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Donor Funds, Private Foundations, and Supporting Organizations

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§4.1 I. SCOPE OF CHAPTER

Many donors who make significant charitable gifts eventually consider the possibility of a private charitable organization. These may include donor funds, private foundations, or supporting organizations. Private charitable organizations offer donors several advantages, including providing donors with the ability to

- Separate the timing of the tax benefits of a charitable gift from the timing of the decision of which charitable organizations or causes will ultimately benefit from it;
- Participate more directly and to a greater extent in their charitable giving; and
- Create charitable legacies for younger generations.

This chapter surveys the requirements, advantages, and disadvantages of the various alternatives for private charitable organizations. It is intended as a resource for making a choice of entity, rather than a comprehensive guide to the complex operations of each type of organization.

Donor and donor-advised funds are discussed in §§4.3–4.22, private foundations are covered in §§4.23–4.55, and supporting organizations are discussed in §§4.56–4.80. Tax considerations with respect to these entities are discussed in more detail in chap 3. Pledge agreements and self-dealing are touched on in §4.81, and maintaining multiple private charities is addressed in §4.82. A table comparing the different types of private charitable organizations is set forth in §4.83.

§4.2 II. CHOOSING A PRIVATE CHARITABLE ORGANIZATION

Donors have a number of options for private charitable organizations. Their advisors need to have detailed discussion with donors regarding their plans and objectives. Once the practitioner has a full understanding of the operations that the donor will expect the organization to carry out and how those operations will be funded, the practitioner can match that information against the available alternatives. The practitioner can then recommend the entity that most effectively and efficiently meets the donor's needs.

Practitioners advising donors and private foundations should keep in mind the possibility of forming a new entity to carry out particular operations. There are times when the private foundation limitations create significant barriers to a particular activity that may be eliminated when the same gift or activity is carried out through a donor-advised fund. By thinking outside the box, or at least thinking of all the available boxes, practitioners can help their clients more effectively and more satisfactorily achieve their philanthropic goals.

§4.3 III. DONOR FUNDS

The first private charitable organization that most donors should consider is a donor fund with a community foundation or other existing public charity. A donor fund is established by an outright gift to the sponsoring charitable organization that has legal control over the fund. Treas Reg §1.170A–9(f)(11)(ii). The charitable organization agrees to separately account for the contribution in the donor fund and to allow the donor to offer advice regarding the fund. See §4.18. The sponsoring organization will usually honor donor recommendations that fall within the sponsoring organization's published guidelines.

Advantages. Donor funds are simple to establish and are usually created by a short agreement with the sponsoring charity. See §4.17. Because donor funds are maintained by public charities, donors receive the most favorable tax treatment for gifts to donor funds. On tax treatment of gifts to public charities, see chap 15. Other than donor-advised funds (as defined in IRC §4966 and discussed in more detail in §§4.9–4.16), donor funds operate under the limitations applicable to public charities, not the more restrictive rules applicable to private foundations. Used creatively, donor funds can be powerful tools for accomplishing philanthropic goals.

A. Types of Donor Funds

§4.4 1. Donor-Advised Funds

The most common type of donor fund is the donor-advised fund. A donor to a donor-advised fund may advise the sponsoring charity on use of the fund. Alternatively, the donor may name another person or group to advise the charity. The advice, however, is not legally binding on the charitable organization because the organization has ultimate control over the distribution of the funds. See *Lapham Found., Inc. v Commissioner* (6th Cir 2004) 389 F3d 606, discussed in §4.22.

PRACTICE TIP► Although the donor's advice is not legally binding, a charity that maintains a donor-advised fund will almost always follow any advice to make a distribution for a legitimate charitable purpose. Charities that maintain donor-advised funds must have the trust of donors that the charity will follow their advice.

A donor may make grants to any number of charitable organizations over almost any time frame from a donor-advised fund. A more detailed discussion on donor-advised funds is included in §§4.9–4.16.

§4.5 2. Field-of-Interest Funds

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

Designation of field of interest generally binding. Unlike the advice for a donor-advised fund, the designation of a field of interest can be legally binding on the charitable organization sponsoring the field-of-interest fund. Treas Reg §1.507–2(a)(7)(v), Example 3. See Bus & P C §17510.8. The charity may not distribute outside the designated field unless it becomes impossible or impractical for the charity to stay within the field of interest. If it becomes necessary for the charity to change the field of interest, the charity must find and select a field as close as possible to the donor's original designation. The extent of a charity's discretion in changing a field of interest and the procedure it must follow depend on the charity's governing instrument, which may expand its variance power.

§4.6 3. Scholarship Funds

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

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

§4.7 4. Designated and Restricted Funds

A donor to a donor fund can impose the same legal limits on the donor fund as can be imposed on other gifts: either designating the fund for a particular purpose (a designated fund) or restricting the spending of the fund to its income or annual return (a restricted fund), or both.

A designated fund is one that makes payments to one or more specific charities. When a fund is designated, the donor has specified a particular charitable purpose for which the fund is to be used. The designated fund is useful when a donor wants to provide a long-term funding source to a charity but is concerned about the charity's ability to manage the funds. The sponsoring charity manages the designated fund with its pool of funds, generally distributing the earnings annually to the designated charity.

Designation of charity generally binds sponsoring charity. Similar to a field-of-interest fund, the designation of a specific charity to receive support is legally binding on the sponsoring charitable organization. See Bus & P C §17510.8. The charity may make distributions to other than the designated charity only if it becomes impossible or impractical to follow the donor's designation. The charity must choose a successor charity that is similar or related to the donor's original charity.

A restricted fund (also called an endowment fund) is limited as to the amount that the charity may spend from the fund over time. A donor may restrict the spending of the fund to its income or annual return, or both. If a fund is restricted, the charity may spend only the income earnings of the fund each year. See Prob C §18502(b). See also §§16.21–16.24 regarding spending restrictions on charitable funds. If no other limitations are imposed, the charity is free to spend the income or earnings of the fund on any charitable purpose it chooses.

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

§4.8 B. Administrative Costs of Donor Funds

Organizations that offer donor funds need to recover the costs of operating the funds. Accordingly, a donor fund may be subject to a fee of 1 percent to 2 percent of the value of the fund each year. The fee may be higher for a fund with a lot of grant-making activity or an administratively burdensome program like scholarships.

§4.9 C. Definition and Characteristics of Donor-Advised Funds

Initially, donor funds were governed by the community trust regulations applicable to community foundations. See Treas Reg §1.170A–9(f)(10)–(12). These regulations define whether a fund that is separately accounted for by a community trust will be treated as a component part of the community trust or as a separate trust that would be classified as a private foundation. Under these regulations, the sponsoring charity must control the fund's investments. The sponsoring charity also must have discretionary power to change the purpose of the fund if the original purpose becomes impractical or is no longer in accordance with community needs.

Although these regulations for community trusts generally still apply, the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) added a new set of rules that applies to "donor-advised funds." The PPA defines the term "donor-advised fund" in the Internal Revenue Code and subjects these donor-advised funds to certain excise taxes, among other changes, resulting in donor-advised funds that fall within that definition being subject to several limitations. Because of these limits, it is important that the donor and charity determine whether a fund is a donor-advised fund under IRC §4966 or some other donor fund as described in §§4.3–4.7.

"Donor-advised fund" defined. Under IRC §4966(d)(2)(A), a donor-advised fund is defined as a fund or account

- Owned and controlled by a sponsoring organization;

NOTE► A sponsoring organization is defined as an IRC §170(c) organization that is not a governmental organization or a private foundation. IRC §4966(d)(1).

- That is separately identified by reference to contributions of a donor or donors; and

NOTE► The Bluebook prepared by the Joint Committee on Taxation indicates that an organization's general fund will not be treated as a donor-advised fund if it is not separately identified by a donor. See Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006, at 342 (Aug. 3, 2006, JCX-38–06) ("Bluebook").

- With respect to which the donor, or any person appointed or designated by the donor ("donor advisor"), has, or reasonably expects to have, advisory privileges concerning the distribution or investment of the funds.

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

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

On scholarship funds, see §4.6. Fiscal sponsorships may also be donor-advised funds, requiring adherence with the PPA. See §3.81.

NOTE► Unlike a private foundation, the sponsoring organization is not required to have every scholarship program approved by the IRS before it can be implemented. Nevertheless, a sponsoring organization may consider seeking IRS approval of its donor-advised funds' scholarship programs to ensure that the programs are consistent with the procedures set forth in IRC §4945(g). See IRC §4966(d)(2)(B).

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

- The fund or account is advised by a committee not directly or indirectly controlled by the donor or donor advisor (and any related parties); or
- The fund or account benefits a single identified charitable purpose.

The IRS has exempted certain employer-sponsored disaster relief assistance programs from the definition of a donor-advised fund. See IRS Notice 2006–109, 2006–2 Cum Bull 1121.

§4.10 1. Taxable Distributions

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

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

- An individual; or
- An organization/entity if
  - The distribution is for any purpose other than one specified in IRC §170(c)(2)(B), or
  - The sponsoring organization maintaining the donor-advised fund does not exercise expenditure responsibility with respect to such distribution in accordance with expenditure responsibility requirements for private foundations.

NOTE► Although a grant to an individual is a taxable expenditure, certain grants to individuals are excepted from the definition of a donor-advised fund and thus not subject to the taxable distribution rules. Specifically, these include certain scholarship funds (see §4.6) and certain employer-sponsored disaster relief assistance programs.

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

- An organization described in IRC §170(b)(1)(A) (other than a disqualified supporting organization);
- The sponsoring organization of that donor-advised fund; or
- Any other donor-advised fund.

Disqualified supporting organizations. Internal Revenue Code §4966(d)(4) disqualifies the following supporting organizations from receiving a grant from a donor-advised fund without exercising expenditure responsibility:

- A Type III supporting organization that is not functionally integrated (*i.e.*, the supporting organization does *not* engage in activities substantially all of which directly further the exempt purposes of the supported organizations to which the supporting organization is responsive by performing the functions of, or carrying out the purposes of, the supported organizations, and the supporting organization is *not* the parent of each of the supported organizations) (see Prop Treas Reg 1.509(a)–4(f)); and
- Any Type I, Type II, or functionally integrated Type III supporting organization in which the donor or donor advisor (and any related parties) directly or indirectly controls a supported organization of the supporting organization.

On types of supporting organizations, see §§4.58–4.65.

§4.11 2. Prohibited Benefits

Excise taxes imposed when more than incidental benefit. Internal Revenue Code §4967 imposes an excise tax of 125 percent if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor-advised fund provides advice as to a distribution from a donor-advised fund that results in any donor, donor advisor, or person related to a donor or donor advisor receiving, directly or indirectly, a more than incidental benefit. IRC §4967(a)(1). The excise tax is imposed on any person who advises as to the distribution and any person who receives the benefit. IRC §4967(a)(1). A separate excise tax may be imposed on a fund manager who agreed to the making of the distribution. IRC §4967(a)(2). The excise tax under IRC §4967 applies to taxable years beginning after August 17, 2006. Pub L 109–280, §1231(c), 120 Stat 780.

Incidental benefit. Based on the Bluebook (see §4.9), generally, a donor receives an incidental benefit if the donor receives any goods or services from the charity that would reduce the donor's income tax deduction for a payment to the charity. For example, if a donor is allowed to attend a charity dinner, the donor will have received an incidental benefit.

§4.12 3. Excess Benefit Transactions

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

NOTE► Because an expense reimbursement is an automatic excess benefit transaction, a donor cannot be reimbursed from a donor-advised fund for out-of-pocket payments for fundraising event expenses. Donors who put funds for fundraising expenses into a donor-advised fund before the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) was enacted on August 17, 2006, have no way of pulling those funds out of the donor-advised fund. Pub L 109–280, §1232(c), 120 Stat 780. Donors who create a donor-advised fund after the PPA must be aware of this rule and reserve some of the funding to support fundraising events, resulting in a potential trap for the unwary donor.

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

§4.13 4. Excess Business Holdings

Internal Revenue Code §4943 imposes excise taxes on the sponsoring organization for excess business holdings of a donor-advised fund. Generally, such a donor-advised fund's voting or profits interests in a business enterprise, when combined with the interests of related persons, may not exceed 20 percent. IRC §4943(c), (e). The excess business holdings rules apply to donor-advised funds for taxable years beginning after August 17, 2006. Pub L 109–280, §1231(c), 120 Stat 780. A donor-advised fund can follow the transition rules that applied to private foundations when IRC §4943 was enacted in 1969. IRC §4943(c)(3). For an example of the application of the excess business holdings rules to a donor-advised fund, see IRS Letter Ruling 201311035 (on transfer of beneficial ownership of stated percentage of corporate voting stock to IRC §501(c)(3) organization, corporate nonvoting stock held in donor-advised fund by organization was permitted holding and not excess business holding under IRC §4943).

§4.14 5. Grants to Supporting Organizations

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

- Type III supporting organizations (SOs) that are not functionally integrated with the supported organization (*i.e.,* the SO does *not* engage in activities substantially all of which directly further the exempt purposes of the supported organizations to which the SO is responsive by performing the functions of, or carrying out the purposes of, the supported organizations, and the SO is *not* the parent of each of the supported organizations) (see Prop Treas Reg §1.509(a)–4(f)); and
- Any Type I, Type II, or functionally integrated Type III SO if the donor or donor advisor controls a supported organization, unless the SO exercises expenditure responsibility.

Guidance for donor-advised funds. In IRS Notice 2006–109, 2006–2 Cum Bull 1121, the Treasury Department and the IRS provided guidance for determining an SO grantee's type, if it was controlled by the donor or donor advisor and, if a Type III, whether it was functionally integrated. The notice allowed a sponsoring organization, in good faith, to rely on certain information to determine the SO grantee's type, such as the IRS Business Master File (BMF), the grantee's IRS determination letter, or written representations by the grantee or the grantor or grantee's counsel. In 2009, the Treasury and the IRS issued proposed regulations for SOs that made significant changes to rules relating to Type III SOs and assured grantors they could rely on these proposed regulations when applying Notice 2006–109. See 74 Fed Reg 48679 (2009). Subsequently, Rev Proc 2009–32, 2009–28 Int Rev Bull 142, provided that the BMF or IRS Determination Letter could be used by the grantor, in good faith, to determine the SO's type, superseding Notice 2006–109's guidelines.

Revenue Procedure 2011–33, 2011–25 Int Rev Bull 887, which modified and superseded Rev Proc 2009–32, provided that a sponsoring organization of donor-advised funds could rely on the classification of an organization listed in or covered by the IRS's Exempt Organizations Select Check (based on former IRS Publication 78) or the BMF with regard to an SO's foundation status and whether an organization is a Type I, Type II, Type III, or functionally integrated Type III SO. See Rev Proc 2011–33, 2011–25 Int Rev Bull 887. The Exempt Organizations Select Check may be accessed at https://www.irs.gov/charities-non-profits/exempt-organizations-select-check.

Sponsoring organizations of donor-advised funds could rely on an organization's foundation status (or SO type) set forth in the Exempt Organizations Select Check or the BMF for grant-making purposes under IRC §4966, except when the grantor (1) had knowledge of the revocation of the ruling or determination letter classifying the organization as one described in IRC §509(a)(1), (a)(2), or (a)(3) (or specifying its SO type) before the publication of the revocation, or (2) was in part responsible for, or was aware of, the act or the failure to act that gave rise to the revocation of the ruling or determination letter classifying the organization as one described in IRC §509(a)(1), (a)(2), or (a)(3) (or specifying its SO type). See Rev Proc 2011–33, 2011–25 Int Rev Bull 887. A grantor may rely on information about an organization from the BMF that is obtained from a third party, as long as the following requirements are met (Rev Proc 2011–33, 2011–25 Int Rev Bull 887):

- The third party provides a report to the grantor that includes (i) the organization's name, employer identification number (EIN), foundation status under IRC §509(a)(1), (a)(2), or (a)(3) (including SO type, if applicable), and whether contributions to the organization are deductible; (ii) a statement that the information is from the most current update of the BMF and the BMF revision date; and (iii) the date and time the information was provided to the grantor or contributor; and
- The grantor retains a copy of the report in hard copy or electronically.

NOTE► Presently, the Exempt Organizations Select Check provides a description code of "SO" (a Type I, Type II, or functionally integrated Type III SO), "SONFI" (a non-functionally integrated Type III SO), or "SOUNK" (an SO, unspecified type). Similarly, the BMF also gives either a foundation code indicating the SO's type or a general classification as an IRC §509(a)(3) organization. New SOs are being given a classification according to their type but, at this time, organizations formed before the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) have been given an unspecified classification, making it difficult for grantors to rely on these sources. The SO's IRS Form 990 or IRS 990-EZ should provide this information. However, the guidance does not state that good faith reliance on information returns is sufficient.

In December 2012, the Treasury Department and the IRS issued final and temporary regulations for SOs that were similar to the previous proposed regulations issued in 2009, except that the payout requirements of a nonfunctionally integrated Type III SO were changed. The payout requirements under the final and temporary regulations are different but less stringent than under the proposed regulations, so if a nonfunctionally integrated Type III SO qualified under the proposed regulations, it should also qualify under the final and temporary regulations. See TD 9605, 2013–11 Int Rev Bull 587. See also §§4.63C–4.63E. The IRS Tax-Exempt and Government Entities Division has published a memorandum instructing its exempt organization determinations specialists to begin issuing determination letters classifying organizations as functionally or nonfunctionally integrated Type III SOs under the criteria in the final and temporary regulations. See IRS Memorandum for Manager, EO Determinations (Feb. 1, 2013), available online at http://www.irs.gov/pub/irs-tege/TypeIII_SupportingOrg_2013_Regs.pdf. (Existing SOs without a determination as to their type can obtain an initial type classification determination by filing a Request for Miscellaneous Determination (IRS Form 8940) with the applicable fee.)

In IRS Notice 2014–4, 2014–1 Cum Bull 274, the Treasury and the IRS announced that, until further guidance is issued addressing the reliance standards of Notice 2006–109, sponsoring organizations that maintain donor-advised funds may continue to rely on the grantor reliance standards of Notice 2006–109, §3, as modified by Rev Proc 2011–33 and Notice 2014–4. Notice 2014–4 also stated that, for grants made after December 28, 2012, a Type III SO must meet the requirements described in Treas Reg §1.509(a)–4(i)(4) or IRS Notice 2014–4, §3.01 (relating to the governmental entity exception described in §4.63A) to be considered functionally integrated for purposes of a representation or opinion of counsel on which a grantor may rely. Accordingly, to determine that a Type III SO is functionally integrated based on a written representation, a grantor must collect and review a written representation and documents that demonstrate the grantee meets the requirements described in Treas Reg §1.509(a)–4(i)(4) or Notice 2014–4, §3.01. On types of supporting organizations, see §§4.58–4.65.

6. Grants From Donors Seeking Charitable Contribution Deduction

§4.15 a. Income Tax Deductions

No charitable deduction. Contributions to a sponsoring organization for maintenance in a donor-advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is (IRC §170(f)(18))

- A veterans' organization described in IRC §170(c)(3);
- A fraternal society described in IRC §170(c)(4);
- A cemetery company described in IRC §170(c)(5); or
- A Type III supporting organization (other than a functionally integrated Type III supporting organization).

§4.16 b. Gift and Estate Tax Deductions

No charitable deduction. Contributions to a sponsoring organization for maintenance in a donor-advised fund are not eligible for a charitable deduction for gift and estate tax purposes if the sponsoring organization is (IRC §§2522(c)(5), 2055(e)(5))

- A veterans' organization described in IRC §2522(a)(4) for gift tax purposes and IRC §2055(a)(4) for estate tax purposes;
- A fraternal society described in IRC §2522(a)(3) for gift tax purposes and IRC §2055(a)(3) for estate tax purposes; or
- A Type III supporting organization (other than a functionally integrated Type III supporting organization).

§4.17 D. Creating a Donor Fund

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

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

- How the fund will be invested.

PRACTICE TIP► If the donor intends any binding designation or restriction on the fund (see §4.7), it is important to carefully review the fund agreement to ensure that the "boilerplate" provisions do not override the legal limits that the donor intends to impose. To avoid being treated as a donor-advised fund, the donor should meet the scholarship exception to the definition of a donor-advised fund (see §4.9).

§4.18 E. Pooling Assets of Donor-Advised Funds

Asset allocation. Typically, the assets of donor-advised funds are pooled for investment. The sponsoring charity may give the donor the right to give advice regarding asset allocation. For example, a donor who expects to recommend distribution of the donor-advised fund over 1 or 2 years would recommend the asset allocation for the fund be 10 percent cash and cash equivalents like money markets to avoid the risk of short-term market swings. A donor who wishes to advise on the distribution of a fund over a long period of time, however, would recommend an asset allocation with a high percentage of equities for growth over time.

Fund managers. Generally, the sponsoring charity selects the fund managers for all the asset classes available to the donor-advised funds. In limited circumstances, a donor may be allowed to recommend a fund manager for a large donor fund.

PRACTICE TIP► If the charity uses a donor-recommended fund manager, the charity should have the power to remove the manager at will, and the manager's activities must be coordinated with the overall investment strategy of the charity. However, this would also result in the fund being treated as a donor-advised fund and potentially subject to certain excise taxes under the Internal Revenue Code. See §§4.11–4.13.

§4.19 1. Agency Funds

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

NOTE► If the charity is using funds that were contributed subject to designations or restrictions imposed by the original donors, the transfer of the funds as an outright gift to another organization may not be permissible.

§4.20 2. Quasi-Endowment Funds

If an agency fund is restricted as an endowment fund, the board of directors of the charity creating the agency fund has accomplished something that it could not do internally: create an endowment by action of the board. When the board of directors takes unrestricted funds and treats them as an endowment, the funds are only a quasi-endowment, and future boards of directors may invade the principal of the fund by approving a board resolution. Distributions from an endowed agency fund are limited to income, and the endowed agency fund would be restricted in the hands of the community foundation.

NOTE► Theoretically, the community foundation and the original charity creating the restriction could agree to remove the restriction. Accordingly, creating an endowed agency fund is not a guarantee that a future board of directors will not invade the principal of the fund. Regarding releases on restrictions in gift instruments, see §§16.15–16.17.

§4.21 F. Uses of Donor Funds

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

- A donor who needs an income tax deduction in the current year but wants more time to consider which charitable organizations will ultimately benefit from the gift can obtain a current deduction by making a gift to a donor-advised fund. In subsequent years, the donor may advise which charitable organizations should receive gifts from the donor-advised fund.
- A donor fund can be used as a memorial fund to honor a deceased individual. If only family members contribute to the memorial fund, and it is advised by family members, such a fund will be a donor-advised fund. If many nonfamily members contribute, however, it will not be a donor-advised fund.
- A donor fund could be an alternative wedding gift for a couple that already has a well-established household. If only family members contribute to the wedding fund, it will be a donor-advised fund, but if a large number of non-family members contribute, it will not be a donor-advised fund.
- A newly formed charitable organization awaiting its determination letter can use a donor fund to accept gifts from donors concerned about the certainty of their charitable contribution deduction. After the new organization receives a determination letter, funds can be distributed to the organization from the donor fund.
- A donor who is interested in providing scholarships can operate the program through a donor fund, taking advantage of the sponsoring community foundation's expertise and infrastructure for granting scholarships.

Additionally, the fund agreement should clarify whether the fund will be considered a donor-advised fund under IRC §4966(d)(2). For example, the agreement should indicate whether gifts will be separately tracked in the fund by reference to a specific donor and whether the donor will have advisory privileges or merely make nonbinding recommendations with respect to distributions and investments of the fund's assets.

§4.22 G. Control Over Donor Funds

The lack of a donor's legal control over a donor-advised fund was confirmed in *Lapham Found., Inc. v Commissioner* (6th Cir 2004) 389 F3d 606. That case dealt with the qualification of a supporting organization (see §4.56). The court held that a donor to a donor-advised fund had no legal control over the funds, and, accordingly, a gift to such a fund is an undesignated gift that can be used by the receiving charity for any charitable purpose.

§4.23 IV. PRIVATE FOUNDATIONS

A private foundation is the form of private charitable organization that offers the founder the greatest degree of legal control over the organization, but it also offers the most limited tax benefits and is subject to the greatest restrictions in its operations.

All charitable organizations that are exempt from tax under IRC §501(c)(3) are private foundations unless the organization meets one of the definitions of a public charity. IRC §509(a). Public charities include charities that are charities based on their function, such as hospitals, churches, and schools, as well as charities that receive broad public support in the form of contributions. IRC §509(a)(1). In addition, organizations that receive broad public support in the form of contributions and revenue from the exempt activity of the organization are public charities. IRC §509(a)(2). Finally, organizations with a close relationship to one or more public charities called supporting organizations are public charities. IRC §509(a)(3). On supporting organizations, see §§4.56–4.80.

NOTE► The IRS maintains a list of organizations classified as private foundations. See, *e.g.,* IRS Announcement 2013–18, 2013–25 Int Rev Bull 1256.

It should be noted that private foundations are not really "private" at all. Private foundations must annually file an IRS Form 990-PF federal tax return. See chap 12. Form 990-PF includes detailed information about the foundation, including the names and addresses of its substantial contributors. The foundation must provide copies of its last three Form 990-PFs to anyone who requests them. They, along with other nonprofit information, are posted on the Internet by GuideStar, at http://www.guidestar.org. For an explanation of the GuideStar database, see §12.84.

Contributions to private foundations are given less favorable tax treatment than contributions to public charities. IRC §170(b)(1)(B). The rules regarding contributions to private foundations are described more fully in §15.40.

NOTE► The IRS has a web-based information tool to assist private foundations in complying with both federal tax rules and requirements that occur through the life cycle of their organizations. It is available online at https://www.irs.gov/charities-non-profits/private-foundations/life-cycle-of-a-private-foundation.

§4.24 A. Limitations on Private Foundations

Private foundations are subject to a number of limitations and prohibitions that are designed to prevent abuse of the tax advantages they offer. See IRC §§4940–4948. To avoid the administrative difficulty of determining whether transactions between private foundations and their insiders are fair and appropriate, Congress prohibited a number of transactions and relationships between private foundations and their major contributors and managers (*i.e.,* disqualified persons; see §§4.25–4.35). While these prohibitions may simplify the tax administration of private foundations, they significantly limit the flexibility of the private foundation for charitable planning.

§4.25 1. Self-Dealing Transactions With Disqualified Persons

The limitations and prohibitions on private foundations apply to "disqualified persons." See IRC §4946. Disqualified persons include (IRC §4946(a)(1))

- Substantial contributors;
- Foundation managers who are the foundation's officers and directors;
- Any owner of more than 20 percent of a business that is a disqualified person;
- Certain family members of disqualified persons, including ancestors, children, grandchildren, and great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren (IRC §4946(d)); and
- A corporation, partnership, or trust that is 35 percent owned by disqualified persons.

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

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

§4.26 2. Types of Self-Dealing Transactions

A self-dealing transaction requires two parties: a private foundation and a disqualified person. Any transaction described in IRC §4941(d)(1) is an act of self-dealing, and a private foundation may not engage in it unless one of the exceptions listed in IRC §4941(d)(2) applies. See §§4.27–4.34.

PRACTICE TIP► It is essential to review the self-dealing rules with care before engaging in any transaction involving a disqualified person, so that the transaction may be restructured, or if necessary avoided, so as to comply with IRC §4941. The disclosure and approval provisions of state law should assist private foundations to comply with these federal tax requirements.

§4.27 a. Sale, Exchange, or Lease of Property

Self-dealing barred. The sale, exchange, or lease of property between a private foundation and a disqualified person is a prohibited act of self-dealing. IRC §4941(d)(1)(A). A disqualified person may, of course, permit a private foundation to use the disqualified person's property without charge. IRC §4941(d)(2)(C). For example, it is common for company foundations to operate from the company's office, and for family foundations to operate from the family home or from the business office of a family member. As long as the foundation does not pay rent directly or indirectly to a disqualified person, such use of property is permitted.

Donation of encumbered property. The self-dealing ban does not apply to a disqualified person's donation of property to a private foundation. However, if the disqualified person's property is subject to debt, the private foundation may not assume the debt. IRC §4941(d)(2)(A). Such a transaction would also be barred by IRC §4941(d)(1)(E), which bans the use of a private foundation's assets by or for the benefit of a disqualified person. It is also considered self-dealing if the property is subject to a mortgage or similar lien that a disqualified person placed on the property within the 10-year period ending on the date of the transfer to the private foundation. IRC §4941(d)(2)(A).

§4.28 b. Extension of Credit

Self-dealing includes lending money, or extending credit, between a private foundation and a disqualified person. IRC §4941(d)(1)(B). There is one exception: a disqualified person may lend money to a private foundation if the loan is without interest or other charge and if the proceeds are used exclusively for IRC §501(c)(3) purposes. IRC §4941(d)(2)(B).

§4.29 c. Furnishing Goods, Services, or Facilities

Self-dealing includes furnishing goods, services, or facilities between a private foundation and a disqualified person. IRC §4941(d)(1)(C). However, as in §4.28, if the disqualified person provides the goods, services, or facilities without charge and the foundation uses them exclusively for exempt purposes, the rule does not apply. In addition, a private foundation may furnish goods, services, or facilities to a disqualified person if it does so no more favorably than it would to the general public. IRC §4941(d)(2)(D).

§4.30 d. Payment of Compensation or Expenses

A private foundation may not compensate a disqualified person, or pay or reimburse the expenses of a disqualified person, unless two conditions are met (IRC §4941(d)(2)(E)):

(1) The compensation must be for “personal services” that are reasonable and necessary to carry out the foundation’s exempt purposes; and

(2) The amount of compensation, payment, or reimbursement must be reasonable and not excessive in the circumstances.

NOTE► Organizations relying on the personal services exception must exercise great care, because the regulations define “personal services” narrowly to include primarily professional services, such as legal counsel, accounting services, and investment advice. Treas Reg §53.4941(d)–3(c). For other types of services, legal counsel should carefully review applicable rulings and cases.

§4.31 e. Transfer or Use of Foundation Income and Assets

Internal Revenue Code §4941(d)(1)(E) is a general provision that traps any self-dealing transactions that might not have been included in the preceding provisions. It bars the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation. Unless the transaction falls within one of the exceptions provided by law, this prohibition is absolute.

§4.32 f. Payments to Government Officials

A private foundation may not make, or agree to make, any payment of money or transfer of property to a government official. IRC §4941(d)(1)(F). However, §4941(d)(1)(F) does permit a private foundation to agree to employ a government official after his or her government service is terminated if that service will terminate within 90 days. Further, the ban on payments to government officials does not apply to the types of payments described in IRC §4941(d)(2)(G).

§4.33 g. Exception for Certain Corporate Transactions

Private foundations are often funded with shares of stock or other investments in enterprises owned or controlled by disqualified persons. Company foundations are often supported by gifts of stock in the company itself. The self-dealing rules, taken literally, appear to bar the redemption by the company of shares held by the foundation, but a specific exception covers this situation. Transactions between a private foundation and a corporate disqualified person under a liquidation, merger, redemption, or similar corporate reorganization are not self-dealing if the following two conditions are met (IRC §4941(d)(2)(F)):

(1) All securities of the same class as that held by the foundation are subject to the same terms; and

(2) Those terms provide that the foundation shall receive no less than fair market value for the securities.

§4.34 h. Indirect Self-Dealing

Any of the self-dealing acts described in §§4.26–4.33 may also occur indirectly between a disqualified person and an organization controlled by a private foundation. Treas Reg §53.4941(d)–1(b). For the definition of “controlled organization,” see Treas Reg §53.4941(d)–1(b)(5).

EXAMPLE► If a private foundation controls ABC Corporation, which makes a loan to XYZ Corporation, which was formed by disqualified persons, the loan is an indirect act of self-dealing between the private foundation and XYZ. Treas Reg §53.4941(d)–1(b)(8), Example 1.

The indirect self-dealing rules apply even if the controlled organization is a public charity. Thus, the payment of a lecture fee to a government official by a private university that is controlled by a private foundation constitutes self-dealing by the foundation. See Treas Reg §53.4941(d)–1(b)(8), Example 3.

§4.35 3. Penalties for Violating Rules Against Self-Dealing

Annual first-tier excise tax. The IRS automatically imposes an annual first-tier excise tax on the self-dealer of 10 percent of the amount involved. IRC §4941(a)(1). An annual first-tier excise tax of 5 percent of the amount involved (up to a maximum tax of $20,000 for each act of self-dealing) may also be imposed on a foundation manager who knowingly participated in a self-dealing transaction, unless it was not willful and was for reasonable cause. IRC §4941(a)(2), (c)(2).

NOTE► The manager has a complete defense if he or she acted in reliance on the advice of counsel expressed in a reasoned, written legal opinion. Treas Reg §53.4941(a)–1(b)(6).

Second-tier excise tax. For each act of self-dealing not corrected within a specific period, the self-dealer must pay a second-tier excise tax of 200 percent of the amount involved. IRC §4941(c)(1), (d)(1). The IRS may impose a second-tier excise tax on the foundation manager of up to 50 percent of the amount involved, but only up to $20,000.

Additional penalties. The IRS can impose an additional penalty equal to the first- and second-tier taxes for willful, flagrant acts by those who have previously been subject to self-dealing excise tax. See

IRC §6684. Finally, if a foundation's self-dealing transactions are repeated or willful, the IRS may terminate the foundation's exempt status and impose a substantial termination tax. See IRC §507.

Correcting self-dealing actions. An act of self-dealing is corrected by reversing it, returning any benefit to the charity, and placing the charity in a financial position not worse than that in which it would have been if the disqualified person were dealing under the highest fiduciary standards. Treas Reg §53.4941(e)–1(c)(1).

PRACTICE TIP► The rules regarding correction are complex and often harsh toward the disqualified person. A practitioner should review the correction procedures carefully. See Treas Reg §53.4941(e)–1(c).

NOTE► Because the facts in a self-dealing situation are often intricate, it is important to ensure that the correction is not itself an act of self-dealing. See Rev Rul 81–40, 1981–1 Cum Bull 508 (when disqualified person attempted to correct indebtedness to private foundation by transferring real property to a private foundation, IRS held that transfer resulted in second act of self-dealing).

§4.36 4. Minimum Annual Distributions

Private foundations are required to make minimum annual distributions. Generally, the amount that a private foundation is required to distribute is equal to 5 percent of the fair market value of the foundation's noncharitable assets. IRC §4942(e).

§4.37 a. Computing Minimum Distribution Requirements

To calculate its minimum required distributions for the current year, the foundation must compute the value of its assets for the preceding taxable year. These values are computed differently, according to the nature of each asset. Cash and marketable securities are valued monthly and then averaged to compute the value for the foundation's taxable year. Treas Reg §53.4942(a)–2(c)(4). Other assets, such as real estate or royalty rights, are valued once a year. Treas Reg §53.4942(a)–2(c)(4). The total asset values are then multiplied by 5 percent to reach the amount that the foundation must distribute during the current year. IRC §4942(e)(1). For example, the minimum amount a foundation must distribute in its taxable year ending in 2017 is 5 percent of the fair market value of its assets during the taxable year ending in 2016. Treas Reg §53.4942(a)–2(c)(1).

§4.38 b. Qualifying Distributions

Qualifying distributions are included in the 5-percent distribution amount. Qualifying distributions include all amounts, including grants or other actual charitable distributions, as well as reasonable and necessary administrative expenses, paid to accomplish one or more exempt purposes. IRC §4942(g)(1)(A). Amounts paid to acquire an asset used directly in carrying out an exempt purpose are also treated as qualifying distributions. IRC §4942(g)(1)(B).

Limitations. Grants to other private foundations that are not private operating foundations, and grants to private operating foundations and public charities that are commonly controlled by the grantor private foundation or its officers, directors, and trustees, will not count as qualifying distributions unless the "out of corpus" rule described in IRC §4942(g)(3)(A) is satisfied. The Pension Protection Act of 2006 (Pub L

109–280, 120 Stat 780) also limits the ability of a private foundation to make qualifying distributions to certain supporting organizations, as discussed more fully in §4.46. IRC §4942(g)(4).

Set-asides for later distribution. From time to time a private foundation may have a philanthropic end in mind that requires more funds than the foundation has on hand in the current year. In this situation, IRC §4942(g)(2) permits the foundation to set aside funds for later distribution and to count the set-aside amount as a qualifying distribution in the year in which the funds are set aside, even though the funds are not actually distributed in that year. Treas Reg §53.4942(a)–3(b)(1).

Carryforward of excess distributions. If a private foundation distributes more than the required 5 percent, the foundation may carry forward, for up to 5 years, any qualifying distributions above the minimum distribution amount. IRC §4942(i)(2). These excess distributions may be applied to reduce the amount that the foundation would otherwise have to distribute in the subsequent year. Treas Reg §53.4942(a)–3(b)(5).

§4.39 c. Penalties

If a private foundation fails to distribute the required amounts, the IRS imposes an annual excise tax of 30 percent of the amount that should have been distributed. IRC §4942(a). If the failure is not corrected within a specified period, an additional tax will be imposed equal to 100 percent of the amount remaining undistributed. IRC §4942(b). As with self-dealing, repeated or flagrant violations may lead to the withdrawal of exemption and the imposition of a termination tax. IRC §507.

§4.40 5. Net Investment Income

Although private foundations are exempt from tax under IRC §501(c)(3), they are required to pay a 2-percent tax on their annual net investment income. IRC §4940. If the private foundation exceeds the required minimum distribution for a year, it can reduce the 2-percent tax down to a 1-percent tax. IRC §4940(e). The increased distribution in 1 year, however, sets the floor for the amount that the private foundation must distribute in the following year in order to take advantage of the 1-percent tax rate. Accordingly, a private foundation will not likely stay in the 1-percent tax rate over several years.

§4.41 6. Interests in Business Enterprises

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

Five years to dispose of contributed excess business interest. A private foundation that receives an excess business interest as a contribution has 5 years to dispose of it. IRC §4943(c)(6). This is often done through a redemption at market value, which must be offered to all shareholders. IRC §4941(d)(2)(F). The redemption may not be desirable, as other shareholders also will tender their shares to the company.

A private foundation may not dispose of an excess business holding by selling to a shareholder who is a disqualified person, except if the sale is through an administration of an estate. Treas Reg §53.4941(d)–4.

NOTE► The IRS may extend the 5-year period for an additional 5 years for an unusually large gift or bequest in which the foundation establishes that the facts and circumstances warrant an extension. IRC §4943(c)(7). However, if excess business holdings exist because of a purchase, no extensions are available. The matter must be corrected promptly, or the foundation will be subject to a tax equal to 10 percent of the value of the excess holdings, calculated as of the day during the tax year when its holdings were greatest. IRC §4943(a).

§4.42 7. Jeopardy Investments

Foundation and manager subject to penalties. Internal Revenue Code §4944 provides that, if a private foundation invests in a manner that is likely to jeopardize its ability to carry out its exempt purposes, the foundation is taxed at 10 percent of the amount so invested for each year (or partial year) during which the investment is held. IRC §4944(a)(1). A foundation manager who participated in making that investment, knowing that it could jeopardize the foundation, is also annually taxed at 10 percent of the amount unless the manager's participation was not willful and was due to reasonable cause. IRC §4944(a)(2). If the investment is not "removed from jeopardy," additional taxes are imposed. IRC §4944(b).

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

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

Ordinary business care standard. An investment will be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making the investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. Treas Reg §53.49944–1(a)(2)(i). When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. IRS Notice 2015–62, 2015–39 Int Rev Bull 411. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity as long as they exercise the requisite ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment in making investment decisions that support, and do not jeopardize, the furtherance of the private foundation's charitable purposes. IRS Notice 2015–62, 2015–39 Int Rev Bull 411. For example, a private foundation will not be subject to tax under IRC §4944 if foundation managers who have exercised ordinary business care and prudence make an investment that furthers the foundation's charitable purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes. IRS Notice 2015–62, 2015–39 Int Rev Bull 411.

Exception for program-related investments. Internal Revenue Code §4944(c) specifically excludes program-related investments from the definition of jeopardizing investments. A program-related investment is an investment whose primary purpose is to accomplish one or more charitable purposes, and the production or the appreciation of property is not a significant purpose. Treas Reg §53.4944–3(a)(1).

§4.43 8. Compensating Family Members

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

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

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

NOTE► Any compensation paid to a disqualified person (*e.g.,* certain family members of a substantial contributor) must comply with the self-dealing rules. See §4.30.

§4.44 9. Taxable Expenditures

Foundation and manager subject to penalties. Numerous expenditures that are prohibited to private foundations are called taxable expenditures. See IRC §4945. Taxable expenditures include expenditures for lobbying and for scholarships and grants to individuals for travel or study unless they are part of a program that has been preapproved by the IRS. IRC §4945(d)(3), (e).

NOTE► These rules require a private foundation to have every scholarship program, as well as any changes in such a program, approved by the IRS before it can be implemented. IRC §4945(g). On scholarship funds, see §4.6.

The IRS imposes penalties on private foundations that make taxable expenditures and on any manager who, knowingly and without reasonable cause, participates in making a taxable expenditure. IRC §4945(a). If the taxable expenditure is not reversed, additional penalties are imposed. IRC §4945(b).

Lobbying. Private foundations may not conduct or pay for any type of lobbying activity at all. IRC §4945(d)(1). See, *e.g., Loren E. Parks* (2015) 145 TC 278 (private foundation and its manager liable for excise taxes on amounts they paid for radio messages to influence state legislation). Many efforts fall outside the definition of "lobbying" in the regulations, however, and private foundations may conduct such efforts.

Grants to individuals. Private foundations may make grants to individuals only if the selection procedures are objective and nondiscriminatory and if the IRS has formally determined in advance that the foundation's selection procedures meet that standard. IRC §4945(g). The requirements for the selection procedure are in Treas Reg §53.4945–4(b)(3).

PRACTICE TIP► Usually, the most convenient occasion to obtain that determination is as part of the initial exemption application process. Accordingly, practitioners should request the IRS to approve grant selection procedures for individual grantees as part of a new private foundation's tax exemption application if there is any interest on the donor's part in such grants, to save the foundation the cost and delay of subsequently obtaining a ruling and the risk of proceeding without one.

Expenditure responsibility. Private foundations may not make a grant to an organization that is not either a public charity or an exempt operating foundation unless the private foundation exercises expenditure responsibility over the grant. IRC §4945(d)(4). "Expenditure responsibility" refers to a process of documented monitoring and oversight, which consists of four elements: a pregrant inquiry, a written grant agreement containing certain specific terms and conditions, a written report from the grantee, and the provision of information to the IRS on Form 990-PF. Treas Reg §53.4945–5(b). Private foundations may also use expenditure responsibility for grants to any supporting organization for which the grant is not considered to be a qualifying distribution under IRC §4942.

Grants to foreign charities. The expenditure responsibility procedures have posed an obstacle to foreign grantmaking. If a private foundation makes a good faith determination that a foreign charity would qualify as a public charity if it were a United States organization, or if it obtains and relies on a written legal opinion to that effect, the private foundation may treat a grant to that charity as if it were made to a United States public charity (*i.e.*, the private foundation need not exercise expenditure responsibility). Treas Reg §53.4945–5(a)(5). Few private foundations, however, have taken advantage of this provision. The IRS has sought to ease the burdens on private foundations by issuing Rev Proc 92–94, 1992–2 Cum Bull 507, which provides a simplified affidavit procedure for determining whether a foreign charity is the equivalent of a public charity.

§4.45 10. Independent Audit Committee Requirement

Audit committee. The Nonprofit Integrity Act (Stats 2004, ch 919) (amending and adding sections to the Supervision of Trustees and Fundraisers for Charitable Purposes Act (Govt C §§12580–12599.8)) requires an independent audit committee for most corporations holding charitable assets in California with revenues over $2 million. Govt C §12586(e)(2). The composition and permissible members of the audit committee are specified in the statute. The Nonprofit Integrity Act thus poses challenges for families that wish to maintain management of their private foundation within the family. Sometimes, it is possible to name a trusted adviser to the family to serve on the audit committee, but some advisers may be professionals who are also rendering services to the corporation. Professional advisers providing services to the foundation will not be considered independent and able to act as the audit committee. See Govt C §12586(e)(2).

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

For a more detailed discussion of these requirements, see §12.53. For a bylaws provision establishing an audit committee, see §7.82.

§4.46 11. Grants to Supporting Organizations

Grants are not qualifying distributions. Grants by private nonoperating foundations to certain supporting organizations (SOs) do not count as qualifying distributions under IRC §4942. IRC §4942(g)(4). These SOs include (IRC §4942(g)(4))

- Type III SOs that are not functionally integrated with the supported organization (*i.e.*, the SO does *not* engage in activities substantially all of which directly further the exempt purposes of the supported organizations to which the SO is responsive by performing the functions of, or carrying out the purposes of, the supported organizations, and the SO is *not* the parent of each of the supported organizations) (see Prop Treas Reg §1.509(a)–4(f)); and
- Any Type I, Type II, or functionally integrated Type III SOs in which a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization of the SOs.

NOTE► These grants are also taxable expenditures for both private nonoperating and private operating foundations under IRC §4945 unless the foundation follows the expenditure responsibility requirements. IRC §4945(d)(4)(A). Regulations may provide other circumstances under which a distribution from a private foundation to an SO is not allowed.

A private foundation uses the same resources as a donor-advised fund to determine the type of SO. For IRS guidance, see §4.14. On types of supporting organizations, see §§4.58–4.65. On private operating foundations, see §§4.47–4.50.

§4.47 B. Private Operating Foundations

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

May not be subject to 2 percent excise tax. Certain private operating foundations that are classified as exempt operating foundations (*i.e.*, private operating foundations that have been publicly supported for at least 10 years) are not subject to the 2 percent excise tax imposed on net investment income that applies to other private foundations. See IRC §4940(d). See also §4.40. On exempt operating foundations, see §4.50.

Private foundation grants. Private foundations can make grants to certain private operating foundations that are classified as exempt operating foundations in the same manner as to public charities. IRC §4945(d)(4)(A). No expenditure responsibility is required. See §4.44. On exempt operating foundations, see §4.50. Grants to all other private foundations require expenditure responsibility. However, the IRS may not require expenditure responsibility for a grant to a private operating foundation even if it is not classified as an exempt operating foundation. See Letter Ruling 201652004. Grants to a private operating foundation would be a qualifying distribution but a grant to a private nonoperating foundation generally would not. IRC §4942(g)(1)(A). On qualifying distributions, see §4.38.

Private foundation rules generally apply. In all other respects, a private operating foundation is subject to the same rules as a private foundation relating to reporting, recordkeeping, and restrictions on activities by disqualified persons.

Two tests. To qualify as a private operating foundation, an organization must satisfy two tests: the income test and an alternative test. See §§4.48–4.49.

§4.48 1. Income Test

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

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

- Amounts paid to acquire assets held for use by the foundation as operating assets in the exempt function;
- Reasonable administrative expenses necessary to conduct the exempt function are direct even though they are not directly for the active conduct of the exempt function; and
- Amounts properly set aside for the purpose of assets to be held for direct use in the exempt function (*e.g.*, funds accumulated over several years to construct a building to be used in the exempt purposes of the foundation).

"Substantially all" means 85 percent, and as a result, a private operating foundation can only retain (or make nonqualifying grants) of up to 15 percent of the lesser of (1) the private foundation's adjusted net income or (2) its minimum investment return. IRC §4942(j)(3)(A); Treas Reg §53.4942(b)–1(c). Adjusted net income is gross income less deductions allowable to a corporation. IRC §4942(f). Gross income does not include grants received by the private foundation, but would include income from a related business carried on by the private foundation. Minimum investment return equals 5 percent of its assets that are not used directly in carrying out its exempt function, less acquisition indebtedness with respect to those assets.

§4.49 2. Alternative Test

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

- **The asset test** requires that 65 percent of the private foundation's assets must be devoted directly to either (1) the active conduct of activities constituting its exempt purpose, or (2) a functionally related business. IRC §4942(j)(3)(B)(i); Treas Reg §53.4942(b)–2(a). Assets used for an exempt function include real estate, facilities, equipment, and intangible assets. Securities are generally not counted as used for exempt purposes unless the private foundation owns 80 percent of the corporation's stock. There are special rules for valuing nonmarketable assets. This test is usually appropriate if the organization has invested substantial capital in assets, typically art or real estate, which it uses in its exempt activities.

- **The endowment test** requires that a private operating foundation make direct distributions of at least two-thirds of its minimum investment return (*i.e.*, 3⅓ percent of its assets). IRC §4942(j)(3)(B)(ii); Treas Reg §53.4942(b)–2(b). Of the three tests, this is usually the easiest to satisfy.
- **The support test** requires that (1) at least 85 percent of the private operating foundation's support, other than investment income, be from a combination of the general public and five or more exempt organizations; (2) not more than 25 percent of support other than investment income be from any one exempt organization; and (3) not more than 50 percent of its support is received from gross investment income. IRC §4942(j)(3)(B)(ii); Treas Reg §53.4942(b)–2(c). This test rarely applies because organizations that can meet this test usually qualify as public charities.

§4.50 3. Exempt Operating Foundations

Some private operating foundations may qualify as "exempt operating foundations" under IRC §4940(d). An exempt operating foundation is not subject to the 2-percent excise tax on its investment income. IRC §4940(d)(1). Moreover, although private foundation grantors must exercise expenditure responsibility over grants to private foundations generally (see §4.44), this requirement does not apply to grants to exempt operating foundations; thus, private foundation grantors may treat grants to these foundations as if the grantee were a public charity. IRC §4945(d)(4).

"Exempt operating foundation" defined. To obtain this privileged status, the foundation must satisfy four criteria (IRC §4940(d)(2)):

- The foundation must either have qualified as a private operating foundation for its last taxable year ending before January 1, 1983, or have qualified as a public charity for at least 10 years;
- At least 75 percent of the governing body must consist of people other than substantial contributors and their relatives;
- The governing body must be broadly representative of the public; and
- No substantial contributor or related person may serve as an officer at any time during the taxable year in question.

As a practical matter, the first of the above criteria makes it unlikely that most operating foundations will ever be able to qualify as exempt operating foundations. Any organization that can demonstrate the necessary degree of public support usually seeks to be classified as a public charity, not a private foundation.

§4.51 C. Donor-Directed Funds

A donor-directed fund is a private foundation that maintains individual donor accounts similar to donor-advised funds. See IRC §170(b)(1)(F)(iii). However, unlike a donor-advised fund (see §4.4), the donor's directions with respect to a donor-directed fund are legally binding. Donor-directed funds are required to distribute all income annually to public charities. IRC §170(b)(1)(F)(iii). On the death of the donor or the survivor of the donor and the spouse of the donor, the entire principal of the donor-directed fund for that donor must be distributed to a public charity. IRC §170(b)(1)(F)(iii).

NOTE► Donor-directed funds have fallen out of favor because donor-advised funds offer the same practical benefits to donors without the disadvantages of the required annual distribution and all the restrictions of operating as a private foundation.

D. Private Pass-Through Foundations

§4.52 1. Requirements for Pass-Through Treatment

Another special type of private foundation, known as a private pass-through, conduit, or flow-through foundation, passes through to the ultimate charitable recipients all contributions that it receives, rather than retaining them for use in its own activities. Thus, qualifying distributions include contributions to IRC §501(c)(3) organizations. See IRC §4942(g)(3).

Annual return must show tests satisfied. To qualify for pass-through treatment, a private foundation need not obtain a ruling from the IRS, but it must demonstrate on its annual information return (IRS Form 990-PF) that the manner in which it has operated for that year satisfies the tests in IRC §170(b)(1)(F)(ii) and Treas Reg §1.170A–9(h). Specifically, the private foundation must, within 2½ months after the close of its tax year, make qualifying distributions equal to the value of all contributions received in that year plus all its income from the current year and any undistributed income from its immediately preceding tax year. The donor must attach to his or her tax return (or amended tax return) evidence from the private foundation that it has made such timely qualifying distributions. Treas Reg §1.170A–9(h)(4).

Precise compliance with IRC §170(b)(1)(F)(ii) and the corresponding regulation is required to obtain the advantages of the private pass-through foundation. For example, all distributions must be "qualifying distributions," but that term is applied narrowly to a private pass-through foundation. Distributions must be made within specified time limits, which requires careful recordkeeping. A foundation may make timely qualifying distributions of all its contributions, yet not qualify for pass-through treatment if it has any undistributed income from its current or preceding tax year.

PRACTICE TIP► The precise requirements are not satisfied by distributing the same property received. Rather, the value of the property distributed must equal the value of the property when contributed. See Treas Reg §1.170A–9(h)(2). Thus, any contributed stock or other property that may decrease in value should be sold immediately and converted into cash or cash equivalents.

§4.53 2. Planning Strategies

Tax strategies. The private pass-through foundation can be a valuable tax-planning vehicle. Like a private operating foundation, an individual donor obtains the same charitable contribution deduction as would be received from contributing to a public charity. IRC §170(b)(1)(A)(vii), (F)(ii). The donor obtains an immediate tax deduction; if he or she controls the foundation, the donor also retains the ability to select the ultimate charitable recipients. The selection and distribution of funds to those recipients by the private pass-through foundation must be made within 2½ months after the close of the foundation's taxable year in which the contribution was received. IRC §170(b)(1)(F)(ii). Thus, selection and distribution may be delayed as long as 14½ months after the foundation receives the contribution. See Treas Reg §1.170A–9(i).

Philanthropic and tax objectives. A donor may also achieve varied philanthropic and tax objectives by switching the foundation from a standard private foundation in one year to a private pass-through foundation in another. Thus, in one year the donor may build an endowment in the foundation through contributions that receive limited deductions and, in a tax year when the donor needs maximum deductions, he or she may use the foundation as a private pass-through foundation. The private pass-through foundation, like any foundation, may also be used by the donor to remain anonymous.

§4.54 E. Private Common Fund Foundations

A private common fund foundation permits a donor to designate public charity recipients to receive the income and corpus from the donor's portion of a pooled fund of contributions. IRC §170(b)(1)(F)(iii). As with a private pass-through foundation, a donor to a common fund foundation obtains the same charitable contribution deductions that gifts to public charities generate, retains control over the designation of the charitable recipient after his or her contribution to the foundation, and may preserve his or her anonymity. See IRC §170(b)(1)(A)(vii).

"Private common fund foundation" defined. To qualify as a private common fund foundation, the organization must satisfy the tests in IRC §§170(b)(1)(F)(iii) and 509(a)(3)(A)–(B) and Treas Reg §1.170A–9(i), and the organization should obtain a ruling from the IRS. The foundation's governing documents (its articles or bylaws) must require the foundation to distribute all the adjusted net income of the common fund to one or more public charities, classified under IRC §509(a)(1), no later than 2½ months after the close of the tax year in which the income is realized by the fund. Treas Reg §1.170A–9(i)(2)(i). All the corpus of the foundation attributable to any donor's contributions must be distributed to similar recipients within 1 year after the death of the donor or his or her surviving spouse. Treas Reg §1.170A–9(i)(2)(ii).

Distinguished from private pass-through foundations. Important differences exist between private common fund foundations and private pass-through foundations:

- Private common fund donors may designate distributions from the contribution and the net income it generates over their entire lifetime, rather than merely for the taxable year (plus 2½ months) in which the foundation receives that contribution.
- Although the designated time period may be more advantageous to the donor, the range of possible designees is narrower. A private common fund foundation may distribute funds only to public charities classified under IRC §509(a)(1); in contrast, a private pass-through foundation may make grants to all types of public charities and private foundations as long as the transfer satisfies the definition of "qualified distribution" under IRC §170(b)(1)(F)(ii).
- A private common fund foundation may not be used as a standard private foundation in some years, as a pass-through foundation can. This restriction is not significant, however, because the donor will nevertheless be able to obtain maximum tax deductions and build an endowment lasting for the donor's lifetime.

PRACTICE TIP► As with pass-through foundations, private common fund foundations must keep careful records to comply with the precise distribution requirements. Further, private common fund foundations must keep separate records for each donor's contributions and the net income attributable to those contributions; these records must be kept for the life of the donor if the contributions are retained for the maximum period.

§4.55 F. Termination of Private Foundation Status

A charity may terminate its private foundation status by distributing all its net assets to a qualified public charity, or by transforming itself into a public charity. IRC §507(a)–(b). See chap 3. When distributing all net assets, the public charity distributee must have been in existence for a continuous period of 60 months or more. IRC §507(b)(1)(A). If terminating private foundation status by transforming into a public charity, the private foundation must operate in a manner to qualify as a public charity for 60 months; notify the IRS before that 60-month period begins; and establish, immediately after that period ends, that it has met the applicable public charity test. IRC §507(b)(1)(B).

Termination tax. Any other termination of private foundation status may result in a termination tax. The tax imposed will be the lesser of the aggregate tax benefits obtained by the private foundation during its existence or the value of the net assets of the foundation. IRC §507(c). The termination tax will apply if the IRS terminates the organization's private foundation status for repeated or flagrant willful violations that resulted in liability for excise taxes under IRC §§4942–4945. See IRC §507(a)(2). The tax will also apply if the private foundation voluntarily terminates itself other than by transforming itself into a public charity or distributing all its assets to a public charity. See IRC §507(a)(1).

V. SUPPORTING ORGANIZATIONS

§4.56 A. Definition

A supporting organization (SO) is a charitable organization operated exclusively for the benefit of one or more public charities organized and described in IRC §509(a)(1)–(2). IRC §509(a)(3)(A). Because of its close relationship with one or more public charities, an SO is treated as a public charity. Thus, donations to SOs receive the most favorable tax treatment. SOs are not subject to as many prohibitions as private foundations. On SO limitations, see §§4.66–4.79.

Close relationship with supported charity. All SOs must satisfy certain basic requirements with respect to support of the public charities and the composition of their board of directors. Each SO must also establish a close relationship with the supported public charities in one of three different ways. IRC §509(a)(3)(C). This relationship requirement distinguishes a Type I SO from a Type II SO or a Type III SO. See §§4.58–4.65.

Operated exclusively for benefit of public charity. Supporting organizations must be operated exclusively for the benefit of the supported public charities. IRC §509(a)(3)(A). These charities can be identified by name or, in some instances, as a class. All of the SO's distributions must be to or for the benefit of the supported public charities.

EXAMPLE► An organization formed to support a university could either make grants directly to the university or distribute scholarships to the students at the university.

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

§4.57 B. Directors

A supporting organization (SO) must satisfy certain basic requirements with respect to the composition of its board of directors. More than 50 percent of the directors of an SO must be persons who are not disqualified persons or entities (other than foundation managers or publicly supported charities). IRC §509(a)(3)(C). For a definition of disqualified persons, see §4.25.

EXAMPLE► A board of directors that has two disqualified persons and two persons who are not disqualified persons would not be a legal board of directors, but a board of directors with three nondisqualified persons and two disqualified persons would be a legal board of directors.

NOTE► The IRS has ruled that the disqualified person control test does not prohibit an SO from being controlled by individuals who are disqualified persons with respect to a private foundation that is a substantial contributor to the SO, if the individuals themselves do not qualify as disqualified persons with respect to the SO. IRS Letter Ruling 200827038.

§4.58 C. Types of Supporting Organizations

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

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

These three types of SOs are discussed in §§4.59–4.68.

NOTE► Internal Revenue Service Notice 2006–109, 2006–2 Cum Bull 1121, as modified by Rev Proc 2011–33, 2011–1 Cum Bull 318, and IRS Notice 2014–4, 2014–1 Cum Bull 274, alerted taxpayers to the new SO rules enacted by the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) and provided interim guidance to SOs and certain grantors. In December 2012, the Treasury Department and the IRS issued final and temporary regulations for SOs that made significant changes to the rules for Type III SOs. The final and temporary regulations were similar to the proposed regulations issued in 2009. See §4.14.

§4.59 1. Type I Supporting Organizations

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

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

Relationship. A Type I SO is sometimes viewed as having a parent-child relationship with the supported public charities. Certainly in circumstances when one public charity appoints the majority of the directors of the SO, the SO functions very much like a subsidiary of the public charity.

PRACTICE TIP► A public charity that appoints the majority of the board of directors of the SO will be required to consolidate its accounting with that of the SO under rules promulgated by the Financial Accounting Standards Board (FASB), available on the Internet at http://www.fasb.org. For further discussion of accounting principles, see chap 21.

§4.60 2. Type II Supporting Organizations

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

§4.61 3. Type III Supporting Organizations

Connected with one or more public charities. A supporting organization (SO) operated in connection with one or more public charities is a Type III SO. Generally, the public charities will appoint only a minority, if any, of the board members of a Type III SO.

Close relationship with supported public charities. Unlike Type I or Type II SOs, a Type III SO is not controlled by public charities or the same persons that control the public charities. Instead, the Type III SO must demonstrate a close relationship with the supported public charities. To show this relationship, a Type III SO must satisfy two tests: a responsiveness test and an integral part test. Treas Reg §1.509(a)–4(i)(1). See §§4.62–4.68. Treasury Regulation §1.509(a)–4(i)(1) also adds a notification requirement.

NOTE► In 2009, the Treasury Department and the IRS issued proposed regulations pursuant to the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780), which made significant changes to the rules relating to Type III SOs. See 74 Fed Reg 48672 (2009). See also §§4.14, 4.46. The Explanation of Provisions issued with the revisions expressly states that a Type III SO that fails to meet the requirements of the proposed regulations, once they are published as final or temporary regulations, will be classified as a private foundation. See 74 Fed Reg 48678 (Sept. 24, 2009). The IRS issued final and temporary regulations relating to Type III SOs, effective December 28, 2012, that were similar to the proposed regulations, except that the IRS significantly changed the distribution requirements of a nonfunctionally integrated Type III SO. See §4.63C. Nevertheless, a nonfunctionally integrated Type III SO that qualified under the proposed regulations should still qualify as such under the final and temporary regulations. See Treas Reg §1.509(a)–4(i)(5)(ii);

former Temp Treas Reg §1.509(a)–4T(i)(5)(ii)(B)–(C). The IRS issued final regulations effective as of December 21, 2015, which conformed the provision regarding the valuation of nonexempt-use assets to the provision in the regulations applicable to the distribution requirements of private foundation under IRC §4942, but which otherwise were the same as the temporary regulation provisions they replaced. TD 9746, 2016–1 Cum Bull 515.

§4.62 a. Responsiveness Test

A supporting organization (SO) is responsive to the needs or demands of a supported organization if (Treas Reg §1.509(a)–4(i)(3))

- One or more officers, directors, or trustees of the SO are elected or appointed by the officers, directors, trustees, or membership of the supported organization; or
- One or more members of the governing bodies of the supported organization are also officers, directors, or trustees of, or hold other important offices in the SO; or
- The officers, directors, or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization; and
- By reason of one of the relationships above, the officers, directors, or trustees of the supported organization have a "significant voice" in (1) the investment policies of the SO; (2) the timing of grants; (3) the manner of making grants; (4) the selection of recipients by such SO; and (5) in otherwise directing the use of the income or assets of the SO.

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

An SO must be responsive to the needs and demands of each of its supported organizations in order to meet the responsiveness test. Prop Treas Reg §1.509(a)–4(i)(3)(i).

NOTE► Before the Pension Protection Act of 2006 (PPA) (Pub L 109–280, §1231(c), 120 Stat 780), the responsiveness test allowed an SO to be a trust under state law if the supported public charities were identified by name and the public charities had the right to enforce the trust and compel an accounting. Former Treas Reg §1.509(a)–4(i)(2)(iii). The PPA eliminated the ability to set up such a trust as a Type III SO. Pub L 109–280, §1241(c), 120 Stat 780. See note to IRC §509. For a more detailed discussion of charitable trusts, see §4.69.

As mentioned above, the regulations provide that all Type III SOs, including those organized as charitable trusts, must demonstrate a relationship between its officers, directors or trustees, and those of the supported organization that results in the officers, directors, or trustees of the supported organization having a "significant voice" in the operations of the SO. Treas Reg 1.509(a)–4(i)(3)(iii). The preamble to the final and temporary regulations relating to Type III SOs stated that the final regulations remove the alternative responsiveness test for charitable trusts contained in former Treas Reg §1.509(a)–4(i)(2)(iii). TD 9605, 2013–11 Int Rev Bull 587. Accordingly, the final regulations provide that all Type III SOs (including charitable trusts) must satisfy the significant voice responsiveness test. See Treas Reg §1.509(a)–4(i)(3)(iii).

§4.63 b. Integral Part Test

The Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) distinguishes between "functionally integrated" and "nonfunctionally integrated" Type III SOs. Pub L 109–280, §1241, 120 Stat 780. The Treasury Regulations require that a Type III SO demonstrate that it is an integral part of a supported organization by satisfying the requirements for either a functionally integrated or a nonfunctionally integrated Type III SO.

§4.63A (1) Functionally Integrated Type III Supporting Organizations

The Treasury Regulations provide that a supporting organization (SO) meets the integral part test as a "functionally integrated" Type III SO if it meets one of following tests (Treas Reg §1.509(a)–4(i)(4)(i)):

- The SO engages in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which the SO is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s), and but for the involvement of the SO, would normally be engaged in by the supported organization.
- The SO is the parent of each of its supported organizations.
- The SO supports a government-supported organization under certain circumstances.

Directly furthering exempt purpose of supported organization. The Treasury Regulations provide that an SO directly furthers the exempt purposes of its supported organization (referenced in the first bullet point above) by holding or managing exempt-use assets but does not directly further such exempt purposes by fundraising, grantmaking, or investing and managing nonexempt-use assets. Treas Reg §1.509(a)–4(i)(4)(ii)(c).

The Treasury Regulations provide the following example of a functionally integrated Type III SO (Treas Reg §1.509(a)–4(i)(4)(v), Example 3):

> O is a local nonprofit food pantry described in section 501(c)(3) … O collects donated food from local growers, grocery stores, and individuals and distributes this food free of charge to poor and needy people in O's community. O is organized and operated as a supporting organization to eight churches of a particular denomination located in O's community, each of which is described in section 509(a)(1) … Control of O is vested in a five-member Board of Directors, which includes an official from one of the churches as well as four lay members of the churches' congregations. The officers of O maintain a close and continuing working relationship with each of the eight churches and as a result of such relationship, each of the eight churches has a significant voice in directing the use of the income and assets of O. As a result, O is responsive to its supported organizations. All of O's activities directly further the exempt purposes of the eight supported organizations to which it is responsive. Additionally, but for the activities of O, the churches would normally operate food pantries themselves. Based on these facts, O [is functionally integrated].

Parent relationship. An SO is the parent of a supported organization (referenced in the second bullet point above) if the SO exercises a substantial degree of direction over the policies, programs, and activities of the supported organization, and a majority of the officers, directors, or trustees of the supported organization is appointed or elected by the governing body, members, or officers of the SO. Treas Reg §1.509(a)–4(i)(4)(iii). In order for an SO to qualify as the parent of each of its supported organizations, the SO and its supported organizations must be part of an integrated system (such as a hospital system), and the SO must engage in activities typical of the parent of an integrated system. Prop

Treas Reg §1.509(a)–4(i)(4)(iii). Examples of these activities include (but are not limited to) coordinating the activities of the supported organizations and engaging in overall planning, policy development, budgeting, and resource allocation for the supported organizations. Prop Treas Reg §1.509(a)–4(i)(4)(iii).

Government entity exception. Note that the Treasury Department and the IRS reserved the regulations that relate to the governmental entity exception in the third bullet point above, as they are considering comments received on the proposed regulations regarding the governmental entity exception and intend to issue proposed regulations in the near future that will provide guidance on how SOs can qualify as functionally integrated by supporting a governmental entity. TD 9605, 2013–11 Int Rev Bull 587. In December 2013, the Treasury and the IRS issued IRS Notice 2014–4, 2014–1 Cum Bull 274, which sets forth interim guidance for Type III SOs seeking to qualify as functionally integrated by supporting a governmental supported organization until final regulations are issued. The notice provides that, until the earlier of the date final regulations are published or the first day of the SO's third taxable year beginning after December 31, 2013, a Type III SO will be treated as functionally integrated under the governmental entity exception if it (i) supports at least one supported organization that is a governmental entity to which the SO is responsive within the meaning of Treas Reg §1.509(a)–4(i)(3), and (ii) engages in activities for or on behalf of such a governmental-supported organization that perform the functions of, or carry out the purposes of, such a governmental supported organization and that, but for the involvement of the SO, would normally be engaged in by such a governmental-supported organization itself.

On February 19, 2016, the IRS issued proposed regulations which provide that in order for an organization that supports a governmental supported organization to be functionally integrated, the following must occur (Prop Treas Reg §1.509(a)–4(i)(4)(iv)(A)):

- The SO must support only governmental supported organizations;
- If the SO supports more than one governmental supported organization, all of the governmental supported organizations either (i) operate within the same geographic region, or (ii) work in close coordination or collaboration with one another to conduct a service, program, or activity that the SO supports; and
- A substantial part of the SO's total activities are activities that directly further the exempt purposes of its governmental supported organization(s).

The proposed regulations further provide that, until the earlier of the first day of the organization's first taxable year beginning after the date final regulations are published in the Federal Register or the first day of the organization's second taxable year beginning after February 19, 2016, a Type III SO in existence on or before February 19, 2016, will be treated as functionally integrated if it meets the requirements of IRS Notice 2014–4, 2014–2 Int Rev Bull 274. Prop Treas Reg §1.509(a)–4(i)(4)(iv)(F).

§4.63B (2) Nonfunctionally Integrated Type III Supporting Organizations

A supporting organization (SO) meets the integral part test as a "nonfunctionally integrated" Type III SO if it satisfies a distribution requirement and an attentiveness requirement. Treas Reg §1.509(a)–4(i)(5).

NOTE► An exception to the attentiveness requirement is provided for a trust that was in existence on November 20, 1970, and continues to meet the pre-1970 "attentiveness" rules set forth in Treas Reg §1.509(a)–4(i)(9).

§4.63C (a) Distribution Requirement

The Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) required the Secretary of the Treasury to set payout distribution requirements for organizations that are not functionally integrated to ensure that such organizations pay a "significant amount" to their supported organization(s). To satisfy the distribution requirement, Treas Reg §1.509(a)–4(i)(5)(ii) provides that a Type III nonfunctionally integrated supporting organization (SO) must distribute to or distribute for the use of its supported organizations amounts equaling or exceeding the SO's "distributable amount" for the taxable year on or before the last day of the taxable year.

The "distributable amount" for a taxable year is an amount equal to the greater of (a) 85 percent of the SO's adjusted net income (as determined by applying the principles of IRC §4942(f) and Treas Reg §53.4942(a)–2(d) for private foundations) for the taxable year immediately preceding the taxable year of the required distribution ("immediately preceding taxable year") or (b) its "minimum asset amount" for the immediately preceding taxable year. Prop Treas Reg §1.509(a)–4(i)(5)(ii)(B). An SO's minimum asset amount for the immediately preceding taxable year is 3.5 percent of the excess of the aggregate fair market value of all of the SO's nonexempt-use assets in that immediately preceding taxable year over the acquisition indebtedness with respect to such nonexempt-use assets increased by (Treas Reg §1.509(a)–4(i)(5)(ii)(C))

- Amounts received or accrued during the immediately preceding taxable year as repayments of amounts that were taken into account by the organization to meet the distribution requirement for any taxable year;
- Amounts received or accrued during the immediately preceding taxable year from the sale or other disposition of property to the extent that the acquisition of such property was taken into account by the organization to meet the distribution requirement for any taxable year; and
- Any amount set aside under Treas Reg §1.509(a)–4(i)(6)(v) to the extent it is determined during the immediately preceding taxable year that such amount is not necessary for the purposes for which it was set aside and such amount was taken into account by the organization to meet the distribution requirement for any taxable year.

The distributable amount for the first taxable year an organization is treated as a nonfunctionally integrated Type III SO is zero. Treas Reg §1.509(a)–4(i)(5)(ii)(D).

The Treasury Regulations provide a reasonable cause exception for failure to meet the distribution requirement. Under the exception, an organization that fails to meet the distribution requirement will not be classified as a private foundation in the taxable year for which it fails to meet such distribution requirement, if the organization establishes to the satisfaction of the Secretary that (Treas Reg §1.509(a)–4(i)(5)(ii)(F))

- The failure was due to unforeseen events or circumstances that are beyond the organization's control, a clerical error, or an incorrect valuation of assets;
- The failure was due to reasonable cause and not to willful neglect; and
- The distribution requirement is met within 180 days after the organization is first able to distribute its distributable amount notwithstanding the unforeseen events or circumstances, or 180 days after the date the incorrect valuation or clerical error was or should have been discovered.

The Treasury Regulations also provide for a temporary reduction in the annual distributable amount in the event of a disaster or emergency. Treas Reg §1.509(a)–4(i)(5)(ii)(E).

NOTE► An SO that is formed to hold assets for the supported public charity may find meeting the definition of a functionally integrated Type III SO difficult and the payout requirements onerous, especially if it does not hold liquid or income-producing assets. The Treasury Department and the IRS issued temporary regulations for the provisions related to the payout requirement to provide opportunity for comment. TD 9605, 2013–11 Int Rev Bull 587.

§4.63D (i) Fair Market Value

The temporary regulations provide the methodology for valuing nonexempt-use assets when determining the "distributable amount." Treas Reg §1.509(a)–4(i)(8). The fair market value of the SO's nonexempt-use assets is made in the year preceding the year of the required distribution. This is the same methodology used for the valuation of a private foundation's assets under Treas Reg §53.4942(a)–2(c).

The amount of a distribution made to a supported organization is the amount of cash or the fair market value of such property as of the date the distribution is made, determined solely on the cash receipts and disbursements method of accounting. Distributions that count toward the distribution requirements include (Treas Reg §1.509(a)–4(i)(6); Prop Treas Reg §1.509(a)–4(i)(6)(iii))

- Any amount paid to a supported organization to accomplish the supported organization's exempt purposes;
- Any amount paid by the supporting organization (SO) to perform an activity that substantially and directly furthers the exempt purposes of the supported organization(s), but only to the extent the amount exceeds any income derived by the SO from the activity;
- Any reasonable and necessary administrative expenses paid to accomplish the exempt purposes of the supported organization(s) that do not include expenses incurred in the production of investment income;
- Certain expenses incurred to solicit contributions that are received directly by the SO;
- Any amount paid to acquire an exempt-use asset described in Treas Reg §1.509(a)–4(i)(8)(ii); and
- Certain set-asides for a specific project that accomplishes the exempt purposes of a supported organization to which the SO is responsive.

§4.63E (ii) Attentiveness Requirement

To meet the "attentiveness requirement," a nonfunctionally integrated Type III supporting organization (SO) must distribute one-third or more of its distributable amount to one or more supported organizations that are attentive to the operations of the SO *and* to which the SO is "responsive" under the responsiveness test. Treas Reg §1.509(a)–4(i)(5)(iii)(A). An SO is "attentive" to the operations of the supported organization if, during the taxable year, the SO meets one of the three following requirements (Treas Reg §1.509(a)–4(i)(5)(iii)(B)):

- Distributes to the supported organization an amount that is 10 percent or more of the supported organization's total support.

- Provides an amount of support to the supported organization that is "necessary to avoid the interruption of the carrying on of a particular function or activity." The support is necessary if the SO or the supported organization earmarks the support for a particular program or activity, even if such program or activity is not the supported organization's primary program or activity, as long as such program or activity is a substantial one.
- Provides an amount of support that constitutes a "sufficient part of a supported organization's total support," based on a consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and SO, and the purpose to which the funds are put.

With regard to the third bullet point, the regulations note that normally the attentiveness of a supported organization is influenced by the amounts received from the SO; thus, the more substantial the amount involved, in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. Treas Reg §1.509(a)–4(i)(5)(iii)(B)(3). However, the regulations further state that in determining whether the amount received from the SO is sufficient to ensure the attentiveness of the supported organization to the operations of the SO (including attentiveness to the nature and yield of such SO's investments), evidence of actual attentiveness is of almost equal importance. Treas Reg §1.509(a)–4(i)(5)(iii)(B)(3).

A supported organization will not be considered attentive to the operations of an SO with respect to any amount received from the SO that is held by the supported organization in a donor-advised fund described in IRC §4466(d)(2). Treas Reg §1.509(a)–4(i)(5)(iii)(C).

Examples provided in the Treasury Regulations help to illustrate the distribution and attentiveness requirements of the integral part test. First, with respect to providing support for a particular activity, the regulations describe the following example (Treas Reg §1.509(a)–4(i)(5)(iv), Example 1):

> K, an organization described in section 501(c)(3), annually pays an aggregate amount equaling or exceeding its distributable amount described in [Treas Reg §1.509(a)–4(i)(5)(ii)(B)] to L, a museum described in section 509(a)(2). K meets the responsiveness test described in [Treas Reg §1.509(a)–4(i)(3)] with respect to L. In recent years, L has earmarked the income received from K to underwrite the cost of carrying on a chamber music series consisting of 12 performances a year that are performed for the general public free of charge at its premises. The chamber music series is not L's primary activity but it is a substantial activity. L could not continue the performances without K's support. Based on these facts, K meets the requirements of [the attentiveness test in Treas. Reg. §1.509(a)–4(i)(5)(iii)(B)(2)].

Another example illustrates distribution requirements for an SO that supports multiple organizations (Treas Reg §1.509(a)–4(i)(5)(iv), Example 4):

> O is an organization described in section 501(c)(3). O is organized to support five private universities, V, W, X, Y, and Z, each of which is described in section 509(a)(1). O meets the responsiveness test under [Treas Reg §1.509(a)–4(i)(3)] only as to V. Each year, O distributes an aggregate amount that equals its distributable amount described in [Treas Reg §1.509(a)–4(i)(5)(ii)(B)] and distributes an equal amount to each of the five universities. Accordingly, O distributes only one-fifth of its distributable amount to a supported organization to which O is also responsive (V). Because O does not distribute at least one-third of its distributable amount to supported organizations that are both attentive to the operations of O and to which the O is responsive, O does not meet the attentiveness requirements [in Treas Reg §1.509(a)–4(i)(5)(iii)].

§4.64 c. Advantages of Type III Supporting Organizations

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

§4.65 d. Disadvantages of Type III Supporting Organizations

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

NOTE► Type III SOs are complicated to operate because of the tests that they must continue to satisfy. These rules have been further complicated since the enactment of the Pension Protection Act of 2006 (PPA) (Pub L 109–280, §1231(c), 120 Stat 780). See §§4.66–4.73.

§4.66 D. Limitations on Supporting Organizations

Over the past several years, the IRS has expressed concerns that supporting organizations (SOs) in general, and Type III SOs in particular, have been abused by taxpayers. In response, when it enacted the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780), Congress applied a number of the rules applicable to private foundations to SOs. See §§4.69–4.70.

1. Rules Applicable to Type III Supporting Organizations

§4.67 a. Responsiveness Information

A Type III supporting organization (SO) must provide to each of its supported organizations information that the IRS requires to ensure that the organization is responsive to the needs or demands of the supported organizations. IRC §509(f)(1)(A). Treasury Regulation §1.509(a)–4(i)(2) requires that each taxable year, a Type III SO provide the following to each of its supported organizations:

- A written notice describing the amount and type of support it provided to the supported organization in the past year;
- A copy of the SO's most recently filed Form 990; and
- A copy of the SO's governing documents, including any amendments.

§4.68 b. Foreign Supported Organizations

A Type III supporting organization (SO) cannot have a foreign supported organization. IRC §509(f)(1)(B)(i). Transition rules apply for existing SOs that support foreign organizations. See IRC §509(f)(1)(B)(ii). See also Treas Reg §1.509(a)–4(i)(10), which states that a Type III SO may not support a supported organization that is organized outside of the United States.

§4.68A c. No Control by Donor

The Treasury Regulations provide that an organization may not qualify as a supporting organization of any kind if the organization accepts any gift or contribution from any person (other than a publicly supported organization or a public safety organization) who directly or indirectly controls one or more of the supported organizations, either alone or together with (Treas Reg §1.509(a)–4(f)(5))

- Members of an individual's family (as determined under the "intermediate sanctions" definition of IRC §4958(f)(4)); or
- A 35 percent controlled entity (as defined under the "intermediate sanctions" definition of IRC §4958(f)(3)).

§4.69 d. Charitable Trusts

After the enactment of the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780), a charitable trust that is a Type III supporting organization (SO) no longer qualifies as a Type III SO solely because it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting. Pub L 109–280, §1241(c), 120 Stat 780. As stated previously, charitable trusts must meet the responsiveness requirements applicable to other Type III SOs. The Explanation of Provisions of the proposed regulations expressly rejects a special rule for trusts. 74 Fed Reg 48674 (2009). Therefore, as of August 17, 2007, trusts previously classified as Type III SOs may be classified as private foundations as a result of the PPA.

IRS Notice 2008–6, 2008–1 Cum Bull 275, provides transitional relief and filing procedures for certain charitable trusts that failed the responsiveness test for Type III SOs after the enactment of the PPA. Specifically, Notice 2008–6 provides that this type of charitable trust would not be required to file an information return on IRS Form 990-PF or pay excise taxes on investment income under IRC §4940 until its first taxable year beginning on or after January 1, 2008.

In addition, IRS Announcement 2010–19, 2010–14 Int Rev Bull 529, provided procedures for charitable trusts that met the requirements to be classified as Type III SOs through the end of the 2008 taxable year (including by meeting the significant voice responsiveness test for periods after August 16, 2007) but erroneously filed IRS Form 990-PF and paid the tax imposed under IRC §4940 for the 2008 taxable year. Announcement 2010–19 also provided procedures that such a trust could use to request a ruling that it was and continued to be a Type III SO and to obtain a refund of any IRC §4940 tax paid with respect to its 2008 taxable year. Announcement 2010–19 was declared obsolete when the IRS updated its procedures for an organization to obtain a determination regarding its foundation status by issuing Rev Proc 2012–10, 2012–2 Int Rev Bull 273. See IRS Announcement 2012–12, 2012–12 Int Rev Bull 562.

§4.70 e. Payout Requirements

Pursuant to the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780), the Department of the Treasury has issued regulations to ensure that a “significant amount” of a supporting organization’s (SO’s) income or assets is paid to its supported organization(s). Joint Committee on Taxation Bluebook at 360. The payout provisions of the Treasury Regulations generally draw from the regulations under IRC §4942 for principles on valuation, timing, and carryovers, with a few distinctions. See Treas Reg §1.509(a)–4.

The Treasury Regulations also provide a slightly different rule regarding the carryover of excess distributions than is applicable to private foundations. Under IRC §4942(i), a private foundation that distributes more than its distributable amount may carry forward that excess amount for 5 years; when calculating qualifying distributions in a future year under IRC §4942, amounts paid out in the future year count first towards the required distributable amount, and any amount carried forward is not “used” in the future year to the extent that the organization made qualifying distributions in that future year. Treas Reg §1.509(a)–4(i)(7). The Treasury Regulations reverse the ordering rule and first count any excess amount carried forward toward the nonfunctionally integrated Type III SO’s distributable amount, followed by amounts paid out in the later year. Treas Reg §1.509(a)–4(i)(7).

§4.71 (1) “Functionally Integrated” Requirements [Deleted]

This section has been deleted because it is no longer relevant under the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780).

§4.72 (2) Proposed Payout Requirements [Deleted]

This section has been deleted because it is no longer relevant under the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780).

§4.73 f. Limitation on Number of Supported Organizations

In the Advanced Notice of Proposed Rulemaking, “Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated” (ANPRM) (REG–155929–06, 72 Fed Reg 42335 (2007)), the IRS proposed limiting the number of supported organizations that a nonfunctionally integrated Type III supporting organization can support to five organizations. The final and temporary regulations issued in 2012 did not adopt the five-organization limitation. See TD 9605, 2013–11 Int Rev Bull 587.

§4.74 2. Contributions to Type I and III Supporting Organizations

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

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

Existing private foundation excess business holdings rules apply to Type III supporting organizations (SOs) that are not functionally integrated with the supported organization, and to Type II SOs if the supported organization is controlled by the SO's donors. IRC §4943(f). Generally, these SOs' voting or profits interests in a business enterprise, when combined with the interests of disqualified persons, may not exceed 20 percent. IRC §4943(c). The excess business holdings rules apply to taxable years beginning after August 17, 2006. Pub L 109–280, §1243(b), 120 Stat 780. An SO can follow the same transition rules that applied to private foundations when IRC §4943 was enacted in 1969. IRC §4943(f)(7).

4. Rules Applicable to All Supporting Organizations

§4.76 a. Excess Benefit Transactions

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

Entire amount treated as excess benefit. The *entire* amount paid to any such person is treated as the amount of the excess benefit. See IRC §4958(c)(3)(A)(ii). The requirement that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rules of IRC §4958, which provide that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received. The Joint Committee on Taxation Bluebook indicates that "other similar payments" include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Exceptions apply for substantial contributors or other disqualified persons who are public charities. IRC §4958(c)(3)(C)(ii). See Bluebook at 342. (On the Bluebook, see §4.9.) The automatic excess benefit transactions rules are effective for transactions occurring after July 25, 2006 (with certain transition rules that are set forth in IRS Notice 2006–109, 2006–2 Cum Bull 1121). Pub L 109–280, §1242(c)(2), 120 Stat 780.

NOTE► Persons who are disqualified persons with respect to an SO are also disqualified persons with respect to the supported organizations under the general excess benefit rules. IRC §4958(f)(1)(D). Organization managers who knowingly participate in the transaction are subject to excise tax as well unless such participation is not willful and is due to reasonable cause. IRC §4958(a)(2).

b. Distributions to Supporting Organizations

§4.77 (1) From Private Foundations

If distributions are made by a private nonoperating foundation to (a) Type III supporting organizations (SOs) that are not functionally integrated with the supported organization, or (b) any Type I, Type II, or functionally integrated Type III SO when a disqualified person of the private foundation directly or indirectly controls the SO or a supported organization of the SO, then the foundation must exercise expenditure responsibility. IRC §4945(d)(4). See §4.46. Additionally, for all private foundations, distributions to such SOs will not count as a qualifying distribution under IRC §4942. IRC §4942(g)(4). Regulations may provide other circumstances under which a distribution from a private foundation to an SO is not allowed.

§4.78 (2) From Donor-Advised Funds

Grants from donor-advised funds are prohibited to (a) Type III supporting organizations (SOs) that are not functionally integrated with the supported organization, and (b) any Type I, Type II, or functionally integrated Type III SO if the donor or donor advisor controls a supported organization or the Treasury Department determines by a rule that a distribution is inappropriate. IRC §4966(c)(2). See §4.15.

§4.79 (3) From a Retirement Plan

The Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) allowed persons who had reached 70½ years of age to exclude from income up to $100,000 per year in retirement plan assets if they were contributing to a qualifying charity. A supporting organization was not a qualifying charity for this purpose. IRC §408(d)(8).

§4.80 E. Reclassification as Public Charity

A supporting organization can seek to change its public charity classification from an IRC §509(a)(3) organization to an IRC §509(a)(1) or §509(a)(2) organization for reasons related to changes made by the Pension Protection Act of 2006 (PPA) (Pub L 109–280, 120 Stat 780) by submitting a written request for reclassification to the IRS pursuant to Rev Proc 2009–4, 2009, 1 Int Rev Bull 118.

VI. ESTABLISHING AND MAINTAINING PRIVATE CHARITABLE ORGANIZATIONS

§4.81 A. Pledge Agreements and Self-Dealing

Problems with satisfying pledges. Donors who enter into pledge agreements with charitable organizations must draft the agreements carefully if they wish to have the flexibility to satisfy the pledge with payments from a private charitable organization. If a private foundation satisfies a legally binding obligation to an individual donor who is a disqualified person under a pledge agreement, that will be an act of self-dealing by using the foundation's assets for the benefit of the disqualified person. IRC §4941(d)(1)(E). It is likely a prohibited benefit for a donor-advised fund to satisfy the pledge, because the individual donor would receive a more than incidental benefit. See IRC §4967. Alternatively, it could be considered an automatic excess benefit transaction, because the donor is indirectly receiving a grant from the donor-advised fund. IRC §4958. It may be prohibited private inurement for a supporting organization to satisfy the enforceable pledge of an individual donor. IRC §501(c)(3).

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

§4.82 B. Maintaining Multiple Private Charities

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

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

§4.83 VII. TABLE: COMPARISON OF PRIVATE CHARITABLE ORGANIZATIONS

COMPARISON OF PRIVATE CHARITABLE ORGANIZATIONS

	Donor-Advised Fund	Private Foundation	Supporting Organization
Public Charity or Private Foundation?	Public Charity	Private Foundation	Public Charity
Adjusted Gross Income (AGI) Limit on Cash Gifts	50%	30% (if not an operating foundation)	50%
AGI Limit on Appreciated Property	30%	20% (if not an operating foundation)	30%
FMV Deduction for Gifts Other Than Public Stock?	Yes	No (limited to basis)	Yes
Form of Tax Return	None (Form 990 filed by sponsoring organization)	Form 990-PF	Form 990
Are Donors Private or Public on Tax Return?	Donors are private	Donors are public	Donors are private
Subject to Self-Dealing Limits?	No	Yes	No
Required Minimum Distribution	None	5%	None for Type I, II, and functionally integrated Type III

	Donor-Advised Fund	Private Foundation	Supporting Organization
			SOs; 85% of net income or 3.5% of value of assets if nonfunctionally integrated Type III
Limits on Business Holdings?	Yes	Yes	Yes for Type II and nonfunctionally integrated Type III
Subject to Prohibited Benefits Limits?	Yes	No	No
Subject to Automatic Excess Benefits Limits?	Yes	No	Yes
Distribution Requirements?	No	Yes	Yes—nonfunctionally integrated Type III only
Subject to Jeopardizing Investment Rules?	No	Yes	No
Funding Limitations Due to Charitable Contribution Deduction Exclusions?	Yes	No	Yes