STRUCTURING PHILANTHROPY:
What Works When

Northern California Planned Giving Council

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Private Foundations
What You Need To Know

Erik Dryburgh

1. INTRODUCTION

The most common manner in which individuals make charitable contributions is by making gifts or bequests outright to institutions and causes important to the donor. An alternative is to establish a charitable vehicle to receive the donor's assets in one or more lump-sum payments, and then make grants/distributions to operating charities over time. As all of the interests in such an entity are dedicated to charity, they are eligible to receive tax exemption from the Internal Revenue Service and the California Franchise Tax Board.

2. WHY CLIENTS WANT A PRIVATE FOUNDATION

Need for Control

Donor wants control over his/her philanthropic vehicle, which she/he cannot get with a Donor-Advised Fund or Supporting Organization.

Donor wants a personal flexible charitable vehicle for whatever charitable undertaking might become interesting to her/him.

Donor likes to have an operation she/he can command, with people in her/his employ.

Prestige and Name Perpetuation

The Smith Family Foundation has a certain ring to it….

Interest in Involving the Children

Gives the children responsibilities and roles they may not be able to experience otherwise.

Helps with family cohesion if different generations get together to manage the foundation and discuss possible grants (or so the argument goes).

Gives the children "social capital" in addition to their "private capital".

Caution: be careful with the idea of "involving the kids" – are the parents really willing to let the children have input and, at some point, control? If not, why do we think the children will ever be interested?

Can the private foundation hire the children? See below.

A Buffer

Some wealthy clients are approached frequently for charitable giving; a private foundation can act as a buffer between the donor and those seeking philanthropic funding.

Caution: On IRS Form 990-PF, private foundations have to disclose major donors to the pubic.

Liquidity Event

The sale of an asset is imminent, but the donor has not decided what to give to yet.

Tax Deduction

3. FORMING THE PRIVATE FOUNDATION

Forming an Entity

The first step in establishing a charity is to form the charity as a separate legal entity. State law governs. In California, a charity can be established as a nonprofit corporation, either a nonprofit public benefit corporation or, for charities with religious purposes, a nonprofit religious corporation (see the Nonprofit Corporation Law in California Corporations Code Sections 5000 *et seq.*). Alternatively, the charity can be formed as a charitable trust or as an association (association status is the least common and will not be further discussed).

Establishing a corporation involves filing Articles of Incorporation with the Secretary of State, drafting and adopting Bylaws, appointing a first Board of Directors, and appointing officers. Establishing a charitable trust involves drafting a trust instrument, selecting one or more trustees, and funding the trust. In both cases, the California Attorney General is notified of the new charity.

Considerations in Choosing Corporate or Trust Form

Charitable trusts are typically established to be irrevocable except as specifically provided in the trust document. As a result, it is easier to impose perpetual restrictions on terms such as the purposes of the trust and the designation of trustees, if desired. On the other hand, where flexibility is desired in modifying the governance structure and activities over time, a corporation is often preferable.

Charitable trust law has generally been created by courts, with legislation eventually following, while nonprofit corporate law in California is generally codified in the Corporations Code. As a consequence, charitable trusts lack the internally cohesive and extensive statutory framework that governs nonprofit corporations in California. This lack of guidance may also be viewed as a lack of bureaucracy; for example, charitable trusts are not required to have annual meetings or comply with specific notice rules, while the Corporations Code imposes clear requirements regarding meetings, notice to directors, etc. Also, corporations provide stronger liability protection to directors.

More importantly, charitable trusts avoid the burden of the statutory rule, discussed below, that limits the number of directors who may be (i) compensated by the charity or (ii) related to persons compensated by the charity. Under Section 5227 of the Corporations Code, not more than 49% of a nonprofit public benefit corporation's governing body may be composed of "interested directors", defined as:

- Any person who has been compensated by the corporation for services within the last 12 months, <u>and</u>

- Any member of such a person's family (including brother, sister, ancestor, descendant, spouse, brother-in-law, sister-in-law, son-in-law, daughter-in-law, mother-in-law, or father-in-law).

The effect of this provision is to limit the number of directors who are compensated by the charity, or related to a person who is compensated by the charity. The consequences of this statute can be broader than one might expect. For example, assume a charity has two directors, Father and Mother. The charity then hires Daughter to serve as grant administrator. Both Father and Mother are interested directors, because they are related to Daughter, and the charity has inadvertently violated Section 5227. In this case, the Board would need to add at least three outside disinterested directors. Alternatively, a charity that intends to employ a family member could consider incorporating in another state (such as Nevada or Delaware) or organizing as a trust rather than as a corporation. However, if the charity does not wish to compensate members of the family that controls the charity, this issue does not arise; the entire governing body may legally consist of family members.

4. TAX STATUS OF THE PRIVATE FOUNDATION

Application for Tax Exemption

Once the charity has been established as a nonprofit corporation or charitable trust, the next step is to apply for a determination that the entity is tax-exempt. For Federal law purposes, charities need to apply for tax exemption under Section 501(c)(3) of the Internal Revenue Code ("IRC"). The equivalent exemption in California is described in Section 23701d of the California Revenue and Taxation Code. The charity must apply with the Internal Revenue Service on IRS Form 1023 (revised and much more complicated/detailed). If the foundation is formed or operates in California, it must also file with the Franchise Tax Board on a Form 3500A (revised and very easy).

Exemption under Section 501(c)(3)

Tax-exempt status under IRC Section 501(c)(3) permits a charitable organization to pay no tax on any surplus funds it may have at the end of a year. Moreover, it permits donors to claim a charitable deduction for their contributions (see IRC Section 170).

Private Foundations and Public Charities

The world of Section 501(c)(3) organizations is divided into two classes: private foundations and public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities, and the income tax charitable contribution deduction available to donors is less attractive.

Avoiding Private Foundation Status

A Section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any one of three ways: (1) by being an institution that is traditionally viewed as publicly supported, such as a church, school, or hospital; (2) by meeting one of two mathematical public support tests; or (3) by qualifying as a supporting organization to another charity that falls in one of the first two categories.

5. DONOR-SIDE ISSUES

The regulatory scheme imposed on private foundations limits the amount of tax deduction available to donor for intervivos gifts (see IRC Sections 170(b), (e)(1), and (e)(5)). Intervivos contributions to private foundations of property other than cash and qualified appreciated stock (stock that is traded on an established securities market and for which market quotes are readily available) are deductible only to the extent of the lesser of the donor's tax basis or fair market value. In addition, the amount of the deduction that the donor can use in a given year is more limited: cash contributions are limited to 30% of the donor's adjusted gross income ("AGI") (vs. 50% for cash donations to public charities). For donations of appreciated property, the deduction is generally limited to 20% of the donor's AGI (vs. 30% for contributions to public charities).

6. FOUNDATION-SIDE ISSUES

Additional restrictions are imposed on private foundations (as opposed to public charities). These restrictions are enforced via the imposition of excise taxes on the foundation, its management, and/or its disqualified persons.

Excise Tax on Net Investment Income (IRC Section 4940)

Foundations must pay an annual excise tax equal to 2% of net investment income. Net investment income is gross investment income (dividends, interest, royalties, rents, capital gains, etc.) minus ordinary and necessary expenses for the collection and management of the foundation's investment assets.

Self-Dealing (IRC Section 4941)

Under federal tax law, most financial transactions between a private foundation and its insiders are outright prohibited. Self-dealing transactions are prohibited by IRC Section 4941, which makes it impossible for private foundation and their "disqualified persons" (including substantial contributors, managers and any related parties) (see IRC Section 4946) to enter into any sales, leases or other uses of property between them, unless the disqualified person is providing a benefit free of charge to the charity. Note there is ***no*** "fair market value" exception for most acts of self-dealing. Furthermore, a private foundation may not pay compensation to a disqualified person, nor pay nor reimburse the expenses of a disqualified person, unless two conditions are both met. First, the compensation must be for personal services that are reasonable and necessary to carrying out the foundation's exempt purposes. Second, the amount of compensation, payment, or reimbursement must be reasonable and not excessive under the circumstances. Care should be taken in applying the reimbursement exception only to reimbursements in connection with personal services. For example, the personal services exception would not apply to a reimbursement of rent paid by a disqualified person on behalf of a private foundation.

Minimum Distributions (IRC Section 4942)

Private foundations must make distributions for charitable purposes each year in prescribed minimum amounts, generally equal to 5% of its investment assets. Grants and charitable distributions qualify, as do reasonable and necessary administrative expenses, payments for assets used in exempt purposes, and professional fees for advice on program activity.

Excess Business Holdings (IRC Section 4943)

This provision generally limits the total holdings of a private foundation and all of its disqualified persons in a business enterprise to 20%.

Jeopardizing Investments (IRC Section 4944)

A private foundation is prohibited from making investments that jeopardize the foundation's ability to carry out its charitable purposes.

Taxable Expenditures (IRC Section 4945)

This provision prohibits or limits various types of grants by a private foundation, including grants for lobbying or electioneering, certain grants to individuals or other private foundations, and grants for noncharitable purposes or to entities that are not US public charities. Especially problematic are the limits (or procedural requirements and restrictions) imposed on grants to foreign charities and scholarships/awards/prizes to individuals.

7. OPERATIONAL ISSUES

Federal Filing Requirements

Annual IRS Return. Private foundations must file Form 990-PF, Return of Private Foundation, with the IRS. This form asks for information about the foundation's gross receipts and expenditures. Form 990-PF must be filed within 4½ months after the close of the foundation's fiscal year.

Unrelated Business Income Tax Return. If a private foundation regularly carries on a trade or business whose conduct is not substantially related to the foundation's exempt purpose, and if the annual gross income from it equals or exceeds $1,000, the income from that business must be reported yearly on IRS Form 990-T, Exempt Organization Business Income Tax Return, due 4½ months after the end of the foundation's fiscal year.

California Filing Requirements

Annual FTB Returns. California law requires each exempt organization to file an annual information return, California Form 199, with the Franchise Tax Board (FTB) in Sacramento due 4½ months after the end of the organization's fiscal year.

Unrelated Business Income Tax Return. If a private foundation regularly carries on a trade or business that is not substantially related to its exempt purpose, and if the annual gross income equals or exceeds $1,000, the income from that business must be reported yearly to the FTB on California Form 109, California Exempt Organization

Business Income Tax Return, due 4½ months after the end of the foundation's fiscal year with Form 199.

Registry of Charitable Trusts Filing. Form RRF-1 is designed to assist the Attorney General's Registry of Charitable Trusts in supervising charitable organizations in order to ensure that funds and assets held for charitable purposes are actually so used. This short form is due annually within 4½ months after the close of the foundation's fiscal year and covers the foundation's prior fiscal year.

Secretary of State Filing. A private foundation must file the Statement of Information (Domestic Nonprofit Corporation), California Secretary of State Form SI-100, every other year after incorporation, by the last day of the month of incorporation.

Non-Profit Integrity Act

For charitable organizations formed in California or "doing business" in California with annual gross revenues of $2 million or more, California law requires an independent financial audit, appointment of an audit committee (with rules governing who may and may not serve on it) if in corporate form, and public disclosure of the audited financial statements.

8. ALTERNATIVES

Donor-Advised Fund

An alternative is to establish a donor-advised fund ("DAF"). A DAF is not a separate charity. Instead, a donor makes a contribution to a pre-existing public charity, which holds the contributions in a separate account. The assets in the account belong to the charity and are reported on the charity's financial statements and returns. The charity, per an agreement with the donor, permits the donor or another designated advisor to provide non-binding advice to the charity regarding what grants to make from the DAF. If implemented correctly, the contribution to the DAF is treated as a contribution to the charity.

Contributions to the DAF are treated as contributions to a public charity, thus being subject to the more favorable deduction rules for public charities. A DAF is also less expensive to establish than a separate entity, and can typically be started with a much smaller amount of assets than would make sense for a private foundation. Another advantage is that the charity holding the fund takes care of all administration and paperwork. The real disadvantage is that the donor must give up legal control over the fund, and can only act in an advisory capacity.

New requirements and limitations were imposed on DAFs under the Pension Protection Act (see IRC Sections 4966, 4967, and 4958(c)(2)). DAFs are defined as a fund or account identified by reference to a donor, with respect to which the donor (or a designee) reasonably expects to have advisory privileges. Excluded are funds that distribute only to one identified charity, or "scholarship" funds with an independent selection committee. DAFs may generally not make distributions to natural persons, or to entities other than public charities without following the "expenditure responsibility" rules. Grants in which the donor receives a more than "incidental" benefit are prohibited, as are grants, loans, or compensation to donors-advisors.

Supporting Organizations

A supporting organization ("SO") is a public charity, not because it meets a public support test, but because it supports and is controlled by one or more other public charities (the "Supported Charities"). To qualify for classification as an SO under IRC Section 509(a)(3), the SO must meet *all four* of the following tests:

- *Relationship test*. This test is most easily met if the Supported Charities control the SO, by appointing at least a majority of the Board of Directors of the SO.

- *Organizational test*. This test is met if the SO's Articles of Incorporation have certain required language, including language limiting the purposes of the SO to operate "exclusively for the benefit of, to perform the functions of, or to carry out the purposes of" the Supported Charities.

- *Operational test*. The SO may make payments to the Supported Charities, or otherwise use its funds in a manner that supports them. It may make grants, conduct independent programs, and raise funds. However, the permissible beneficiaries of its grants or programs are limited to:

    a. The Supported Charities named in the Articles of Incorporation;

    b. Individual members of the charitable class served by Supported Charities, either through direct payments or benefits to the individuals, or earmarked for such individuals and given through an unrelated organization;

    c. Other SOs that support the Supported Charities; or

    d. Public colleges and universities.

- *Lack of outside control test*. The control test is a negative test, requiring that the SO not be "controlled" by "disqualified persons". Generally, a person becomes a "disqualified person" by being a substantial contributor to the SO. It also includes a person who owns an entity that is a substantial contributor, and family members of a substantial contributor.

As with DAFs, the Pension Protection Act has added limitations and restrictions on SOs.

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Basics of Donor Advised Funds

Rosemary E. Fei
September 2012

This overview of donor advised funds is provided for educational purposes only, and not as legal advice; it is not a comprehensive treatment of the rules relating to donor advised funds, their donors, their advisors, or their sponsoring organizations. Prospective sponsoring organizations should consult legal counsel before implementing a donor advised fund program.

I. Basic DAF Legal Framework

A. What is a donor advised fund ("DAF")?

1. Not a separate legal entity; merely a fund
2. DAF assets belong to sponsoring charity (it must have "discretion and control")
3. Sponsoring charity segregates contribution to the DAF on its books
4. Donor or other advisor advises sponsoring charity to make grants out of DAF
5. Internal Revenue Code definition (Section 4966):
   a. A fund or account separately identified by reference to contributions of donor(s) that is . . .
   b. Owned and controlled by a public charity . . .
   c. Over which a donor or her appointee has (or reasonably expects to have) advisory privileges over
      - distributions, and/or
      - investments
6. There are NO REGULATIONS to interpret the statute yet

B. Who is regulated as a sponsor organization of a DAF?

1. A 501(c)(3) organization (i.e., formed and operated for charitable purposes; no private inurement; no political campaigning, no substantial lobbying) that is . . .
2. Not a private foundation, and that . . .
3. Maintains one or more DAFs.

C. To whom is a DAF permitted to make distributions? (Internal Revenue Code Section 4966)

1. The sponsoring organization
2. Another DAF
3. Public charities (except certain "supporting organizations")
4. Foreign public charity equivalent organizations
5. Any other entity if the sponsor exercises "expenditure responsibility"

D. What DAF distributions are prohibited? (Internal Revenue Code Section 4966)

1. Any distribution to any individual
2. Distributions for any non-charitable purpose
3. Distributions to certain public charities classified as "supporting organizations" unless the sponsor exercises expenditure responsibility
4. Distributions to any other entity (such as for-profit businesses or private foundations) unless the sponsor exercises expenditure responsibility
5. Penalties for making a prohibited distribution (Internal Revenue Code Section 4966)
   a. On the sponsoring organization: 20% of the prohibited distribution
   b. On the sponsoring organization's "fund managers" (directors, officers, etc.) who knowingly agreed to the prohibited distribution: 5% of the prohibited distribution, up to $10,000 per prohibited distribution

E. DAF tax on "more than incidental benefit" (Internal Revenue Code Section 4967)

1. Tax imposed "on the advice" of . . .
2. The donor, the advisor (if different) and certain related parties . . .
3. If the distribution directly or indirectly results in a "more than incidental benefit" . . .
4. To the donor/advisor or related parties
5. How much is the tax?
   a. On the donor/advisor or related parties: 125% of the benefit

- No exception for 501(c)(3) organizations as donors/advisors
- Does this mean that if private foundation is a donor/advisor to a DAF and has made a pledge or grant commitment to a grantee, the DAF may not pay it? What will the regulations say?

b. On fund managers, if they knowingly agreed to the distribution: 10% of the benefit, up to $10,000

c. But no tax will be imposed if the distribution was already taxed under Internal Revenue Code Section 4958 (see F. below)

6. What is a "more than incidental benefit"?

a. No regulations have been issued yet

b. Legislative history ties to Section 170 charitable deductibility rules

F. Prohibited "excess benefit" DAF transactions (Internal Revenue Code Section 4958)

1. On the recipient of the excess benefit: a tax equal to 100% of a grant, loan, compensation, or similar payment (an "excess benefit payment") from a DAF to the DAF's donors or advisors, their family members, or their 35%-controlled entities

- In other words, a DAF created by a private foundation may not pay its donor/advisor foundation (or any entity 35% or more owned by that foundation) for services, goods, etc., out of the DAF

2. On the advisor: a tax equal to 25% of the excess benefit payment

3. On managers who willfully participated: a tax equal to 10% of the excess benefit payment

G. Penalties on investment advisors (Internal Revenue Code Section 4958)

1. On investment advisors who manage investments of or provide investment advice to a sponsoring organization for any of its DAFs, their family members, or their 35%-controlled entities, if compensation is excessive: a tax equal to 25% of the excessive amount

2. Correction required, in addition to tax

H. Excess business holdings (Internal Revenue Code Section 4943(e))

1. The limits on excess business holdings for private foundations apply to DAFs

- For example, a DAF and its donors/advisors, their families, and their 35%-controlled entities together may not own more than 20% of a business entity

II. What is **not** a DAF? (Internal Revenue Code Section 4966)

A. A fund that makes distributions only to a single identified organization or government entity

B. Certain scholarship funds

1. A fund that makes grants to individuals for travel, study, or similar purposes if:

    a. Donor or her designee advises only as member of a committee where the sponsoring organization appoints all members

    b. Donor and donor's designees cannot control the committee, and

    c. Grants are awarded on an objective and non-discriminatory basis pursuant to a procedure approved in advance by the sponsoring organization's Board

C. The Treasury Secretary is authorized to exempt other funds from DAF rules if:

1. The fund benefits a single identified charitable purpose, or

2. The funds is advised by a committee not directly or indirectly controlled by the donor or the donor's designees

3. Under this authority, the Secretary has exempted employer-sponsored disaster relief funds that meet specific purpose and procedural requirements (Notice 2006-109)

III. Still so many unanswered questions!

A. Can you purchase stuff to be used in a charitable program using DAF funds?

B. What about fiscal sponsorship arrangements, or "fundraising funds" – are they DAFs?

C. Do all the expenditure responsibility rules for private foundations apply to DAFs? If not, which do, and which don't? How to apply those that are inherently tied to a private foundation status?

IV. Weighing DAFs as an option

A. Advantages of DAFs

1. Donor gets immediate deduction, without having to create a legal entity to receive it

2. Donor gets public charity deduction limits, rather than private foundation limits, both as to annual percentage of income cap on deductions, and as to valuation of contributions other than cash and qualified stock (especially important in contribution of highly appreciated assets, such as pre-IPO

stock, where deduction for contribution to a private foundation would be limited to donor's basis)

3. Only costs are sponsoring organization's fees, often a percentage of gift or fund
4. Little administrative hassle (no new entity to create, or to operate)
5. Ease of making gifts to established U.S. public charities
6. Permits a high level of donor anonymity
7. If important for planning, a donor may purchase back at full fair market value an asset previously contributed to a DAF, whereas no such purchase from a private foundation recipient is permitted
8. Sponsor maintains all infrastructure to conduct due diligence on grantees, administer grants, etc., allowing substantial economies of scale

B. Disadvantages of DAFs

1. Lack of donor control – funds are owned by sponsoring organization
2. "Expenditure responsibility" required for gifts to foreign entities, most non-public charities, and even some public charities
3. Many sponsoring organizations do not have the capacity to accept donations of risky or labor-intensive assets
4. Stiff penalties for any benefits to donors or related parties, regardless of intent

V. Bifurcation Example: Gala Tickets

A. Assume a charity holds a gala and the admission price is $500 per ticket. If $100 is the fair market value of food/drink/entertainment benefits to each attendee, then $100 is not deductible to the donor/ticket purchaser as a charitable contribution. $400 – the excess of the ticket price over the value of the return benefits – is deductible to the donor/purchaser

B. Clearly, a DAF can never pay the $100 portion of the ticket price for a donor/advisor, because of the benefit it confers on the attendee.

C. BUT, if the donor/advisor pays that $100, may the DAF pay the $400?

1. Maybe yes: Legislative history may support that position, and the donor's benefit is the same either way (the donor gets a deduction whether she $400 paid to the DAF or to the charity holding the gala)
2. Maybe no: Without the DAF funds, the donor/advisor could not have attended the gala and received the attendant benefits
3. What will the regulations say?

D. Related Issue: What if the donor/advisor is a private foundation that wants to advise a distribution from a DAF to pay for gala tickets to be used by a substantial contributor to the private foundation?

1. Technically, the substantial contributor is not a "related party" of the donor/advisor (Internal Revenue Code Section 4967)

2. But be careful of the private foundation prohibition on self-dealing (Internal Revenue Code Section 4941)

VI. When might using a DAF be helpful to a private foundation?

A. Where, due to the private foundation's prior history of support or the size of a single gift, the private foundation is concerned that its grant might tip the grantee from public charity into private foundation status. A grant from a DAF is a grant from the sponsoring organization, and public charity grants are 100% public support to the grantee

B. Grants to most private operating foundations. Private foundations must exercise expenditure responsibility over such grants, but such grants from a DAF do not require expenditure responsibility

C. Any grant that would require expenditure responsibility or foreign public charity equivalency if made by either the private foundation or the DAF – using a DAF shifts the work to the sponsoring organization

D. Grants where a private foundation wants to make a grant anonymously. Any grant made directly by a private foundation would be reported on its 990-PF, and perhaps also on the grantee's 990 Schedule B; a grant from a DAF could be described as coming from the sponsoring organization without stating the DAF's name at all, or the grant could be attributed to the DAF if the DAF's name does not disclose who its donor/advisors are and that information is not otherwise public

E. Caveat for private foundations using DAFs: Make sure the foundation doesn't earmark its grant to the DAF at the sponsoring organization for the ultimate recipient! If earmarked, the private foundation's gift to the DAF could be deemed a direct gift from the foundation to the DAF's grantee, with unexpected and often unfavorable consequences

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PUBLIC CHARITY STATUS
UNDER INTERNAL REVENUE CODE SECTION 509(a)(3):
The Type I Supporting Organization

April 2014

I. INTRODUCTION

Tax-exempt status under Section 501(c)(3) permits a charitable organization to pay no tax on any surplus funds it may have at the end of a year. Moreover, it permits donors to claim a charitable deduction for their contributions.

The world of Section 501(c)(3) organizations is divided into two classes: private foundations and public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. The private foundation laws impose a nominal tax on investment income, limit self-dealing and business holdings, require annual distributions, prohibit lobbying entirely, and restrict the organization's operations in other ways. The regulatory scheme also limits the amount of tax deduction available to donors. In most circumstances, public charity status is preferable to private foundation status. Some charities, however, accept private foundation status because their funding is unavoidably dependent on a single individual, family, or corporation, or because their donors seek the closer control more often found in the governance structures of private foundations.

A Section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any one of three ways: (1) by being an institution that is traditionally viewed as publicly supported, such as a church, school, or hospital; (2) by meeting one of two mathematical public support tests; or (3) by qualifying as a supporting organization to another charity that falls in one of the first two categories.[1] There are three categories of supporting organizations, distinguished by their different relationships with their supported public charities and subject to different legal compliance obligations. The most frequently used form is known as the Type I supporting organization. This memo summarizes the requirements for gaining and maintaining public charity status as a Type I supporting organization.[2]

[1] Supporting organization status is also available to a 501(c)(3) organization that supports a social welfare organization exempt under Section 501(c)(4), a labor union exempt under Section 501(c)(5), or a trade association exempt under Section 501(c)(6), or a foreign charity, provided the supported organization has enough diversified sources of income to meet one of the mathematical public support tests. This memorandum only addresses the situation where the supported organization(s) are domestic nonprofits exempt under Section 501(c)(3). Some of the requirements discussed here would differ slightly if the supported organization were exempt under a section other than Section 501(c)(3), and Type III status (*see* footnote 2) is not available if the supported organization is a foreign entity.

[2] In a Type II supporting organization relationship, a majority of the persons who control or manage the supported organization also control or manage the supporting organization. Type III supporting organizations have a more

II. QUALIFYING AS A TYPE I SUPPORTING ORGANIZATION

To qualify as a Type I supporting organization under Section 509(a)(3), an organization must meet all five of the following tests:

A. The relationship test under Section 509(a)(3)(B);

B. The organizational test of Section 509(a)(3)(A);

C. The operational test of Section 509(a)(3)(A);

D. Lack of donor control over the supporting organization under Section 509(a)(3)(C); and

E. Lack of donor control over the publicly-supported organization(s) under Section 509(f)(2).

Each of these tests is discussed separately below. We refer to the organization that obtains public charity status under Section 509(a)(3) as the supporting organization or "SO." We refer to the public charity or charities which the SO supports as the publicly-supported organization, or "PSO."

A. The Relationship Test

The relationship test for a Type I SO is straightforward: the SO is operated, supervised, or controlled by the PSO. This relationship is equivalent to a parent-subsidiary relationship. At least a majority of the board of the SO must be appointed by the PSO.[3] The donor or related parties may appoint the rest of the Board. For some donors, having the tax benefits associated with public charity status for their donee is worth this loss of formal legal control.

An SO must report each year on its Form 990 whether it is a Type I, II or III SO, and must also identify its PSOs.

attenuated relationship with their supported public charities and are subject to a range of additional requirements not discussed here. For more information on Type II and Type III supporting organizations, and the specific rules applicable to them, please consult legal counsel.

[3] The relationship test must be viewed in conjunction with the donor control rules discussed in Section II. D below. As discussed there, the SO must not appoint people who are "disqualified persons" or the charity will not qualify as a supporting organization.

B. The Organizational Test

This test is met if the SO's governing instrument—in California, its Articles of Incorporation or trust instrument—complies with four requirements.

1. The governing instrument must limit the purposes of the SO to one or more of the purposes set forth in Section 509(a)(3). That is, the SO must be organized "exclusively for the benefit of, to perform the functions of, or to carry out the purposes of" the PSO. The PSO must be one or more Section 501(c)(3) organizations which are classified as public charities under either Section 509(a)(1) or 509(a)(2).[4]

2. The governing document must not expressly empower the SO to engage in activities which are not in furtherance of those purposes.

3. The governing document must specify the PSO on whose behalf the SO is to be operated. A Type I SO may specify its PSO either by name or by class. It is important, in the planning stages, to determine whether the SO intends to support only specific named PSOs, or whether it wishes to support a category of public charities. In the latter case, the PSO should be defined by class – for example, for an SO interested in environmental preservation, the class could be "public charities which work to preserve wilderness and prevent pollution and environmental harm." However, SOs that support a class of PSOs should pay particular attention to the burdens imposed on grant-making donor advised funds and private foundations, explained in Part III of this memo.

4. The SO's governing document must not empower the SO to support or benefit any organization other than its PSO or PSOs (which, as noted above, may in some circumstances be a class of public charities).

C. The Operational Test

The SO may make payments to or for the use of the PSO; it may make grants, conduct independent programs, raise funds, and engage in an unrelated trade or business. However, the permissible beneficiaries of its grants or programs are limited[5] to:

1. The SO's PSO;[6]

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[4] The PSO may also be exempt under other sections of the Internal Revenue Code, so long as it would qualify as publicly supported.

[5] *See* Treas. Reg. Section 1.509(a)-4(e)(1).

[6] Recall that the PSO may be one charity, or several named charities, or a class of charities. If the PSO includes more than one charity, the SO may grant funds to any or all of them.

2. Individual members of the charitable class served by the PSO, either through direct payments or benefits to the individuals, or earmarked for such individuals and given through an unrelated organization;

3. Other SOs that support the PSO; or

4. Public colleges and universities.[7]

D. Lack of Donor Control over the SO

This is a negative test. To satisfy this test, the SO must not be "controlled" directly or indirectly by "disqualified persons." For purposes of this test, "control" means either holding 50% of the combined voting power on the Board of Directors of the SO, or veto power over the SO's activities, unless it can be shown that actual control is held by some other party (for example, by the bishop of a church corporation). The term "disqualified person" means:

1. A substantial contributor (defined as any person or entity who gives more than the greater of $5,000 or 2% of the total gifts received by the SO, including gifts from a spouse);[8]

2. If the SO is a trust, the creator of the trust;

3. An owner of more than 20% of a corporation, partnership, trust, or other enterprise that is a substantial contributor to the SO;

4. A family member of any person described in 1, 2, or 3 above ("family member" here means spouse, ancestor, child, grandchild, great grandchild, and any of their spouses);

5. A corporation, partnership, or trust in which persons described in 1, 2, 3, or 4 above hold more than 35% of the voting power, profits interest, or beneficial interest, respectively; and

6. Employees of any of the above.[9]

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[7] Public colleges and universities are included by reference to Section 511(a)(2)(B) in Treas. Reg. Section 1.509(a)-4(e)(1).

[8] Public charities (other than SOs) do not qualify as substantial contributors, but SOs and private foundations do.

[9] Rev. Rul. 80-207, 1980-2 C.B. 113 (an employee of a disqualified person shares that status for purposes of the control test).

In reviewing a SO's compliance with this test, the IRS looks not only at direct control by disqualified persons but at indirect control as well. For example, the IRS views the presence of a disqualified person's attorneys, accountants, and other professionals on an SO's governing body as being evidence of indirect control by the disqualified person.[10]

An SO must certify each year on its Form 990 that it is not controlled, directly or indirectly, by one or more of the above disqualified persons.

E. Prohibition on Gifts or Contributions from Persons Controlling a PSO

This, too, is a negative test: the SO may not accept gifts or contributions from anyone who directly or indirectly controls any of its PSOs. Specifically, the SO cannot accept gifts from:

1. An individual, business, or nonprofit organization (other than a publicly supported charity) that directly or indirectly controls any PSO. A person is treated as controlling a PSO if the person can control the PSO either acting alone, or acting together with people or organizations described in 2 and 3 below.

2. A member of the family of an individual described above. Family members who cannot donate to the SO include the spouse of an individual described in 1, or his or her siblings, ancestors, children, grandchildren, great grandchildren, or the spouses of any of those relatives.

3. A business or trust owned 35% by the people described above. This includes any corporation in which persons described in 1 or 2 directly or indirectly own more than 35% of the voting power, or any partnership in which such persons own more than 35% of the profits interest, or any trust or estate in which such persons own more than 35% of the beneficial interest.

If a Type I SO fails the test, it will revert to private foundation status. It is important to monitor compliance with this test, particular where the PSO is a class of public charities, since the consequence of failure is harsh.

[10] *See* http://www.irs.gov/irm/part7/irm_07-020-007.html for the Internal Revenue Manual's discussion of these issues, including guidesheets used by IRS agents to test for the presence of direct or indirect control of a supporting organization by disqualified persons.

III. ADDITIONAL RESTRICTIONS AFFECTING SUPPORTING ORGANIZATIONS

A. Excess Benefit Transactions

Certain transaction involving SOs will result in automatic excess benefit transactions under Section 4958. An SO is effectively prohibited from making (i) any loan to a disqualified person, or (ii) any grant, loan, compensation or other similar payment[11] to a substantial contributor to the SO, his or her family members, or entities 35% controlled by either. The full amount of any such loan, compensation, or other payment is considered an automatic "excess benefit" under Section 4958. Therefore, the substantial contributor will be subject to excise taxes and will have to return the full amount to the SO.

In addition, Section 4958 provides that any disqualified person of an SO is also a disqualified person of any PSO of the SO.[12] This means, for instance, that if an officer or director of the SO receives any economic benefit from its PSO, that benefit is a potential excess benefit transaction under Section 4958 and should be reviewed accordingly.

B. Contributions from Donor-Advised Funds and Private Foundations

Sponsoring charities of donor-advised funds ("DAFs") may treat grants to Type I SOs like any grants to public charities, with one important exception: they must exercise expenditure responsibility over any distribution to a Type I SO, *if* either the donor to or advisor of the DAF directly or indirectly controls any PSO supported by the SO.[13] As a result, if a sponsoring charity is considering a grant from a DAF to a SO, it must first determine what type of SO its proposed grantee is. A sponsoring charity may generally rely on the information published by the Internal Revenue Service in Publication 78[14] or the Business Master File (BMF) extract[15] for purposes of determining a proposed grantee's SO type.[16] The sponsoring charity is

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[11] According to the Joint Committee on Taxation's explanation of the Pension Protection Act, "other similar payments" includes grants, loans, or payment of compensation such as expense reimbursement, but does not include payments made pursuant to a bona fide sale or lease of property with a substantial contributor. Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006*, JCX-38-06, p360, note 571 (August 3, 2006).

[12] Section 4958(f)(1)(D).

[13] This rule also applies to Type II SOs and to Type III SOs that are functionally integrated with their PSOs. If a Type III SO is not functionally integrated with its PSO, however, a sponsoring charity must use expenditure responsibility over grants to that SO in all cases.

[14] Publication 78 is accessible at http://www.irs.gov/app/pub-78.

[15] The BMF extract is accessible at http://www.irs.gov/uac/SOI-Tax-Stats-Exempt-Organizations-Business-Master-File-Extract-(EO-BMF). Grantors may also rely on BMF information obtained from third party sources, provided that the requirements of Section 4 of Revenue Procedure 2011-33 are met.

[16] Reliance by a sponsoring charity on Publication 78 or the BMF extract information is not permitted where the sponsoring charity: (1) had knowledge of the revocation of the ruling or determination letter specifying the proposed

also likely to require a list of the prospective grantee's PSOs from the grantee to determine whether any of the PSOs is controlled by the fund's donor or donor advisor (or any related parties). If such control exists, the DAF sponsor must exercise expenditure responsibility or the grant will be treated as a taxable expenditure.[17] These rules also apply to grants from private foundations to Type I SOs.[18] This can be a complex challenge for a Type I SO whose PSO is defined as a class.[19]

grantee's SO type prior to 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 specifying the proposed grantee's SO type. *See* Rev. Proc. 2011-33.

17 *See* IRS Notice 2006-109.

18 Section 4942(g)(4)(A)(ii).

19 If the potential SO grantee is a Type II or Type III SO, consult legal counsel for more information as different rules may apply.