that private foundations are recognized as the free agents of the charitable world: They are not answerable to large public memberships or required continuously to raise funds, as are most public charities, including community foundations. They enable the donor to refer grant seekers to her foundation, where their proposals can be evaluated against the donor's charitable goals. They can provide anonymity in giving and a shield from nonprofit bulk mail.<sup>7</sup>

But the features that make a private foundation so attractive are also present in a donor-advised fund in somewhat diluted form. Specifically, the donor may make non-binding grant recommendations for charitable grant making but is relieved of administrative and investment authority (and burdens). Thus, for many donors, the donor-advised fund represents the best of both worlds.

The first major advantage of a gift to a donor-advised fund over a gift to a private foundation is that federal tax law does not subject donor-advised funds to the private-foundation excise-tax system discussed below.

The second major advantage is that a gift to a donor-advised fund is a gift to a public charity. Therefore, it is subject to the more favorable public charity percentage and other limitations, which do not apply to gifts to most private foundations.<sup>8</sup>

## II. COMPARISON OF CONTRIBUTIONS

There are three income-tax differences for the living donor who gives to an organization classified as a private foundation rather than as a public charity: treatment of gifts of cash, treatment of gifts of appreciated property, and valuation of gifts of appreciated property.<sup>9</sup>

First, an individual who donates cash generally is limited to deducting as a charitable contribution in any year an amount equal to no more than 50% of the donor's adjusted gross income. This 50% limitation applies to cash gifts to public charities (including the supporting organization and typical donor-advised fund) and to three types of special private

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<sup>7</sup> Legal aspects of private foundations are discussed in greater detail at Sections III and IV below.

<sup>8</sup> Section 170. All section citations unless otherwise noted, are to the Internal Revenue Code of 1986, as amended (the "Code").

<sup>9</sup> The estate tax rules do not contain the same limitations.

foundations.<sup>10</sup> Cash gifts to the main types of private foundations (namely, the usual endowed or family foundation) can be deducted up to 30%.

Second, the deduction limitations on gifts of appreciated property are 30% of adjusted gross income for gifts to public charities and to the three types of private foundations identified above, but 20% for gifts to main types of private foundations. If in any year the donor exceeds either of these limitations, the excess can be carried forward for the next five years.

Third, in addition to the percentage limitations for gifts of appreciated property, gifts of appreciated property to a private foundation are generally deductible only at basis, not at fair market value.<sup>11</sup>

It is important to note that Congress has finally made permanent Code section 170(e)(5), which was first enacted in 1984. In general, this provision permits donors to deduct the full fair market value (up to their maximum percentage limitations) of gifts to a private foundation of qualified appreciated stock, which is stock

- for which market quotations are available on an established securities market,
- which is capital gain property in the donor's hands, and
- in a company of which the donor and her family will have contributed less than 10% in value, counting prior contributions.

This rule which has repeatedly expired and been reinstated<sup>12</sup> now finally permits the donor to a private foundation to claim a deduction in an amount equal to the fair market value of qualified appreciated stock. But this rule only applies to gifts of qualified appreciated stock and does not apply to other types of appreciated property. As stated above gifts of appreciated property to public charities, a category which includes the donor-advised fund and the supporting organization are deductible at fair market value. Therefore, in weighing the alternatives to the private foundation, the donor-advised fund--with its relative administrative ease, lower costs,

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<sup>10</sup> They are the private operating foundation, the flow-through foundation, and the pooled common fund. Section 170(b)(1)(E)(i), (ii), and (iii).

<sup>11</sup> Section 170(e)(1)(B)(i), although three types of foundations listed in the previous footnote qualify for the more favorable limits applicable to public charities. *Id.*

<sup>12</sup> Monica Langley, "All in the Family: A Tax Break Prompts Millionaires' Mad Dash to Create Foundations--Private Charities Let Them Keep Control of Money and Get Full Deductions--A Wrinkle: It's Over in May," *The Wall St. J.*, Monday, Jan. 27, 1997, at A1. The extension was made permanent on October 22, 1998 by enactment of the Omnibus Consolidated and Emergency Supplemental Appropriations Act.

and equal-or-higher deductibility limitations--and the supporting organization are attractive alternatives to a private foundation, especially if the donor has appreciated property other than publicly-traded stock to contribute.

### III. WHAT IS A PRIVATE FOUNDATION?

By tax-law definition, a private foundation is a religious, charitable, etc., domestic or foreign organization that does NOT meet the definition of a public charity.<sup>13</sup> Having been created as a legal negative construction contributes to a private foundation's cachet: The organizations carved out as public charities all have higher responsibilities to persons other than a single donor, whether those persons are the constituents who pay for the organization's services or who contribute to the organization in great enough numbers and even enough amounts to be able to satisfy mechanical or facts and circumstances public support tests<sup>14</sup> or whether those persons are representatives of such publicly supported organizations.<sup>15</sup> Those organizations that are left are the private foundations. Stated differently, the private foundation is the default classification.

Confusion exists about what it means for an organization to be a foundation. As a practical matter, any not-for-profit organization, even a public charity, may use the word "foundation" in its name. Federal tax law, however, classifies as "private foundations" only those organizations that typically have three features:

- a single major source of funding—usually gifts from one family or corporation, rather than funding from the general public,
- a grant-making program instead of direct operation of charitable programs, and
- payment of grants and administrative expenses from the organization's endowment income rather than from the proceeds of a fund-raising program.

If an organization intends to have many sources of funding and an on-going fund-raising program, it should consider seeking classification as a public charity rather than a private foundation. If an organization intends to support one or more identified public charities, it should consider seeking classification as a supporting organization.<sup>16</sup> If a donor

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<sup>13</sup> Section 509(a).

<sup>14</sup> Section 501(a)(1) and (2). These tests are discussed at Section V below.

<sup>15</sup> Section 509(a)(3). Supporting organizations are discussed at Section VIII below.

<sup>16</sup> The list below of categories of foundations was adapted from John Edie's *First Steps. Starting a Foundation*, published by the Council on Foundations, 1828 L Street NW, Washington, DC 20036.

wants to conduct grant making from an endowment but does not want to run her own organization, she should consider a donor-advised fund. If a donor wants to control grant making and investments, and plans to contribute assets in an amount sufficient to justify the operating costs of a stand-alone organization, the donor should form a private foundation.

In practice, private foundations generally fall into five categories:

- A. *Endowed private foundations.* This is the most familiar type of private foundation and is usually funded by an individual or a family. Examples include the Charles Stewart Mott Foundation and the William Randolph Hearst Foundation. Endowed foundations may build up their endowments through quality investments and annually expend only the minimum distributable amount in a variety of grant programs. Some endowed foundations are dedicated to particular areas of interest that may change from time to time, such as homelessness or pre-school education. Family members or business colleagues may serve as directors and officers and participation may be intergenerational.
- B. *Unendowed private foundations.* This type of foundation has little or no endowment and usually receives its funding annually from its founder. It is sometimes used as a vehicle for extending the donor's giving season over a period of a few months or for other timing reasons. Many corporate foundations are unendowed private foundations.
- C. *Pass-through or "conduit" foundations.* This type of foundation is a short-term holding tank for certain charitable contributions. The donor's contribution must be passed-through within two and one-half months after the close of the year in which the contribution was made. A donor to a pass-through foundation is entitled to the more advantageous deduction limitations. A pass-through foundation is sometimes used by executives who wish to contribute low-basis assets likely to realize rapid appreciation, such as closely held stock in a company that may go public.<sup>17</sup>
- D. *Pooled common funds.* The donor and the donor's spouse may retain the right annually to designate the recipients of income earned from the donor's prior contributions. The recipients must be public charities. At the end of the donor's or surviving spouse's life the corpus goes to a charity that they have designated. An example is The Boston

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<sup>17</sup> For a fuller discussion of pass-through foundations, see V. Bjorklund, "Current Developments Affecting Private Foundations," Proceedings of NYU's Twenty-Third Conference on Tax Planning for 501(c)(3) Organizations (Matthew Bender, 1995); Paul Feinberg, "Creative Uses of Flow-Through Foundations," 12 E.O.T.R. 972 and 984 (November 1995); and Martin E. Grief, "Charitable Contributions of Stock to Private Foundations--Window of Opportunity Exists," 12 E.O.T.R. 1215 (Dec. 1995).

Community Fund. A donor to a pooled common fund is entitled to the more advantageous deduction limitations.

- E. *Operating foundations.* A private operating foundation is a private foundation that behaves like a public charity in that it runs its own charitable activities (e.g., a museum, library, or historic building) instead of making grants for charitable activities conducted by other organizations. Examples are the Isabella Stewart Gardner Museum in Boston and the de Menil collection in Houston. George Soros's Open Society Institute is a private operating foundation with a multiplicity of charitable and educational programs. A private operating foundation's donors are entitled to the more advantageous deduction limitations.

#### IV. THE PRIVATE FOUNDATION EXCISE TAXES

Except for the 2% tax on net investment income, the private foundation excise taxes discussed below are avoidable. Nevertheless, they cannot be ignored because they set the boundaries for all foundation operations. And, if incurred, these penalty taxes can be substantial and can be imposed on both the foundation and its managers.

The donor generally will be deemed to be a substantial contributor to the foundation. Therefore, the donor's dealings with the foundation will come under special scrutiny, as will those of other "disqualified persons." In the case of a donor who is an individual, disqualified persons include the donor's relatives (except siblings) and any corporation, trust, or partnership in which the donor directly or indirectly owns more than a 35% interest.

Benefits to the donor or to any other disqualified person that are more than incidental and tenuous can trigger excise taxes. A benefit that the Internal Revenue Service ("IRS") has held to be more than incidental and tenuous is displaying a foundation's art collection in the donor's home. Similarly, a foundation cannot buy, sell, or lease anything from a disqualified person without penalty. If a disqualified person directly or indirectly leases office space to the foundation, the space must be leased rent-free, or else both the disqualified person and the foundation can be subject to excise taxes. Naming the foundation after the donor is permissible, however, and does not trigger excise taxes.

The specific excise taxes are:

- A. *Excise tax on investment income.*<sup>18</sup> A private foundation is subject to a 2% tax on its net investment income. This is the only excise tax that is not avoidable. If the foundation donates a sufficient amount to qualified charities in a given year, it may be entitled to a rate reduction to 1% for that year.

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<sup>18</sup> Section 4940.

- B.** *Excise tax on self-dealing.*<sup>19</sup> Subject to certain exceptions, a private foundation cannot engage in any prohibited transactions with disqualified persons. Prohibited transactions include, but are not limited to, selling or leasing the foundation's property, loaning assets, and furnishing goods, services, or use of the foundation's facilities. For useful roadmaps on some of the unexpected aspects of direct and indirect self dealing, see PLR 9312022 (December 28, 1992) and PLR 9325061 (April 1, 1993). This is probably the most important Chapter 42 excise tax. It is the provision that prevents the influential persons in control of a private foundation from taking unfair advantage of the organization or its assets. It is the provision upon which the relatively new Code Section 4858, intermediate sanctions on public charities, is modeled.
- C.** *Excise tax on failure to distribute income.*<sup>20</sup> Within 12 months after the end of each fiscal year, a private foundation must make qualifying distributions in an amount equal to or greater than 5% of the aggregate fair market value of the foundation's assets that are not used directly to carry out the foundation's exempt purposes.
- D.** *Excise tax on excess business holdings.*<sup>21</sup> A private foundation may own the stock and securities of a corporation only up to a permitted level, which is generally 20% of the corporation's voting stock less the amount of voting stock owned by the foundation's officers, directors, trustees, or substantial contributors. Similar rules apply to ownership of other business interests.
- E.** *Excise tax on jeopardy investments.*<sup>22</sup> A private foundation cannot invest its funds in ways that could jeopardize the foundation's ability to carry out its charitable purposes.
- F.** *Excise tax on taxable expenditures.*<sup>23</sup> A private foundation cannot make taxable expenditures, which include payments for political campaigns and lobbying, and certain grants to individuals. In addition, while a private foundation may make qualifying distributions to another private foundation or even to a for-profit entity, the distributing foundation will have to monitor the grant to avoid a penalty. If the private foundation intends to make certain grants to individuals (*e.g.*, scholarships, travel stipends, writing

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<sup>19</sup> Section 4941.

<sup>20</sup> Section 4942.

<sup>21</sup> Section 4943.

<sup>22</sup> Section 4944.

<sup>23</sup> Section 4945. It specifies a "generic affidavit" procedure intended to encourage grant making to non-United States organizations that could otherwise qualify for exemption as public charities within the meaning of section 509(a).



allowances), advance written approval of the selection procedures must be obtained from the IRS or the grants will be subject to tax. Grants to foreign charities are also governed by this section. On April 27, 1999, The Council on Foundations issued through its counsel, Caplin & Drysdale, a discussion draft proposal to simplify grant making abroad. These changes are warranted and should be supported both by foundations and by the public charities they support.

Foundation managers would be well advised to obtain and review the most recent version of IRS Publication 578, *Tax Information for Private Foundations and Foundation Managers*, for a discussion of the excise taxes as well as to consult their own tax advisors and the Code, regulations, and applicable rulings as to particular matters.<sup>24</sup>

## V. NEW DEVELOPMENTS REGARDING PRIVATE FOUNDATIONS

From 1990 to 2000, the number of private foundations in the United States increased 75 percent to almost 57,000, compared to an increase of 47 percent in the 1980s. By far the biggest growth was for foundations with less than \$10 million in assets.<sup>25</sup> Entitled "New Philanthropies Find Drudgery -- Giving Away Cash Can Be More Cumbersome Than Glamorous," New York Times reporter Stephanie Strom interviewed would-be private foundation managers and donors who have found that the legal requirements of running a foundation require "far more time and expense than they had imagined."

These statistics and anecdotes beg the question: When is a private foundation the best option? Generally, the answer to this question turns on CONTROL. How much control the donor and/or managers require determines the vehicle:

- private foundation?
- supporting organization?
- donor-advised fund?

1. How employer-controlled private foundations can make disaster-relief grants to employees:

Disaster-Relief Payments Made by Employer-Controlled Private Foundations--Victims of Terrorism Tax Relief Act of 2001, Public Law 107-134 (signed into law by President Bush on

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<sup>24</sup> For practical and easy-to-understand explanations of the private foundation rules in operation, see John A. Edie, *Family Foundations and the Law: What You Need to Know* (Washington, D.C.: The Council on Foundations, 1995). For information on compensation, see the most recent *Grantmakers Salary Survey and Management Report* (Washington, D.C.: Council on Foundations).

<sup>25</sup> January 12, 2003 *New York Times*.

January 23, 2002)/Revised Version of Publication 3833: The Victims of Terrorism Tax Relief Act of 2001 added, among other things, new Section 139 to the Code. The legislative history behind Code section 139 provided new guidance regarding disaster-relief payments made by employer-controlled private foundations.

The legislative history to the Victims of Terrorism Act, however, stated that if payments are made by an employee-controlled private foundation in connection with a "qualified disaster" to employees (and family members), the foundation will be presumed to be acting consistently with requirements of Code section 501(c)(3) if the class of beneficiaries is large or indefinite and if beneficiaries are selected based on an objective determination of need by an independent committee of the foundation, a majority of the members of which are persons other than persons who are in a position to exercise substantial influence over the affairs of the controlling employer.

2. How private foundations can terminate without incurring §507 termination penalty taxes:

a. Revenue Ruling 2002-28, 2002-20 IRB 941: The IRS issued guidance on the filing obligations and excise tax issues that arise when a private foundation transfers assets to other private foundations under Code section 507(b)(2). Specifically, in this Revenue Ruling, the IRS set forth three factual situations involving the transfer of all of the assets of a private foundation to one or more private foundations and discussed (i) whether each transfer constituted a Code section 507(a) termination, (ii) the transferor private foundation's tax-return filing obligations if it subsequently terminates or does not terminate, (iii) the implications under Code sections 4940 through 4945 if the transfer is to one or more private foundations that are controlled by the same person(s) who control the transferor private foundation, and (iv) the implications for the transferor foundation's aggregate tax benefits under Code section 507(d) if the transfer is to one or more private foundations that are controlled by the same person(s) who control the transferor private foundation. The IRS ruled that a private foundation that transfers all of its assets to one or more private foundations in a Code section 507(b)(2) transfer does not need to notify the TE/GE division of the IRS that it plans to terminate its private foundation status.

The IRS also ruled that if the private foundation does not provide notice and does not terminate, it is not subject to the Code section 507(c) termination tax. However, if the private foundation does provide notice and terminates, it is subject to the tax, although if it has no assets on the date it provides notice to the IRS, its termination tax will be zero. The IRS concluded that a private foundation that has transferred all of its assets and does not terminate its private foundation status must file a Form 990-PF for the tax year of the transfer and must comply with any expenditure responsibility reporting obligations for that year, but does not need to file returns in the subsequent tax years if it has no assets and does not engage in any activities.

b. Revenue Ruling 2003-13, 2003-4 IRB 1: The IRS issued guidance on the termination and excise tax issues that arise when a private foundation transfers assets to one or more public charities. Specifically, in this Revenue Ruling, the IRS set forth four factual situations involving the transfer of all of the assets of a private foundation to one or more public charities, followed by the dissolution of the private foundation, and discussed (i) whether each transfer constituted a Code section 507(a) termination such that payment of the Code section 507(c) tax would be required, and (ii) the implications under Code sections 4940 through 4945 of the transfer.

The IRS ruled that if a private foundation distributes all of its net assets to one or more Code section 509(a)(1) public charities that have been in existence and so described for at least 60 calendar months prior to the distribution, the foundation terminates its private foundation status under Code section 507(b)(1)(A) and is neither required to file a notice of termination under Code section 507(a)(1) nor liable for the termination tax of Code section 507(c). The IRS also ruled that if a private foundation distributes all of its net assets to one or more Code section 509(a)(1) public charities that have NOT been in existence and so described for at least 60 calendar months prior to the distribution, the foundation does not terminate its status unless it gives notices pursuant to Code section 507(a)(1).

If the foundation does not give such notice and therefore does not terminate, the foundation will not be subject to the Code section 507(c) termination tax. If the foundation does give such notice and therefore terminates, it will be subject to the Code section 507(c) termination tax on the date notice is given, although if it has no assets on the date it provides notice to the IRS, its termination tax will be zero. Last, the IRS ruled that in any of the above cases, the distribution does not give rise to any Chapter 42 excise tax liability.

3. How private foundations can monitor alternative investments:

Technical Advice Memorandum 2002-18-038 (Apr. 23, 2002): The IRS ruled that a private foundation's investment of a "significant amount" of its assets in a limited partnership that traded in the futures and forward markets was not a jeopardizing investment under Code section 4944 because the foundation took reasonable measures and foundation managers exercised ordinary business care and prudence in making the investment. The IRS found the following factors significant in reaching its conclusion: (i) the foundation's degree of involvement in establishing the partnership and choosing its investment managers; (ii) the foundation's use of multiple investment advisers with differing investment strategies to counterbalance the investments (i.e., a form of diversification); (iii) the foundation's right to withdraw from the investment at any time; and (iv) the fact that the foundation had received and its managers had reviewed two separate opinions of counsel concluding that the investment was not a jeopardizing one.

4. Anti-terrorist financing issues for grantmaking foundations:

On November 7, 2002, the Treasury Department's Office of Public Affairs issued a press release entitled, "Response to Inquiries from Arab American and American Muslim Communities for Guidance on Charitable Best Practices." The press release announces that the Treasury Department has developed voluntary best practices guidelines for U.S.-based charities so that they can "avoid any ties to terrorist organizations that might lead to further blocking actions." The best practices guidelines are attached and comprise seven pages of recommendations. Those recommendations are grouped under four headings: Governance, Disclosure/Transparency in Governance and Finance, Financial Practice/Accountability, and Anti-Terrorist Financing Procedures.

5. Consider the donor-advised fund alternative to a private foundation:

- as an easier and less costly alternative to accept memorial gifts following a death, before a funeral, or for a special birthday or other event
- for family giving without administrative responsibilities
- for lower start-up and annual operating costs
- terminate a foundation into a donor-advised fund

In selecting a sponsoring charity of a donor-advised fund,

- Consider its grantmaking policies:
  - any geographic limits within the U.S.?
  - overseas grants?
  - fees after a certain number of grants?
- What kind of assets will it accept?
  - closely held stock?
  - restricted securities?
  - real estate?

6. Revenue Ruling 2003-32:

In late March 2003, the IRS released Rev. Rul. 2003-32 regarding certain disaster-relief payments by a private foundation. Specifically, the IRS ruled that educational grants awarded by a private foundation to employees or children of employees who are victims of a qualified disaster are treated as scholarships under IRC section 117 and are not taxable expenditures under section 4945.

Typically, a scholarship program run by a company foundation would not be permitted to make scholarship awards to every employee or child, but only to a minority percentage of them pursuant to Rev. Rul. 76-47. Instead, the eligibility criteria of death or serious injury as a result of a qualified disaster is found to be sufficient to assure that the grant is educational and

not compensatory. The person on the street would certainly consider this the obvious and logical conclusion but the ruling is welcome confirmation.

#### VI. WHAT IS A PUBLIC CHARITY?

A public charity is an organization that falls into a specified category that is excluded from the definition of a private foundation. In general, public charities are organizations that:

- A. are engaged in inherently public activities;<sup>26</sup>
- B. meet one of the public support tests;<sup>27</sup>
- C. support one of the above-noted organizations;<sup>28</sup> or
- D. test for public safety.<sup>29</sup>

Public charities are not subject to the private foundation excise tax regime, but they are subject to an excise tax on certain excess benefit transactions. These rules are modeled on the private foundation rules regarding self-dealing.

#### VII. WHAT ARE INHERENTLY PUBLIC ACTIVITIES?

Organizations that are engaged in inherently public activities and are thus accountable to the public are classified as public charities, and donors to them are entitled to the more advantageous deduction limitations. These organizations are churches, associations of churches, certain educational organizations, hospitals, medical research organizations, university endowment funds, and governmental units.

Churches. There is no statutory definition of a church or association of churches. A court has stated that, at a minimum, a church must include a body of believers that assemble regularly in order to worship and must be reasonably available to the public in its conduct of worship, educational instruction and promulgation of doctrine.<sup>30</sup> In addition, the IRS has

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<sup>26</sup> Section 509(a)(1).

<sup>27</sup> Sections 509(a)(1) and 509(a)(2).

<sup>28</sup> Section 509(a)(3).

<sup>29</sup> Section 509(a)(4).

<sup>30</sup> See also U.S. v. Jeffries, 854 F.2d 254 (7<sup>th</sup> Cir. 1988); American Guidance Foundation, Inc. v. U.S., 490 F. Supp. 304 (D.D.C. 1980).

developed a set of criteria that are used to determine whether an organization qualifies as a church, although no single factor is determinative and all factors need not be met.<sup>31</sup> The IRS will look to whether the organization has a distinct legal existence, a recognized creed and form of worship, a definite and distinct ecclesiastical government, a formal code of doctrine and discipline, a distinct religious history, a membership not associated with any other church or denomination, ordained ministers ministering to its congregations, ordained ministers selected after completing prescribed studies, a literature of its own, established places of worship, regular congregations, regular religious services, Sunday schools for religious instruction of the young, and schools for religious instruction of its ministers.<sup>32</sup> In a number of instances, individuals seeking to avoid paying income taxes have set up organizations that claim to be churches. In general, the individual will contribute all of his or her income to the organization, and the organization will then pay the individual's living expenses. The courts<sup>33</sup> and the IRS<sup>34</sup> have refused to recognize these organizations as churches.

Educational Organizations. To qualify as an educational organization, an organization must normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of students in attendance at the place where educational activities are carried on. This category is intended to encompass private and public primary, secondary, preparatory or high schools, colleges, universities and other instructional institutions.<sup>35</sup>

Hospitals. An organization will qualify as a hospital if its principal purpose or function is the providing of medical or hospital care. Included in this definition are organizations that are engaged in medical education or research, if they also are actively engaged in providing medical or hospital care in their facilities. This category applies to rehabilitation institutions, outpatient clinics, community mental health or drug treatment centers, and certain extended care facilities if their principal purpose is the provision of hospital or medical care. It does not apply to convalescent homes or homes for children or the elderly.<sup>36</sup>

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<sup>31</sup> IRS Private Foundations Handbook (IRM 7752), Section 220.

<sup>32</sup> Id.

<sup>33</sup> U.S. v. Jeffries, 854 F. 2d 254 (7<sup>th</sup> Cir. 1988); Basic Bible Church v. Commissioner, 74 T.C. 846 (1980), *aff'd* Granzow v. Commissioner, 739 F.2d 265 (7<sup>th</sup> Cir. 1984).

<sup>34</sup> Rev. Rul. 81-94, 1 C.B. 330.

<sup>35</sup> Treas. Reg. § 1.170A-9(b)(1).

<sup>36</sup> Treas. Reg. § 170A-9(c)(1).

Medical Research Organizations. A little-known Code provision<sup>37</sup> authorizes creation of a hybrid entity known as a medical research organization. In summary, a contribution to this type of organization generally will be treated as favorably as a gift to a public charity even where the donor retains a degree of control comparable to that exercisable over a private foundation. Where a donor is otherwise interested in medical research and that research can be conducted continuously, actively, and “in conjunction with” a not-for-profit or government hospital, this hybrid can provide an attractive alternative to a private foundation, supporting organization or a donor-advised fund.<sup>38</sup>

University Endowment Funds. This category covers endowment funds organized and operated in connection with state universities and colleges. The laws of certain states prevent state-owned universities from receiving certain gifts or bequests directly because such gifts are required to be placed in the state treasury. This category is intended to encourage gifts to state universities because a donor to a university endowment fund is entitled to the more advantageous deduction limitations.<sup>39</sup>

Governmental Units. This category covers a state or possession of the United States, any political subdivision thereof, the United States or the District of Columbia. Like the exception university endowment funds, gifts to a governmental unit for exclusively charitable purposes are subject to the 50% charitable contribution limitation.

#### VIII. WHAT ARE THE PUBLIC SUPPORT TESTS?

A large number of organizations qualify as public charities pursuant to one of the public support tests. These charities must continually show that a certain amount of their total support is received from a broad cross-section of the public and not from one source. The first public support test relies primarily on gifts and contributions to meet the minimum required public support. The second test includes gross receipts (admission fees, fees for services) as public support and limits the amount of investment income the organization may earn.

The first public support test can be met in one of two ways: by demonstrating that the amount of public support equals or exceeds one-third of total eligible support (the “mechanical test”) or, if public support is less than one-third of total support, by meeting a facts and circumstances test (the “facts and circumstances test”).

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<sup>37</sup> Section 170(b)(1)(A)(iii) and Treas. Reg. § 170A-9(c)(2).

<sup>38</sup> For a detailed discussion of a medical research organization, see Marvin Goodson, “Private Medical Research Organizations: Long-Term Research Funding Source for Non-Profit Hospitals,” 20 *Tax Management Estates, Gifts and Trusts Journal* 75 (March 9, 1995).

<sup>39</sup> Treas. Reg. § 170A-9(b)(2).

The Mechanical Test.<sup>40</sup> The organization must calculate both its public support and its total support. Public support must equal one-third of total support. The sources of support that must be included in the calculation of total support are:

- A. Bequests and gifts, grants and contributions from individual donors, private foundations, corporations, other public charities or non-charitable tax-exempt organizations.
- B. Government grants or contracts, so long as the purpose of the payment is primarily to enable the organization to provide a service to the direct benefit of the public.
- C. Membership fees, if the basic purpose for such fees is to provide general support for the organization.
- D. All net income from unrelated business activities, regardless of whether such activities are regularly carried on.
- E. Gross investment income, including interest, dividends, rent and royalties, but not including gain from the sale of appreciated property.
- F. Tax revenues levied by a governmental unit for the benefit of the organization and either paid to it or expended on its behalf.
- G. The value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) provided by a governmental unit to the organization without charge.

All of these sources of support count as total support, but only a portion of this income qualifies as public support. The following are the only sources of support which may count as public support:

- A. Gifts, grants contributions from individual donors, private foundations or corporations, but limited to two percent of total support. For example: if total support for the period is \$100,000, a grant from one donor of \$40,000 will all count as total support, but only \$2,000 (two percent of \$100,000) will count as public support.
- B. Government grants or contracts. This type of support is not subject to the two percent limitation mentioned above.

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<sup>40</sup> This discussion is adapted from John Edie's *How to Calculate the Public Support Test*, published by the Council on Foundations, 1828 L Street NW, Washington, D.C. 20036.



- C. Gifts or grants from other publicly supported charities. This type of support is not subject to the two percent limitation mentioned above.
- D. Membership fees, if the basic purpose for such fees is to provide general support for the organization.
- E. Tax revenues levied by a governmental unit for the benefit of the organization and either paid to it or expended on its behalf.
- F. The value of services and facilities (exclusive of services or facilities generally furnished to the public without charge) provided by a governmental unit to the organization without charge.

To the extent that gifts or grants from a governmental unit or publicly supported charity originally came from an individual donor, private foundation or corporation and were earmarked for the organization, then the funds will be subject to the two percent limitation. In addition, gross investment income and net unrelated business income will not count as public support.

Certain sources of support are excluded completely in calculating the mechanical test and are not counted in determining either public support or total support. These include the value of voluntary services, gross receipts from the performance of an exempt function, capital gains and unusual grants. In general, a substantial contribution will qualify as an unusual grant if it is attracted by reason of the publicly supported nature of the organization, it is unusual or unexpected with respect to the amount and, by reason of its size, it will adversely affect the public charity status of the organization.

The public support test need not be met within each and every tax year. The law states that a charity must “normally” demonstrate that a substantial part of its support comes from the general public. Normally means over a four-year period. Thus, to determine whether an organization satisfies the public support test for 2000, the years that count are 1999, 1998, 1997, and 1996. If the organization passes the test for the current tax year, then the organization will be publicly supported for the current tax year and the taxable year immediately succeeding the current tax year.

Facts and Circumstances Test. Under the facts and circumstances test, the organization must be able to show that the total amount of public support equals or exceeds ten percent of total support. In addition, the organization must be organized and operated to attract new and additional public support on a continuous basis. The following factors will also be considered: (1) whether support is received from a representative number of persons, rather than from the members of a single family; (2) whether the governing body represents the broad interests of the public, or the personal and private interests of a limited number of donors; and (3) whether the organization (A) provides facilities or services directly for the benefit of the general public

on a continuing basis, (B) sponsors programs in which members of the public participate or (C) maintains a definite program to accomplish charitable work in the community. Certain other factors are taken into account for membership organizations.

The Gross Receipts Test. To meet this test, the organization must meet two tests, the one-third-support test and the not-more-than-one-third-support test. The one-third-support test will be met if an organization normally receives more than one-third of its support from any combination of:

- G. Gifts, grants, contributions or membership fees. This support must come from publicly supported organizations, governmental units, and persons other than disqualified persons (in general, substantial contributors, managers, a more than 20% owner of a substantial contributor, a member of the family of such persons, or a corporation, partnership, trust or estate which is more than 35% owned by such persons).
- H. Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in an activity that is not an unrelated trade or business. Gross receipts received from any person or governmental unit are includible only to the extent that they do not exceed the greater of \$5,000 or 1% of the organization's total support.

The not-more-than-one-third-support test will be met if the organization normally receives not more than one-third of its support from the sum of gross investment income and the excess of unrelated business taxable income over the tax imposed on such income.

## IX. WHAT IS A SUPPORTING ORGANIZATION?

A supporting organization is the third subcategory of public charity and therefore not a private foundation. Unlike the first two categories of public charity, however, a supporting organization is only indirectly "public." That is, the public constituency that monitors a supporting organization's operations does so through the filter of an intervening public charity. It is to that public charity or charities that the supporting organization must respond regarding organization, operation and on-going relationship with the supported public charity or charities.

While the supporting organization is attractive because it is a public charity, it is less attractive to a control-minded donor: By definition, a supporting organization must give a donor less control over the organization's assets—both investment and expenditure—than would be the case with a private foundation. Some donors combine the investment advantages of a supporting organization with the grant-making convenience of a donor-advised fund by creating supporting organizations to a donor-advised fund.<sup>41</sup> In addition, the supporting

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<sup>41</sup> See Rochelle Korman and William F. Gaske, "Supporting Organizations to Community Foundations: A Little-Used Alternative to Private Foundations," 10 *Ex. Org. Tax Rev.* 1327 (Dec.

organization has fairly cumbersome organizational and operational rules that some donors find as or more onerous than those applicable to private foundations.

In narrative summary, a supporting organization is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more public charities; is operated, supervised or controlled by or in connection with one or more public charities; and is not controlled directly or indirectly by any disqualified person.<sup>42</sup> Note that the removal of control dominates every part of this definition.

The IRS will find that a supporting organization is organized exclusively for the purposes of the benefitted public charity(ies) only if its certificate of incorporation or articles:

- (1) limit the supporting organization's purposes to the purposes of one or more benefitted public charities (which, as a practical matter, can curtail the donor's future philanthropic activities),
- (2) do not expressly empower the supporting organization to engage in activities that do not further the purposes of the benefitted public charity(ies) (which confirms that the donor is to be given no special latitude if she errs in choosing beneficiaries whose purposes may someday be narrower or different from her then-goals),
- (3) identify the public charities to be benefitted (although this designation may not have to be in the incorporation papers, it must be answered to the satisfaction of the IRS), and
- (4) do not authorize the supporting organization to benefit any other public or private charities.

The IRS will find that a supporting organization is operated exclusively for the benefitted public charities only if it engages solely in activities that benefit the public charity(ties) by making payments to or for the use of or by providing services or facilities for members of the charitable class benefitted by the supported organizations.

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1994). It is also possible to make payments from a charitable lead trust to a donor-advised fund. See PLR 9604031 (Nov. 5, 1995) and PLR 8146072 (undated). Professor Chris Hoyt has also reminded me that the IRS has permitted an individual to "disclaim" an inheritance to a donor-advised fund that the disclaiming individual would advise, whereas the same result would not apply to a disclaimer to a private foundation. See PLR 9532027 (May 12, 1995) and PLR 9635011 (May 23, 1996). Email from Professor Hoyt (Aug. 19, 1999).

<sup>42</sup> Section 509(a)(3)(A),(B) and (C).

The IRS will find that a supporting organization is not controlled by a disqualified person so long as the disqualified persons<sup>43</sup> have less than 50% of the voting power of the board or other controlling body AND do not have the ability to veto any action.<sup>44</sup> Compared with a private foundation, the donor and her family have much less capacity to govern the organization than they would with a private foundation. Further, the attribution rules applicable to disqualified persons guarantee that a donor can involve only a limited number of relatives, including children and grandchildren, and must look more to sharing power with persons outside close family and business ties.<sup>45</sup>

The IRS will find that a supporting organization is qualified only if it can demonstrate one of three types of relationships with benefitted public charities:

- (1) the Type 1 supporting organization is “operated, supervised, or controlled by one or more benefitted public charities, which the regulations liken to a “parent-subsidiary” relationship,<sup>46</sup>
- (2) the Type 2 supporting organization is “supervised or controlled in connection with” the benefitted public charity(ies), like brother-sister corporations,<sup>47</sup> or
- (3) the Type 3 supporting organization is “operated in connection with” the benefitted public charity(ies).<sup>48</sup>

The chart at Appendix C summarizes these Treasury Regulations applicable to supporting organizations.

Donors comparing a supporting organization to a private foundation will likely consider the “operated in connection with” option the best supporting-organization alternative because it requires the least supervision of the three by the benefitted public charity(ies). In exchange

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<sup>43</sup> Determined by reference to section 4946 and not including foundation managers and publicly supported organizations.

<sup>44</sup> Treas. Reg. § 1.509(a)-4(b)-(i).

<sup>45</sup> Regarding attribution, see section 4946(a)(1) and the regulations promulgated thereunder. See also rulings and cases regarding effective control by a donor causing the failure of supporting - organization classification with default reclassification as a private foundation.

<sup>46</sup> Treas. Reg. § 1.509(a)-4(g)(1).

<sup>47</sup> Treas. Reg. § 1.509(a)-4(h)(1).

<sup>48</sup> Treas. Reg. § 1.509(a)-4(i).

for that relative independence, however, this type of supporting organization must still demonstrate to the IRS its connection to an existing public charity by satisfying a responsiveness test and an integral-part test. It is these two tests that clarify the supporting organization's difference from a private foundation.

To satisfy the responsiveness test, the supporting organization must show the IRS how it is responsive to the needs and demands of the benefitted public charity(ies). If the supporting organization is a trust, the responsiveness test will be satisfied if the supported organization is a named beneficiary of the trust and has enforcement powers as to the trust under state law. If the supporting organization is a corporation or association, it must authorize officials of the benefitted public charity(ies) to have a significant role in governing the supporting organization's investment policies, the timing and terms of grants, the selection of recipients and other decisions concerning income or assets.

To satisfy the integral-part test, the supporting organization must maintain a significant involvement in the operation of the benefitted public charity(ies) and the supported organization must be dependent on the supporting organization.<sup>49</sup> This requires additional proof as to the intent of the supported organization to carry on a particular program "but for" the supporting organization's willingness to pay for it or that the supporting organization pays over at least 85% of its income to or for the use of the supported organization so long as that amount is sufficient to ensure the supported organization's attentiveness to the operations of the supporting organization.<sup>50</sup>

## X. NEW DEVELOPMENTS REGARDING SUPPORTING ORGANIZATIONS

### A. 2001 CPE Text.

In its 2001 Continuing Professional Education text<sup>51</sup>, the IRS addresses supporting organizations and highlights two areas of concern:

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<sup>49</sup> See, e.g., *Windsor Foundation* (77-1 USTC ¶ 9709), where the organization was classified as a private foundation instead of a supporting organization because it failed the integral-part test since the supported organizations had no interconnection with the foundation and it failed the responsiveness test because the supported organizations had no voice in investments.

<sup>50</sup> For a fuller discussion of the rules governing supporting organizations, see Virginia Sikes, "Supporting Organizations Have Advantages of Private Foundations, but Fewer Headaches," 4. *J. of Tax Exempt Orgs.* 20-23 (November/December 1992).

<sup>51</sup> Ron Shoemaker and Bill Brockner, "Control and Power: Issues Involving Supporting Organizations, Donor Advised Fund, and Disqualified Financial Instructions," Topic G, FY 2001 CPE Textbook.

1. Organizations attempting to qualify as supporting organizations that provide services to unrelated specified charities as a primary activity. The text notes that organizations that provide noncharitable services to a class of charities do not qualify for exemption unless specifically permitted by statute (*i.e.*, Section 501(e), Section 501(f)) or they provide services at substantially below cost.
2. Excessive donor control over supporting organizations and inadequate conflict of interest procedures. The IRS notes that in determining whether an organization is controlled by disqualified persons, one circumstance to consider is whether a disqualified person is in a position to influence the supporting organization's governing body. All facts and circumstances should be considered, including whether members of the governing body are employees of the disqualified person. In addition, organizational documents will be examined to determine whether disqualified persons select the "independent" members of the board or committees controlled by disqualified persons nominate board members. The IRS will also look to whether disqualified persons have indirect control over the organization's assets.

The CPE text also addresses the situation where a donor-advised fund seeks to be classified as a supporting organization. In the example provided in the text, the DAF is a separately organized trust that supports a public charity. Because a majority of the DAF's board consists of disqualified persons (the donors) and board approval is required for most actions, the DAF does not meet any of the supporting organization control tests.

**B. *Supporting Organization Dissolutions.***

As part of an estate plan, DeWitt and Lila Acheson Wallace, founders of Reader's Digest Association, Inc., formed the Wallace-Reader's Digest Funds (the "Funds") and seven supporting organizations (the "Supporting Organizations") which supported 13 specific charities, including the Metropolitan Museum of Art, Memorial Sloan-Kettering Cancer Center, Lincoln Center, and the Wildlife Conservation Society. The value of the Funds is approximately \$1.5 billion and the value of the Supporting Organizations was approximately \$1.7 billion. The Funds and the Supporting Organizations were funded with Reader's Digest stock. Throughout the 1990s, while most of the economy was benefiting from the bull market, the value of the Reader's Digest stock fluctuated and decreased. However, the Supporting Organizations were organized in a manner that some viewed as impeding the sale of the Reader's Digest stock. Therefore, news reports noted that the supported charities did not receive the benefits of being invested in a highly diversified portfolio of assets.

Under New York State law, the directors of not-for-profit corporations like the Supporting Organizations have certain fiduciary duties with respect to management of the organization's assets. In making and retaining investments, directors must consider the long and short term needs of the organization in carrying out its purposes (in this case, providing

funds to the supported charities), its present and anticipated financial requirements, expected total return, price level trends, and general economic conditions. For these and other reasons, in 1998, the New York Attorney General began an investigation into the structure of the Supporting Organizations. On April 30, 2001, after months of negotiations, the Funds, the Supporting Organizations, and the Attorney General's office reached an agreement to dissolve the Supporting Organizations and distribute their assets to the supported charities. The assets will be held in endowments named for the Wallaces. The charities will now be able to manage their own assets directly in a manner consistent with the wishes of the Wallaces and the historical practices of the Wallace Supporting Organizations.

For a more detailed discussion, see Ralph Blumenthal, "13 Institutions Obtain Control of Vast Bequest," *New York Times*, May 4, 2001, at A1.

**C. *Private Letter Rulings Involving DAFs and SOs.***

1. Supporting Organization of a Business League Can Be A Sponsoring Charity of DAFs. On August 3, 2001, the IRS issued PLR 200149045 which is the first ruling to recognize that an SO described in IRC § 509(a)(3) can be a Sponsoring Charity. While this result should be expected, the facts were somewhat unusual.

Y, an IRC § 501(c)(6) business league, such as the American Bar Association, is supported largely by member dues. If it were a charity described in 501(c)(3), it would qualify as a fee-supported public charity under IRC § 509(a)(2). This fact is important because it means that under Treasury regulations Y can have an SO. And Y does in fact have an SO, whose members are all members of Y. A majority of the SO's board is elected by the members and "several Y officers serve ex officio" as directors. The SO's primary activity is making grants to two charities also "established by and affiliated with Y that conduct charitable and educational activities pertaining to the field of Y's membership."

The SO "proposed to establish a charitable gift fund for its members" to make charitable contributions. The SO expects this fund to appeal to members who wish to provide for the long-term needs of the two affiliated charities and similar organizations. Contributions will be maintained in separate accounts. Those accounts can be of two types: a specific donee account or a DAF account. The SO will also permit grants to governmental units and public charities but not to individuals or private foundations. Grants can be recommended to foreign organizations that are the functional equivalent of U.S. public charities or governmental units. The SO also retained a variance power, which is a modification right usually retained by community foundations. The SO will "strongly urge" donors to "designate or recommend that at least 20% of distributions from each account" be paid to charities of the type supported by the business league and the SO.

The IRS ruled that the SO will operate in a manner similar to a community trust, and therefore furthers charitable purposes. The SO is a Type 3 SO and the IRS ruled that its

operation of DAFs will not adversely affect this classification. Finally, analogizing to the component-part rules applicable to community trusts, the IRS ruled that the gift fund and its separate accounts will be treated as integral parts of the SO and not as separate entities.

2. Gifts to an SO of a Community Foundation are Fully Deductible. On October 30, 2001, the IRS issued PLR 200204040 which ruled that gifts to an SO of a community foundation are fully deductible. As an SO is a public charity, and gifts to SOs are deductible by donors, it is not evident why the community foundation would think it needed this ruling. On further inspection, however, one finds that this SO made some unusual organizational choices. First, the SO amended its articles of incorporation and by-laws to refer to the community-trust provisions of the regulations. Second, it elected to treat each account as a component fund. These complicated operations, however, do not defeat SO classification or deductibility of gifts, although it is not clear from the ruling why this component-part structure was desirable.

Personal and anecdotal experience suggest that organizing and operating a supporting organization is no less complicated than organizing and operating a private foundation. This is true for three reasons. First, the supporting organization rules are less familiar to most people than the private foundation rules. As the chart at Appendix C also shows, the applicable regulations are detailed and nuanced. Thus, for example, it is not uncommon for major public charities to have policies (if they have thought about it at all) against permitting any of their officers to serve on the governing board of a supporting-organization. If discovered too late, such a refusal could destroy qualification, thereby causing the would-be supporting organization to be classified by the IRS as a private foundation anyhow. Second, the donor may find the supporting organization rules unduly restrictive if the donor truly desires control. Therefore, the supporting organization option may be most practical where a donor has (i) a particular public-charity beneficiary in mind and that public charity is motivated to cooperate, (ii) a group of friends suitable to be directors without violating the control rules, and (iii) sufficient assets to make a stand-alone entity worthwhile. Third, even well-intentioned and well-advised donors may not be able to articulate the “control” differences between a private foundation and a supporting organization.<sup>52</sup> Therefore, competent legal advice from a lawyer who knows supporting organizations is important, as the consequence for making a mistake is potentially private-foundation classification or the application of intermediate sanctions.

3. Priv. Ltr. Rul. 2002-36-051 (Jun. 17, 2002): A Code section 509(a)(3) supporting organization formed to support M, a business school at N university, proposed to acquire and/or develop student housing projects on or near N's campus to house only N's students and assist these students in finding affordable housing. The housing projects will be used as a clinical program for M's students, who would be involved in the acquisition, management and

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<sup>52</sup> See, e.g., Monica Langley, “Gimme Shelter: The SO Trend: How to Succeed in Charity Without Really Giving – A ‘Supporting Organization’ Lets the Wealthy Donate Assets, Still Keep Control – Carl Icahn’s School Project,” *The Wall St. J.*, May 29, 1998 at A1.



development of the projects under the supervision of an M professor. The IRS ruled that this activity would assist both N and M in fulfilling their respective educational purposes and therefore would not affect the supporting organization's section 501(c)(3) exemption or generate UBTI under Code section 512.

4. Priv. Ltr. Rul. 2002-33-025 (May 23, 2002): Reorganization of a hospital group such that X, a tax-exempt hospital, will be organized and operated to support Y, a Code section 501(c)(3) organization, will result in X being reclassified as a Code section 509(a)(3) supporting organization.

**D. *IRS FY 2003 EO Implementing Guidelines.***

In the Implementing Guidelines for Fiscal Year 2003, the IRS said that seven market segment studies will start in FY 2003.

One of those studies is of SOs:

- Section 509(a)(3) Supporting Organizations: After determining whether this is one or more segments, we will capture data on issues relating to supporting organizations. A key focus will be whether organizations appropriately claim section 509(a)(3) status under the "in-connection-with" rules.<sup>53</sup>

**E. *Two New Cases on Type 3 Supporting Organizations.***

Late in 2002, the Tax Court concluded in two separate decisions that two separate organizations each failed the Type 3 SO tests. These cases are analyzed in detail by my Simpson colleague, David Shevlin in an article published in the January 2003 Exempt Organization Tax Review. The article is attached as Appendix F.

The IRS and the Tax Court have given clear signals that the Type 3 "in-connection-with" tests are not to be trifled with. It is my personal opinion that too many practitioners are too casual about the Type 3 tests and either fail properly to apply the tests or to instruct their clients about satisfying the tests in practice.

I predict that the IRS and Tax Court will reclassify as private foundations many more Type 3 SOs before these projects are completed. I attach as Appendix B my chart of the SO regulations and draw the reader's attention to the additional criteria applicable to the Type 3 sub-classification. Clearly, the Type 1 and 2 tests, which depend largely on governance, are easier to satisfy than Type 3, which depends both on governance and on operations. Neither component should be underestimated.

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<sup>53</sup> FY 2003 Implementing Guidelines, [www.irs.gov](http://www.irs.gov), p. 7.

## XI. WHAT IS A COMMUNITY FOUNDATION?

Despite the word “foundation” in its name, a community foundation is classified as a public charity, rather than a private foundation, for federal income tax purposes. This is because, by aggregating its component funds (if separate trusts) and carrying on a fund-raising program through banks, lawyers and other professionals, a community foundation can satisfy the mechanical public support test.<sup>54</sup> This ability to aggregate multiple trusts and funds rather than treat those “component funds” as separate private foundations<sup>55</sup> is a distinguishing feature of community foundations. Most new community foundations, however, are formed as corporations which manage segregated accounts, rather than as separate trusts subject to the component-part tests. The component-part rules are not coherent when applied to corporations with segregated accounting entries rather than component entities. Nonetheless, many corporate community foundations have voluntarily adopted the rules applicable to community foundations in trust form.

Community foundations may be the fastest-growing subset of the U.S. philanthropic sector, thanks in large part to their donor-advised fund accounts. In 1995, there were more than 500 community foundations in the United States, up from approximately 400 in 1992.<sup>56</sup>

The first community foundation was created in 1914 by Cleveland lawyer and banker Frederic H. Goff, who created The Cleveland Community Foundation. Goff intended the community foundation to do good locally by awarding grants from charitable trust funds to local organizations. Goff was also concerned about the problem of obsolescence of charitable trusts, that is, the inability of a trust to function as a grantmaker because its stated charitable purpose has become obsolete or impossible to carry out. Such trusts did no good on behalf of the donor or for the community. Therefore, the model community foundation trust instruments included a so-called “variance power” to enable the community fund trustees to use the fund for other purposes as close as possible to the donor’s original purpose in the event that such a purpose became obsolete with the passage of time. The variance power would avoid the need to go to court for a costly *cy-pres* proceeding.<sup>57</sup>

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<sup>54</sup> Section 509(a)(1) and section 170(b)(1)(A)(vi) and the applicable regulations. Community foundations have a modified “facts and circumstances” test in Treas. Reg. § 1.170A-9(e)(10).

<sup>55</sup> Treas. Reg. § 1.170A-9(e)(11)(ii).

<sup>56</sup> Cynthia Jones Eiseman, “Value Added: Donor-Advised Funds at Community Foundations,” *Trusts & Estates* 16 (March 1997); Council on Foundations, *Building Successful Community Foundations* (1992).

<sup>57</sup> *Id.* at 16. For a fascinating new decision invalidating use of the variance power by the New York Community Trust, *see* *In the Matter of Application of the Community Service Society of New York to compel. . . Members of the Distribution Committee of the New York Community Trust. .*

A distinguishing characteristic of a community foundation is its separation of the investment function from the disbursement function. According to one commentator, this separation of functions allows each side to do what it does best: The trustee banks do best at making investments and the management committees do best at making grants that address the needs of the particular community. For example, The New York Community Trust (formed in 1923) currently has seventeen banks acting as its trustees and a large program staff and committee acting as its grantmakers. Community foundations may do more than make grants: they may act as facilitators of charitable know-how in their communities, galvanize resources to respond to local problems, and incubate new charities to address local needs.<sup>58</sup>

Many community foundations were created in the 1920s and 1930s on the multiple trust model.<sup>59</sup> Legal title to the assets of the multiple trusts is not in the community foundation's name but with the trustees. Nonetheless, the community foundation does not have to file a separate information return for each component fund. Instead, a single return is filed aggregating information for all the component funds.<sup>60</sup> Newer organizations are usually organized as corporations with commingled common funds, but which retain the variance power and use the traditional grant-making instruction categories: unrestricted funds, designated funds (e.g., for the benefit of a particular named charity), field-of-interest funds (e.g., to promote libraries in public schools) and donor-advised funds. Some organizations, such as the New York Community Trust, also have a corporate affiliate which manages donor-advised funds as segregated accounts.

The first donor-advised fund is reported to have been created at the New York Community Trust around 1931. Even though the donor-advised fund existed before the 1974 regulations,<sup>61</sup> the regulations do not directly prescribe requirements for launching an advised-fund program. While community foundations have been the traditional home of the donor-advised fund, there have long been donor-advised funds at other public charities, e.g., the Jewish Communal Fund, which was formed in 1972. For information on finding a donor-advised fund at a community foundation, see Appendix D.

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.to Make and Settle an Intermediate Account (Oct. 15, 1999, Surrogate Preminger). The decision was appealed and arguments were heard by the Appellate Division on April 14, 2000.

<sup>58</sup> Christopher R. Hoyt, *Legal Compendium for Community Foundations* (Washington, D.C.: Council on Foundations, 1996) at 4. This book is a "must-have" for any lawyer planning to form or work with a community foundation.

<sup>59</sup> Hoyt at 3.

<sup>60</sup> This capacity is authorized in Treas. Reg. 1.170A-9(e)(14)(i) (last sentence).

<sup>61</sup> For a summary of the regulations, See Appendix C.

## XII. WHAT IS A DONOR-ADVISED FUND?

What constitutes a donor-advised fund? First, there is no statute that defines what is or is not a donor-advised fund. Second, the term “donor-advised fund” is not to be found in the Treasury regulations. Third, the term “donor-advised fund” has been used in a relatively few private letter rulings and one general counsel memorandum.<sup>62</sup>

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<sup>62</sup> They are: PLR 200037053 (June 22, 2000, superseded on August 2, 2000, holding that contributions made through a donor-advised fund established by a public charity will be considered contributions from the general public for purposes of Section 509(a)(1)); PLR 200010036 (Dec. 13, 1999, charitable lead trust can pay annuity amount to a public charity, with a percentage of that amount to be paid to a donor-advised fund that is a component part of the public charity); PLR 20009048 (Nov. 24, 1999, private foundation’s transfer of all of its assets to a donor-advised fund of a public charity will not subject private foundation to any excise taxes, transfer will meet requirements of Treas. Reg. § 507-2(a)(8) because it does not involve material restrictions); PLR 9807030 (Nov. 19, 1997, holding that assets transferred by a private foundation to a donor-advised fund will be considered a component part of a community trust); PLR 9532027 (property was effectively disclaimed into a donor-advised fund and the estate could claim a charitable contribution deduction under section 2055); PLR 9412039 (private foundation can establish a donor-advised fund for a director with different grant making interests from those of other directors, to be funded with proceeds from the sale of timberlands); Tech. Adv. Memo. 8936002 (May 24, 1989, finding that donor involvement in funds did not provide more than incidental benefit to the donors, fund administration was related to charity’s exempt purposes, and fees received for administration were not unrelated business taxable income); PLR 8836033 (June 14, 1988, private foundation can pay over all its assets into a donor-advised fund at a community foundation but stay in existence as a corporate entity for the sole purpose of making grant recommendations); Gen. Coun. Memo. 39748 (Aug. 3, 1988, finding that earmarked contributions and contributions to donor-advised funds could be counted in the public support test of a public charity so long as the public charity is not merely acting as the agent of the donor). Other rulings approve of donor-advised funds without using that term, including : PLR 9250041 (September 17, 1992, holding that the creation of an “Advise and Consult Fund” by a public charity, which is not required to follow the recommendation of donors as to the identity of possible distributees and the possible timing and amounts of distributions, will not adversely affect the sponsoring organization’s status as a public charity); PLR 7827015 (March 31, 1978, holding that a university can hold a donor’s contributions in a separate account or commingled with other funds and make distributions out of the fund to other organizations selected by a committee, taking into account “solely advisory” recommendations by the donor); PLR 7821096 (February 27, 1978, holding that a donor’s contributions to a fund similar to the one described in PLR 7827015 will be considered gifts “to” and not merely “for the use of” the university). None of these three rulings cites to either the component-fund or material-restriction regulations. See also PLR 8134046 (May 26, 1981) (Proposed recommendation to make grant from donor-advised fund to pooled common fund would cause the retroactive reclassification of the donor-advised fund as a private foundation.)

We have only two decided cases ten years apart that discuss the donor-advised fund. The first, *National Foundation, Inc. v. U.S.*,<sup>63</sup> involved an organization that the IRS declined to recognize as a tax-exempt public charity because, among other things, the organization paid commissions to ministers, insurance agents, and others to refer donors to the organization and exercised minimal review of the donor's recommendations. In a sharply worded opinion, however, the court made clear its view that donations to National Foundation were destined for charitable recipients and the costs were not excessive to achieve that goal. Therefore, the court ordered the National Foundation to be recognized as exempt.

Ten years later, the IRS won in *Fund for Anonymous Gifts v. U.S.*,<sup>64</sup> only to have the decision vacated by the United States Court of Appeals on April 12, 1999. The District Court for the District of Columbia was ordered to enter summary judgment to the Fund for Anonymous Gifts on the section 501(c)(3) determination. The District Court on remand was told to determine whether the Fund should be classified as a public charity or a private foundation under section 509.

The IRS discussed this case in its FY 2000 CPE Text.<sup>65</sup> Saying that the IRS "continues to contend with...donor-advised or gift funds", the author emphasized that "the Service will continue to review the issue of donor control in donor-advised funds."

On September 25, 2001, the U.S. District Court ruled on remand that the Fund for Anonymous Gifts is properly classified as a private foundation, rather than as a public charity, because it did not appear from the record that the Fund's trustee could reasonably expect to satisfy the public support test.<sup>66</sup>

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<sup>63</sup> 13 Cl. Ct. 486 (1987).

<sup>64</sup> 1997 WL 198108, 79 A.F.T.R. ¶ 97-874 (U.S. D.C. for the District of Columbia, Number 95-1629 (April 15, 1997)), vacated in part by *Fund for Anonymous Gifts v. IRS*, 194 F.3d 173, 1999 WL 334519, D.C. Cir. No. 97-5142 (Doc 1999-13695), (D.C. Cir. Apr. 12, 1999).

<sup>65</sup> "Public Charity Classification and Privation Foundation Issues: Recent Emerging Significant Developments," Topic P, Exempt Organizations FY 2000 Continuing Professional Education Textbook, Tax Analysts Website (August 1999), pp. 219-220. See this text for details of other donor-advised fund litigations by the IRS, including the following. On October 5, 1998, the IRS obtained an injunction in California in *U.S. v. Estate Preservation Service*, which used donor-advised funds in conjunction with split-dollar life insurance arrangements that also benefit the donors' heirs. On April 5, 1999, a declaratory judgment was sought in Claims Court for the district of Columbia by *New Dynamics Foundation (99-197T)*, which the IRS viewed as an abusive donor-directed fund.

<sup>66</sup> See the decision at 88 A.F.T.R. 2d 2001-2 USTCP5Q649.

As noted below in the text accompanying footnote 86, this case has now been resolved in March 2003 through the federal government's mediated settlement program. The Fund was classified as a public charity through December 2007, at which time it will have to prove that it has satisfied the § 509(a)(1) public support test. Mr. Lehrfeld died in fall 2002.

If not a creature of the tax or case law, then, what is a donor-advised fund in practice?

A donor-advised fund is one where the donor or her designees exercises the privilege of making nonbinding recommendations to the sponsoring charity suggesting which charitable entities<sup>67</sup> should receive grants from that particular fund. Clearly donor control is sacrificed in the donor-advised fund because the donor's recommendations can be advisory only. For that reason, a donor-advised fund is the term life insurance of charitable giving: naked grant making. Donors are attracted by the administrative ease of grant making, no need to collect and retain substantiation letters, and no need to prepare and/or file information returns, state reports, or other exemption applications or filings. Administrative costs are borne by all funds managed by the same sponsoring charity with the result that costs per advised-fund are usually significantly lower than for private foundations or supporting organizations. The boards of public charities offering donor-advised funds generally choose their own operating guidelines and fees.

It is also instructive to compare the donor-advised fund with its cousins, the pooled common fund and the Type 3 supporting organization. This is especially true because much of the public discussion about donor-advised funds has historically asked whether their sponsoring charities should be classified as public charities or as private foundations based on two factors: (1) indices of control retained by the donor and (2) whether following a donor's advice should lessen deductibility. Some individuals have asked whether sponsoring charities are more "donor directed" than donor-advised.<sup>68</sup> IRS officials have mused from time to time whether donor-advised accounts that are actually directed accounts are ineligible for

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<sup>67</sup> Grantee entities are almost always public charities or private operating foundations. This has not always been the case and the change is due largely to operating policies adopted voluntarily by most, but not all, sponsoring charities of donor-advised funds. The policy is appropriate because, if the advisees are private non-operating foundations, questions could be raised about the donor improperly circumventing charitable deduction and private foundation excise-tax provisions, e.g., by means of a private foundation grant advised back to the same private foundation that made a qualifying distribution to the advised fund.

<sup>68</sup> See, e.g., Ronald J. Shoemaker and Amy Henchey, "Donor Directed Funds," Topic M, 1996 Ex. Org. Continuing Professional Education Technical Instruction Program Textbook, reprinted by Tax Analysts; Topic O, Part I, "Gift Funds-A New Direction in Charity," FY 1999 EO CPE Textbook; Topic P, Section B, "Update on Donor Advised or Gift Funds," FY 2000 EO CPE Textbook. See also, "Hill Meetings on Advised Funds and Supporting Organizations," 40 Foundation News & Commentary (March/April 1999) at 10.

component-fund treatment, with the default position being the classification of each account as a separate private foundation.<sup>69</sup> That result might equalize deductibility and operating rules with the rules that apply to private foundations but it is not legally compelled: the component-fund rules do not apply to organizations that do not elect to be community trusts. The IRS has homed in on “donor-designated funds” as distinguished from “donor-advised funds” and has published an essay entitled “Donor Control”.<sup>70</sup> The Council on Foundations has also focused on donor involvement, including publishing a “best-practices” guidebook.<sup>71</sup>

In its FY 2000 CPE text, the IRS has stated that “[t]o qualify under IRC 501(c)(3), a donor-advised fund must have appropriate control over the donated assets . . . . The Service applies the material restriction provisions (relating to the termination of private foundation status) in Reg. 1.507-2(a)(8) to measure the level of control. The criteria in this regulation are applied to donor-advised funds held in trust that seek to be treated as a component fund of a community trust that is a public charity. See Reg. 1.170A-9(e)(11).”

“Designation” is difficult to distinguish from “advice” as a practical matter. Presumably the right to specify in the governing documents that the donor’s advice shall govern the expenditure of principal and income is a “designation” with anything less constituting only a right to advise. The Code contains only one provision that addresses classification based on a retained right to designate a recipient and it is not in the component-part or private-foundation termination provisions. Instead, it is in section 170 (charitable deduction), where the pooled common fund is identified as one of three types of private foundation eligible for the more favorable public charity deductibility limitations.<sup>72</sup> The pooled common fund is in effect a defective supporting organization. The statute says that it “would be described in section 509(a)(3) [that is, a supporting organization] but for the right of any substantial contributor . . . or his spouse to designate annually the recipients from among organizations” that are public charities within section 509(a)(1).<sup>73</sup>

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<sup>69</sup> One practical problem with this approach is that each account, unlike community-foundation aggregation of trusts, has no separate existence, directors, or officers so a break off would be inoperable under current law.

<sup>70</sup> Ron Shoemaker, Debra Kaweck, Sadie Copeland and David Jones, “Donor Control,” Topic O, FY 1999 EO CPE Textbook.

<sup>71</sup> *See Guide to Donor Involvement: Basic Considerations and Best Practices--A Resource for Community Foundations*, from the Committee on Community Foundations Legal Advisory Subcommittee of the Council on Foundations (Washington, D.C.: 1996), which includes sample guidelines.

<sup>72</sup> I.R.C. § 170(b)(1)(E)(iii).

<sup>73</sup> The reasons for exclusion of gifts to public charities described in 509(a)(2), (3), and private operating foundations are not readily apparent.

Thus, the Code explicitly recognizes the concept of donor designations (as opposed to the “non-binding” advice traditionally rendered by a donor advisor of a donor-advised fund) and penalizes that control by classifying the pooled common fund as a private foundation subject to the Chapter 42 excise taxes discussed above. Note, however, that the Code simultaneously blesses the donor to a pooled common fund with public-charity-level deductibility. In summary, the deductibility of gifts is favored while the operations of the entity are held to a higher standard through application of Chapter 42 of the Code.

Compare that private-foundation operations treatment of the pooled common fund with the Type 3 supporting organization formed as a trust. There the donor can name the trustees, and so long as the donor and her disqualified persons do not “control” the supporting organization, the trust will be classified as a public charity.<sup>74</sup> But what does “control” mean in this context? For example, the donor could name herself and two siblings as trustees, name 50 charities in the trust, participate with her siblings in managing the investments (which neither the donor-advised fund donor-advisor<sup>75</sup> nor the pooled-common-fund donor can do) and the trust can still enjoy public charity status. In the Type 3 trust, the named charities must have the right to enforce the trust under state law but query whether one of 50 named beneficiaries would risk the donor’s ire or the cost to sue to compel enforcement. That assumes that the charity even knows it has been named in the trust, as notice is not required by the statute or regulations.

### XIII. NEW DEVELOPMENTS REGARDING DONOR-ADVISED FUNDS

In addition to the Fund for Anonymous Gifts case discussed above, the past three years have seen several new administrative developments for the donor-advised fund.

#### A. *Determination Letters Involving DAFs.*

Community foundations have been the traditional home of the DAF. In the 1970s, however, public charities (including religious organizations) that wished to become sponsoring charities of DAFs began running DAF programs. In addition, new sponsoring charities that wished to run DAFs as their main activity applied for and received private letter rulings and favorable determination letters in response to submissions of IRS Form 1023 (Application for Recognition of Exemption). This main-activity trend accelerated in the 1980s and the 1990s. In 1991, the Fidelity Charitable Gift Fund began its operations, having been recognized by the IRS as a public charity. In 1992, the Council on Foundations published Ed Beckwith’s and David

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<sup>74</sup> I.R.C. § 509(a)(3).

<sup>75</sup> See, *Fund for Anonymous Gifts v. Cmr.*, No. 95-1629, 1997 U.S. Dist. LEXIS 7771 (D.C.D.C. April 15, 1997), *vacated and remanded in part by Fund for Anonymous Gifts v. IRS*, 1999 U.S. App. LEXIS 8307 (D.C. Cir. 1999).



Marshall's informative treatise entitled "Establishing An Advised Fund Program", which includes model documents and resolutions. In 1996, the National Philanthropic Trust was recognized by the IRS as a public charity. In 1998, the Vanguard Charitable Endowment was recognized by the IRS as a public charity.

The Vanguard Charitable Endowment application came at a time when questions had been raised by some in the charitable community as to whether sponsoring charities of DAFs required particular characteristics and whether a sponsoring charity could invest in a particular mutual fund family. Therefore, the exempt-organization community read with interest the detailed files on the Form 1023 and supplemental correspondence between the Vanguard Charitable Endowment and the IRS National Office reviewers.<sup>76</sup> This correspondence ended on December 8, 1997, with the issuance of a favorable determination letter. In this detailed review, a number of operating characteristics were reviewed favorably. They have been voluntarily and uniformly adopted by the national donor advised funds formed in the 1990s and currently. For example, the American Gift Fund accepted these principles on its way to recognition by the IRS as a public charity in 1998.<sup>77</sup> In July 1998, the Fidelity Charitable Gift Fund voluntarily adopted (and reported to the IRS its adoption of) operating procedures consistent with these principles.

Anecdotal evidence suggests that the IRS is routinely referring sponsoring charities' Applications for Exemption to the IRS National Office for review against these principles. Thus, the file, for the OppenheimerFunds ® Legacy Program, was measured against them.<sup>78</sup> An interesting feature of this application for exemption is the detailed disclosure that the OppenheimerFunds ® Legacy Program will contract with financial advisors for services including making potential donors aware of the program and acting as a liaison between donors and the program. The compensation paid to financial advisors is a complicated topic and one that requires an understanding of securities laws that is not common in the exempt-organization community. The seminal article on the topic is authored by my colleague, David Shevlin, "Donor-Advised Funds: The Applicability of Rule 12b-1 Fees and Trail Commissions."<sup>79</sup> It is required reading for anyone interested in this topic, especially its analysis of current practices and existing authorities, such as the National Foundation case in which the U.S.

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<sup>76</sup> For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, May 1998, at 33ff.

<sup>77</sup> For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, June 1998, at 37ff.

<sup>78</sup> For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, February 2001.

<sup>79</sup> 32 EOTR (June 2001) at 423ff.

Claims Court approved of particular compensation arrangements for referral and other payments associated with DAFs.

Given the eventual favorable review by the IRS of the Oppenheimer application for exemption, it was therefore equally noteworthy when the IRS National Office released on February 15, 2001, a favorable determination letter approving the application for recognition of exemption for a new sponsoring charity for DAFs but only after the IRS had first rejected the organization's initial application.<sup>80</sup> Review of the letter suggests that the application did not comply on its face with the Vanguard Principles, which led to the IRS's rejection. The organization, the Tompkins Community Charitable Gift Fund (the "Tompkins Fund"), was organized by the Tompkins Community Trust Company (the "Bank") a state-chartered bank in Ithaca, New York. Among other things, the IRS required that the Tompkins Fund amend its by-laws to provide that a majority of the Tompkins Fund's directors will not have any connection with the Bank and that the Tompkins Fund will adopt a conflict-of-interest policy. In addition, the IRS required the materials sent to donors by the Tompkins Fund to inform potential donors that their contributions are unconditional and irrevocable.<sup>81</sup>

In his latest installment, Paul Streckfus has published the IRS's favorable determination letter dated November 21, 2001, to the National Charitable Gift Fund in Houston, Texas.<sup>82</sup> In its application for exemption, the National Charitable Gift Fund described itself as "the Trust" and went on to say that it intended to qualify as a "community trust" within the meaning of Treas. Reg. § 1.170A-9(e)(10). The Trust stated that, in order to distinguish itself from other existing community foundations, the Trust intended to enter into affiliations with colleges and universities throughout the United States to offer DAFs for them and that it had held preliminary discussions with Texas Christian University. The package included a letter from a Texas Christian University development vice chancellor expressing excitement about bringing "this great ideal to fruition."

Under the request for names of officers, trustees, the applicant listed National Fiduciary Services of Houston, Texas. This was a designation not acceptable to the IRS.

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<sup>80</sup> See Tax Notes Today for March 6, 2001 for an article analyzing the letter.

<sup>81</sup> For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, April 2001.

<sup>82</sup> For a reprint of the complete IRS administrative file, see Paul Streckfus' EO Tax Journal, March/April 2002, at 123ff. This file marks the fifth exemption application for a national donor-advised fund published by Mr. Streckfus. These files are required reading for any advisor preparing an application for recognition of exemption of a sponsoring charity of a donor-advised fund.

On May 15, 2001, Ronald Webster of Fizer Beck et al in Houston wrote to the IRS requesting expedited review. What followed was an exchange of four supplemental requests from the IRS and responses from the applicant. The correspondence provides a roadmap of IRS concerns that every Sponsoring Charity be governed by a serious board composed of a majority of independent trustees who are prominent philanthropists. The IRS required the Trust to adopt changes to bring its governance more in line with existing Sponsoring Charities and to appoint individuals as Trustees.

**B. *Current Developments.***

While it is difficult to find statistics, it appears that fewer new Sponsoring Charities have been created and applied to the IRS for recognition of exemption over the past twelve months than in prior recent years.

In his November/December 2002 EO Tax Journal, Paul Streckfus published the exemption application materials of Allfirst Charitable Gift Fund, Inc. of Baltimore, MD. The Fund has an independent board of directors and answered 17 additional questions asked by the IRS in a request for supplemental information. The IRS granted recognition of exemption in a letter dated July 18, 2002.<sup>83</sup>

In his January/February 2003 issue, Mr. Streckfus published the correspondence leading to the favorable recognition of the Wealthnet Charitable Gift Fund.<sup>84</sup> In his Editor's Notebook, Mr. Streckfus offers editorial comments on the application process for new Sponsoring Charities and, in particular, the IRS's review of the applicant's governance. In that connection, Mr. Streckfus stated in part, "I think the recommended 'Common Operating Procedures' . . . are correct in stating under 'Governance of a Sponsoring Charity,' that 'A sponsoring charity is governed by a board, the majority of whose members are independent from any for-profit organization that provides goods or services to the sponsoring charity.'" (Emphasis added.)<sup>85</sup>

**C. *IRS FY 2001 EO CPE Textbook, Topic G, Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Financial Institutions.***

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<sup>83</sup> For a reprint of the complete IRS Administrative file, see Paul Streckfus' EO Tax Journal, November/December 2002 at 159ff.

<sup>84</sup> For a reprint of the complete IRS Administrative file, see Paul Streckfus' EO Tax Journal, January/February, 2003, at 211ff. This is the most recent in the series of Sponsoring Charities exemption files helpfully published by Mr. Streckfus.

<sup>85</sup> *Id.* at pp. 235-6.

In the CPE article, the IRS reports that it has seen an increasing number of exemption applications and ruling requests regarding DAFs. The IRS says that it will continue to scrutinize these cases and plans to review the applications and requests using “principles similar to the material restriction or condition requirement of the regulations.” The IRS will scrutinize applications that include contractual or promotional material that indicates a DAF would always follow donor advice, provided the donor recommends a public charity grantee. The IRS is also considering whether to treat the fact that distributions from DAFs may only be triggered by donor recommendations as a negative factor. The IRS is considering the view that if a DAF is unable to initiate a charitable distribution to a public charity, it lacks ownership over the property. However, if a DAF imposes an annual five percent distribution requirement on each separate donor advised account, and provides that a failure to distribute would result in transfer of the funds to an unrestricted account, this provision may be viewed as a method by which a DAF initiates a distribution.

**D. *IRS FY 2002 EO Implementing Guidelines.***

On October 5, 2001, the Exempt Organizations Division of the Internal Revenue Service released its Implementing Guidelines for Fiscal Year 2002 (the “IRS 2002 Workplan”), which included projected activities and emphasis areas for EO Rulings and Agreements, EO Examinations, and EO Customer Education and Outreach.

In the IRS 2002 Workplan, the EO Examinations group stated that it would begin six market segment studies in fiscal year 2002, including a market segment study of community trusts. The market segment study of community trusts would involve collating available information, including compliance information regarding the organizational test, employment tax, unrelated business income tax, fundraising, inurement/private benefit, charitable contribution deductions, intermediate sanctions and public disclosure, for the “community trust” market segment and then identifying and analyzing the compliance risks associated with that market segment. The IRS indicated that the market segment study would involve “a nation-wide sample of 150 returns.”

In addition, in the IRS 2002 Workplan, the EO Examinations group stated that it had designated several compliance/education projects for fiscal year 2002 to “address concerns or known areas of non-compliance.” These projects included a project involving donor-advised funds whereby “a cross-functional taskforce will provide the Director, EO Examinations, by April 1, 2002, with a detailed plan specifying how the IRS will identify organizations that provide donor-advised funds as well as strategies to determine the organizations’ level of compliance with the tax laws, including the rules relating to [charitable contribution deductions].” In the IRS 2002 Workplan, the IRS stated that this project is being undertaken as a result of the “large volume of contributions” being received by national donor advised funds.

**E. *Update on DAF Cases.***

On March 20, 2003, the Chronicle of Philanthropy reported that the longstanding dispute over the Fund for Anonymous Gifts ended with the granting by the IRS of an advance ruling classification as a public charity.<sup>86</sup>

Set up in 1994 by the late William Lehrfeld, the Fund had originally been denied exemption in 1996. Since then, reporting on the Fund's status in litigation had become an annual event at this conference. Ironically, the final chapter in this saga occurred when the case was randomly selected for a mediated settlement program. The Fund will now have until December 2007 to prove that it has sufficient support to satisfy the public support test.

#### **XIV. COMMON OPERATING PROCEDURES FOR DONOR ADVISED FUNDS.**

As noted above, successful sponsoring charities that operate donor-advised fund programs as their principal activity (often known as "national donor-advised funds" or "NDAFs") have certain operating procedures in common. These procedures have become standardized largely through the parade of Forms 1023 and the ensuing correspondence between the applicants and the IRS. These operating procedures are not static and have and will continue to evolve in response to developments in the legal, philanthropic and Internet environments.

Over the past fourteen months, several national donor advised funds have developed a self-governance document entitled "Common Operating Procedures for Donor Advised Funds." This document has been reviewed by and subscribed to by a number of Sponsoring Charities. A roadmap to common operating procedures currently being used by many national donor advised funds, this document is intended as a general resource for new and existing Sponsoring Charities. It contains useful definitions and plain-English discussions of governance of a Sponsoring Charity; roles and privileges of the Sponsoring Charity, the Donor, and the Donor Adviser; interaction between a Sponsoring Charity and Donors and Donor Advisers; grantmaking procedures for many different categories of grants; and maintaining levels of activity in DAF accounts. A copy of the current version is attached as Appendix E.

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<sup>86</sup> Stephen G. Greene, "Anonymous-Gift Fund Gets Final OK From IRS," March 20, 2003.

**A MATRIX OF CONTROL**

	Favorable Deduction Levels?	Donor Can Have Exclusive Control Over Grantmaking?	Donor Can Have Exclusive Control Over Investments?	Remarks
Endowed Private Foundation	NO	YES	YES	Deductibility limits and I.R.C. Chapter 42 excise-tax boundaries are the trade off for complete control over contributions (except for the completed gift rules), investments, expenditures.
Type 3 Corp SO	YES	NO	NO	SO must meet responsiveness test which requires one or more common officers or directors or close and continuous working relationship <u>AND</u> the supported organization's managers have a "significant voice" in the supporting organization's investment policies, grant timing, grant making, selection of recipients, directing use of income or assets.
Type 3 Trust SO	YES	YES	NO	Special trust responsiveness test: Each public charity is named in and can enforce the trust and compel an accounting.
Pooled Common Fund	YES	YES	NO	A defective supporting organization: "would be described in section 509(a)(3) but for the right of any substantial contributor . . . or his spouse to designate annually" public charity recipients described in 509(a)(1) only.
Donor Advised Fund	YES	NO	NO	Component-part test has been voluntarily adopted by community foundations, although only component-part trusts must likely abide by it. Material-restriction rules look to lack of completed gift and excessive donor control for purposes of private-foundation terminations. Newly created sponsoring charities DAFs generally provide in Forms 1023 that they will operate in accordance with "Vanguard Principles".

PROFILE OF A SUPPORTING ORGANIZATION (“SO”)  
UNDER IRC § 509(a)(3) AND TREAS. REG. § 1.509(a)-4

- I. IRC: A. Organized & operated test      Operated, supervised, or controlled by or in connection with a public charity (“PC”) and      B. Not controlled directly or indirectly by disqualified persons or non-PCs
- II. Treasury Regulations:
- A. Organization Test<sup>87</sup> - Articles of organization (charter, trust, articles of association) must
1. Limit the purposes to 509(a)(3)(A) purposes: to benefit, perform functions of, or carry out purposes of specified PC(s),
  2. Not expressly empower organization to engage in activities beyond those above,
  3. State the specified PC(s) to be benefitted, and
  4. Not expressly allow the SO to support any but the specified PC(s).
- Operational Test<sup>88</sup>
- a. Permissible beneficiaries: payments to or for use of specified PC(s), providing payments, services, or facilities to individuals in charitable class benefitted by specified PC(s), and certain grants to organizations
  - b. Permissible activities: pay income to specified PC(s) or use income for independent activity to benefit specified PC(s) or its charitable beneficiaries

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<sup>87</sup> Treas. Reg. § 1.509(a)-4(c) and (d) (specified-organization rules).

<sup>88</sup> Treas. Reg. § 1.509(a)-4(e).

B. Relationship Test<sup>89</sup>

All require: SO must be responsive to specified PC(s)'s needs, demands and SO will be integral part of or significantly involved in PC operations. Three types of relationships:

TYPE 1	TYPE 2	TYPE 3
<u>Operated, supervised, controlled BY PC(s)</u>	<u>Supervised or controlled IN CONNECTION WITH PC(s)</u>	<u>Operated IN CONNECTION WITH PC(s)</u>
<u>Analogy:</u> Parent-subsidiary	<u>Analogy:</u> Brother-sister affiliates	<u>Analogy:</u> Responsive and significantly involved private foundation
<u>Key Features:</u> PC elects or appoints majority of SO's officers, directors, or trustees. PC can exercise power through its governing body, their designees, officers acting in their official capacity or membership	<u>Key Features:</u> PC and SO are under common control of same persons who can thereby insure that SO will be responsive to PC's needs	<u>Key Features:</u> SO must prove responsiveness by having one or more of the SO's officers, director or trustees elected or appointed by PC(s); or overlap between PC(s)' and SO's officers, directors, trustees, or other important officers, or SO's officers, directors, or trustees maintain a "close and continuous working relationship" with PC counterparts <u>AND</u> PC managers have significant voice in SO's investment policies, grant timing, grant making, selection of recipients, directing use of income or assets.
		Special trust responsiveness test: Each PC is named in trust and can enforce trust and compel accounting under state law.
		Integral part test for all Type 3 SOs: PC(s) must depend upon SO for support -- (i) "but for" SO, PC would do what SO does or (ii) SO pays "substantially all" of its income to PC and amount is sufficient to assure PC's attentiveness.

<sup>89</sup> Treas. Reg. § 1.509(a)-4(f)-(i).



C. Disqualified Persons Do Not Control SO<sup>90</sup>

One or more disqualified persons under IRC § 4946 cannot directly or indirectly control SO. IRC § 4946 substantial contributors, 20%+ owner of corporation, partnership, or trust, their families and their corporations, trusts, or partnerships. Foundation managers who are not otherwise DQPs and PCs are not counted in testing for control. “Control” means DQPs can aggregate votes or positions of authority to require SO to perform or refrain from performing an act.

Indirect control: Facts and circumstances including asset analysis and appointment of a DQP’s employees.

Church rule: Church SO won’t be controlled by DQPs if governed by individuals each of whom is a substantial contributor if bishop or other church representative controls policies and decisions.

D. Non-PC Sos<sup>91</sup>

“ Flush left” language in Code allows SOs for charitable, etc. purposes of organizations described in § 501(c)(4) (social welfare or labor organizations); (c)(5) (agricultural organizations); or (c)(6)(business leagues) that meet the one-third support test of a § 509(a)(2) PC.

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<sup>90</sup> Treas. Reg. § 1.509(a)-4(j).

<sup>91</sup> Treas. Reg. § 1.509 (a)-4(k).

**A. Summary of Treasury Regulations I — The Component-Part Rules.**

As mentioned in the text, many older community foundations were formed under the “component-fund” rules as aggregations of multiple trusts. These rules are found in the regulations governing qualification as a “community trust,” which also apply to aggregations of nonprofit corporations or unincorporated associations.<sup>92</sup> As noted above, many newer community foundations which are formed as single corporations which manage segregated donor accounts choose voluntarily to comply with these rules. Following is a summary of the section 1.170A regulations governing organizations seeking component-part treatment:

1. To qualify as a public charity, a community trust is required to meet one of two public support tests: the 33 1/3 percent of support test<sup>93</sup> or the facts and circumstances test.<sup>94</sup> A community trust can satisfy the second test by seeking gifts from a wide range of potential donors through banks, trust companies, or attorneys, or in other ways which call attention to the community trust as a potential recipient of gifts made for the community’s benefit. It is not required to engage in “community-wide . . . campaigns directed toward attracting a large number of small contributions.”<sup>95</sup>
2. “The organization must be commonly known as a community trust, fund, foundation or other similar name conveying the concept of a capital or endowment fund to support charitable activities . . . in the community or area it serves.”<sup>96</sup>

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<sup>92</sup> Treas. Reg. § 1.170A-9(e)(11)(i). This structure is distinguishable from an organization structured as a corporation which manages aggregations of accounts, each of which exists solely as an entry in the corporation’s books, not as a separate entity.

<sup>93</sup> Treas. Reg. § 1.170A-9(e)(2).

<sup>94</sup> Treas. Reg. § 1.170A-9(e)(3).

<sup>95</sup> Treas. Reg. § 1.170A-9(e)(10). Note: It is not clear whether an organization operating as a community foundation, but not seeking component-fund treatment, may take advantage of this modified facts and circumstances test.

<sup>96</sup> Treas. Reg. § 1.170A-9(e)(11)(iii).

3. All funds of the organization must be subject to a common governing instrument, and the organization must have a common governing body or distribution committee.<sup>97</sup>
4. The governing body must possess and be committed to exercising the following powers:
  - (A) To modify any restriction or condition on the distribution of funds if, in the governing body's sole judgment, such restriction or condition becomes unnecessary, incapable of fulfillment, or inconsistent with the community's charitable needs;
  - (B) To replace a trustee, custodian, or agent for breach of fiduciary duty; and
  - (C) To replace a trustee, custodian or agent for failure to produce a reasonable return of net income.<sup>98</sup>
5. The governing body must take steps to see that each component trust or fund is administered in accordance with the terms of its governing instruments and accepted standards of fiduciary conduct to produce a reasonable return of net income, with due regard to safety of principal, in furtherance of the community trust's exempt purposes.<sup>99</sup>
6. The organization must prepare periodic common financial reports, treating all funds as funds of the organization.<sup>100</sup>

If an organization meets the requirements outlined above, it will be treated as a single entity, rather than as an aggregation of separate funds. A trust or fund which meets the following requirements will be treated as a "component part" of the single entity:

- (A) It must be created by a gift, bequest, legacy, devise or other transfer to an organization treated as a single entity; and
- (B) It may not be directly subjected by the transferor to any material restriction or condition (within the meaning of Treas. Reg. § 1.507-2(a)(8)) with respect to the transferred assets.<sup>101</sup>

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<sup>97</sup> Treas. Reg. § 1.170A-9(e)(11)(iv), (v)(A).

<sup>98</sup> Treas. Reg. § 1.170A-9(e)(11)(v)(B), (E).

<sup>99</sup> Treas. Reg. § 1.170A-9(e)(11)(v)(F).

<sup>100</sup> Treas. Reg. § 1.170A-9(e)(11)(vi).

If the component-part requirements are not met, the failed component part will be treated as a separate trust, corporation or association, and would likely be treated as a private foundation because, standing alone, it would fail the public-support test.<sup>102</sup>

**B. *Summary of Treasury Regulations II — The Private Foundation Termination Rules.***

Transfers of assets to the entities that comprise the component parts of a community trust are governed by the “material-restriction” regulations. Originally drafted to govern the termination of private foundations, the standards outlined in these regulations have traditionally been applied to donor-advised funds (whether or not affiliated with a community foundation). There has, however, been controversy over whether and to what the extent these rules apply to donor-advised funds which are in corporate form or not seeking “component-fund” treatment under the component-part regulations discussed above. Note that the rules also address behavior of the donor and whether the donor has made a completed gift. A summary of the material-restriction regulations follows:

1. To transfer “all right, title and interest” in an asset, the donor “may not impose any material restriction or condition that prevents the transferee organization ... from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes.” Whether a particular restriction is “material” is determined from the facts and circumstances.<sup>103</sup>
2. Four Factors Test. Some of the more significant facts and circumstances are:
  - (A) Whether the transferee public charity (for purposes of this summary the “PC”) is the fee owner of the assets received;
  - (B) Whether the assets are held and administered by the PC in a manner consistent with one or more of its exempt purposes;
  - (C) Whether the governing body of the PC has the ultimate authority and control over the assets and the income derived from them; and
  - (D) Whether the governing body of the PC is independent from the donor.<sup>104</sup>

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<sup>101</sup> Treas. Reg. § 1.170A-9(e)(11)(i). *See* discussion below of the material-restriction regulations.

<sup>102</sup> Treas. Reg. § 1.170A-9(e)(14).

<sup>103</sup> Treas. Reg. § 1.507-2(a)(8).

<sup>104</sup> Treas. Reg. § 1.507-2(a)(8)(i)(A)-(D).

3. Non-Adverse Factors. Some or all of the following factors may be present without preventing the PC from freely and effectively employing the assets or income:
- (A) A fund is given the name of the donor or donor's family.
  - (B) The income and assets are to be used for a designated purpose or for one or more PCs and such use is consistent with the transferee PC's own exempt purposes.
  - (C) The transferred assets are administered in an identifiable or separate fund, some or all of the principal of which is not to be distributed for a specified period, if the PC is the legal and equitable owner of the fund and its governing body exercises ultimate and direct authority and control over such fund, as, for example, to endow a chair at a university or a medical research fund at a hospital. In the case of a community trust, the transferred assets must be administered in or as a component part of the community trust within the meaning of § 1.170A-9(e)(11), discussed above.
  - (D) If the donor restricts disposition by the transferee PC, the asset retention must be important to the achievement of charitable purposes in the community because of the peculiar features of the property, as, for example, where a donor transfers a woodland preserve which is to be maintained by the PC as an arboretum for the benefit of the community. "Such a restriction does not include a restriction on the disposition of an investment asset or the distribution of income."<sup>105</sup>
4. The Adverse Factors. The Treasury regulations recite that the presence of any of the following seven factors (as well as subparagraph A's nine subfactors) will be considered as preventing the PC from freely and effectively employing the assets and income:
- (A) Distributions--The donor reserves the right, directly or indirectly to name the persons to which the PC must distribute, or to direct the timing of such distributions.<sup>106</sup>

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<sup>105</sup> Treas. Reg. § 1.507-2(a)(8)(iii)(A)-(D).

<sup>106</sup> An exception exists for designations as to persons or timing contained in the instrument of transfer to the PC. Treas. Reg. § 1.507-2(a)(8)(iv)(A)(1).

In a facts and circumstances review, the IRS will determine if a right was indirectly reserved: “In any such case, the reservation of such a right will be considered to exist where the only criterion considered by the PC in making a distribution on income or principal from a donor’s fund is advice offered by the donor.”

The following five subfactors (some or all) indicate that a right is NOT reserved:

- (i) an independent investigation by the PC’s staff evaluated whether the donor’s advice is consistent with specific charitable needs most deserving of support (as determined by the PC);
- (ii) the PC has promulgated guidelines enumerating specific charitable needs consistent with the PC’s charitable purpose and the donor’s advice is consistent with those guidelines;
- (iii) the PC has an educational program telling about the guidelines;
- (iv) the PC distributes funds in excess of amounts distributed from the donor’s fund to the same or similar types of organizations as the donor recommends; and
- (v) the PC’s written or oral solicitations specifically state that the PC will not be bound by the donor’s advice.<sup>107</sup>

The following four subfactors (some or all) indicate that the reservation of a right by donor DOES exist:

- (vi) the written or oral solicitations state or imply, or a pattern of conduct by the PC creates the expectation, that the donor’s advice will be followed;
- (vii) the advice of a donor is limited to amounts from the donor’s fund and the independent investigation or guidelines discussed above do not exist;
- (viii) only the advice of the donor as to distributions from the donor’s fund is solicited by the PC and no procedure is provided for considering advice of persons other than the donor as to the donor’s fund; and

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<sup>107</sup> Treas. Reg. § 1.507-2(a)(8)(iv)(A)(2)(i)-(v).

- (ix) for the taxable year in question and all prior taxable years the PC follows the advice of all donors substantially all the time.<sup>108</sup>
- (B) Other action or withholding of action. Through the terms of the transfer agreement or through some other understanding, the donor requires the PC to act or not act in a way that does not further its exempt purposes (and an excise tax would result if the act or withholding was done by a transferor private foundation);
- (C) Assumption of leases, etc. The PC assumes leases, contractual obligations, or liabilities of the donor or takes the assets subject to such liabilities, for purposes not in the best interests of the PC.
- (D) Retention of investment assets. The PC is required expressly or impliedly to retain any investment, except as required by law or regulatory authority; retention of assets with low annual returns of income will be examined carefully.
- (E) Right of first refusal. Donor transfers the property subject to a right of first refusal to herself or her “disqualified persons”.
- (F) Irrevocable Relationships. An agreement is entered into between the donor and the donee which establishes irrevocable relationships with banks, brokerage firms, investment counselors or others (other than a trustee or custodian acting as such).
- (G) Other conditions. Any other condition is imposed to prevent the PC from exercising ultimate control over the assets for purposes inconsistent with its exempt purposes.<sup>109</sup>

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<sup>108</sup> Treas. Reg. § 1.507-2(a)(8)(iv)(A)(3)(i)-(iv). To address this provision, The Columbus Foundation has a policy of requiring that one-third of the income from each donor-advised fund account be expended at the recommendation of the Foundation’s staff and board without any involvement of the donor as to that portion.

<sup>109</sup> Treas. Reg. 1.507-2(a)(8)(iv)(B)-(G).

**WHERE TO FIND A DONOR-ADVISED FUND**

1. **Community foundation.** The community foundation is the traditional home of the donor-advised fund. In 1994, combined assets of U.S. community foundations exceeded \$10.07 billion. The New York Community Trust alone manages assets in excess of \$1 billion. There are approximately 550 community foundations that offer donor-advised fund programs. A potential donor can locate her nearest community foundation by consulting her financial or tax advisor or by contacting the Council on Foundations in Washington, D.C. ((202) 466-6512 or on the web at [www.cof.org](http://www.cof.org)) or by contacting Community Foundations of America at (502) 581-0804 or on the web at [www.cfamerica.org](http://www.cfamerica.org).
  
2. **A Selection of National Donor-Advised Funds.**
  - a. **The Fidelity Charitable Gift Fund.**

Fidelity Charitable Gift Fund  
Cynthia Egan, President  
82 Devonshire Street, F35  
Boston, MA 02109  
Tel: 1-800-682-4438  
The Gift Fund maintains an excellent website at [www.charitablegift.org](http://www.charitablegift.org).  
Now over ten years old.
  
  - b. **The National Philanthropic Trust (“NPT”).**

The National Philanthropic Trust  
Eileen Heisman, SVP  
One Pitcairn Place, Suite 3000  
Jenkintown, PA 19046  
(888) 878-7900  
Website: [www.nptrust.org](http://www.nptrust.org).
  
  - c. **Vanguard Charitable Endowment Program.**

Vanguard Charitable Endowment  
Benjamin Pierce, Executive Director  
P.O. Box 3075  
Southeastern, PA 19398-9917  
Tel.: 1-888-383-4483  
Fax: 1-888-426-3273  
Website: [www.vanguardcharitable.org](http://www.vanguardcharitable.org)



d. **The American Gift Fund.**

The American Gift Fund  
H. Lee Cheney III, President  
220 Continental Drive, Suite 401  
Newark, DE 19713  
Tel.: 1-800-240-4248  
Fax: (302) 731-2828  
Website: [www.giftfund.org](http://www.giftfund.org)

e. **The Bessemer National Gift Fund.**

Bessemer National Gift Fund  
William Forsyth, Jr., Managing Director  
630 Fifth Avenue  
New York, NY 10111  
Tel: (212) 708-9100  
Fax: (212) 265-5826  
E-mail: [wealth@bessemer.com](mailto:wealth@bessemer.com).

f. **The Ayco Charitable Foundation.**

The Ayco Charitable Foundation  
Peter Martin, General Counsel  
P.O. Box 8009  
Clifton Park, NY 12065-8009  
1-800-335-5353

g. **Schwab Fund for Charitable Giving.**

Schwab Fund for Charitable Giving  
Kim Wright-Violich, President  
101 Montgomery Street  
San Francisco, CA 94104  
Tel.: 1-800-746-6216  
Website: [www.schwabcharitable.org](http://www.schwabcharitable.org).

h. **The U.S. Charitable Gift Trust.**

The U.S. Charitable Gift Trust  
Eric Woodbury, Vice President  
The Eaton Vance Building  
255 State Street  
Boston, MA 02109  
Tel: 1-800-664-6901  
Website: [www.charitablegifttrust.org](http://www.charitablegifttrust.org).

i. **T. Rowe Price Program.**

The T. Rowe Price Program for Charitable Giving  
Ann Boyce, Executive Director  
100 East Pratt Street, 8<sup>th</sup> Floor  
Baltimore, MD 21202  
Tel: 1-800-690-0438  
Website: [www.programforgiving.org](http://www.programforgiving.org).

j. **Oppenheimer Funds Legacy Program.**

Oppenheimer Funds Legacy Program  
Raquel Granahan, Vice President  
10200 E. Girard Bldg. D  
Denver, CO 80231-5516  
Tel: 1-877-OFI-GIVE  
Website: [www.opplegacy.org](http://www.opplegacy.org).

k. **J.P. Morgan Charitable Giving Fund.**

Amy H. Davidsen, VP  
The Chase Manhattan Private Bank  
1211 Avenue of the Americas, 37<sup>th</sup> Floor  
New York, NY 10036-8890  
(212) 789-4867  
Fax (212) 596-3131  
(Administered through National Philanthropic Trust)

1. **Calvert Giving Fund.**

Calvert Social Investment Foundation  
4550 Montgomery Avenue  
Bethesda, MD 20814  
1-800-248-0337  
Website: [www.calvertgiving.org](http://www.calvertgiving.org).

m. **LeggMason Donor Advised Fund.**

Website: [www.leggmason.com](http://www.leggmason.com)  
(Administered through National Philanthropic Trust)

n. **American Express Charitable Giving Program.**

Launched November 1, 2001. (Administered through National Philanthropic Trust)

3. **Public Charities With Substantial Advised Fund Programs.**

Many PCs have (or will create upon request) donor-advised funds dedicated to the furtherance of the PC's exempt purposes. For advice on setting up a program, see *Establishing an Advised Fund Program* (Washington, D.C.: Council on Foundations (202-466-6512), 1992), which includes sample documents; "The Donor-Advised Fund," 12 *Charitable Gift Planning News* 4 (March 1994).

- a. **The Funding Exchange.** The Funding Exchange ("FEX" for short) is a national membership network of community funds that fund grassroots groups working for social change. Between 1979 and 1993, FEX made over \$55 million in grants. FEX awards over \$3 million each year in donor-advised and activist-advised funds. The activist-advised funds are the Saguaro Fund (grants to communities of color), the Paul Robeson Fund for Independent Media, and OUT: A Fund for Gay and Lesbian Liberation.

Funding Exchange  
666 Broadway, Suite 500  
New York, NY 10012  
(212) 529-5300

Member funds include: Appalachian Community Funds, Bread & Roses Community Fund (Philadelphia & Camden), Chinook Fund (Colorado), Crossroads Fund (Chicago), Fund for Southern Communities, Haymarket People's Fund (New England), Headwater's Fund (Minneapolis/St.

Paul), Liberty Hill Foundation (LA County), McKenzie River Gathering Foundation (Oregon), North Star Fund (NYC), Vanguard Public Foundation (northern California), Wisconsin Community Fund, The People's Fund (Hawaii), and Three Rivers Community Fund (SW Pennsylvania).

- b. **The Tides Foundation.** Founded in 1976 by Drummond Pike, who is the Tides Foundation's President, the Tides Foundation is organized like a community foundation but differs in that (i) it is national in scope, (2) provides financial and management services to more than 200 projects around the country, and (3) provides donor advisory services to other foundations, individuals and corporations. In 1996, the Tides Foundation created a sibling entity, the Tides Center, to conduct the public education programs previously conducted within the Tides Foundation. The Tides Foundation has component funds and donor-advised funds and a socially screened asset management policy. The grantmaking program promotes change toward a healthy society, founded on principles of social justice, broadly shared economic opportunity, robust democracy, and sustainable environmental practices.

The Tides Foundation  
P.O. Box 29903  
San Francisco, CA 94129-0903  
(415) 561-6400

- c. **The Philanthropic Collaborative, Inc. ("TPC").** TPC is a public charity established by several generations of Rockefeller family members in 1991 to facilitate philanthropy and to support the growth of a creative nonprofit sector. TPC assists donors by offering administrative, financial, and program development support. TPC also achieves its mission through donor-advised funds, which require an initial contribution of \$50,000 or more.

The Philanthropic Collaborative, Inc.  
Room 5600  
30 Rockefeller Plaza  
New York, NY 10112  
(212) 649-5949

- d. **CAF America.** A U.S. public charity, CAF America is the U.S. affiliate of the UK's Charities Aid Foundation. CAF America combines features of a donor-advised fund with those of an "American Friends of" organization

for grantmaking to non-U.S. charities. It charges fees for its administrative and grantmaking services.

CAF America  
King Street Station  
Suite 150  
1800 Diagonal Street  
Alexandria, VA 22314  
(703) 549-8931

- e. **The American Ireland Fund.** The American Ireland Fund administers an advised-fund program promoting peace, culture, and charity in Ireland, north and south, since 1976.

The American Ireland Fund  
320 Park Avenue  
Fourth Floor  
New York, NY 10022  
(212) 224-1286

- f. **The Giving Back Fund.** The Giving Back Fund specializes in advised funds for professional athletes such as Buffalo Bills quarterback Doug Flutie. The new minimum initial contribution is \$250,000, according to a January 2002 Boston Globe article.

The Giving Back Fund  
230 Congress Street  
Boston, MA 02110  
(617) 556-2820  
Fax: (617) 426-5441  
Website: [www.givingback.org](http://www.givingback.org)

- g. **The Nature Conservancy Donor Advised Fund.**

The minimum initial gift is \$100,000 and 50% or more of the distributions from both income and principal must go to projects within the Conservancy; the balance can be recommended to "charitable organizations or private operating foundations with values not inconsistent with" TNC. Website: [www.tnc.org](http://www.tnc.org).

- h. **United Way of Massachusetts Bay.**

Website: [www.uwmb.org](http://www.uwmb.org)

i. **Family Care Foundation Donor Advised Fund.**

Website: [www.familycare.org](http://www.familycare.org).

j. **Give2Asia Donor Advised Fund.**

Administered through the Asia Foundation.

Website: [www.give2asia.org](http://www.give2asia.org)

k. **Rotary Foundation Donor Advised Fund**

Each year \$250 per DAF or 1% of the value of a group DAF is automatically allocated to the Annual Programs Fund to support the Rotary Foundation's programs. Upon the death of the account holder, at least 50% of the remaining account balance will be transferred to the Rotary Foundation's Permanent Funds. The site includes DAF brochures, DAF leaflets, DAF program circulars, and a 2002 PowerPoint presentation.

Website: [www.rotary.org](http://www.rotary.org) and click on the donor-advised fund links.

4. **University Donor Advised Funds:**

a. Cornell University

The Cornell University Foundation

Website: [www.alumni.cornell.edu/giving/Foundation](http://www.alumni.cornell.edu/giving/Foundation)

b. Harvard University

The Harvard Donor Advised Fund (HDAF)

Website: [www.aad.harvard.edu/pgo](http://www.aad.harvard.edu/pgo)

c. University of California-Los Angeles

d. The University of Colorado Foundation

e. Oklahoma State University Foundation

f. Boston University. Website: [www.bu.edu/alumni/dagf](http://www.bu.edu/alumni/dagf)

g. Haverford Donor Advised Fund. Website: [www.haverford.edu](http://www.haverford.edu)

5. **Religiously-Initiated Donor Advised Funds.**

a. **Jewish Community Foundation**

5700 Wilshire Boulevard

Suite 2000  
Los Angeles, CA 90036  
(213) 761-8700  
Fax: (213) 761-8720

b. **Jewish Community Endowment Foundation**  
843 St. Georges Avenue  
Roselle, NJ 07203  
(908) 298-8200  
Fax: (908) 298-8220

c. **National Catholic Community Foundation**  
1210C Benfield Boulevard  
Millersville, MD 21108  
1-800-757-2998

d. **National Christian Foundation**  
Terry Parker, Director and General Counsel  
1275 Peachtree St. NE, Suite 700  
Atlanta, GA 30309  
(404) 888-7444  
Fax: (404) 870-4843

NCF will not honor donor advice contrary to its published doctrinal principles. Its material also states that it "is unique among Foundations because we offer our Donors the comfort and safety of a Private Letter Ruling from the IRS that 'pre-approves' the NCF Donor-Advised Fund."

e. **InterVarsity Christian Fellowship Donor Advised Fund**  
Website: [www.ivcf.org](http://www.ivcf.org)  
InterVarsity charges a minimum \$1,000 set up fee per account and advertises itself as "an alternative to commercial gift funds...."

f. **World Vision Charitable Vision Fund**  
Website: [www.worldvision.org](http://www.worldvision.org)

g. **LDS Foundation Donor Advised Fund**  
Website: [www.lds.org](http://www.lds.org)  
Administered by Deseret Trust Company

6. **Other Donor Advised Funds:**

a. **FJC**  
130 East 59<sup>th</sup> Street

New York, NY 10022  
(212) 832-2405  
Fax: (212) 832-3832

FJC is a “Foundation of Donor Advised Funds.” Formed in 1995, FJC has approximately \$70 million in DAFs. Through its Grant Assistance Program, FJC makes grants to foreign charities and non(c)(3) donees.

- b. **Jewish Communal Fund**  
130 East 59th Street, Suite 1204  
New York, NY 10022  
(212) 752-8277  
Fax: (212) 319-6963  
[www.jewishcommunalfund.org](http://www.jewishcommunalfund.org)

The JCF was established in 1972 and has over 2,000 donors. Since its inception has made grants in excess of \$1 billion to thousands of charities, sectarian and nonsectarian. The Jewish Communal Fund has approximately \$650 million in DAFs.

7. **Calling for Caution or Critical Investigation.**

- a. **National Community Foundation**  
101 Westpark Drive, Suite 160  
Brentwood, TN 37027  
1-800-535-2601 or  
(615) 309-5030  
Fax: (615) 309-5031
- b. **The American Foundation**  
4518 North 32nd Street  
Phoenix, AZ 85018  
1-800-788-8992  
(602) 955-470  
Fax: (602) 955-4707
- c. **Charitable Alliance  
Charitable Advisors, Inc.**  
1 Turtle Creek Village  
3818 Oak Lawn Avenue, Suite 606  
Dallas, TX 75210-4471  
(214) 523-3982  
Fax: (214) 523-3929



- d. **National Foundation, Inc.**  
700 Valley View Drive, Suite D  
Woodland Park, CO 80863  
(719) 687-8764  
Fax: (719) 687-8780  
Shares office space with Christian Community Foundation.
  
- e. **National Heritage Foundation**  
6218 Beachway Drive  
Box 1776  
Falls Church, VA 22041  
1-800-986-4483  
Fax: (703) 820-4483

## Common Operating Procedures for Donor Advised Funds

February 2002

### I. Introduction.

The charitable community has recently seen tremendous growth in the area of Section 501(c)(3) public charities operating donor advised funds. In a donor advised fund, a donor makes a charitable contribution to a sponsoring charity that maintains the donor's contributions in a separately-identified account (each of which is referred to as a "donor advised fund account"). The sponsoring charity receives and retains exclusive ownership and legal control over amounts contributed to and investment returns of each donor advised fund account. The sponsoring charity allows the donor and persons designated by the donor ("donor advisers") to have advisory privileges with respect to grants from each donor advised fund account. In addition, the sponsoring charity may allow the donor and donor adviser to have advisory privileges with respect to the investment allocation of assets in each donor advised fund account.

Sponsoring charities, including those that operate donor advised fund programs as their principal activity (often known as "national donor advised funds" or "NDAFs"), play an important and growing role in the world of philanthropy. In the past few years, NDAFs have raised and granted billions of dollars for charitable purposes. As they have evolved, NDAFs have developed a number of common operating procedures. These procedures are continually being improved by NDAFs in response to changes and developments in charitable giving and in response to guidance from the IRS, the U.S. Treasury Department and other sources of legal authority.

This document describes the common operating procedures currently being used by many NDAFs. The procedures discussed below cover a broad range of potential activities by a NDAF, and not every NDAF participates in all of these activities. This document is intended to be a general resource for new and existing sponsoring charities. Each sponsoring charity should consult its own advisers as it develops its own operating procedures.

**II. Governance of a Sponsoring Charity.**

**A. A Sponsoring Charity Has an Independent Board.**

*A sponsoring charity is governed by a board, the majority of whose members are independent from any for-profit organization that provides goods or services to the sponsoring charity. The board is responsible for all aspects of the sponsoring charity's operations, including (i) overall stewardship of the charitable mission, (ii) grants and expenditures from each donor advised fund account, (iii) investment of funds maintained in each donor advised fund account; (iv) grantmaking from the sponsoring charity's general fund, and (v) the reasonableness of its contractual and other relationships with third parties.*

**B. A Sponsoring Charity Has a Written Conflicts of Interests Policy.**

*A sponsoring charity adopts a written conflicts of interest policy governing participation by board members and officers in matters involving the sponsoring charity*

**C. A Sponsoring Charity is Subject to an Annual Audit.**

*A sponsoring charity's financial records are audited annually by an independent public accounting firm.*

**III. Roles and Privileges of the Sponsoring Charity, the Donor and the Donor Adviser.**

**A. Roles of the Sponsoring Charity.**

*A sponsoring charity has exclusive ownership and legal control over amounts contributed to or earned by each donor advised fund account. This means that contributions made to a donor advised fund account of a sponsoring charity are irrevocable and that advice regarding grant recommendations and investment allocation is not binding on, and is subject to review and approval by, the sponsoring charity.*

**B. Privileges of a Donor.**

*The donor makes charitable contributions to a donor advised fund account, and has the privilege of (i) naming the donor advised fund account, (ii) designating donor advisers and successor donor advisers, (iii) making recommendations regarding grants paid out of a donor advised fund account, and (iv) advising on the investment allocation of assets in a donor advised fund account.*

**C. Privileges of a Donor Adviser.**

*A donor adviser (who may also be the donor) may have the privilege of (i) making recommendations regarding grants paid out of a donor advised fund account, (ii) advising on the investment allocation of assets in a donor advised fund account, and (iii) naming successor donor advisers.*

**IV. Interaction between a Sponsoring Charity and Donors and Donor Advisers.**

**A. Solicitation and Ongoing Communications.**

*Solicitation materials for a sponsoring charity's donor advised fund program and ongoing communications with donors, donor advisers and other third parties make explicit that (i) the sponsoring charity has exclusive ownership and legal control over amounts contributed to and investment returns of each donor advised fund account, (ii) contributions to the sponsoring charity are irrevocable, and (iii) a donor or donor adviser's recommendations regarding grants and advice regarding investment allocations are not binding on, and are subject to review and approval by, the sponsoring charity.*

**B. Education of Donors and Donor Advisers.**

*A sponsoring charity educates its donors and donor advisers on an ongoing basis about charitable giving and ways to increase philanthropy. These educational endeavors can take a wide variety of forms, including one-on-one counseling, technology-based communications, efforts to provide broader access to sources of information about charitable organizations, and communications regarding grants from the sponsoring charity's general funds.*

**C. Certain Transactions with Donors or Donor Advisers**

*Most sponsoring charities that are NDAFs have elected not to engage in certain transactions with donors or donor advisers in part because of the significant additional review that would be required. A sponsoring charity that does engage in these transactions with donors or donor advisers must ensure that such transactions serve exclusively charitable purposes and do not result in any impermissible benefit. Such transactions might include, for example, the purchase or sale of assets, the lending or borrowing of funds, the payment of compensation or reimbursement of expenses, or the receipt of contributions of property that is illiquid and cannot be converted to use for charitable purposes within a reasonable period. In the unusual case where a sponsoring charity determines that a proposed transaction with a donor or donor adviser is appropriate and in the charity's best interest, it will document the basis for such determination, including appropriate data used by the charity to determine that such transaction is on a fair market value basis.*

**V. Grantmaking Procedures.**

*A sponsoring charity adopts procedures and safeguards with respect to grantmaking to ensure that funds are used exclusively in furtherance of charitable purposes. A sponsoring charity does not necessarily engage in all the grantmaking activities described below. In certain circumstances, a sponsoring charity may have made specific representations to the Internal Revenue Service that it will not engage in a particular type of the grantmaking described below.*

*Most sponsoring charities that are NDAFs have elected not to engage in the following activities in part because of the significant additional review that would be required in order to assure that such activities serve exclusively charitable purposes and do not result in any impermissible benefit: (i) grants to individuals; (ii) grants to U.S. private foundations; and (iii) grants to foreign organizations.*

*However, other sponsoring charities, including some NDAFs, currently engage in these grantmaking activities or may choose to do so in the future. If so, significant review should be conducted and documented, as described in section V.B.2. below.*

**A. In General.**

**A.1. Grant Recommendations Are Not Binding On, and Are Subject to Review and Approval By, a Sponsoring Charity.**

*Grant recommendations made by a donor or donor adviser are not binding on, and are subject to review and approval by, a sponsoring charity, and any recommendations that fail the sponsoring charity's grantmaking criteria will be declined.*

**A.2. A Sponsoring Charity Will Not Make Grants That Confer an Impermissible Benefit.**

*A sponsoring charity will not make any grant that would confer an impermissible benefit on a donor, donor adviser or other third party. A sponsoring charity obtains a representation from the donor or donor adviser that neither the donor, the donor adviser nor a third party will receive an impermissible benefit if the grant recommendation is approved by the sponsoring charity. A sponsoring charity also notifies the grant recipient that, by accepting the grant, the grant recipient acknowledges that the grant will not be used to provide an impermissible benefit to the donor, donor adviser or other third party.*

**A.3. A Sponsoring Charity Makes Grants Only In Furtherance of its Charitable Purposes.**

*A sponsoring charity makes grants only in furtherance of its charitable purposes.*

**B. A Sponsoring Charity Reviews Grant Recommendations in a Manner Appropriate to the Status of a Proposed Grant Recipient.**

**B.1. Grants to U.S. Public Charities, Private Operating Foundations and Governmental Units.**

*Grants may be recommended to organizations formed under the laws of the United States and its territories that are public charities described in Section 509(a)(1), (a)(2), or (a)(3) of the Internal Revenue Code, or private operating foundations described in Section 4942(j)(3) of the Internal Revenue Code. A sponsoring charity reviews such recommendations by verifying a proposed grant recipient's exempt, public charity or exempt, private operating foundation status, as appropriate, in IRS Publication 78.*

*In addition, depending on the particular circumstances, the sponsoring charity may perform additional review of grant recommendations to U.S. public charities and private operating foundations. Such additional review may include: (i) requesting relevant documents from the proposed grant recipient (e.g., IRS determination letter, audited financial statements, IRS Forms 990 or 990-PF), (ii) requiring the proposed grant recipient to provide information on its operations (e.g., charitable objectives, operating budget, directors), (iii) obtaining additional assurances that the donor or donor adviser will not receive an impermissible benefit from the proposed grant, and (iv) obtaining a current address and the name of a contact person from the grant recipient.*

*Furthermore, grants may be recommended to governmental units defined in Section 170(c)(1), if the grant funds are used for exclusively public purposes.*

**B.2. Grants to U.S. Private Foundations, Foreign Organizations, and Individuals.**

*Most sponsoring charities do not currently make grants to U.S. private foundations, foreign organizations or individuals. Where a sponsoring charity chooses to make grants to individuals or to entities other than public charities and private operating foundations, additional review procedures are appropriate to ensure that funds are used for charitable purposes.*

**B.2.1. Grants to U.S. Private Foundations and Foreign Organizations.**

*A sponsoring charity choosing to make grants to a U.S. private foundation or a foreign organization requires that the proposed grant recipient provide the sponsoring charity with*

*information specifying the charitable purposes for which the grant funds will be used, including information on the proposed grant recipient's charitable objectives and how use of the grant funds will further those objectives. A sponsoring charity generally enters into a written grant agreement with the U.S. private foundation or foreign organization providing (i) the charitable purposes for which the grant funds will be used, and (ii) that the grant recipient will periodically submit reports describing the expenditure of grant funds and the grant recipient's progress in accomplishing the charitable purposes for which the grant was made. The sponsoring charity monitors the performance of the grant recipient under the terms of such agreement. The sponsoring charity may follow other appropriate procedures where the foreign organization is the equivalent of a U.S. public charity.*

**B.2.2. Grants to Individuals.**

*A sponsoring charity choosing to make grants to individuals within a charitable class adopts procedures to assure that there is no impermissible benefit being conferred on the individual. A sponsoring charity also keeps records specifying (i) the name and address of the grant recipient, (ii) the amount of the grant, (iii) the charitable purposes for which the grant funds will be used by the individual, (iv) the manner in which the sponsoring charity selected the grant recipient, and (v) the relationship (if any) between the grant recipient and (a) members, officers or trustees of the sponsoring charity, (b) the donor or donor adviser, or (c) a family member or controlled corporation of either.*

**VI. A Sponsoring Charity Maintains a Minimum Level of Activity in its Donor Advised Fund Accounts.**

**A. Aggregate Grant Distributions Will Exceed a Minimum Threshold.**

*Grant distributions from the aggregate of a sponsoring charity's donor advised fund accounts exceed a minimum threshold of, for example, 5% of the sponsoring charity's net assets on a fiscal five-year rolling average basis.*

**B. A Sponsoring Charity Has a Policy Ensuring a Minimum Level of Activity in Each Donor Advised Fund Account.**

*A sponsoring charity has a policy ensuring that a minimum level of activity occurs in each donor advised fund account. The Internal Revenue Service, for example, has approved a policy requiring activity, in the form of contributions or grant recommendations, within a seven-year period.*

## Recent Court Decisions Analyze the Rules Governing “Type 3” Supporting Organizations

By David A. Shevlin<sup>110</sup>

### Introduction

In two separate decisions, the Tax Court concluded that two organizations failed to qualify for recognition as a supporting organization under section 509(a)(3) of the Internal Revenue Code of 1986, as amended (the “Code”),<sup>111</sup> and therefore would be classified as a private foundation.<sup>112</sup> These cases highlight the complexity, and to some degree the subjectivity, inherent in the regulations that govern “Type 3” supporting organizations. The cases also illustrate the difficulty that a newly-formed organization may have in demonstrating to the Internal Revenue Service (“IRS”) that it satisfies the tests required to qualify for recognition as a Type 3 supporting organization.

### Background

#### *Supporting Organizations Generally*

In summary, supporting organizations are organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more public charities;<sup>113</sup> are operated, supervised or controlled by or in connection with one or more public charities; and are not controlled directly or indirectly by a disqualified person.<sup>114</sup> Organizations that

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<sup>110</sup> Copyright © 2003. Mr. Shevlin is counsel with the firm Simpson Thacher & Bartlett in New York and practices in the firm’s Exempt Organizations and Corporate Departments. Mr. Shevlin wishes to gratefully acknowledge the contributions of Victoria Bjorklund and Marion Ringel in the preparation of this article.

<sup>111</sup> Unless otherwise indicated, all “section” references are to the Code.

<sup>112</sup> *Lapham Foundation Inc. v. Commissioner*, T.C. Memo 2002-293 (2002); *Christie E. Cuddeback and Lucille M. Cuddeback Memorial Fund v. Commissioner*, T.C. Memo 2002-300 (2002).

<sup>113</sup> In lieu of, or in addition to, supporting a 509(a)(1) or 509(a)(2) organization, a supporting organization may support a 501(c)(4), 501(c)(5) or 501(c)(6) organization that would qualify as a 509(a)(2) organization if it were a 501(c)(3) organization. See section 509(a).

<sup>114</sup> Section 509(a)(3)(A), (B) and (C).



qualify for recognition as supporting organizations under section 509(a)(3) are excluded from the definition of “private foundation” and therefore enjoy the same favorable tax treatment as other types of public charities.

In order for an organization to qualify for recognition as a supporting organization under section 509(a)(3), it must demonstrate one of three types of relationships with the public charity it supports (the “supported charity”), as set forth below. The purpose behind this required relationship is to ensure that the supporting organization is responsive to the needs or demands of the supported charity and the supporting organization constitutes an integral part of, or maintains a significant involvement in, the operations of the supported charity.<sup>115</sup>

(1) The Type 1 supporting organization is “operated, supervised, or controlled by one or more public charities,” which the regulations analogize to a “parent-subsidiary” relationship,<sup>116</sup>

(2) the Type 2 supporting organization is “supervised or controlled in connection with” one or more public charities, like “brother-sister” organizations,<sup>117</sup> and

(3) the Type 3 supporting organization is “operated in connection with” one or more public charities.<sup>118</sup>

### *Type 3 Supporting Organizations*

The organizations that are the subject of the cases discussed in this article sought recognition as Type 3 supporting organizations. Of the three types, Type 3 supporting organizations require the least supervision and control by the supported charity. However, in exchange for this independence, Type 3 supporting organizations still must demonstrate a sufficient nexus with the supported charity, as set forth in detailed regulations. In particular, the regulations set forth two tests that must be satisfied by organizations seeking recognition as Type 3 supporting organizations: a responsiveness test and an integral part test. The Tax Court summarized the policy behind these two tests, as follows:

“While the responsiveness test guarantees that the supported organization will have the ability to influence the supporting organization’s activities, the integral part test insures that the supported organization will have the motivation to do so.”<sup>119</sup>

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<sup>115</sup> Treas. Reg. § 1.509(a)-4(f)(3).

<sup>116</sup> Treas. Reg. § 1.509(a)-4(g)(1).

<sup>117</sup> Treas. Reg. § 1.509(a)-4(h)(1).

<sup>118</sup> Treas. Reg. § 1.509(a)-4(i).

To satisfy the responsiveness test, the supporting organization must show the IRS how it is responsive to the needs or demands of the supported charity. The supported charity must have a significant voice in the supporting organization's investment policies, the timing of and manner of making grants, the selection of recipients and in directing the use of the income or assets of the supporting organization.<sup>120</sup> If the supporting organization is a trust, the responsiveness test will be satisfied if the supported charity is a named beneficiary of the trust and has enforcement powers as to the trust under state law.<sup>121</sup>

The main focus of the Court in the cases discussed in this article was the integral part test. To satisfy the integral part test, the supporting organization must maintain a significant involvement in the operations of the supported charity and the supported charity must in turn be *dependent* upon the supporting organization for the type of support which it provides.<sup>122</sup> The integral part test can be satisfied in one of two alternate ways, as follows:

"But For." The supporting organization engages in activities that perform the functions of, or carry out the purposes of, the supported charity and, but for the involvement of the supporting organization, such activities would normally be carried out by the supported charity itself.<sup>123</sup>

"Substantially All." The supporting organization makes payment of substantially all<sup>124</sup> of its income to or for the use of the supported charity, and the amount of support is sufficient to ensure the *"attentiveness"* of the supported charity to the supporting organization. The amount of support received by the supported charity must represent a sufficient part of the supported charity's total support so as to ensure attentiveness.<sup>125</sup> If it does not, the integral part test may still be satisfied if it can be demonstrated that in order to avoid the *"interruption"* of the carrying

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<sup>119</sup> *Nellie Callahan Scholarship Fund v. Commissioner*, 73 T.C. 626 (1980), at 637-638.

<sup>120</sup> Treas. Reg. § 1.509(a)-4(i)(2)(ii).

<sup>121</sup> Treas. Reg. § 1.509(a)-4(i)(2)(iii).

<sup>122</sup> Treas. Reg. § 1.509(a)-4(i)(3)(i).

<sup>123</sup> Treas. Reg. § 1.509(a)-4(i)(3)(ii).

<sup>124</sup> "Substantially all" has been interpreted to require that the supporting organization distribute at least 85 percent of its income to one or more supported charities. See Rev. Rul. 76-208 (1976). The IRS has stated that accumulations of income in some years are acceptable if the accumulations are not extended and the income is ultimately distributed to the supported charity. See GCM 36523 (December 18, 1975).

<sup>125</sup> Treas. Reg. § 1.509(a)-4(i)(3)(iii)(a).

on of a particular function or activity, the supported charity will be sufficiently attentive to the operations of the supporting organization. This may be the case where the support received from the supporting organization is earmarked for a particular program or activity. The particular program or activity need not be the primary activity of the supported charity, but it must be a substantial one.<sup>126</sup> The regulations cite as examples a chamber music series at a museum and an endowed chair of international law at a law school.<sup>127</sup>

In determining whether the amount of support received by the supported charity is sufficient to ensure the attentiveness of the organization to the supporting organization, the regulations provide that “all pertinent factors” will be considered, including (i) the number of supported charities, (ii) the length and nature of the relationship between the supported charity and the supporting organization and (iii) the purpose for which the funds are used. The more substantial the amount of support in terms of the supported charity’s total support, the greater the likelihood that sufficient attentiveness will be present. Evidence of actual attentiveness, however, is of “almost equal importance.”<sup>128</sup> For example, the regulations cite as acceptable evidence of actual attentiveness the imposition of a requirement that the supporting organization furnish reports at least annually to the supported charity to assist the charity in ensuring that the supporting organization has invested its endowment in assets productive of a reasonable rate of return and has not engaged in any activity which would give rise to a penalty excise tax if the supporting organization were classified as a private foundation.<sup>129</sup>

## The Cases

### Lapham

The Lapham Foundation (the “Lapham Foundation” or the “Foundation”) was formed on December 29, 1998 to operate exclusively for the benefit of The American Endowment Foundation (AEF), an Ohio nonprofit corporation exempt under section 501(c)(3) and qualified

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<sup>126</sup> Treas. Reg. § 1.509(a)-4(i)(3)(iii)(b).

<sup>127</sup> Treas. Reg. § 1.509(a)-4(i)(3)(iii)(c).

<sup>128</sup> Treas. Reg. § 1.509(a)-4(i)(3)(iii)(d).

<sup>129</sup> Treas. Reg. § 1.509(a)-4(3)(iii)(d). The IRS, however, has stated that it does not accept the position that there is a safe harbor for achieving attentiveness simply by virtue of a large grant and providing annual reports to the supported charity. See Internal Revenue Service Continuing Professional Education Text for Fiscal Year 1997, Chapter I, “Public Charity Status on the Razor’s Edge.”

as a public charity under section 509(a)(1).<sup>130</sup> AEF is a community foundation that benefits the community consisting of the “inhabitants of the United States of America.”<sup>131</sup> AEF operates a donor-advised fund program pursuant to which donors are entitled to make non-binding recommendations regarding the charitable use or beneficiaries of their contributions. The ultimate decision with respect to the timing, manner and recipient of any distribution lies with AEF.<sup>132</sup>

Upon formation, the Lapham Foundation received from Charles and Maxine Lapham a contribution of a promissory note in the face amount of approximately \$1.5 million. The obligor under the note was a family business controlled by the Laphams. The note was payable in quarterly interest-only installments of approximately \$30,000 and principal on the note was due in December 2013.<sup>133</sup> Contemporaneously with the contribution of the note, the Laphams entered into a charitable gift annuity agreement whereby the Foundation agreed to pay the Laphams an annual annuity of approximately \$116,000 over the joint lives of the Laphams, payable in quarterly installments of approximately \$29,000.<sup>134</sup>

The Lapham Foundation’s Form 1023 stated that the Foundation intended to pay at least 85 percent of its income to a donor-advised fund account at AEF and in that regard anticipated an annual contribution of approximately \$7,600.<sup>135</sup> In correspondence with the IRS, the Foundation stated that one-third of its contributions to its donor-advised fund account at AEF would be recommended to support activities in southeastern Michigan and two-thirds would be recommended to support charities in Northville, Michigan.<sup>136</sup>

The IRS issued an adverse ruling regarding the Foundation’s status as a supporting organization, on two grounds.<sup>137</sup> First, the IRS determined that the Foundation failed to satisfy

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<sup>130</sup> *Lapham*, T.C. Memo 2002-293 at 2-4.

<sup>131</sup> *Id.* at 4-5.

<sup>132</sup> *Id.* at 6.

<sup>133</sup> *Id.* at 3-4.

<sup>134</sup> *Id.* at 8.

<sup>135</sup> *Id.* at 10.

<sup>136</sup> *Id.* at 11.

<sup>137</sup> After the IRS issued a proposed adverse ruling as to its supporting organization status, the Foundation proposed to amend its articles of incorporation to include the First Presbyterian Church of Northville, Michigan and the Boy Scouts of America Detroit Area Council as

the “attentiveness” requirement under the integral part test. Second, the IRS determined that disqualified persons controlled the Foundation. In particular, because the Foundation’s primary asset was a promissory note secured by assets of a corporation controlled by the Laphams, the IRS determined that the Laphams are in a position to control the Foundation by means of the power they exercise over the Foundation’s primary asset.<sup>138</sup>

During the administrative process, the IRS also claimed that the Lapham Foundation failed to satisfy the responsiveness test, alleging that the AEF-appointed director lacked the requisite “significant voice” in the activities of the Foundation.<sup>139</sup> However, the Court found that the IRS did not satisfy its burden in that regard. The Court noted that although the Foundation had few assets requiring active management, the IRS had not shown that future revenue would not be earned to render the management role increasingly material. Moreover, the Court stated that certain of the IRS’ statements “seem to conflate influence with control” to a degree unsupported by the regulations and the case law.<sup>140</sup> Interestingly, the Court noted favorably the fact that the AEF-appointed director would serve on the advisory committee of the Foundation’s donor-advised fund account at AEF and would therefore have a significant voice in recommending grants. The Court also noted favorably the fact that AEF exercises final authority over distributions from the Foundation’s donor-advised fund account because the Foundation may only make non-binding recommendations.<sup>141</sup>

The Court next analyzed whether the Foundation satisfied the integral part test, and concluded it did not. First, the Court addressed the “but for” test and noted that this test has been interpreted by the Tax Court to generally apply to situations where the supporting organization actually engages in specific functions or activities, as opposed to mere grant making.<sup>142</sup> Similarly, the IRS argued that the “but for” test applies only in cases where the supporting organization’s involvement extends beyond mere grant making.<sup>143</sup> The Court did not reach a

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supported charities. However, on procedural grounds, the Court reached its decision without considering these proposed changes. *Id.* at 27-31.

<sup>138</sup> *Id.* at 15-16.

<sup>139</sup> *Id.* at 34.

<sup>140</sup> *Id.* at 35-36.

<sup>141</sup> *Id.* at 36.

<sup>142</sup> *Id.* at 38, citing *Roe Foundation Charitable Trust v. Commissioner*, TC Memo 1989-566 (1989), at 89-2810.

<sup>143</sup> *Lapham*, T.C. Memo 2002-293 at 38-39.

definitive view on this issue in this case because it found that the Foundation did not satisfy the second prong of the “but for” test, namely that but for the involvement of the supporting organization, the activities carried out by the supporting organization would normally be engaged in by the supported charity itself. The Foundation argued that it was providing the only support for AEF’s activities in Northville, Michigan and therefore, but for the Foundation’s support, those activities would not exist. However, according to the Court, AEF is not bound by the Foundation’s recommendations and theoretically could use the Foundation’s support anywhere in the United States. Moreover, the Court found that distributing grant funds is an activity in which AEF is and will continue to be engaged regardless of the Foundation’s support. The Foundation, therefore, could not demonstrate the type of dependency required by the “but for” test.<sup>144</sup>

The Court next turned to the “substantially all” test, focusing in particular on the requirement that the amount of support received by the supported charity ensure the attentiveness of the supported charity and that the amount of support represent a sufficient part of the supported charity’s total support so as to ensure attentiveness. The Court found that anticipated annual contributions from the Foundation of \$7,600, when measured against annual contributions received by AEF in excess of \$7 million, was not sufficient to ensure attentiveness.<sup>145</sup>

But the Foundation argued that it supported a particular activity of AEF -- supporting charities in Northville, Michigan – and that without the Foundation’s support, this activity would be interrupted.<sup>146</sup> The Court did not accept this argument. First, the Court stated that this approach is only available if the supporting organization or the supported charity earmarks the support. Because the Foundation could only make non-binding recommendations with respect to its donor-advised fund account, it could not earmark its contributions. Moreover, the Foundation had not established that AEF had earmarked the Foundation’s contributions. Second, the Court stated that there was no evidence that benefiting Northville, Michigan is a substantial activity of AEF or that AEF’s minimal expenditures in Michigan would be interrupted absent the Foundation’s support.<sup>147</sup>

Finally, the Foundation argued that evidence of AEF’s actual attentiveness existed, citing the Foundation’s intention to provide AEF with annual reports and AEF’s appointment of a

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<sup>144</sup> *Id.* at 39-41.

<sup>145</sup> *Id.* at 42-43.

<sup>146</sup> *Id.* at 44.

<sup>147</sup> *Id.* at 44-45. Because the Court ruled that the Foundation did not satisfy the integral part test, it did not reach the question of whether the Foundation was controlled by disqualified persons by virtue of the Laphams’ control of the Foundation’s primary asset. *Id.* at 45.

Northville, Michigan resident to the Foundation's Board. The Court was not persuaded. In light of the vast difference in the size and scope of the programs of the Foundation and AEF, establishing attentiveness would require more than "pointing to a few administrative formalities."<sup>148</sup>

Accordingly, the Court concluded that the Lapham Foundation should be classified as a private foundation.<sup>149</sup>

### **Cuddeback**

The Christie E. Cuddeback and Lucille M. Cuddeback Memorial Fund (the "Cuddeback Fund" or the "Fund") was created as a testamentary trust. Upon the death of the testator's niece, the income of the Cuddeback Fund was to be paid to three organizations – two churches and a section 509(a)(1) nursing home care facility, Keswick Multi-Care Center ("Keswick"). The two churches were each to receive ten percent of the Cuddeback Fund's income and Keswick was to receive eighty percent.<sup>150</sup>

In conjunction with its adult daycare program, Keswick offers grants to some participants who could not otherwise afford to pay Keswick's charges.<sup>151</sup> The testator's will provided that the income paid to Keswick should be used by it "to cover not more than one-half (1/2) of the cost of such elderly persons enrolled in the Day Care Program operated by Keswick, who do not have financial means to pay all costs thereof."<sup>152</sup>

Several years after the death of the testator and her niece, the Cuddeback Fund filed a Form 1023 seeking recognition as a supporting organization.<sup>153</sup> Along with the Form 1023, the Cuddeback Fund submitted a letter from Keswick's chief financial officer describing the Fund's participation in Keswick's activities.<sup>154</sup> Nonetheless, the IRS issued a proposed adverse ruling,

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<sup>148</sup> *Id.* at 43-44.

<sup>149</sup> *Id.* at 46.

<sup>150</sup> *Cuddeback*, T.C. Memo 2002-300 at 2-4.

<sup>151</sup> *Id.* at 4.

<sup>152</sup> *Id.*

<sup>153</sup> *Id.* at 6.

<sup>154</sup> *Id.* at 6-7.

concluding that the support provided by the Cuddeback Fund was not sufficient to ensure Keswick's attentiveness and that therefore the Fund did not satisfy the integral part test.<sup>155</sup>

In its appeal, the Cuddeback Fund argued that Keswick's adult day care program is a substantial activity and that without the Fund's support, the "grant program" would be interrupted. Accordingly, the Fund argued that its support of Keswick's grant program would ensure the attentiveness of Keswick.<sup>156</sup> The Fund also submitted supplemental letters from Keswick with additional information regarding the number of participants in the adult daycare program and the extent to which the Fund's support defrayed the costs of the grant program. The correspondence from Keswick claimed that without the Cuddeback Fund's support, there would be a "significant reduction in the number of seniors served" at Keswick.<sup>157</sup> Nonetheless, the IRS issued a final adverse ruling that the Fund failed to qualify as a supporting organization.<sup>158</sup>

The Cuddeback Fund did not claim to satisfy the "but for" test, and the Court noted that the Fund does not engage in any activities on behalf of Keswick, other than distributing funds to Keswick.<sup>159</sup> Therefore, the Court's analysis focused on the "substantially all" test, and in particular on the "attentiveness" requirement. The Fund and the IRS disputed several key points: (i) whether the Fund's support was earmarked for the adult daycare program generally or specifically a program to provide support to needy participants, (ii) whether "interruption" means discontinuance of a program, as opposed to curtailment, and (iii) whether the adult daycare program and the grant programs are "substantial" activities as required by the regulations.<sup>160</sup> The Court, in large part, did not resolve these questions. Rather, in ruling against the Fund, the Court relied on what it viewed as a sketchy and inconsistent record. According to the Court, the record did not provide sufficient information to evaluate the financial impact of the adult daycare program or the grant program on Keswick as a whole, and critically, the impact the Cuddeback Fund's support had on these programs.<sup>161</sup> The Court emphasized that the existence of other funding sources for the grant program suggested that

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<sup>155</sup> *Id.* at 9-10.

<sup>156</sup> *Id.* at 11.

<sup>157</sup> *Id.*

<sup>158</sup> *Id.* at 12-14.

<sup>159</sup> *Id.* at 22.

<sup>160</sup> *Id.* at 32-33.

<sup>161</sup> *Id.* at 33-43.



Keswick might not depend on the Fund to the extent asserted by the Fund and Keswick.<sup>162</sup> The Court held that the Fund did not demonstrate that Keswick would be sufficiently attentive to the Fund's operations in order to avoid an interruption of either the adult daycare program or a program to provide grants to needy participants.<sup>163</sup> In addition, the Court found that there was no evidence that Keswick exercised actual attentiveness, notwithstanding Keswick's letters of support to the contrary.<sup>164</sup>

Accordingly, the Court did not resolve the interesting question of whether interruption requires actual discontinuance of a program or activity, as the IRS argued.

### **Lessons Learned from the Cases**

A number of lessons may be learned from these cases.

*First, the facts must support the required relationship.*

The *Lapham* and *Cuddeback* cases illustrate the importance of a factual record that can support the relationship required by the regulations. The Court in *Cuddeback* relied heavily on what it viewed as an incomplete and inconsistent record in reaching its decision. Despite several supportive letters submitted by Keswick, the Court nonetheless concluded that the record did not provide sufficient information to conclude that Keswick would be attentive to the Cuddeback Fund. While the *Lapham* case did not suffer from a deficient record, the facts convinced the Court that the Lapham Foundation's support was insubstantial in relation to AEF's overall support.

Moreover, newly-formed organizations may face a particular challenge in demonstrating attentiveness since there is no history of its support of the supported charity. This is not necessarily an insurmountable obstacle so long as the organization's anticipated contributions in relation to the total support of the supported charity or a specific and identifiable program of the charity is sufficient to persuade the IRS that the supported charity will be dependent upon the organization, and therefore attentive to the supporting organization.

But the cases also illustrate the inherent subjectivity of the regulations. Attentiveness and dependence are not necessarily quantifiable, and to rely solely on numerical information to draw conclusions in this regard can possibly yield disparate results. For example, in another

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<sup>162</sup> *Id.* at 39-40.

<sup>163</sup> *Id.* at 43.

<sup>164</sup> *Id.* at 44.

Tax Court case from 1986, the income from a testamentary trust was to be used to provide scholarships to students attending college in Oregon, with a preference for students attending Northwest Christian College (“Northwest”).<sup>165</sup> Although the support provided by the trust amounted to only eight percent of the scholarship funds at Northwest and affected only nine percent of the full-time students, the Court nonetheless found that there was sufficient evidence of actual attentiveness. The Court took into account all of the pertinent circumstances, including the amount of funds distributed, the number of students affected, and the history and nature of the relationship between the trust and Northwest.<sup>166</sup> Testimony from Northwest’s president that a reduction in funds from the trust would cause Northwest to “expend efforts to obtain offsetting funds elsewhere” was given credence as well.<sup>167</sup> If the trust had been a newly-formed organization seeking recognition as a supporting organization, query whether the fact that the trust’s support amounted to only eight percent of Northwest’s scholarship funds and affected only nine percent of the students would have persuaded the IRS or the Court that Northwest would be sufficiently attentive to the trust. Furthermore, contrast this holding with the IRS’ position that the “rule of thumb” in testing attentiveness is that the supporting organization’s grants must represent at least *ten* percent of the supported charity’s total support.<sup>168</sup>

Some degree of subjectivity in this analysis is unavoidable. Yet, the extent to which subjectivity affects the outcome may be ameliorated through the submission of a thorough and strong record of facts to support a conclusion that, as required by the regulations, the amount of support provided by the supporting organization is sufficient to ensure a meaningful degree of dependence by the supported charity upon the support provided by the supporting organization.

*Second, the “interruption” approach requires demonstration of a substantial and separately identifiable activity, and in the IRS’ view, may require a showing of discontinuance.*

Both the Lapham Foundation and the Cuddeback Fund argued that they supported a specific program or activity of the supported charity and that a reduction in their support would interrupt the program or activity. These arguments failed to sway the IRS or the Tax Court.

Substantial Activity. First, the Court correctly noted, as specified by the regulations, that the purported program or activity must be substantial. In neither case did the Court find that the

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<sup>165</sup> *Cockerline Memorial Fund v. Commissioner*, 86 T.C. 53 (1986) at 54-55.

<sup>166</sup> *Id.* at 61-62.

<sup>167</sup> *Id.* at 62.

<sup>168</sup> GCM 36379 (August 15, 1975).

organization satisfied its burden in this regard. In the *Lapham* case, the Foundation failed to convince the Court that the activity in question really was a separate and identifiable program or activity. In the *Cuddeback* case, there was a clear dispute regarding the nature of the separate program or activity being supported by the Cuddeback Fund. If an organization seeking recognition as a supporting organization relies on the “interruption” approach to demonstrate attentiveness, the record should reflect that the activity supported is indeed a separately identifiable and substantial activity.

Interruption vs. Discontinuance. The IRS argued in *Cuddeback* that “interruption” of a program or activity requires its discontinuance. The Court did not address this question in reaching its decision. It can be argued, though, that “interruption” should not require a showing that the program or activity would be discontinued. As discussed above, the regulations governing the integral part test seek to ensure that the supported charity is motivated to be attentive to the supporting organization. Presumably, a reduction in support for a particular program or activity that has a material impact on the program (e.g., a substantial reduction in the number of charitable beneficiaries that can be served by the program), short of requiring its discontinuance, would nonetheless motivate a supported charity to be attentive to the supporting organization.

*Third, grant making organizations may have difficulty satisfying the “but for” test.*

In the *Lapham* case, the IRS argued that the “but for” test applies only in cases where the supporting organization’s involvement extends beyond mere grant making. The Court supported this view as well. The IRS has made this same argument in several general counsel memoranda.<sup>169</sup> However, in GCM 38417, which, like *Lapham*, also involved an organization seeking recognition as a supporting organization to a community trust, the IRS Chief Counsel took a different approach:

“The argument that grant-making is not an activity which performs the functions of or carries out the purposes of a publicly supported community trust ignores the fact that grant-making is frequently the means by which such trusts accomplish their charitable purposes . . . . Consequently, while the only activity of the supporting organization is grant-making, we do not believe that activity falls outside the scope of term ‘activities’ in section 1.509(a)-4(i)(3)(ii).”<sup>170</sup>

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<sup>169</sup> See GCM 36523 (December 18, 1975); GCM 36379 (August 15, 1975). See also Internal Revenue Service Continuing Professional Education Text for Fiscal Year 1997, Chapter I, “Public Charity Status on the Razor’s Edge.”

<sup>170</sup> GCM 38417 (June 20, 1980).

However, it should be noted that in GCM 38417 the supporting organization made grants directly to the class of charitable beneficiaries that were also supported by the community trust. This distinction is clearly significant in the IRS' view. In GCM 36043, for example, two supporting organizations were operating their own scholarship programs rather than making grants to the colleges' scholarship programs. The Chief Counsel was of the view that the supporting organization was performing a function of the colleges:

“Both the \*\*\* trusts are operating their own scholarship programs rather than simply making grants to the publicly supported organizations. Since the granting of scholarships is an accepted function of the colleges, the trusts may be considered to be performing a function of the colleges.”<sup>171</sup>

*Finally, supporting organizations to donor-advised funds can learn several lessons from the Lapham Case.*

The *Lapham* case raises several interesting issues for organizations seeking recognition as supporting organizations to public charities that sponsor donor-advised funds.

The Court, in holding that the Lapham Foundation satisfied the responsiveness test, noted favorably the fact that the AEF-appointed director would serve on the advisory committee of the Foundation's donor-advised fund account at AEF and would therefore have a significant voice in recommending grants. The Court also noted favorably the fact that AEF exercises final authority over distributions from the Foundation's donor-advised fund account. Accordingly, the fact that the supporting organization may make only non-binding recommendations with respect to distributions from the donor-advised fund can be seen a positive factor in demonstrating satisfaction of the responsiveness test. Another positive factor is the participation by the officer or director appointed by the supported charity in making such recommendations.

In the *Lapham* case, the Court stated that the “interruption” approach is available only if the supporting organization or the supported charity earmarks the support. Because the Lapham Foundation could only make non-binding recommendations with respect to its donor-advised fund account, it could not earmark its contributions. But must actual earmarking be a prerequisite to the availability of the “interruption” approach? While it is true that the regulations state that that interruption of an activity or program “may be the case” where the contributions are earmarked, this language could be interpreted as illustrative, rather than mandatory. Moreover, while a supporting organization (like any donor) may not formally

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<sup>171</sup> GCM 36043 (October 9, 1974). Nonetheless, the Chief Counsel was of the view that the second prong of the “but for” test was not satisfied because there was no evidence that the colleges would have engaged in the scholarship programs without the trusts.

earmark its contributions to a donor-advised fund, the supporting organization could in its account opening documentation commit to supporting a substantial program or activity of the supported charity. Therefore, while the supported charity retains the discretion with respect to each recommendation, the same result is achieved, from an “interruption” perspective, as if the funds had actually been earmarked.

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ALI-ABA

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CHOOSING AMONG THE PRIVATE FOUNDATION,  
SUPPORTING ORGANIZATION AND  
DONOR-ADVISED FUND

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