Public Charities and Private Foundations
Reference Outline

by

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Information set forth in this outline should not be considered legal advice, because every fact pattern is unique. The information set forth herein is solely for purposes of discussion and to guide practitioners in their thinking regarding the issues addressed herein.

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Mr. Bourland is the founding shareholder of Bourland, Wall & Wenzel, P.C., a Fort Worth, Texas law firm which represent individuals, closely held and family businesses, professional practices and charitable organizations within its areas of legal practice. Mr. Bourland was born in Fort Worth, Texas on October 2, 1943. He earned a B.A. from Baylor University and his J.D. from Baylor University School of Law. He earned his LL.M. in Taxation from University of Miami, Florida. Additionally, he was a Captain in JAGC, USAF, 1970-1975.

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PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

TABLE OF CONTENTS

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PUBLIC CHARITIES AND PRIVATE FOUNDATIONS

I. INTRODUCTION

This outline describes the major considerations in the planning, creation and operation of private nonoperating foundations, private operating foundations, publicly supported charities, supporting organizations, and community foundations. It is intended as an overview of planning considerations for the practitioner to help clients define and achieve their philanthropic goals.

II. TYPES OF ORGANIZATIONS

A. Foundations in General:

The word "foundation" can be deceptive, as it may refer to any number of nonprofit organization types. I.R.C. § 509(a) defines a private foundation as any domestic or foreign organization described in I.R.C. § 501(c)(3) other than the following types of public charities:

1. Organizations that are, by definition or by activity, public charities I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i)-(v) ("traditional" public charities);

2. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. §509(a)(1); I.R.C. §170(b)(1)(A)(vi) ("publicly supported charities");

3. Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(2) ("gross receipts" or "service provider" publicly supported charities);

4. Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations, I.R.C. § 509(a)(3) (supporting organizations); and;

5. Organizations organized and operated exclusively to test for public safety, I.R.C. § 509(a)(4) (beyond the scope of this outline).

In other words, an I.R.C. §501(c)(3) organization is presumed to be a private foundation unless it demonstrates that it fits one of the exceptions listed above.

B. Private Nonoperating Foundation:

The most common type of private foundation is the nonoperating foundation. It does not generally directly perform any charitable programs or services. It generally receives its funding from one primary source, such as an individual, a family or a corporation. It does not generally actively raise funds or seek grants. It is required to distribute approximately 5% of its assets annually in qualifying distributions (most often to public charities). Donors' charitable income tax deductions are more limited than when made to a public charity.

C. Private Operating Foundation:

The operating foundation has a stated charitable purpose and carries out its own programs. It generally seeks grants rather than awarding grants to other charitable organizations. The operating foundation must expend substantially all of its net investment income directly for the purposes of its own charitable activities. Although donors receive the more liberal public charity income tax deduction limitations, this type of foundation remains subject to the private foundation restrictions because its source of funding is generally from one individual, family or corporation.

D. Institutions:

1. Institutions I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i-v):

a. Churches and conventions and associations of churches;

b. Educational organizations that normally maintain a regular faculty and curriculum, and normally have a regularly enrolled body of students in attendance at the place where the activities are regularly carried on;

c. Hospitals and medical research organizations;

d. Endowment funds for state and municipal universities;

e. Governmental units, including a state, a possession of the United States, a political subdivision of a state or the United States, the United States, or the District of Columbia

E. Publicly Supported Organizations:

1. *I.R.C. §509(a)(1) Publicly Supported Organization*: Another type of charitable organization is the publicly supported charity described in I.R.C. §509(a)(1) and I.R.C. §170(b)(1)(A)(vi), sometimes referred to as a "donative" publicly supported charity, because it does not typically provide services (as compared to §509(a)(2) organizations). It is not a private foundation; rather it is taxed as a public charity. It must meet a public support test and generally must demonstrate that it is organized to attract contributions from a broad range of donors. A community foundation is described in I.R.C. §170(b)(1)(A)(vi). It is not a private foundation; rather it is taxed as a public charity. It does not perform any charitable programs or services. It is generally established to attract large contributions of capital or endowment for the benefit of a particular community or area. Its attractiveness is enhanced by the donor's ability to benefit multiple charities through the donor's gift to a single community foundation.

2. *I.R.C. §509(a)(2) Publicly Supported Organization*: Another type of charitable organization is the gross receipts, or publicly supported charity, which is described in I.R.C. §509(a)(2). It is not a private foundation; rather it is taxed as a public charity. It is generally established to attract contributions from a broad range of donors and must meet a public support test.

F. Supporting Organization:

Another type of charitable organization is the supporting organization, which is described in I.R.C. §509(a)(3). It is not a private foundation, but is a sub-category of public charity and is really only indirectly public, meaning that the public that monitors this organization's operations does so through an intervening public charity. That intervening public charity is the entity to which the supporting organization must answer regarding organization and operation. Because of its "public charity" nature, its attractiveness to potential donors is enhanced because donations are allowed the more favorable tax deduction limitation of those made to public charity. However, a donor seeking control is not as likely to favor this organization as the choice for his or her donation because the organization cannot be controlled by the donor, the donor's family or other "disqualified persons" defined later in this outline.

G. General Considerations:

If a donor desires to have control of the organization's distributions and is not concerned about the reduced income tax percentage deduction limitations applicable to private foundations, the donor should consider classification as a private foundation. If an organization intends to have many sources of funding and have fundraising activities, it should consider classification as a public charity. If the organization intends to support a limited number of existing public charities, it should consider classification as a supporting organization. If a donor does not want the administrative burden of operating a private foundation, but would rather recommend grants from an endowment the donor has funded, the donor should consider creating a donor advised fund through a community foundation.

III. PRIVATE NONOPERATING FOUNDATION

A. Presumption of Private Foundation Status:

I.R.C. § 508(b) provides generally that an organization described in I.R.C. § 501(c)(3) will be presumed to be a private foundation unless it notifies the Internal Revenue Service that it is not a private foundation by demonstrating on Form 1023, Application for Recognition of Exempt Status (discussed below), that it meets the criteria for public charity status. In other words, a § 501(c)(3) organization is by default a private foundation.

B. Tax Treatment by Donors of Contributions:

1. *Gifts of Cash and Non-Appreciated Property:* Income tax deduction is limited to an amount equal to thirty percent (30%) of the donor's adjusted gross income in the taxable year (as opposed to 50% for gifts of cash and other non-appreciated property to public charities and to other organizations which qualify as public charities). Any excess can be carried forward for the next five years. However, the deduction may be zero if the donor has contributed capital gain property to public charities in excess of the 30% deduction limitation. Corporate contributions are limited to 10% of taxable income with a five year carry forward of excess contributions. See IRC § 170(b)(2) and § 170(d)(2)(A).

2. *Gifts of Appreciated Property:* Income tax deduction is limited to twenty percent (20%) of donor's adjusted gross income on gifts of appreciated property (as opposed to 30% for gifts of appreciated property to public charity.) Additionally, gifts of appreciated assets are limited to a deduction of only the donor's basis in the asset, unless the asset is publicly traded stock. Any excess can be carried forward for the next five years.

3. *Deduction for gifts to certain Private Foundations - Pass Through Foundations:* If a foundation meets the criteria of I.R.C. §170(b)(1)(A)(vii) and §170(b)(1)(E)(ii), the donor may receive a deduction as if the gift was made to a public charity (i.e. limited to 50% of the donor's adjusted gross income for gifts of cash and other non-appreciated property and 30% of the donor's adjusted gross income for gifts of appreciated property to a public charity) . Pass through (or conduit) foundations are described as any other foundation (as defined in section 509(a)), which makes qualifying distributions in an amount equal to 100% of the foundation's contributions for the year, before the 15th day of the third month following the close of the foundation's taxable year. To substantiate the deduction, the taxpayer must obtain adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions. I.R.C. § 170(b)(1)(A)(vii) and §170(b)(1)(E)(ii). These types of distributions may be attractive to a founder who would be willing to make the required distributions from the foundation during his or her life in order to receive the 50% deduction, further funding the foundation with an endowment at his or her death.

Itemized Deduction Limitation: Subject to the limitations above, a donor's federal income tax deduction for a gift to a qualified charity (whether public charity or a private foundation) in any year is reduced by the lesser of 80% of the donor's itemized deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 3% of the amount by which the donor's adjusted gross income for that year exceeds that year's adjusted gross income threshold amount (2014-$305,050 if a joint return or surviving spouse, $279,650 if head of household, $254,200 if unmarried, $152,525 if married filing separately). Rev.Proc. 2013-35.

C. Restrictions upon Foundations:

1. *Self-Dealing*: Because of the retention of control involved with private foundations, there are restrictions upon acts of self-dealing under I.R.C. § 4941(d) by certain "disqualified persons" of the foundation.

a. I.R.C. §4946 defines the term "disqualified person." A disqualified person, with respect to a private foundation, is:

1) A substantial contributor to the foundation. Substantial contributor is defined in I.R.C. §507(d)(2) as any person who contributes an aggregate amount in excess of $5,000 to the foundation, if his or her total contributions are more than 2% of the total contributions received by the foundation (since its inception) before the close of the taxable year of the contribution. Substantial contributor also includes:

(a) A family member of a substantial contributor (spouse, descendants and spouses of descendants), or any other person who would be a Disqualified Person by reason of his relationship to such person.
(b) Persons owning more than 20% of an entity which is a substantial contributor to the foundation. I.R.C. §4946(a)(1)(C),
(c) Where the substantial contributor is a corporation, the term also includes any officer or director of such corporation.

2) A foundation manager,
3) A member of the family of anyone described in (1) and (2) above, and
4) A corporation in which persons described in (1),(2), and (3) above own more than 35% of the total combined voting power (more than 35% of profit interest of a partnership or more than 35% of beneficial interest of a trust)

b. Self-dealing includes any direct or indirect: a) sale or exchange or leasing of property between the private foundation and a disqualified person; b) lending of money or extension of credit between a private foundation and a disqualified person; c) furnishing of goods, services, or facilities between a private foundation and a disqualified person, unless such goods, services or facilities are made available to the general public on at least as favorable a basis as they are made to the disqualified person, Treas. Reg. § 53.4941(d)(3)(b)(1); d) payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person, unless compensation is payment for personal services, is reasonable, necessary and not excessive Treas. Reg. § 53.4941(d)(3)(c)(1); e) transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and, f) agreement by a private foundation to make any payment of money or other property to a government official [as defined in I.R.C. § 4946(c)] other than an agreement to employ such individual for any period after the termination of his government service if such individual is terminating his government service within a 90 day period. I.R.C. § 4941(d).

c. Reimbursement for Expenses: Reimbursement to a director (disqualified person) for travel expenses causes the foundation and the director (i.e. a foundation manager) to be potentially liable for penalty taxes for self-dealing, for making noncharitable expenditures, or possibly both. (Additionally, a foundation can lose its exempt status if any of its net earnings inure to the benefit of a private person.) Such reimbursement of

expenses will not be taxed if the expenses are reasonable and necessary to carrying out the exempt purposes of the foundation and are not excessive. I.R.C. § 4941(d)(2). The Code does not explain what is "reasonable and necessary." Treas. Reg. § 53.3941(d)-3(c)(1). Generally, business expense deductions under Treas. Reg. § 1.162-2(1) include travel fares, meals and lodging and expenses incident to travel. Travel expenses are not included if the trip is primarily personal in nature. Treas. Reg. 1.162-2(a). The Code does cross-reference Treas. Reg. § 1.162-7 to determine what is "excessive." Under Treas. Reg. § 1.162-7, an amount spent on director's services will not be deemed "excessive" if it is only such as would be paid "for like services by like enterprises under like circumstances." Treas. Reg. 1.162-7 (i.e. as the organization would pay to someone independent of the foundation). Additionally, a director cannot receive a cash advance for expenses in excess of $500 unless extraordinary expenses are included. Treas. Reg. 53.4941(d)-3(c)(1). Upon receipt of such a cash advance, the director must then account to the foundation under a periodic reimbursement program for actual expenses incurred. If this is done, then the cash advance, additional replenishment of the advance upon receipt of supporting vouchers, or the temporary addition to the advance to cover extraordinary expenses anticipated to be incurred in fulfillment of the assignment will be not considered to violate any act of self-dealing. Only a director or employee is entitled to a cash advance. Treas. Reg. 53.4941(d)-3(c).

2. *Minimum Distribution Requirements*: A private foundation must generally distribute at least 5% of its assets on an annual basis in qualifying distributions. These assets are those not used in furtherance of the exempt purposes of the foundation (such as the building at which the foundation offices, capital equipment and fixtures are located) but are generally cash, stocks, bonds and other investment assets. This minimum distribution is required to prevent foundations from holding gifts, investing the assets and never spending the assets on charitable purposes.

a. Time Period for Distribution: A foundation has 12 months after the close of the taxable year to satisfy the minimum payout requirement for that taxable year. Any foundation can retroactively satisfy last year's payout requirements with the current year's qualifying payment. If a foundation has a shortened first taxable year, then the foundation will have an additional 12 months to complete the prior year's minimum distribution requirement.

b. Qualifying Distributions: Generally, a private foundation's qualifying distributions will consist of grants to qualified charitable organizations (I.R.C. § 501(c)(3) organizations). Qualifying distributions also include grants to charities and non-charities for "charitable purposes," costs of all direct charitable activities (such as running a library or art gallery, providing technical assistance to grantees, maintaining a historical site, conducting a conference, etc.), amounts paid to acquire assets used directly in carrying out charitable purposes, set asides, program-related investments and all reasonable administrative expenses necessary for the conduct of the charitable activities of the foundation.

1) Grants to individuals. Since a qualifying distribution may be made to a non-charity, it is possible for a grant to an individual to be a qualifying distribution, subject to the I.R.C. § 4945 restrictions on taxable expenditures for grants to individuals for travel, study or any similar purpose (see discussion below). Accordingly, grants, scholarships or other similar payments to individuals may be qualifying distributions, but only if the foundation maintains some "significant involvement" in the active programs in support of which the grants are made. Treas. Reg. § 53.4942(b)-1(b)(2). "Significant involvement" will be met if: 1) an exempt purpose of the foundation is the relief of poverty or human distress and the grants must be made or awarded without the

assistance of an intervening organization or agency, Treas. Reg. § 53.4942(b)-1(b)(2)(ii)(A); or 2) the foundation has developed some specialized skills, expertise or involvement in the area to which the grant pertains and hires a staff to supervise and conduct the foundation's work in this area. The grants are then made to encourage involvement in the area. Treas. Reg. § 53.4942(b)-1(b)(2)(ii)(B). Whether or not a grant is made "directly" for the active conduct of the foundation's exempt activities will be determined according to the facts and circumstances of the particular case. Treas. Reg. § 53.4942(b)-1(b)(2). If a foundation only selects, screens and investigates applicants for grants or scholarships and the grantees perform their work alone or under the supervision of some other organization, then the grants will not be treated as qualifying distributions; however, the administrative expenses incurred in screening may still be treated as qualifying distributions. Qualifying distributions in excess of the minimum payout may be carried forward for 5 years.

2) Administration Expenses: Administration expenses do not include investment expenses incurred in managing the endowment. Accordingly, investment management fees, brokerage fees, custodial fees, salaries, or board meeting expenses to oversee investments do not count toward meeting the minimum payout requirement. All other administration expenses that are necessary and reasonable can be taken into consideration. Administration expenses that do count toward the payout include salaries, benefits, trustees' fees, professional fees, travel expenses, general overhead, training, publications, office supplies, telephone, rent, preparation of tax returns, defending legal matters, obtaining rulings from the Service, state and federal filing requirements, costs to purchase newspaper ad announcements of the availability of the tax return for public inspection, cost of annual report and year-end audit. The amount of "grant" administrative expenses paid during any taxable year which may be taken into account as qualifying distributions cannot exceed the excess of (i) 65% of the sum of the foundation's net assets for such taxable year over, (ii) the aggregate amount of grant expenses paid during the two preceding taxable years which were taken into account as qualifying distributions. I.R.C. § 4942(g)(4). Furthermore, unreasonable expenditures for administrative expenses, including compensation and consultant fees will be taxable unless the foundation can prove that the expenses were paid or incurred in the good faith belief that they were reasonable and that the payment or incurrence of such expenses was consistent with ordinary business care and prudence. Treas. Reg. 53.4945-6(b)(2). Reasonableness is determined upon a case by case facts and circumstances determination. Treas. Reg. 53.4945-6(b)(2); Rev. Rul. 77-161. Expenses should be able to be validated by the foundation and somehow associated with the exempt purpose of the organization or the payment of the expenses may be construed to be "private inurement" and risk the exempt status of the organization.

3) Set-Asides: Set-asides are funds of the foundation which are applied for to the Internal Revenue Service in advance to set aside over a multiple year period, not exceeding 5 years, for a specific project. Such set-asides are treated as qualifying distributions. If the Internal Revenue Service approves such set-asides, the full amount of the multi-year grant may count toward payout in the first year.

4) Calculating the 5% Distribution Amount:

   (a) 12 Month Average: The foundation first must calculate the 12 month average of its assets, which allows for fluctuation in investment markets. Any reasonable and consistently applied method can be chosen. In a short taxable year, the payout will be determined based upon the average of the numbers in the short year.

(b) 1.5% Reduction of 12 Month Average: The 12 month average of the fair market value of the foundation's assets may be reduced by 1.5% of the "cash deemed held for charitable purposes." This takes into account that any foundation needs cash to conduct its ongoing business operations. Accordingly, cash given and held for the endowment is reduced by 1.5%.

(c) Calculate 5% of net of (a) & (b): Multiply the net of (a) & (b) by 5%.

(d) Reduce the amount of (c) by taxes: The net figure obtained in (c) above is reduced by taxes paid by the foundation during the year. This is the "distributable amount" that the qualifying distributions must equal each year. Note Pertaining to Estates: Treas. Reg. § 53.4942(a)-2(c)(2)(ii) provides that the asset base for determining the minimum investment return of a private foundation does not include "the assets of an estate until such time as such assets are distributed to the foundation or, due to a prolonged period of administration, such estate is considered terminated for federal income tax purposes pursuant to Treas. Reg. § 1.641(b)-3.

5) Private foundations may no longer count grants or payments to supporting organizations that are directly or indirectly controlled by persons who are disqualified persons of the foundation as part of their qualifying distributions.

3. *Excess Business Holdings*: To prevent private foundations from having an advantage over other businesses which operate in the taxable income sector, Congress and the Internal Revenue Service have adopted restrictions on a private foundation's ability to engage in certain business activities.

a. Permitted holdings: The foundation may own 20% of the voting stock in a corporation, reduced by the percentage of voting stock held by all Disqualified Persons. If control of the entity can be shown to be held by Non-Disqualified Persons, the foundation and the Disqualified Persons may own 35% of the entity's voting interest. The foundation may hold a non-voting interest, but only if all Disqualified Persons together hold no more than 20% of the voting interest or no more than 35% of the voting interest if effective control is with a Non-Disqualified Person(s). The foundation may own a de minimis 2% of the voting stock or value.

b. 5 year period to dispose: A private foundation has 5 years to dispose of excess business holdings acquired by gift or bequest. The disposal must be to a non-Disqualified Person. Additionally, during the 5 year period, the excess business holdings will be treated as held by a Disqualified Person (rather than by the foundation).

c. Unusual gifts and bequests: A private foundation may be granted an additional 5 year period to dispose of an excess business holding received by an unusually large gift or bequest, or holdings with complex business structures.

d. Business enterprise: The private foundation is not permitted to retain excess business holdings, as defined in I.R.C. §4943(c). For the entity in which an interest is held, to be considered a business holding, must be engaged in a business enterprise. An entity is not engaged in a business enterprise if 95% or more of gross income is from passive activity, I.R.C. § 4943(d)(3), or if the business is a functionally related business (i.e. to the foundation's charitable purpose) defined in I.R.C. § 4942(j)(4). Investment in

such assets as passive rental real estate or marketable securities is not a business enterprise.

4. *Jeopardizing Investments*: The private foundation must not make investments which would jeopardize the carrying out of the exempt purpose as prohibited by I.R.C. § 4944. Although no investment is a per se violation, this rule requires close scrutiny of foundation managers' standard of care. The foundation managers will be held to a "prudent investor" standard of care. Caution should be exercised in the consideration of speculative investments such as working interests in oil and gas, trading on margin, trading in commodity futures, purchase of "puts" and "calls" and "straddles", warrants, selling short or other high risk investments. This restriction applies to investment actions by the foundation managers and does not apply to assets received by a private foundation by gift or bequest.

5. *Taxable Expenditures*: A private foundation is prohibited from making taxable expenditures, I.R.C. § 4945, which are expenditures not in furtherance of the foundation's exempt purposes. Taxable expenditures include amounts paid or incurred by a private foundation to carry on propaganda or otherwise attempt to influence legislation or the outcome of any public election. Additionally, if the foundation makes a distribution to a for-profit entity, (i.e., including an individual) it must monitor (i.e., exercise expenditure responsibility) the grant in order to avoid a penalty.

a. Exercise of expenditure responsibility includes the conducting of a pre-grant inquiry concerning grantee's management and programs, obtaining a written agreement from the grantee prior to making the grant, obtaining regular written status reports from the grantee regarding its progress in using the grant, and filing reports regarding the grant's status with the private foundation's annual information return and checking the appropriate box.

b. Awarding of Grants: Grants not awarded on an objective and nondiscriminatory basis are taxable expenditures. Treas. Reg. § 53.4945-4(a)(3)(ii)(a). To establish that grants are being made on these bases, the program with which they are associated must be consistent with the existence of the foundation's charitable purpose. Treas. Reg. § 53.4945- 4(b)(5)(b)(1)(i). No part of the program should benefit a private individual or attempt to influence legislation. I.R.C. § 501(c)(3). Also, the group from which the grantees are selected should be chosen on the basis of criteria related to the purposes of the grant and the group should be sufficiently broad so that grants to members will fulfill the foundation's charitable purpose (religious, charitable, scientific, public safety, literary or educational purposes or foster national or international amateur sports competition, or prevent cruelty to children or animals.) Treas. Reg. § 53.4945-4(b)(2). Selection from a group is not necessary, however, when the grantees are selected because they are exceptionally qualified to carry out the purposes of the grant, or it is sufficiently clear that the selection of the particular grantee is calculated to accomplish a charitable purpose rather than benefit a particular person or class of persons. Likewise, the person or group of persons who select recipients of grants should not be in a position to gain a personal benefit, directly or indirectly due to the choice of grantee. Treas. Reg. 53.4945-4(b)(4).

c. Grants to Individuals: If the foundation intends to make grants to individuals, advanced written approval of the selection process must be received from the Internal Revenue Service or such grants will be subject to tax. I.R.C. § 4945(g). Any grant to

an individual not approved in advance is a taxable expenditure. A request for approval of the grant selection process to individuals must contain the following[1]:

1) Statement describing the grantee selection process;

2) Description of the terms and conditions under which the foundation ordinarily makes such grants, in sufficient detail to enable the Commissioner to determine whether the grants awarded would meet the foundation's exempt purposes (charitable, etc.).

3) Detailed description of the foundation's procedure for exercising supervision of scholarship and fellowship grants;

4) Description of the foundation's procedure for reviewing grantee reports and for investigating or correcting possible misuse of grant funds by the recipient; and

5) A user fee. Rev. Proc. 88-8, 1988-41 R.B. 22.

The foundation is not required to have a written agreement from the prospective grantee and does not have to have written approval of each grant program. The approval is to provide for an evaluation of the foundation's entire system of standards, procedures, and follow-up in order to evaluate if grants will meet required standards. Treas. Reg. 53.4945-4(d). As long as the foundation's procedures for selection are not altered, the approval will continue to apply. Treas. Reg. 53.4945-3(iii)(a), (b) and (c)

d. Grants to individuals for purposes other than study, travel or similar purposes do not require Internal Revenue Service approval but the foundation should exercise diligence to ensure these grants are used for charitable purposes. Grants to individuals for study, travel or similar purposes are taxable expenditures unless specific requirements are met. I.R.C. § 4945(2)(6)(3). In order to obtain approval for grants to individuals for travel, study or other similar purpose, the following must be established to the Internal Revenue Service's satisfaction:

1) The grant must constitute a scholarship or fellowship grant which would be subject to the provisions of I.R.C. § 117(a). Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(1), (i.e., the grant would not be included as gross income by the grantee because it is received by an individual who is a candidate for a degree at an educational institution.) The grant must be used for tuition and fees for enrollment or attendance at the educational institution or for fees, books, supplies, and equipment required for courses of instruction at the educational institution. I.R.C. § 117(a); or,

2) The grant must constitute a prize or award, and the recipient of the prize or award must be selected from the general public. The prize or award must be such that it would be subject to the provisions of I.R.C. § 74(b). Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(2). I.R.C. § 74(b) requires prizes or awards to be made primarily in recognition of religious, charitable, scientific, educational, artistic, literary, or civic achievement. Furthermore, (i) the recipient must be selected without any action on his or her part to enter the contest or proceeding; (ii) the recipient must not be required to render substantial future services as a condition to receiving the prize or award; and (iii) the prize or award must be transferred by the payor to a governmental unit or organization pursuant to a designation made by the recipient; or,

[1] Note that completing Schedule H of Form 1023 is the procedure for foundations seeking advance approval at the time of formation; otherwise, a private letter ruling should be requested.

3) The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance literary, artistic, musical, scientific, teaching, or other similar capacity, skill or talent of the grantee. Treas. Reg. § 53.4945-4(a)(3)(ii)(c)(3). "Specific objective . . . or other similar product" is intended to encompass purposes which are sufficiently narrow and definite to ensure that grantees only be able to use funds in furtherance of charitable purposes. Rev. Rul. 77-434. Long-term, low-interest educational loans may fit into this category provided their use is sufficiently limited.

e. Supervision of Grants: Standards for supervision of scholarship and fellowship grants are set forth in the Treasury Regulations and provide that the foundation must arrange to receive a "verified" report from the appropriate educational institution at least once for each year in which the grantee takes courses and receives grades. If the grant involves research, projects, or other work not involving the taking of actual courses, the foundation manager must receive an annual progress report approved by the faculty member supervising the grantee or by another appropriate university official. The foundation must receive a final report upon completion of the grantee's studies. Treas. Reg. § 53.4945-4(c)(2). The foundation must be able to insure that the grantees have not diverted funds away from the original purpose of the grant. If the foundation fails to investigate or correct grant misuse, the grant may become a taxable expenditure. Treas. Reg. § 53.4945-4(c)(4). The Treasury Regulations do provide an alternative to the above mentioned supervisory requirements for scholarship and fellowship grants. Treas. Reg. 53.4945-4(c)(5). The foundation need not receive reports or investigate grants which may be being misused if the following criteria are met:

1) The scholarship or fellowship grants are excludable from the recipient's gross income and are used for study at an educational institution described in I.R.C. § 151(e)(4); and,

2) The grantor pays funds directly to the educational institution and not to the individual grantee; and,

3) The educational institution agrees to use the grant funds directly to defray the recipient's expenses, or to pay the funds (or portion thereof) to the recipient only if the recipient is enrolled at the institution and his or her standing at the institution is considered with the purposes of the grant.

The private foundation must retain records pertaining to all grants to individuals for travel, study, or other similar purposes. Treas. Reg. § 53.4945-4(d). These records must include:

4) All information the foundation secures to evaluate the qualifications of potential grantees.

5) The identification of grantees. This should include any relationship of any grantee to,
(i) members, officers, trustees of the organization,
(ii) a grantor or substantial contributor to the organization or a member of the family of either, and
(iii) a corporation controlled by a grantor or substantial contributor. Rev. Rul. 56-304.

6) Specification of the amount and purposes of each grant.

7) Any follow-up information which the foundation obtains regarding possible misuse of funds.

A grant meeting all of the above may still constitute a taxable expenditure if, (i) the grant is to be used to attempt to influence legislation or affect the outcome of a public election, or (ii) there is an agreement between the fund and the grantee whereby the fund may cause the grantee to engage in and the grantee does engage in such an activity, or (iii) the grant is made for a purpose other than religious, charitable, scientific, public safety, literary, or educational purposes, fostering of national or international amateur sports competition, or prevention of cruelty to children or animals. Treas. Reg. § 53.4945-4(a)(5).

f. Distributions to Foreign Organizations or for Foreign Purposes: A foundation can make a contribution to a foreign organization and it not be deemed a taxable expenditure if the foreign organization has received a tax exempt determination letter from the Internal Revenue Service that it is a public charity or it qualifies as the equivalent of an I.R.C. § 501(c)(3) organization and a public charity under I.R.C. § 509(a)(1), (2) or (3); Treas. Reg. § 53.4945-6(c)(1), I.R.C. § 4945(d)(4)(A); or, if in the reasonable judgment of a foundation manager, it is determined that the foreign organization will be treated as the equivalent of an I.R.C. § 501(c)(3) organization and a public charity under I.R.C. § 509(a)(1), (2) or (3), Treas. Reg. § 53.4945-6(c)(2)(ii), and a good faith determination is made based upon an affidavit of the foreign organization or an opinion of counsel by either the foreign organization's or the foundation's counsel, setting forth sufficient facts concerning the operation and support of the organization to enable the Internal Revenue Service on audit to determine that the grantee organization would likely qualify as a public charity under I.R.C. § 509(a)(1), (2) or (3). Treas. Reg. § 53.4945-5(a)(5). There is no requirement that the affidavit or opinion of counsel be attached to the donor foundation's annual information return. Treas. Reg. § 53-4942(a)-3(a)(6)(i). The foundation can make a grant to a foreign organization not meeting these requirements only if the foundation exercises expenditure authority as to the grant. If the contribution is made to a domestic organization which is to be used for a charitable activity in a foreign country, the domestic organization will be considered the recipient of the contribution and the contribution will be a qualifying distribution if the use of the contribution is subject to the domestic organization's discretion and control. Rev. Rul. 66-79, 1966-1 C.B. 48. However, the donating foundation must not earmark the contribution to the domestic organization directly for the use of the foreign organization. If they do, they will be deemed to have made a grant directly to the foreign organization and the foreign organization must meet the qualifications of a public charity in order for the distribution to be a qualifying distribution. As long as the donating foundation does not earmark the use of its grant for any named secondary donee, it will not be deemed to have made a contribution to the secondary donee. Treas. Reg. 53.49429(a)-3(c)(4). Care should be taken to comply with anti-terrorism measures to ensure funds are not diverted to terrorist purposes. That discussion is beyond the scope of this paper.

g. Recordkeeping: Review procedures should be adopted and records kept to document that a private foundation is not making taxable expenditures. These procedures should include:

1) Verification that a grantee is listed in Publication 78 – Cumulative List of Exempt Organizations (now referenced as Select Check) (searchable online at www.irs.gov) or; investigate at www.guidestar.org.

2) Review of the grantee's determination letter granting grantee exempt status as a public charity;

3) Review of the grantee's current 990, Schedule A, Part IV to review its proof of non-private status and that is still classified as a public charity; and,

4) Filing reports regarding the grant's status with the private foundation's annual information return and checking the appropriate box pertaining to expenditure responsibility.

6. *Exempt Status*: The private foundation must be operated exclusively for its exempt purpose. Thus, no part of the foundation's net earnings may "inure to the benefit" of a private person. Treas. Reg. § 1.501(c)(3)-1(c)(2). If it does, the private foundation may lose its tax exempt status.

D. Excise Taxes:

Private foundations are not subject to the intermediate sanctions rules applicable to public charities under I.R.C. §4958. Private foundations are subject to the following excise taxes (I.R.C. §4940-4945):

1. *Excise Tax on Investment Income (I.R.C. § 4940(a)): Tax of 2% (1% under certain circumstances) of the net investment income of a private foundation (other than an exempt operating foundation) for the taxable year:* The private foundation is subject to an excise tax of 2% of its net investment income and, unlike the excise taxes listed below, is not avoidable. If the private foundation distributes an amount to qualified charities that is equal to the amount determined by the calculation of V. B. 1.b., herein, the tax may be reduced to 1% for that year.

2. *Excise Tax on Acts of Self-Dealing (I.R.C. § 4941): Restrictions on acts of self-dealing*: Any Disqualified Person who engages in an act of self-dealing is assessed an excise tax of 10% of the amount involved in the transaction for each year that the transaction is uncorrected. Additionally, a foundation manager who willingly participates in the act knowing it is prohibited is subject to a tax of 5% of the amount involved (not to exceed $20,000 for each such act) for each year that the transaction is uncorrected. If the transaction is not timely corrected and the 10% was initially assessed timely paid, the Disqualified Person is subject to being assessed an additional tax of 200% of the amount involved. Any foundation manager who does not correct the transaction may also be subject to an additional assessment of 50% of the amount involved (up to $20,000 for each such act.) If more than one foundation manager is liable under this section, such persons are jointly and severally liable.

3. *Excise Tax on Failure to Distribute Income (I.R.C. §4942): Minimum requirements for distribution of income*: The foundation must make qualifying distributions in an amount equal to or greater than 5% of the aggregate fair market value of assets not used directly to carry out the foundation's exempt purposes for each taxable year. A qualifying distribution is one paid to accomplish one or more charitable purposes under I.R.C. § 4942(g). If such amount is not distributed by the close of the following taxable year, the foundation is assessed a penalty of 30% of the difference between the amount actually distributed and the amount which should have been distributed. An additional penalty of 100% of the undistributed amount is assessed if the original penalty is assessed and the distribution is not timely made. I.R.C. § 4942. The penalties apply only to the foundation and not the foundation manager.

4. *Excise Tax on Excess Business Holdings (I.R.C. §4943): Restrictions on retention of excess business holdings* : The foundation is taxed on its excess business holdings in the amount of 10% of the value of the excess business holding. A penalty of 200% is imposed on the foundation if the initial penalty is assessed and the excess business holding is not timely corrected. I.R.C. § 4943 (b). Although the private foundation has a 5 year time period to dispose of the excess business holding, the disposition of such holding is subject to the restrictions against acts of self-dealing. (See below discussion of Excess Business Holdings).

5. *Excise Tax on Jeopardizing Investments (I.R.C. §4944): Restrictions on investing assets in a manner which jeopardize the carrying out of exempt purpose:* The foundation is not

allowed to invest its funds in investments which could jeopardize the foundation's ability to carry on its exempt purpose. If it does, a tax is imposed on the foundation equal to 10% of the amount of the improperly invested assets. Additionally, each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed a tax of 10% of the amount of the improper investment (not to exceed $20,000 for each such act). If the jeopardizing investment is not disposed of within the taxable period, the foundation is assessed an additional tax of 25% of the amount improperly invested and each foundation manager who willfully participated in the making of the investment knowing that it jeopardized the carrying out of the foundation's exempt purposes is assessed an additional tax of 5% of the amount of the improper investment (not to exceed $20,000 for each such act). The taxable period begins on the date of investment and ends the earlier of (i) the date of the mailing of a deficiency; (ii) the date on which the tax is assessed; or (iii) the date on which the investment is removed from jeopardy. (See below discussion of Jeopardizing Investments.)

6. *Excise Tax on Taxable Expenditures (I.R.C. §4945): Restrictions on expenditures*: The foundation is subject to a 20% tax on each taxable expenditure, and any foundation manager who willingly participates in making the distribution knowing it is a taxable expenditure, without reasonable cause, is subject to a 5% tax on such taxable expenditure. If the expenditure is not corrected within the taxable period, the foundation is subject to a tax of 100% of the amount of the taxable expenditure and the foundation manager is subject to a tax of 50% of the amount of the taxable expenditure, if the foundation manager refused to correct the transaction. The taxable period is the date starting when the expenditure is made and ending the earlier of the date (i) of mailing of a notice of deficiency; or (ii) the tax is assessed) Taxable expenditures include payments for noncharitable purposes or to non-qualifying recipients, including political campaigns and lobbying, and certain grants to individuals. (See below discussion of Taxable Expenditures.)

I.R.C. § 507: *Tax upon termination of status as private foundation unless certain requirements are met:* Additionally, a private foundation must take great care in dissolution or merger with another organization so as to avoid a taxable termination under *I.R.C. § 507 (Discussed below)*

E. Other Considerations:

1. *The Board of Directors*: The board of directors establishes policy of the foundation in accordance with its purposes as set forth in the entity's organizational documents. It also works with donors in acceptance of donations and using the foundation's assets in accordance with its exempt purpose.

2. *Hiring Professional Management*: Staff may be needed to administer the programs and handle operations. Directors of the private foundation usually delegate day-to-day management to an executive committee or an executive director. However, a small private foundation that makes grants only once per year generally operates without the necessity of a staff. Directors should, however, hire appropriate professional advisors as warranted.

a. Delegation of Authority to Invest:

1) Trusts: The Uniform Prudent Investor Act (Chapter 117 of the Texas Trust Code) was adopted in 2003. It replaces the modified "prudent man" investment standard with the "prudent investor" rule based on the American Law Institute's Restatement (third) of Trusts: Prudent Investor Rule (1992). Under the Uniform Prudent Investor Act, the Trustee must generally diversify the assets of the trust. The

Act also codifies the common law duties of loyalty and impartiality. The Trustee may delegate investment and management functions, but may be held liable for actions of the agent under certain circumstances. (See Section 117.011of the Texas Trust Code). These standards apply effective January 1, 2004 to new and existing trusts.

2) Corporations: The Board of Directors of a nonprofit corporation is not subject to liability for any action or omission by an advisor if the Board of Directors has acted in good faith and with ordinary care in selecting the advisor. Texas Business Organizations Code ("BOC") § 22.224(c). The Board of Directors can contract with appropriate investment advisors, trust companies, banks, investment counsel or managers and delegate to them full power and authority to: (i) purchase or otherwise acquire stocks, bonds, securities, and other investments on behalf of the corporation; and (ii) sell, transfer or otherwise dispose of any of the corporation's assets and properties at a time and for a consideration that the advisor deems appropriate.

3. *Developing Operating Procedures*: Operating procedures should be adopted and strictly followed so as to avoid excise tax complications and avoid jeopardizing the private foundation's charitable status. These procedures include grant application guidelines, and should include, where necessary, review and compliance with procedures to be followed when making grants to foreign grantees, individuals or non-charitable entities. A written statement about the foundation's guidelines, policies, programs of interest, any geographic limitations or other restrictions should be adopted by the board of directors.

4. *Making Grants*: Grants are distributions by the foundation to other organizations to perform charitable activities within their domain and under their control and such grants must be in an annual amount of at least 5% of the annual fair market value of foundation's assets not used directly to carry out the foundation's exempt purposes, after considering certain qualifying expenses. These grants may be to public charities (those which have received an IRS determination letter stating that the organization is an I.R.C. § 501(c)(3) organization and that it is not a private foundation because it is either classified under I.R.C. § 509(a)(1), 509(a)(2) or 509(a)(3)) or to a governmental unit such as a school board, fire department or public library (as long as the purpose for the grant is a charitable purpose) or to social welfare or civic action organization (under I.R.C. § 501(c)(4)), or trade associations and professional organizations (under I.R.C. § 501(c)(6), such as trade associations, chambers of commerce, real estate boards, boards of trade and similar professional organizations.) However, grants to such civic action organizations or social welfare organizations or trade associations and professional organizations require the foundation to conduct expenditure responsibility in order to avoid penalties. (See discussion regarding "expenditure responsibility.")

a. Grant Making Policy: The foundation should establish policies defining programs of interest and establishing objectives to be served. It should also establish its function and position as how to further its charitable purpose. Many private foundations designate a grant committee to review grant applications and make recommendations to board of directors.

b. Grant Application Guidelines: Processes for receiving, examining and deciding on grant applications should be established on a clear and logical basis and should be followed in a manner consistent with the organization's policies and purposes. The foundation's written statement about the foundation's guidelines, policies, programs of interest, any geographic limitations or other restrictions should be provided to applicants. Status reports to applicants should be given promptly.

c. Discretionary Grants: The board of directors may also establish a policy allowing each board member to designate grantees of grants of his or her own choosing up to a predetermined amount. An advantage to discretionary grants is that if each board member can designate a portion of the minimum distribution amount, then he or she would not be as self-motivated on discussing and deciding upon the distributions of the remaining minimum distribution amounts, but a conflict of interest may arise as to the director making decisions in favor of certain grantees.

d. Review of Applications: The directors may evaluate applications and put into written form their interests in certain applications. Foundation staff may further investigate potential grants.

e. Grant Agreement: The foundation should require each grantee to sign a Grant Agreement which binds the grantee to use the grant funds for the purposes provided.

f. Reclaiming of Grant Funds: If the grantee fails to follow the Grant Agreement, the foundation can demand repayment of the grant funds.

g. Recordkeeping: The foundation should obtain and maintain documentation reflecting that distributed funds were used for charitable purposes. These records should include:

1) A copy of any Grant Agreement;
2) Reports regarding grant, if any;
3) Copy of grantee's IRS tax exempt determination letter and documentation that Publication 78 was consulted (a search of Publication 78 is available at www.irs.gov and the relevant portion can be printed for the file); and if the grantee is not a public charity, the foundation must keep complete documentation on its expenditure responsibility (see discussion above), or, in the case of a grantee that is a non-U.S. charity, equivalency determination documentation (see discussion above).

h. Tipping: Generally, a public charity must continually meet a public support test evidencing that a percent of its funding is obtained from a broad cross-section of donors of the general public, not from one foundation or one person. A large grant to a small public charity may cause the public charity to fail to meet its public support test and "tip" it into private foundation status. If the foundation's grant to the public charity tips the public charity, no penalty will be imposed upon the granting foundation if: 1) the grantee had an IRS tax exempt determination letter at the time of the grant, 2) the Service had not revoked the letter and the foundation was not aware of imminent action to do so by the IRS; and 3) the foundation did not control the grantee.

i. Grants to Entities of Which a Disqualified Person Serves on the Board of Directors:

1) Self-Dealing: The foundation may make a distribution to an organization on which a Disqualified Person serves on the board of directors without violating the rules against self-dealing if the Disqualified Person only receives an incidental and tenuous benefit from the grant. See Treas. Reg. § 53.4941(d)-2(f)(2). See also Rev. Rul. 75-42, 1975-1 C.B. 359, where the Service determined that two individuals serving as trustees of both organizations did not violate rules against self-dealing because the benefit to Disqualified Persons was only incidental; and Rev. Rul. 82-136, 1982-2 C.B. 300, where the Service determined that a violation of rules against self-dealing did not occur where a bank served as trustee of two foundations where one was making a grant to the other and determined that any benefit

received by the Disqualified Person (the bank) was incidental. Determinations should be made on a case by case basis as to whether any benefit is incidental or tenuous.

2) Qualifying Distribution: A distribution from the grantee organization is not a qualifying distribution if the donor organization is a "controlled organization".

(a) Controlled Organization: An organization is treated as controlled by the private foundation if one or more of its Disqualified Persons may by aggregating their votes or positions of authority, require the donee organization to make an expenditure or to prevent it from making an expenditure, regardless of the method by which the control is exercised or exercisable. Treas. Reg. § 53.4942(a)-3(a)(3). This is the case whether or not such control is actually exercised.

(b) However, even if the donee organization is a controlled organization, a grant from a foundation will still qualify as a qualifying distribution if within the year in which the grant is made:

(1) The donee organization expends for charitable purposes described in I.R.C. § 170(c)(2)(B) an amount equal to the value of the grant not later than the end of the recipient's first taxable year after the taxable year in which the grant is received;
(2) If the recipient is a private operating foundation, the redistribution is treated by the foundation as made out of corpus, as if the charity were a private nonoperating foundation; and,
(3) The donor foundation obtains adequate records or other sufficient evidence reflecting that the redistribution has been made, the names and addresses of the recipients of the redistributed amount and the amount received by each, and that the redistribution would be treated as made from corpus as if the public charity were a private nonoperating foundation. I.R.C. § 4942(g)(3); Treas. Reg. § 53.4942(a)-3(c)(1).

5. *Advisory Board*: Often directors form an advisory board to advise them on policy matters. This advisory board is generally made up of professionals and other persons having expertise in differing areas that impact the foundation. This board lacks governing authority over the private foundation and cannot legally bind the private foundation.

6. *Governance*: The private foundation through its board of directors, committees and managers, should adopt policies as to governance and other related matters.

7. *Compensation and Other Expenses*: No part of the net earnings of a private foundation may inure to the benefit of any individual. Private inurement can cause the exempt organization to lose its tax exempt status. However, payments of compensation that are reasonable and necessary and not excessive may be paid to employees, consultants and others. Such compensation does not violate the restriction upon acts of self-dealing. Directors of private foundations often, however, serve without compensation. The private foundation may pay for the directors' liability insurance and reimburse the director for out-of-pocket expenses (subject to the restrictions upon acts of self-dealing). Federal law requires that the salaries and benefits of the private foundation's highest paid employees and all directors be disclosed to the public on the foundation's annual information return.

8. *Outside Audit*: Although not required, many foundations obtain outside audits to shield the directors from potential liability.

9. *Insurance*: Private foundations should and generally do purchase liability insurance and property insurance. Often, the insurance includes that for officers and directors ("D&O Insurance"). D&O Insurance protects the foundation and the directors from the costs of legal defense and the payment of certain losses where there is no bodily injury or property damage but is generally resulting from some wrongful act, including breach of duty, neglect, error, misstatement, misleading statement, omission, or other acts done or wrongfully attempted. Claims generally covered included those for wrongful termination, discrimination in employment, sexual harassment, breach of fiduciary duty, self-dealing violations and failure to timely file tax returns. The D&O policy generally is designed to pay attorney's fees and court costs.

10. *Employment*: The private foundation must comply with all federal, state and local employment laws, including withholding and other taxes applicable to private sector employers.

11. *Documents Subject to Inspection*: Applications for exempt status, annual returns (Form 990-PF) and unrelated business income tax returns (Form 990-T) must be made available for public inspection at the private foundation's office. Annual returns for many exempt organizations are available at www.guidestar.org.

F. Termination:

Upon the termination of a private foundation, the private foundation must follow certain federal tax laws or risk a termination penalty. The private foundation may terminate voluntarily under I.R.C. 507(a)(1) or "involuntarily" under I.R.C. 507(a)(2), in either event of which the foundation has to pay a termination tax under I.R.C. 507(c) equal to the lesser of its "aggregate tax benefit" (i.e., all tax benefits accruing to the organization and its contributors) resulting from its I.R.C. § 501(c)(3) status or the net fair market value of its assets. The "aggregate tax benefit" is the sum of four amounts: 1) The aggregate increase in income, estate and gift taxes to substantial contributors if contribution deductions had been disallowed; 2) the aggregate increase in income tax which would have been imposed on the foundation if it had not been exempt from income tax and in the case of a trust, if deductions under I.R.C. § 642(c) had been limited to 20% of the taxable income of the trust; 3) any amounts received by one private foundation from another if a tax is imposed upon the termination; and 4) interest on the increases in tax for each of the increases under 1-3 from the date on which each increase would have been due and payable to the date on which the organization ceases to be a private foundation. Alternatively, the private foundation may avoid the termination tax and either make a grant of all assets to an organization which has been classified as a public charity for a sixty (60) month continuous period, or convert the private foundation into a public charity and give appropriate notice to the Internal Revenue Service of a sixty (60) month termination and reclassification as a public charity. The private foundation may also merge with another private foundation and then begin a voluntary termination under I.R.C. § 507(b)(1), and pay no termination tax because it no longer has any assets.

G. Split of Entity:

The split of assets between two foundations from one requires federal filing and may be the most effective way to resolve family differences regarding the operations of the foundation.

H. Advantages of a Private Foundation:

Establishing and funding a private foundation allows the donor to feel satisfied that he or she is returning something to society. It provides more control to the donor than does a donation to a community foundation or supporting organization because the donor has the right to distribute the foundation assets to organizations (public charities) he or she prefers and he or she can stay in control of the foundation's investments. Thus, the foundation often makes the donations for the family. Additionally, the family can stay in control over time by specially drafting into the organizational documents that family members are to serve on the board of directors. It also gives the younger family members an opportunity to participate in a meaningful endeavor and become familiar with the charitable

goals, intentions and business and management philosophies of the foundation creator. If the foundation employs family members, compensation must be reasonable under I.R.C. § 4941. This should be contrasted with the prohibition arising from the Pension Protection Act of 2006 on payment of any compensation to substantial contributors or their family members by supporting organizations. Additionally, the private foundation is not beholden to public memberships, nor is it required to continuously raise funds. Further it enables the donor to evaluate grant seekers' proposals against the charitable goals of the foundation without being bombarded by the charities and provides anonymity in giving. It also is a vehicle which allows for contributions to foreign organizations.

I. Disadvantages of a Private Foundation:

One disadvantage of the private foundation is the application of the excise tax system, including annual excise tax of 2 % on net investment income, which prevents the private foundation from abusing the greater flexibility and control that it has. Another disadvantage is that the deduction for income tax charitable contributions is more limited than a contribution made to public charities or supporting organizations. Additionally, since the costs of reporting, hiring professional advisors (legal, tax reporting and investment, etc.) and the reporting requirements of the foundation are significant, it is not generally considered cost effective in the mind of many legal advisors to create such a private foundation unless the donor has significant charitable inclinations and the funding is expected to be $1,000,000 or more (though some institutions are providing administrative services to encourage smaller foundations). Most important of all, if the donor is a control and investment "maverick", then the private foundation may prove problematic because of the applicable stringent rules and reporting requirements.

IV. PRIVATE OPERATING FOUNDATIONS

One private foundation that is given some of the advantages of being treated as a public charity is the private operating foundation. Becoming a private operating foundation is as simple as changing the organization's manner of operations, something that is within the control of the members, and does not result in termination of private foundation status. (See discussion under Nonoperating Private Foundations regarding termination.) Although these private foundations continue to be subject to most rules affecting private foundations, donors receive more favorable tax deductions for donations to such. (Note: Certain "exempt" operating foundations are exempt from the net investment income tax applicable to nonoperating private foundations discussed above.) Typically, these organizations actively operate as a charity, rather than making grants to other charities. Unless these organizations are able to raise substantial contributions from the general public, they are classified as private foundations subject to the rules and excise taxes concerning private foundations discussed above.

A. Qualification as Private Operating Foundation:

To qualify as a private operating foundation, an organization must meet the "income test" and any one of the 3 following tests: 1) the "assets test", 2) the "endowment test," and 3) the "support test." See Treas. Regs. § 53.4942(b)-1(a)(1).

1. *"Income Test":* The organization must distribute substantially all of the lesser of its adjusted net income or its minimum investment return directly for the active conduct of its exempt purposes. Does not include grants to other organizations, but may include grants, scholarships or other payments to individuals if the organization is involved in the programs in support of which the grants, etc. were made. "Substantially all" is defined to mean 85% or more. Treas. Regs. § 53.4942(b)-1(c). "Adjusted net income" is defined as gross income less deductions allowable to a corporation, subject to certain modifications. See I.R.C. § 4942(f)(2); Treas. Regs. § 53.4942(a)-2(d)(2). It does not include gifts, grants or contributions but does include a functionally related business. Treas. Regs. § 53.4942(a)-2(d)(1). "Minimum investment return" is equal to 5% of the assets not used directly in carrying out the organization's exempt function, after subtracting the amount of any acquisition indebtedness (under I.R.C. §

514(c)(1)) with respect to any property. [This is the same definition as that used to calculate the minimum distribution for a private foundation.] Excluded interests include any future interest in income or corpus of property, any interest in an estate before receipt, any interest in a trust created or funded by another person, and any pledge to the foundation, enforceable or otherwise. See Treas. Regs. § 53.4942(a)-2(c)(2)(i)-(iv).

2. *Three Alternative Tests:*

a. "Assets test": Requires that substantially more than ½ of the organization's assets be held for use for the organization's exempt function activities. I.R.C. § 4942(j)(3)(B)(I); Treas. Regs. § 53.4942(b)-2(a). "Substantially more" than ½ is defined to mean 65% or more. Treas. Regs. § 53.4942(b)-2(a)(5). These assets must be devoted directly to either the active conduct of the organization's exempt purpose or functionally related business or any combination of these two. Treas. Regs. § 53.4942(b)-2(a)(4) and –2(c)(4) contain the rules for valuing the assets; or

b. "Endowment Test": Requires direct distributions of at least 2/3 of the foundation's minimum investment return (or 3 1/3% of its endowment). I.R.C. § 4942(j)(3)(B)(ii); Treas. Regs. § 53.4942(b)-2(b). [All definitions are the same as those provided under the "income test" described above.] The asset base for applying the 3 1/3% to is defined in Treas. Regs. § 53.4942(a)-2(c); or

c. "Support Test": Requires that at least 85% of the organization's support (excluding gross investment income) be from a combination of the general public and 5 or more exempt organizations and not more than 25% of support (other than gross investment income) be from any one exempt organization, and not more than 50% of support be from gross investment income. I.R.C. § 4942(j)(3)(B)(iii); Treas. Regs. § 53.4942(b)-2(c)(1). "Support" includes gifts, grants, contributions, membership fees, gross receipts from admissions, sales of merchandise, performance of services, furnishing facilities, net income from unrelated business activities, gross investment income, tax revenues and the value of services or facilities furnished by a governmental unit without charge. I.R.C. § 509(d).

3. *Computation Periods*: The tests for qualifying as a private operating foundation are based upon the year in question and three immediately preceding years, but may be met on an aggregate basis. Treas. Regs. § 53.4942(b)-3(a). Generally, it is only available, therefore, in the fourth year of the test. See TAM 9108001. New organizations must use the aggregate method for each of the first three years of existence. Treas. Regs. § 53.4942(b)-3(b)(1). A new organization may be treated as an operating private foundation for its first year if the organization makes a good faith determination (based on an affidavit or opinion of counsel which sets forth facts) that it will meet the private operating foundation tests for its first year. Treas. Regs. § 53.4942(b)-3(b)(2).

4. *Tax On Undistributed Income:* Private operating foundations are not subject to the excise tax on undistributed income under I.R.C. § 4942.

5. *Income Tax Deduction:* Because the private operation foundation is treated as a public charity for purposes of donors' charitable contributions, the limitations on contributions to public charities apply to any such contributions.

a. Fifty Percent (50%) Limitation - Limit applicable to cash charitable contributions to public charities. Contributions in excess of 50% of Adjusted Gross Income may be carried over to the 5 succeeding taxable years.

b. Thirty Percent (30%) Limitation - Limit applicable to charitable contributions of appreciated property to public charities. Contributions in excess of 30% of Adjusted Gross Income may be carried over to the 5 succeeding taxable years.

6. *Creation of Organization*: A private operating foundation is created in the same manner as a nonoperating private foundation and is generally subject to the same reporting requirements described for nonoperating private foundations described above.

V. FORMATION OF PRIVATE FOUNDATION OR PUBLIC CHARITY

A. Trust or Corporation:

The charitable organization is established by the creation of not-for-profit entity under applicable state law (usually a trust or a corporation). The charitable organization may be created during life or through testamentary disposition. If created testamentary, the Will should allow for the executor to create the charitable organization and should state that the charitable organization is created for charitable purposes to make distributions to qualified charities. A corporation is generally the preferred entity for the charitable organization as it provides greater protection from liability for the organization's officers and directors. Their decisions in a corporation structure are evaluated on the business judgment rule as opposed to the more strict fiduciary standards applicable to trustees of trusts. On the other hand, a trust does not have to hold annual meetings, adopt Bylaws or comply with state enacted not-for-profit statutes as does a corporation. These materials focus on a corporation as the organizational entity for the foundation.

Certificate of Formation must include:

a. Federal Law Requirements:

1) Within the statement of the organization's purpose, the organization must define its charitable, educational or similar charitable purpose.
2) Statement that the earnings of the corporation shall not result in any private benefit to its members, trustees, or officers, other than for reasonable compensation for services rendered.
3) Statement that no part of the corporation's activities shall consist of attempts to influence legislation and that it shall not participate in political campaigns.
4) Statement that the corporation will comply with the requirements of I.R.C. §§ 4941 through 4945.

b. State Law Requirements (Texas):

1) Entity name and type.
2) The street address of its initial registered office and the name of its initial registered agent at such street address.
3) Management structure (i.e. The number of directors constituting the initial board of directors, (must be at least three (3)) and the names and addresses of the persons who are to serve as the initial directors unless the management of the corporation is vested in its members, in which case, a statement to such effect must be included.).
4) The purpose(s) for which the organization is organized.
5) A statement that the organization is to have no members if such is the case.
6) The name and street or post office address of each organizer, of which only one is required.
7) A statement describing the manner of distribution of the corporation's assets if the organization is to be authorized on its dissolution to distribute its assets in a manner other than as provided by State law.

8) Any other provision not inconsistent with law.

Bylaws: The organization's bylaws govern the operation of the organization. They should include provisions governing:

a. The Board of Directors, including terms, election, meetings, manner of acting and notices.
b. If the organization has members, requirements for membership, term of membership and powers of the members.
c. Officers, including election, duties and compensation.
d. Creation of committees, their duration and operation and management of committee meetings.
e. Capacity of the organization to enter into contracts.
f. Establishment of the organization's tax or fiscal year.

B. Annual or Other Periodic Filings:

1. *Net Investment Excise Tax*: The private foundation must pay an annual excise tax equal to 2% of the foundation's "net investment income." The net investment income equals gross income (interest, dividends, rents, royalties and realized capital gains), minus all ordinary and necessary expenses paid or incurred for the production or collection of such income. It includes the gain on the sale of appreciated property because the foundation receives a carry-over basis from the donor. However, if the assets are gifted upon the death of a donor, the assets receive a step-up in basis as to the date of the donor's death. The ordinary and necessary expenses paid or incurred for the production and collection of such income and which are not subject to the excise tax include: brokerage fees, investment management fees and director fees applicable to managing the investments. This excise tax is reported on the foundation's annual Form 990-PF. These excise taxes must be paid on a quarterly estimated basis. The first quarterly payment being due 4 and ½ months after the beginning of the tax year (May 15 for calendar year filers), even though the tax return is not due to be filed until 4 and ½ months after the end of the tax year. I.R.C. § 6655.

a. Penalties: Failure to pay the excise tax in a timely fashion subjects the foundation to penalties and interest applicable to other corporate filers.

b. Reduction of Excise Tax From 2% to 1%: The excise tax may be reduced from 2% to 1% provided that the foundation meets a "maintenance of effort" test. To meet such test, the foundation's total qualifying distributions that are paid out during the tax year must equal or exceed the sum of the following two calculations:

1) 5 Year Average Payout Times Current Year Assets: The foundation must calculate what its average payout percentage has been over the 5 years immediately preceding the year for which the return is being filed. If the foundation has been in existence for less than 5 years, then the calculation is based upon the number of years the foundation has been in existence. A newly organized foundation is not allowed the reduction in its first year of existence. The payout percentage is the amount of qualifying distributions for the year divided by the amount of noncharitable use assets for the year. In short, the percentage is determined by dividing the dollar value of the endowment into the amount of dollars that qualified in meeting the payout for that year. After the 5 year average payout is determined, this percentage is multiplied by the value of the net noncharitable use assets (or endowment) for the tax year for which the return is being filed, plus:

2) Tax Savings or 1% of Net Investment Income: After a final figure is calculated for the 5 year average payout described above, it must be added to 1% of the net investment income.

3) In summary, the foundation must demonstrate that its qualifying distributions paid out before the end of the tax year equal or exceed the sum of (a) the 5-year average payout times current years assets, plus (b) 1% of net investment income. If this test is met, the applicable tax is reduced to 1%.

c. Application in Estate Administration: Under Treas. Reg. § 53.4940-1(d)(2), a distribution from an estate does not retain its character for purposes of I.R.C. § 4940 when received by the distributee foundation. Thus, investment income earned by an estate will be treated as a contribution when received by the foundation beneficiary. See Rev. Rul. 80-118, 1980-1 C.B. 254, which provides that interest income on a bond not reported by an estate is taxable to the private foundation under I.R.C. § 4940.

2. *Form 990-PF, Return of Private Foundation*: Each private foundation must file an annual information return, Form 990-PF, on or before the 15th day of the fifth month following the close of the foundation's annual accounting period, which is generally May 15 if the foundation is on a calendar year. All foundations are on a calendar year reporting basis unless a fiscal year is elected. The Form 990-PF is required to be filed also with the Attorney General of any state in which the principal office of the foundation is located, the foundation was incorporated or created, or to which the foundation reports in any fashion concerning its organization, assets, or activities. The deadline for filing Form 990-PF may be extended by filing Form 2758. The foundation may be fined $10.00 per day for failing to timely file Form 990-PF up to a maximum amount of $5,000.00.

Copies of Form 990-PF for every foundation are required to be provided to the public upon request. Additionally, returns are also available though the Internal Revenue Service and at www.guidestar.org.

3. *Public Inspection of Form 990-PF*: Under I.R.C. §6104(d), a tax-exempt organization, including a private foundation, must allow public inspection at its principal office (and at certain regional or district offices) and to comply with such requests, made either in person or in writing, for copies of the organization's application for recognition of exemption and the organization's three most recent annual information returns. An "annual information return" is defined to include any return that is required to be filed under I.R.C. § 6033 (meaning Form 990-PF and Form 4720 pertaining to private foundations). The private foundation must also, unlike other tax-exempt organizations, disclose to the general public the names and addresses of contributors, consistent with I.R.C. § 6104(d)(3). The term "tax-exempt organization" includes nonexempt private foundations and nonexempt charitable trusts described in section 4947(a)(1) that are subject to the information reporting requirements of I.R.C. § 6033.

4. *Form 990-T, Exempt Organization Business Income Tax Return*: If the private foundation has $1,000 or more of unrelated business taxable income, it must file a return and pay tax on that unrelated business taxable income. The foundation may be required to pay tax quarterly using Form 990-W Estimated Tax on Unrelated Business Taxable Income. Pursuant to the Pension Protection Act of 2006, a private foundation must allow public inspection of its Form 990-T to the same extent as inspection of its Form 990-PF. (See discussion concerning Unrelated Business Taxable Income above.)

VI. Qualifying as an Institutional Public Charity

A. Churches and Conventions and Associations of Churches:

1. The term "church" is found, but not defined in the Internal Revenue Code.

2. In *Foundation for Human Understanding v. Commissioner*, the IRS set out its fourteen factor test for determining whether an organization qualifies as a church. 88 T.C. 1341 (1987). None of the fourteen factors are exclusive. Rather, the test is one utilized by the IRS (significantly, as Schedule A to Form 1023 discussed below) for determining whether an organization has the markers commonly associated with a church. Those factors include the following:

a. Distinct legal existence.
b. Recognized creed and form of worship.
c. Definite and distinct ecclesiastical government.
d. Formal code of doctrine and discipline.
e. Distinct religious history.
f. Membership not associated with another church.
g. Organization of ordained ministers.
h. Ordination after prescribed studies.
i. Literature of its own.
j. Established place of worship.
k. Regular congregations.
l. Regular worship services.
m. Sunday schools for religious instruction of the young.
n. Schools for the preparation of ministers.

3. While none of the criteria are controlling, it has become increasingly clear that the IRS as well as courts focus on the associational aspect (i.e. people joining together) as central.

a. In a 2004 Technical Advice Memorandum, the IRS noted that churches, while not being required to meet all of the criteria, ought to at least meet some minimum standard—those standards centered around this associational concept—having regular religious worship services, having a regular congregation, having an established place of worship, etc. TAM 200437040.

b. This issue has been litigated in the context of Internet and radio based ministries with courts determining that such organizations lack the requisite associational aspect. *See e.g., Foundation of Human Understanding v. United States*, 88 Fed. Cl. 203 U.S.C.T. Fed. Cl. (2009)).

4. The phrase "convention or association of churches" has not been defined in the Code or Regulations either. Rather, it is a historical phrase generally referring to groupings of churches that are congregational as opposed to hierarchical in nature. *See Lutheran Social Servs. of Minn. v. United States*, 758 F.2d 1283, 1288 (8th Cir. 1985). Associations of churches may include both churches and individuals. *See* I.R.C. § 7701(o).

5. The phrase "integrated auxiliary of a church" is defined in the Regulations. Specifically, Section 1.6033-2(h) defines integrated auxiliary of church as referring to a class of organizations related to a church or association of churches that (1) fits the definition of public charity; (2) is affiliated with a church or association of churches; and (3) receives its financial support primarily from internal church sources (with limited exceptions).

a. An organization is affiliated with a church or association of churches if its governing documents evidence such affiliation (through common doctrine, authority to appoint and remove directors, annual reporting, or other similar factors whereby the organization is akin to a subsidiary of the church or association of churches).

b. An organization is internally supported when it receives more than 50% of its support from internal church sources.

B. Educational Organizations:

1. Section 170(b)(1)(a)(ii) of the Code and Section 1.170A-9(b)(1) of the Regulations provide the definitions for the phrase "educational organization."

2. An educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at a place where its educational activities are regularly carried on.

3. The Regulations further make clear that the term "educational" relates to "(a) the instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community."

4. The Regulations go on to explain that an organization may be educational even where it is advocating a specific viewpoint so long as it gives a "full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion."

a. This phraseology has been the subject of litigation which resulted in the "full and fair exposition test" being struck down as unconstitutionally vague.

b. The IRS now commonly relies on a methodology test whereby it considers the methodology by which the proponent of the purported educational materials developed its argument in an effort to test whether there is "factual foundation for the viewpoint or position being advocated." *See* Rev. Proc. 86-43, 1986-2 C.B. 729.

C. Hospitals and Medical Research Organizations:

1. Hospitals

a. Defined in the IRC as "an organization the principle purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital . . ." *See* IRC § 170(b)(1)(A)(iii)

b. Regulations add rehabilitation institutions, outpatient clinics, and community mental health or drug treatment centers if their "principal purpose or function is the providing of hospital or medical care" *See* § 1.170A-9(c)(1)

c. To qualify as charitable (promotion of health), a hospital must demonstrate it operates for a public interest

1) Prior to 1956: relief of illness and distress; care of the poor
2) 1956-1969: charity care standard/financial ability test

3) 1969-2010: community benefit standard/facts and circumstances (still applies to healthcare entities that are not "hospitals" for purposes of Section 501(r))
   (a) Emergency room opened to all (unless no ER because community already served or specialty hospital)
   (b) Non-emergency care (open to all who can pay)
   (c) Community board (disinterested)
   (d) Open medical staff (privileges available to all qualified physicians consistent with size and nature of facility)
   (e) Surplus funds used to improve quality of care, expand facilities, advance education, research, training programs
   (f) Provide other services to meet healthcare needs of community (education)
   (g) Charity care and research
4) 2010-Current: Community benefit standard + Section 501(r) – applies to a "hospital organization" defined as (i) an organization that operates a facility required by the State to be licensed, registered, or similarly recognized as a hospital, or (ii) any other organization that the Secretary of the Treasury determines has the provision of hospital care as its principal function or purpose constituting the basis for its exemption under Section 501(c)(3)
   (a) Community Health Needs Assessment
   (b) Written financial assistance policy
   (c) Limitation on charges (restricted from charging eligible patients more than the amounts generally charges to insured patients for emergency or other medically necessary care)
   (d) Billing and collection practices limitations

2. Medical Research Organizations

a. Organization "directly engaged in the continuous active conduct of medical research in conjunction with a hospital" *See* § 1.170A-9(c)(2)(i)
b. Medical research must be principal function *See* § 1.170A-9(c)(2)(iv)
c. Must devote a substantial portion (more than 50%) of assets to, or expend a significant percentage (3.5% of FMV) of its endowment for, medical research *See* § 1.170A-9(c)(2)(v)
d. Must be in conjunction with (joint effort) a hospital

D. Certain Endowment Funds for State and Municipal Universities:

1. Must normally receive a substantial part of support (exclusive of exempt function income) from the U.S. or any state or political subdivision thereof or from contributions from general public. *See* § 1.170A-9(b)(2)

2. Use substantial support tests under § 1.170A-9(e) for determination but must tweak for differences in appropriate sources of support. *See* Rev. Rul. 82-132.

E. Governmental Entities: *See* § 170(b)(1)(A)(v)

VII. I.R.C. §509(a)(1) PUBLICLY SUPPORTED CHARITIES ("DONATIVE" PUBLIC CHARITIES)

A. Publicly Supported Charity:

Defined in I.R.C. § 509(a)(1) and § 170(b)(1)(A)(vi) is an organization that receives a substantial part of its support from the public or governmental units. It generally does not provide any services, so it is sometimes referred to as a "donative" public charity.

B. Public Support Test:

The public support test is broken into two additional "either/or" tests - mechanical test or mathematical formula and the subjective "facts and circumstances test." If the foundation fails to satisfy either test, it will be treated as a private foundation.

1. Mechanical Test: An organization is publicly supported under I.R.C § 170(b)(1)(A)(vi) if it normally receives at least 33 1/3% of its total support from governmental units, direct or indirect contributions from the general public, or a combination of these sources. Treas. Regs. § 1.170A-9(e)(2). Such organizations must thus calculate their public support by constructing a support fraction.

a. The numerator (public support) includes: i) gifts and grants from private donors (persons [up to 2% of the total gifts over the five year test period; excess cannot be counted because it is a gift by a Disqualified Person], private foundations, bequests and corporations); ii) gifts and grants from public donors (governmental agencies or certain other publicly supported charities); membership fees; tax revenues levied on behalf of the organization; and, government services or facilities given without charge.

b. The denominator (total support) includes: i) gifts and grants from private donors (persons, private foundations, bequests and corporations); ii) gifts and grants from public donors (governmental agencies or certain other publicly supported charities); membership fees; tax revenues levied on behalf of the organization; government services or facilities given without charge; gross investment income; and net unrelated business income.

c. Excluded from support fraction: i) gross receipts income, ii) unusual grants, iii) voluntary services, and, iv) capital gains.

2. Facts and Circumstances Test: Even if the organization does not meet the 33 1/3% test, the organization may, nonetheless, be considered publicly supported if it normally receives a substantial part, which the regulations state is 10% or more, of its support from governmental units, the general public or a combination of these sources and if it meets other factors tending to show that it is organized and operated to attract public and governmental support on a continuing basis. Treas. Regs. § 1.170A-9(e)(3)(i).

a. Under this "facts and circumstances" test, the charity must maintain a continuous and bona fide program for soliciting funds from the general public or conduct activities so as to attract support from governmental units or other publicly oriented organizations described in I.R.C. § 170(b)(1)(A)(i) through (vi) Treas. Regs. § 1.170A-9(e)(3)(ii).

b. The Treasury Regulations state that in determining whether a continuous and bona fide solicitation program is maintained, the Service will look to three factors. The first is whether the scope of the organization's fundraising activities is reasonable in light of its charitable activities. The second is that a new organization may rely on limited sources or amounts of support until it can expand its solicitation program or activities. The third is that the facts and circumstances of each case will be analyzed in accordance with the organization's nature and purpose. Treas. Regs. § 1.170A-9(e)(3)(ii).

c. For example, a high support percentage of investment income from endowment funds will normally be treated as an adverse factor, especially if such funds were originally contributed by a few individuals or members of their families. On the other hand, if such endowments were originally contributed by a governmental unit or by the general public,

this would be favorable to a conclusion that the organization is publicly supported. Treas. Regs. § 1.170A-9(e)(3)(iii).

3. An organization that does not normally receive at least 10% of its support from a governmental entity or the public will not qualify as a public charity under either the facts and circumstances test or the 33 1/3% test. Treas. Regs. § 1.170A-9(e)(3)(i).

4. Under the 10% facts and circumstances test, the greater the organization's governmental or public support is in excess of 10% of total support normally received, the lesser is its burden of establishing its publicly supported nature through other factors, and vice versa. Treas. Regs. § 1.170A-9(e)(3)(iii).

5. Such other factors include the following:

a. If an organization's public support is derived from a representative number of persons rather than from members of a single family, this factor indicates a publicly supported nature. This factor is less important when dealing with a new organization or an organization whose activities can be expected to limit its appeal to a particular segment of the public. Treas. Regs. § 1.170A-9(e)(3)(iv).

b. If an organization's governing body represents the broad interests of the public rather than the private interests of a limited number of donors, this factor indicates a publicly supported nature. In general, the broad interests of the public will be served by a governing body comprised of public officials or their representatives, persons with expertise in the organization's field of operation, community leaders or persons elected by a broadly based membership. Treas. Regs. § 1. 170A9(e)(3)(v).

c. If an organization provides a facility or service directly for the benefit of the general public on a continuing basis, this factor indicates a publicly supported nature. Such organizations include museums and libraries whose facilities are open to the public, symphony orchestras and senior citizens' homes providing housing or nursing services for the general public. Treas. Regs. § 1.170A-9(e)(3)(vi)(a).

d. Other factors useful in considering whether membership organizations have the requisite publicly supported nature include the following:

(1) whether solicitations for dues-paying members is designed to enroll a substantial number of persons in the community area or in a particular profession or field of interest;
(2) whether membership dues for individual members have been fixed at rates designed to make membership available to a broad cross section of the interested public; and,
(3) whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies or civic affairs in the case of parent-teacher associations. Treas. Regs. § 1.170A-9(e)(3)(vii).

VIII. I.R.C. §509(a)(2) PUBLICLY SUPPORTED CHARITIES (“GROSS RECEIPTS” OR “SERVICE PROVIDER” PUBLIC CHARITIES):

A. Defined:

A “gross receipts” or “service provider” publicly supported charity is defined in I.R.C. §509(a)(2). If an organization meets the support tests described in I.R.C. §509(a)(2), it will be treated as a public charity

and will not be subject to the private foundation restrictions. Fundraising activities should solicit a broad range of public support.

B. Support Tests:

There are two public "support" tests that must be applied in determining whether the organization meets the requirements of an I.R.C. §509(a)(2) public charity, the "more than 1/3 support test," and the "not more than 1/3 support test." The organization must normally receive more than 1/3 of its total annual support from the public, and not more than 1/3 of its total annual support from gross investment income and excess unrelated business taxable income.

1. *The "More than 1/3" Support Test:*
The organization must "normally" receive more than one-third (1/3) of its support from gifts, grants, contributions, membership fees, or gross receipts from the public.

a. Total support (denominator), includes contributions, memberships, and grants, gross receipts, UBTI, and gross investment income as defined in §509(e). Capital Gains and the value of exemption from federal, state or local taxes are excluded from total support. Support is determined on the cash receipts/disbursements method of accounting, which may be used to spread contributions from Disqualified Persons over a period of years.

b. Public support (numerator) includes amounts received from governmental units, amounts received from persons other than Disqualified Persons (as defined in I.R.C. §4946(a)), and amounts received from I.R.C. §509(a)(1) organizations, (most I.R.C. §170(b)(1)(A) charitable organizations).

c. Contributions, grants, gifts and memberships are distinguished from gross receipts because of different limitations. Receipts from Disqualified Persons as defined in §4946(a) are not counted at all in determining public support. Disqualified Persons include Substantial Contributors (any person who has contributed more than $5,000 to the organization, if this amount is more than 2% of all the contributions and bequests received by the organization since its creation as of the close of the taxable year of the contribution), directors/trustees, officers, entities controlled by Disqualified Persons or by family members of Disqualified Persons, and family members of Disqualified Persons.

d. Gross receipts are receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business. Gross receipts are subject to different limitations than contributions. Receipts from Disqualified Persons are not counted as Public Support, but are counted as Total Support. Gross receipts are counted as Public Support only to the extent that the total amount received from each person or governmental unit during the taxable year does not exceed $5,000 or 1% of total support for the year. Unrelated business taxable income is not included in gross receipts for purposes of determining public support.

2. *The "Not More Than 1/3 of Support" Test:*

a. No more than 1/3 of the organization's total support can come from the sum of gross investment income plus the excess of unrelated business taxable income over the amount of tax imposed on such unrelated business taxable income.

b. Gross Investment Income is defined as the gross amount of income from interest, dividends, payments with respect to securities loans, rents and royalties, but not including any such income to the extent included in computing the tax imposed by I.R.C. §511.

c. Unrelated Business Taxable Income (UBTI) does not include income from the sale of merchandise, substantially all of which has been received by the organization as gifts or contributions, or the mere acknowledgement of contributions or sponsorship in fundraising activities. Valuable advertising, marketing, and similar services on a quid pro quo basis for the sponsor will raise issues of UBTI.

C. Determination of "Normally":

1. The determination of whether the organization has "normally" met these two support tests is determined on the basis of a five year moving average (the year in question and the previous four years). The sum of public support for the five-year period must total more than 1/3 of the organization's aggregate total support for the five-year period, and gross investment income and excess unrelated business taxable income for the five-year period must not exceed 1/3 of the organization's total support. If the organization meets the five-year test, it is considered to qualify for the year in question and the following year. If there is a material change in the organization's support during the two year period (other than unusual grants), compliance with the two support tests is determined on the basis of the year of the material change and the four preceding taxable years.

2. An unusual grant is one which is: (1) received from disinterested parties; (2) attracted by reason of the publicly supported nature of the organization; (3) is unusual and unexpected in amount; and (4) by reason of its size, would adversely affect the status of the organization under the 1/3 public support test. Grants paid over a number of years may be excluded in their entirety if they qualify as unusual grants. If the grant does not meet the above stated criteria, then a "facts and circumstances" test is applied. Treas. Regs. §1.509(a)-3(c)(4). The IRS will also consider, if the grant or contribution is to underwrite operating expenses, rather than capital expenditures, whether the terms and amount of the grant or contribution are expressly limited to no more than one year's operating expenses. Rev. Proc. 81-7, 1981-1 C.B. 621.

3. Effect of Ruling on Grantors and Contributors

a. If there are material changes in an organization's support, the organization's status remains unchanged as to innocent grantors and contributors until the IRS gives public notice that the organization no longer qualifies under §509(a)(2). (This protection does not apply to any grantor or contributor who was responsible for, or aware of, the material change in support or who knows the IRS has notified the organization that it no longer qualifies under §509, even though notice has not been formally published.)

b. Grantor can rely on a written statement from the organization (signed by a responsible officer and including information from the test period sufficient to indicate that the contribution will not disqualify the organization

D. Revocation of §509(a)(2) Status:

If an organization's public charity status under §509(a)(2) is revoked, the organization becomes a private foundation. The organization then has one year from the date of receipt of such ruling or determination letter, or the final ruling or determination letter if a protest is filed to an earlier one, to meet the requirements of §508(e). The regulations state that §508(d)(2)(A), which disallows deductions for

contributions to a private foundation in a taxable year for which it does not meet the §508(e) requirements, will not apply to gifts or bequests made during that one-year period if the requirements are met by the end of the one year period.

IX. SUPPORTING ORGANIZATIONS

Although a less commonly used estate planning organization because of lack of familiarity (as opposed to the private foundation) and because of the lack of control, the supporting organization is more commonly used in close association with public charities for purposes of the support of the organization (or often created by the charitable organization which they are organized to support) and may be a useful if the donor desires to benefit a few specifically named charities and influence the actions of the organization without violating any rules against controlling the organization. Here, the donor may have a specific project envisioned at a particular charity or may be actively involved in a charity or charities so much that he or she desires to create an organization to support those charities in the future. It is important, therefore, to weigh the donor's desire for continuing control with his or her need to surrender to control of the supported organization. If he or she is comfortable with giving up actual control in exchange for having a limited or even significant voice in the organization, then the supporting organization may be a planning option for the donor and will result in avoiding the private foundation restrictions discussed above. The organizational documentation is no different from a private foundation (discussed above); however, the difference is in the organizational structure and its governance and is reflected by the tax status created and approved through the filing of Form 1023 (discussed below).

A. Defined:

A supporting organization is an organization exempt under I.R.C. § 501(c)(3) and § 509(a)(3) which supports one or more public charities qualifying under I.R.C. § 509(a)(1) or (2). It may also, under certain circumstances, support a social welfare league, civic league, labor or agricultural organization, real estate board, or business league that is exempt under I.R.C. § 501(c)(4), (5) or (6) [(4) describing civic leagues, social welfare organizations and local associations of employees, (5) describing labor, agricultural or horticultural organizations and (6) describing business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues]. It is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the exempt purposes of one or more public charities.

B. "Support" Tests:

Supporting organizations are not required to meet the public "support" tests that some I.R.C. § 509(a)(1) and all I.R.C. § 509(a)(2) organizations must satisfy to establish the public support necessary to exempt them from the private foundation rules. As long as a supporting organization is organized and operated exclusively to support one or more public charities it does not matter whether the organization's funding is from one or from multiple sources.

C. Tax Treatment by Donors of Contributions:

Because of its affiliation with public charities it supports, a gift to the supporting organization may be provided favorable income tax deduction treatment. To obtain this favorable treatment, it is important to name the supported organization(s) in the organizational documents (even if not required) in order to assure favorable tax treatment and recognition of the entity as a supporting organization.

1. *Gifts of Cash or Non-Appreciated Property:* Deduction is limited to an amount equal to fifty percent (50%) of the donor's adjusted gross income in the taxable year of the gift on gifts of cash or other non-appreciated property. Excess can be carried forward for the next five years.

2. *Gifts of Appreciated Property:* Deduction is limited to thirty percent (30%) of donor's adjusted gross income in the taxable year of the gift on gifts of appreciated property. Any excess can be carried forward for the next five years.

D. Organizational Test:

The supporting organization, like the private foundation, may be established by a trust or as a corporation. The governing instruments of the supporting organization must:

1. State that the purposes of the organization are limited to the purposes of one or more benefited public charities;
2. Not expressly empower the supporting organization to engage in activities that do not further the charitable purposes of the benefited public charity or charities;
3. Designate by class or purpose or by name, the public charities to be benefited; and,
4. Not authorize the supporting organization to benefit any other public or private charity or charities.

E. Operational Test:

The supporting organization must be "operated exclusively" for the support of the supported organizations, including the making of payments to or for the use of, or providing services or facilities for individual members of the charitable class benefited by the specified publicly supported organizations (sometimes referred to as the "permissible beneficiary" requirement). Additionally, the supporting organization must either pay over its income to the supported organization or use its income to carry on an independent activity or program which supports or benefits the supported organization (sometimes referred to as the "permissible activities" requirement). All types of supporting organizations are prohibited from making any payments or loans (including reasonable compensation for services) to any individual who is a substantial contributor or is a family member of a substantial contributor or to any company in which a substantial contributor or family member owns 35 percent or more of the controlling interest.

F. Must Not Be Controlled By Disqualified Persons:

A supporting organization must not be controlled directly or indirectly by one or more disqualified persons (as defined in I.R.C. § 4946) other than foundation managers and other than one or more organizations described in I.R.C. § 509(a)(1) or (2). An organization will be considered "controlled" if the disqualified person(s), by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This control is demonstrated if the voting power of such disqualified persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. (There is a narrow exception to this rule, in situations such as a religious organization operated in connection with a church, where the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization. If a representative of the church, such as a bishop or other official has control over the policies and decisions of the organization, the disqualified persons on the governing body will not disqualify the organization under 509(a)(3)(C). Treas. Reg. §1.509(a)-4(j)(2)).

However, all pertinent facts and circumstances including the nature, diversity and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization. For example, if the governing body of the supporting organization is composed of seven (7) directors, none of whom has a veto power over the actions of the supporting organization and no more than three directors are at any time disqualified persons, such

foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all of the facts and circumstances will be examined to determine if a disqualified person (or persons) has indirect control over the organization. Where persons on the governing body have a relationship with a disqualified person such that the disqualified person could exert control over such persons (e.g. an employer-employee relationship), the disqualified person may be deemed to possess indirect control of the organization.

G. Three Subclasses of Supporting Organizations:

At least one of the following relationships must be present in order to qualify as a supporting organization:

1. *"Operated, supervised, or controlled by" one or more publicly supported organizations (parent-subsidiary relationship) [Type I organization]:*

a. Includes a substantial degree of direction by the publicly supported organization(s) over the conduct of the supporting organization.

b. Existence established by majority of officers, directors or trustees of the supporting organization being appointed or elected by the governing body, members of the governing body, officers or membership of one or more of the supported organizations. (If multiple charitable organizations are being supported, then it is not necessary that each supported organization has a voice in management of the supporting organization.)

c. Purposes Requirement: The purposes of the supporting organization as set forth in the governing instrument may be similar to, but no broader than, the purposes set forth in the governing instrument of the controlling publicly supported organizations.

d. Specified Organization Requirement: May specify the publicly supported organizations in one of three ways: 1) designate by name in the governing instruments; 2) designate by class or by purpose in governing instruments; and 3) remain silent in the governing instruments if two conditions met: i) there exists a historic and continuing relationship between the supporting organization and the supported organization; and ii) by virtue of such relationship, there has developed a substantial identity of interest between the organizations.

2. *"Supervised or controlled in connection with" one or more publicly supported organizations (brother-sister relationship) [Type II organization]:*

a. Must exist common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations, such that the supporting organization will be responsive to the needs and requirements of the supported organization. To meet this requirement, the control or management of the supporting organization must be vested in the same persons that manage the supported organization.

b. The mere making of payments to the publicly supported organizations, even if such payment is enforceable by state law, does not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervision or control in connection with such organization.

c. Other Requirements: The organizational test may be satisfied for a Type II organization in the same manner as Type I "operated, supervised or controlled by" supporting organization.

3. *"Operated in connection with" one or more publicly supported organizations [Type III organization]:*

The third sub-class of supporting organization is one that is "operated in connection with" one or more publicly supported organizations.

a. Type III supporting organizations are the most independent form of the supporting organizations, as they may have an independent Board, with specified beneficiary organizations. Because of this, a Type III supporting organization has two additional tests to meet: the responsiveness test and integral part test.

b. Responsiveness Test: A Type III supporting organization satisfies the Responsiveness Test if it is responsive to the needs and demands of the supported organization. The supported organization must have a "significant voice" in the Type III supporting organization's investment policies, operations and grant-making activities. Treas. Reg. § 1.509(a)-4(i)(3).

i. The supported organization can have the required significant voice in one of the three following ways:
    1. If one or more officers or directors of the supporting organization are appointed or elected by the supported organization's officers, directors, trustees or members;
    2. If one or more members of the supporting organization's governing body are also officers, directors or trustees of, or hold other important offices in, the supported organization; or,
    3. The supporting organization's officers, directors or trustees maintain a close and continuous working relationship with the supported organization's officers, directors or trustees.

ii. Whether a supported organization has this significant voice in directing the use of the supporting organization's income or assets, and whether it has a close and continuous relationship with the supporting organization, will be determined based on all relevant facts and circumstances.
    1. The IRS and Treasury Department have concluded that the term "significant voice" requires only that the officers, directors or trustees of the supported organization have the *ability to influence* the supporting organization's decisions on the use of its income or assets, not that they have complete control over those decisions.

iii. Prior to the final regulations effective December 28, 2012, charitable trusts were able to meet this requirement under an alternative responsiveness test pursuant to Treas. Reg. § 1.509(a)-4(i)(2)(iii); however, this alternative test has been removed by the 2012 regulations.
    1. Trustees must actually have a close, continuous working relationship with the directors, trustees or officers of the supported organization, just like any other Type III supporting organization.

c. Integral Part Test: The Type III supporting organization must meet one of the two alternate prongs of the Integral Part Test, which further classifies the supporting organization as either "Functionally Integrated" or "Non-Functionally Integrated."

i. Functionally Integrated: A functionally integrated Type III supporting organization actually conducts direct programs, rather than merely holding investment assets to produce income to then fund operations conducted by the supported organization. To be a functionally integrated organization, it must meet one of the following criteria:

1. Engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations. This means the activities directly further the supported organization(s)'s exempt purposes, by either performing the functions or carrying out the purposes of such supported organization(s), and but for the involvement of the supporting organization, those activities would usually be done by the supported organization(s). Treas. Reg. § 1.509(a)-4(i)(4)(ii).
    a. To be considered direct furtherance activities, a supporting organization's grants, scholarships or other payments to individual beneficiaries must satisfy three prongs: (1) the individual beneficiaries must be members of the charitable class benefitted by a supported organization; (2) the officers, directors or trustees of that supported organization must have a significant voice in the timing of the payments, the manner of making them and the selection of recipients; and (3) the individual beneficiaries must be selected on an objective and non-discriminatory basis. Examples provided in the regulations include operating a food pantry and maintaining local parks on behalf of the supported organization.
    b. Fundraising, making grants and investing and managing non-exempt-use assets are not considered to be activities bringing the organization within this provision, but holding title to and managing exempt-use assets are considered to be such activities.
2. The supporting organization is the parent of each of its supported organizations.
    a. A supporting organization is considered the parent of its supported organization if it 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 (directly or indirectly) by the governing body, members of the governing body or officers of the supporting organization. Treas. Reg. § 1.509(a)-4(i)(4)(iii).
    b. The IRS and Treasury Department intend to issue proposed regulations in the near future to provide a new definition of "parent," to specifically address the power to remove and replace officers, directors or trustees of the supported organization.
3. Supports a governmental supported organization.
    a. This option is not currently explained further under the regulations.
    b. The Treasury Department and IRS intend to issue proposed regulations which will provide further guidance on how supporting organizations can qualify by supporting a governmental entity.

ii. Non-Functionally Integrated: The second way to meet the Integral Part Test is to meet the requirements of being a "non-functionally integrated" supporting organization ("NFI"), determined by the amount of support provided to the supported organization(s).
    1. Distribution Requirement
        a. Each taxable year, to qualify as an NFI, the organization must distribute to, or for the use of, one or more supported organizations an amount equal to the greater of 85% of adjusted

net income (based on the principles of § 4942) or the supporting organization's minimum asset amount for the prior taxable year (essentially, 3.5% of the fair market value of the organization's non-exempt use assets, described in further detail below).

i. Because this distributable amount is significantly different from that described in the 2009 proposed regulations, the Treasury Department and IRS have issued the provisions regarding the *distributable amount* (below) as temporary and proposed regulations, to provide an opportunity for comment.

ii. The distributable amount for the first taxable year an organization is treated as an NFI is zero; however, for determining whether an excess amount is created, the distributable amount for the first year is considered equivalent to the amount that would otherwise apply. If an excess amount is created, it can be used to reduce the distributable amount in a following year, for a period of up to five years. An excess is created if the total distributions made in that year which count toward the distribution requirement exceed the distributable amount for that taxable year. The distributable amount is reduced by any excess amounts carried over from prior years first (the oldest excess amounts are applied first), and then by any distributions made in that taxable year.

b. The minimum asset amount is the average of the fair market value of the organization's non-exempt use assets, less the average acquisition indebtedness related to those assets, multiplied by 3.5%.

i. This number is then added to the recoveries of any amounts taken in a prior year to meet the distribution requirement,

ii. Plus amounts received from the sale or disposition of property (to the extent the acquisition of that property was taken into account to meet the distribution requirement),

iii. Plus any set-aside that was not ultimately deemed necessary for that purpose for which it was set-aside, and was taken into account to meet the distribution requirement.

c. In valuing the organization's assets, the same rules for valuing assets of a private foundation apply (i.e. § 4942). "Exempt-use" assets include those assets used or held for use in carrying out the exempt purposes of either the supporting organization or its supported organization (if made available to the supported organization for no or nominal cost).

d. Distributions which count toward the distribution requirement include:

i. Amounts paid to a supported organization to accomplish its exempt purposes;

ii. An amount paid to perform an activity that furthers the exempt purpose of the supported organization, but only

to the extent it exceeds any income derived by the supporting organization from the activity;

iii. Reasonable and necessary administrative expenses paid to accomplish the supported organization's exempt purposes (not including expenses incurred in producing investment income);

iv. Amounts paid to acquire an exempt-use asset that would be excluded from the payout requirement calculations; and

v. Amounts set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive follow the set-aside rules for private foundations (not including the cash distributions set-aside).

e. An NFI Type III supporting organization which fails to meet the distribution requirement will be treated as a private foundation for that taxable year, unless it can prove reasonable cause for the failure, and meets the distribution requirement within 180 days of the time it discovers the deficiency or becomes able to distribute following unforeseen events. Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F). Reasonable cause is shown if the failure was due solely to unforeseen events or circumstances that were beyond the organization's control, a clerical error, or an incorrect valuation of assets, and not due to willful neglect.

2. Attentiveness Test: The NFI's support must be sufficient to assure that the supported organization will be attentive to its operations. The NFI must distribute at least 1/3 of its distributable amount to one or more supported organizations that are "attentive" to the operations of the supporting organization and to which the supporting organization is "responsive" (as defined in the Responsiveness Test, above). Treas. Reg. § 1.509(a)-4(i)(5)(iii). In determining whether a supported organization will be considered attentive to the operations of a supporting organization, any amount received from the supporting organization that is held by the supported organization in a donor advised fund is disregarded.

   A supported organization is considered attentive to the operations of the supporting organization during a taxable year if, in the taxable year, at least one of the following requirements is satisfied:

   a. The supporting organization distributes to the supported organization an amount equal to at least 10% of the supported organization's total support received during the last taxable year ending before the beginning of the supporting organization's taxable year; or

   b. The amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular (substantial but not primary) function or activity of the supported organization. The program or activity does not have to be the supported organization's primary activity, so long as it is a substantial one. Support is considered "necessary" if the supporting organization or the supported

organization earmarks the support for that particular program or activity of the supported organization; or

c. Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supporting organization and its supported organization(s) and the purpose to which the funds are used, the amount of support received from the supporting organization is a sufficient part of a supported organization's total support to ensure attentiveness. 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. However, in determining whether the amount received from the supporting organization is sufficient to ensure the attentiveness of the supported organization to the operations of the supporting organization (including attentiveness to the nature and yield of the supporting organization's investments), evidence of actual attentiveness by the supported organization is of almost equal importance. A supported organization is not considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

3. Alternate Test: An NFI Type III supporting organization formed as a trust on or before November 20, 1970 does not have to satisfy the integral part requirements described above (i.e. the Distribution Requirement and Attentiveness Test), if it satisfies the following:
    a. For taxable years beginning October 16, 1972, the trustee of the trust makes annual written reports to all of the trust's supported organizations, setting forth a description of the trust's assets, including a detailed list of the assets and income derived therefrom;
    b. All of the unexpired interests in the trust are devoted to charitable purposes and a deduction (under appropriate Code sections) was allowed regarding such interests;
    c. The trust has not received any grants, contributions, bequests or other transfers since November 20, 1970;
    d. The trust is required by its governing instrument to distribute all of its net income to a designated beneficiary supported organization. (If there is more than one beneficiary, all of the net income must be distributable in fixed amounts to each beneficiary);
    e. The trustee does not have discretion to vary the beneficiary supported organizations or the amounts payable to them. The ability to cease making payments to a particular supported organization in the event of certain occurrences such as the supported organization's loss of exemption or failure to operate for charitable purposes is not treated as impermissible discretion; and
    f. None of the trustees would be disqualified persons within the meaning of § 4946(a) with respect to the trust if it were a private foundation (not including foundation managers in the definition of disqualified persons).

d. Additional Requirements for Type III Supporting Organizations

i. Foreign Supported Organizations: Type III supporting organizations may not support a supported organization which is organized outside of the United States. Treas. Reg. § 1.509(a)-4(i)(10).

ii. Notification Requirement: All Type III supporting organizations must satisfy the notification requirement for taxable years including December 28, 2012 and following, based on the new final regulations. Treas. Reg. § 1.509(a)-4(i)(2). This requires the supporting organization to provide annual notice to each supported organization(s) including information to help ensure the supporting organization is responsive to the supported organization's needs.

1. The information must meet the following requirements:
    a. Written notice addressed to a principal officer of the supported organization, with the amount and type of support it provided to the supported organization during the immediately preceding taxable year of the supporting organization, and during any other taxable year of the supporting organization ending after December 28, 2012, for which support information has not previously been provided;
    b. A copy of the supporting organization's Form 990 or other annual information return most recently filed as of the date the notification is given, and any other return for other taxable years ending after December 28, 2012 and which has not been previously provided to the supported organization; and
    c. A copy of the supporting organization's governing documents as in effect on the date the notification is provided, including its articles of organization and bylaws (if any) and any amendments to such documents, unless such documents have been previously provided and not subsequently amended.
2. The notification may be provided electronically, and must be postmarked or electronically transmitted by the last day of the fifth calendar month following the close of that taxable year.

e. Transition Rules: The December, 2012 regulations provide for special transition rules for meeting the notification requirements and the Integral Part Test for (both functionally integrated and non-functionally integrated) Type III supporting organizations. Type III supporting organizations will be treated as having satisfied the notification requirement or its taxable year that includes December 28, 2012, if the required notification is postmarked or electronically transmitted by the later of the last day of the fifth calendar month following the close of that taxable year or the due date (including extensions) of the supporting organization's annual information return (Form 990) for that taxable year. Treas. Reg. § 1.509(a)-4(i)(11). A Type III supporting organization qualifying as functionally integrated that has met and continues to meet the requirements in effect before December 28, 2012 will continue to be treated as meeting the Integral Part Test until the first day of its second taxable year following December 28, 2012. Both Type III functionally integrated and non-functionally integrated supporting organizations must meet the new regulation requirements effective the first day of its second taxable year beginning after December 28, 2012, if they wish to continue such classification.

H. Termination of Supporting Organization:

No particular requirements are to be met by a supporting organization which terminates its existence. It must, however, inform the Internal Revenue Service of its termination in accordance with I.R.C. § 6043 (b). Distribution of the organization's assets must be in accordance with its organizational documents to a qualified charitable organization.

I. Application for Recognition of Exempt Status:

Organizations seeking to qualify as supporting organizations are required to prepare and file Form 1023, Application for Recognition of Exemption. (See discussion below for the requirements of a completed Form 1023 and the time requirements for filing.) If the supporting organization is a Type I organization, check the box on Part X, line d. No Advance Ruling Period: No advance ruling period is available to the supporting organization in contrast to the advance ruling period available to public charities.

J. Reporting Requirements:

1. Form 990, Return of Organization Exempt from Income Tax. (Churches, integrated auxiliaries of churches and conventions or associations of churches are not required to file Form 990.)
2. Form SS-4, Application for Employer Identification Number.
3. Form 990-T, Exempt Organization Business Income Tax Return.
4. Form 990-W, Estimated Tax on Unrelated Business Taxable Income for Tax Exempt Organizations, if applicable.
5. Form 2758, Application for Extension of Time to File Certain Excise, Income, Information and Other Returns.
6. Form 4720, Return of Certain Excise Taxes on Charities and Other Persons Under Chapters 41 and 42 of the Internal Revenue Code; and
7. Form 8282, Donee Information Return.

X. COMMUNITY FOUNDATIONS/DONOR ADVISED FUNDS:

A. Definition:

There is no clear definition under federal or state law as to what constitutes a "community foundation" or a "community trust," although the Internal Revenue Code makes several references to a "community chest, fund or foundation." The law governing community foundations is found in the Treasury Regulations. The regulations refer to community foundations as community trusts and state that "Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body." Treas. Reg. § 1.170A-9(e)(10). Community foundations convey the concept of capital or endowment funds to support charitable activities in the communities or areas they serve. Treas. Reg. § 1.170A-(e)(11)(iii).

B. Legal Structure:

1. *State Law*:

Community foundations can operate in a variety of legal forms. Some operate in trust form with single or multiple banks as trustees; some operate as multiple trusts with an incorporated distribution committee; some operate as a single corporation with no trusts; and some operate as a combination of trusts and corporation. The Treasury Regulations recognize this diversity and permit a community foundation to operate in the form of a trust, not-for-profit corporation, unincorporated association or a combination thereof. Treas. Reg. § 1.170A-9(e)(11)(i).

2. *Federal Law*:

The organizational documents of the community foundation must qualify it to be treated as a tax-exempt charitable organization under I.R.C. § 501(c)(3). Therefore, the organizational documents, whatever form they take, must provide that the community foundation is organized exclusively for

charitable purposes and that its assets will be distributed to other tax-exempt charitable organizations upon dissolution.

D. Tax Requirements:

In General:

In order for multiple trusts, not-for-profit corporations or unincorporated associations to be treated as a single entity for tax purposes rather than separate organizations, the community foundation must comply with the single-entity requirements that are outlined in Treas. Regs. §§1.170A-9(e)(11)(i) and 1.170A-9(e)(11)(iii) through (vi).

1. *Must be Commonly Known as a "Community Foundation," "Community Trust" or "Community Fund":*

   The organization must be commonly known as a community trust, fund, foundation or other similar name conveying the concept of a capital or endowment fund to support charitable activities (within the meaning of I.R.C. § 170(c)(1) or (2)(B)) in the community or area it serves. Treas. Regs. § 1.170A-9(e)(11)(iii).

2. *Common Instrument*:

   All funds of the organization must be subject to a common governing instrument or a master trust or agency agreement which may be embodied in a single document or several documents containing common language. Treas. Regs. § 1.170A-9(e)(11)(iv). If the donor recites language in his or her gift instrument transferring assets to the community trust making a fund subject to the community trust's governing instrument or master trust or agency agreement then the common governing instrument requirement will have been met even if the fund could be considered a separate entity. Id.

3. *Common Governing Body*:

   The community foundation must have a common governing body or distribution committee which either directs or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all of the funds exclusively for charitable purposes (within the meaning of I.R.C. §§ 170(c) (1) or (2)(B)). If the community foundation consists of multiple trusts whose grants are determined by a distribution committee of the community foundation, then that committee will be considered the governing body rather than the trustees of the various trusts.

4. *Required Governing Body Powers*:

   Pursuant to Treasury Regulations § 1. 170A-9(e)(11)(v)(E), the governing body must have, and must commit itself toward exercising, the powers listed below. The regulations provide that there must appear in either the governing instrument, the instrument of transfer, the resolutions or Bylaws of the governing body, a written agreement, or some other document that grants these powers to the governing body. Treas. Regs. § 1.170A-9(e)(11)(v)(B). The required powers are:

   a. To modify any restriction or condition on the distribution of funds for any specified charitable purpose or to any specified organization if in the sole judgment of the governing body such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served. The governing body must be able to modify the restrictions without obtaining the approval of any participating trustee, custodian or agent of the community foundation; provided however, the donor is able to require the community foundation to obtain the donor's consent. Treas. Reg. § 1.170A-9(e)(11)(v)(B)(1). This requirement is commonly referred to as the "variance power" and has historically been essential to community

foundations. The variance power enables the governing body to exercise "cy pres" without having to first obtain court approval.

b. To replace any participating trustee, custodian or agent for breach of fiduciary duty under state law. Treas. Reg. § 1.170A-9(e)(11)(v)(B)(2).

c. To replace any participating trustee, custodian, or agent for failure to produce a reasonable (as determined by the governing body) return of net income (within the meaning of Treas. Reg. § 1.170A-9(e)(11)(v)(F)) over a reasonable period of time (as determined by the governing body). Treas. Reg. § 1.170A-9(e)(11)(v)(B)(3).

5. *Reasonable Return on Investments*:
The governing body must commit itself (i) to obtain information and (ii) take other appropriate steps to ensure that each participating trustee, custodian, or agent administers the trust or fund in accordance with the terms of its governing instrument and accepted standards of fiduciary conduct to produce a reasonable return of net income (or appreciation where not inconsistent with the community trust's need for current income), with due regard to safety of principal. Although the measurement of performance is on an aggregate basis for most component funds, it is on a fund-by-fund basis for designated funds. In the case of a low return of net income (and, where appropriate, appreciation), the Internal Revenue Service will examine carefully whether the governing body has, in fact, committed itself to take the appropriate steps to remedy the low investment return. Assets held for the active conduct of the community foundation's exempt activities are not subject to this standard. Treas. Reg. § 1.170A-9(e)(11)(v)(F).

6. *Financial Report Required*:
The community foundation must prepare periodic financial reports that treat all of the funds which are held by it, either directly or in component parts, as funds of the organization. Treas. Reg. § 1.170A-9(e)(11)(iv).

7. *Transitional Rules for Community Foundations in Existence Before November 11, 1976*:
The Treasury Regulations contain transitional rules for certain community foundations that were in existence before 1976. These rules qualified them to be treated as publicly supported organizations under special rules until 1982, and to then qualify under the general rules. Treas. Regs. §§ 1.170A-9(e)(12) and 1.170A-9(e)(13).

D. Tax Status – Public Charity or Private Foundation:

A community foundation and private foundation perform similar grant making and philanthropic functions. However, if a community foundation satisfies the "public support test" by attracting contributions from a diverse group of donors, it will be classified as a public charity and thereby has significant advantages over a private foundation. See I.R.C. § 170(b)(1)(A)(vi) and Section VI of this outline for discussion of support test.

E. Component Funds:

1. *Requirements*: There are three requirements for a fund to be treated as a component fund of a community foundation (enabling gifts to it to be treated as gifts to a public charity) rather than as a separate trust, nonprofit corporation or association (requiring an independent determination):

a. If the fund is a separate legal entity (such as a trust), then the community foundation must meet the single entity requirements. Treas. Reg. § 170A-9(e)(11)(ii)(A).

b. If the fund is a separate legal entity, it must subject itself to the common governing instrument of the community foundation. Treas. Reg. § 1.170A-9(e)(11)(iv).

c. The fund may not be directly or indirectly subjected by the donor to any material restriction or condition with respect to the transferred assets. Treas. Reg. § 1. 170A-9(e)(I 1)(ii)(B). Unrestricted Funds are generally set up in the donor's name, but the community foundation is given discretion in determining how to apply the funds.

2. *Definition of Material Restrictions*:

a. A material restriction is a restriction or condition that prevents a community foundation from "freely and effectively employing the transferred assets, or the income derived there from, in furtherance of its exempt purposes." Treas. Reg. §§ 1. 170A-9(e)(1)(ii)(B) and 1.5072(a)(8).

b. A donor's restrictions, if any, usually appear in the instrument of transfer that accompanies the gift to the community foundation governing the terms of the gift. If a material restriction in the instrument of transfer to the community foundation is not imposed, then the contribution is made to a component fund of the community foundation. The donor can then claim a tax deduction for a contribution to a public charity and the community foundation can use the contribution to satisfy the public support test. Treas. Reg. § 1. 170A-9(e)(1)(ii).

c. If a material restriction is imposed, then the contribution is to a "noncomponent fund", i.e. a separate trust, not-for-profit corporation or association that is generally treated as a separate private foundation. Treas. Reg. § 1.170A-9(e)(14)(1).

3. *Non-Material Restrictions*:

a. The Treasury Regulations list several donor-imposed restrictions that are not material restrictions. Donor imposed restrictions that are not material restrictions include the designated fund, field of interest fund and donor advised fund.

1) Designated Funds: The instrument of transfer may designate that the income or assets are to be used for one or more particular public charities described in I.R.C. §§ 509(a)(1), (2), or (3).

2) Field of Interest Funds: The instrument of transfer may instruct the community foundation to limit the use of a fund's income and assets to a specific charitable purpose or purposes (such as art, youth services, etc.). See Treas. Reg. § 1.5072(a)(8)(iii)(B).

3) Donor Advised Funds: Pursuant to the Pension Protection Act of 2006, effective August 17, 2006 a donor advised fund is a fund that is (i) owned and controlled by a sponsoring organization; (ii) tracked with reference to donor(s) or related persons; and (iii) with respect to which a donor, donor appointee or related party has advisory privileges concerning distributions or investments. If any one of these three elements is absent, the fund is not donor-advised. In practice, a donor advised fund instrument of transfer provides that the donor or his or her designee has the privilege of making nonbinding recommendations to the governing body of the community foundation suggesting those public charities, which should receive grants from that particular fund.

However, a donor may not, directly or indirectly, reserve the right to later name the charitable beneficiaries of the fund. Treas. Reg. § 1.507-(a)(8)(iv)(A)(1).

F. Taxation:

1. *Community Foundation*:
Properly structured, the community foundation will be treated as a tax-exempt charitable organization under I.R.C. § 501(c)(3), as a public charity.

2. *Donor's Income Tax Deduction*:
Presuming the foundation qualifies as a public charity, the value of the donor's federal income tax deduction is a function of the kind of property contributed to the foundation.

a. Gift of cash and non-appreciated property: In the year of the gift, the donor's charitable income tax deduction is based on the fair market value of the property contributed, but is limited to 50% of the donor's adjusted gross income ("AGI") in the gift year, with a five year carry-forward. I.R.C. § 170(b)(1)(A); Treas. Reg. § 1.170A-8(a)(2).

b. Gift of appreciated property: In the year of the gift, the donor's charitable income tax deduction is based on the fair market value of the property contributed but is limited to 30% of the donor's AGI in the year of the gift, with a five year carry-forward. I.R.C. § 170(b)(1)(C)(i); Treas. Reg. § 1.170A-8(a)(2).

c. If the community foundation does not qualify as a public charity (but is treated for federal income tax purposes as a private foundation) the donor's federal income tax deduction is limited to the deductions allowed to a private foundation.

d. Itemized Deduction Limitation - Subject to the limitations above, a donor's federal income tax deduction for a gift to a qualified charity (whether public charity or a private foundation) in any year is reduced by the lesser of 80% of the donor's Itemized Deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 3% of the amount by which the donor's Adjusted Gross Income for that year exceeds that year's Adjusted Gross Income Threshold Amount (2007 - $156,400 [$78,200 for married filing separate]. Rev.Proc. 2006-53).

3. *Donor's Estate Tax Deduction*: The value of property transferred at decedent's death to a community foundation is 100% deductible in determining the amount of federal estate tax . I.R.C. § 2055(c).

4. *Donor's Gift Tax Deduction*: The donor receives a 100% gift tax charitable deduction for the value of the assets donated during life to the community foundation. I.R.C. § 2522(a).

G. Advantages:

The gift made through the community foundation gives the donor flexibility by allowing the gift to be made for an area of interest without the donor being bound to any specific charity. Additionally, there is less expense because no new organization is required to be formed and the donor has the opportunity to work with the existing experienced staff of the organization with the organization charging a small percentage of the income or principal of the fund for its handling of the fund. Also, the organization may already have existing forms for agreements for establishing certain types of funds that may be used or adapted to meet the donor's wishes. The relationship with the community foundation also affords the donor anonymity by the organization acting as an intermediary for the donor.

H. Comparison to "Advise and Consult Funds":

Often, public charities work with donors to provide agreements to accommodate the goals and desires of the donor through the creation of "advise and consult funds." The "advise and consult fund" is considered a separate fund of the charity and controlled by the charity with purposes consistent with that of the charity of maintained exclusively for the purposes of the charity. Care should be taken to make certain that the transfer to the organization is a completed gift and that the organization has control over the fund, that the organization has ultimate control over the disposition of the fund's assets (although the donor may suggest where assets are to be given without retaining control), the contribution is not to be used by the charity to benefit the donor nor does the donor retain a right of first refusal over the disposition of the fund's assets, the use of the gift is consistent with and not beyond the purposes of the organization, the governing body of the organization is independent of the donor, the organization does not take property subject to liabilities for purposes beyond that of the organization; and, the organization is not required to retain any investments received from the donor nor maintain any relationship with donor's advisors regarding such funds. A prime example of an "advise and consult fund" is a scholarship funds agreement with an educational institution.

I. Intermediate Sanctions:

The organization, as a public charity, will be subject to the intermediate sanctions rules. (Discussed below in Section X. of this outline).

XI. PUBLIC CHARITY EXCISE TAXES/INTERMEDIATE SANCTIONS:

Public charities are not subject to the excise taxes imposed on private foundations under I.R.C. §§ 4940-4945. (See discussion of excise taxes pertaining to private foundations above.) Rather, a public charity is subject to the intermediate sanctions rules under I.R.C. §4958 and the related Treasury Regulations (Treas. Reg. §§53.4958-1 through 53.4958-8). The final regulations pertaining to I.R.C. §4958, issued in January 2002, apply to excess benefit transactions between an applicable tax-exempt organization (public charity) and a Disqualified Person.

A. Tax Imposed:

Any Disqualified Person who benefits from an excess benefit transaction with an applicable tax-exempt organization is liable for a tax of 25% of the excess benefit. The Disqualified Person is also liable for a tax of 200% of the excess benefit if the excess benefit is not corrected by a certain date.
Additionally, organization managers (officer, director, or trustee) who knowingly participate in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause) are assessed a tax of 10% of the excess benefit transaction.

B. "Disqualified Person"

Is defined as any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, a member of the family of that person, or an entity that is 35% controlled by a Disqualified Person. I.R.C. §4958(f). Note the difference between a Disqualified Person for private foundation purposes (I.R.C. §4946) and for intermediate sanctions purposes.

1. The following persons are considered to have substantial influence:
   a. Presidents, chief executive officers, or chief operating officers,
   b. Treasurers and chief financial officers,
   c. Persons with a material financial interest in a provider-sponsored organization (generally, in the context of nonprofit hospitals)

2. The following persons are deemed NOT to have substantial influence:

a. Tax-exempt organizations described in I.R.C. §501(c)(3),
b. Certain I.R.C. §501(c)(4) organizations,
c. Employees receiving economic benefits of less than a specified amount in a taxable year

3. Facts and circumstances govern in all other instances. Facts and circumstances tending to show substantial influence:
   a. The person founded the organization,
   b. The person is a substantial contributor to the organization (within the meaning of I.R.C. §507(d)(2)(A),
   c. The person's compensation is primarily based on revenues derived from activities of the organization, or of a particular department or function of the organization, that the person controls,
   d. The person has or shares authority to control or determine a substantial portion of the organization's capital expenditures, operating budget, or compensation for employees,
   e. The person manages a discrete segment or activity of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole,
   f. The person owns a controlling interest (in vote or in value) in a corporation, partnership, or trust that is a Disqualified Person,
   g. The person is a non-stock organization controlled directly or indirectly by one or more Disqualified Persons.

4. Facts and circumstances showing no substantial influence:
   a. The person is an independent contractor whose sole relationship to the organization is providing professional advice,
   b. The person has taken a vow of poverty on behalf of a religious organization,
   c. Any preferential treatment the person receives based on the size of the person's donation is also offered to others making comparable widely solicited donations,
   d. The direct supervisor of the person is not a Disqualified Person,
   e. The person does not participate in any management decisions affecting the organization as a whole or a discrete segment of the organization that represents a substantial portion of the activities, assets, income, or expenses of the organization, as compared to the organization as a whole. Treas. Reg. §53.4958-3

5. Excess Benefit Transaction. An excess benefit transaction means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any Disqualified Person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization for providing the benefit.
   a. An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a Disqualified Person, or in an exchange of property between a Disqualified Person and the exempt organization.
   b. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is its fair market value.

6. Rebuttable Presumption of Reasonableness
   b. Compensation paid to a Disqualified Person is not excessive if it is reasonable. Reasonableness is determined under an I.R.C. §162 standard, which is the value that would ordinarily be paid by like enterprises under like circumstances

c. All items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation
d. There is a rebuttable presumption of reasonableness, and the payments under a compensation arrangement are presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the tax-exempt organization follows the following procedures:
    1) The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction,
    2) Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services,
    3) The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:
        a) The terms of the transaction that was approved and the date it was approved,
        b) The members of the authorized body who were present during the debate on the transaction that was approved and who voted on it,
        c) The comparability data obtained and relied upon by the authorized body and how the data was obtained, and
        d) Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction. Treas. Reg. §53.4958-6

If the payment is not a fixed payment, generally, the rebuttable presumption arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are satisfied.

XII. FILING PROCEDURES FOR I.R.C. §501(C)(3) ORGANIZATIONS

A. Application for Recognition of Exempt Status:

I.R.C. § 508(a)(1) provides that an organization organized after October 9, 1969, generally will not be treated as exempt under I.R.C. § 501(c)(3) until it notifies the Internal Revenue Service that it seeks recognition of exemption under that section. If the required notice is filed late, the exempt status, if granted, will not be retroactive and will not apply to any period prior to date of such filing.

1. *Form of Notice:* The proper Notice is provided on Form 1023 – Application for Recognition of Exemption Under § 501(c)(3) of the Internal Revenue Code.

2. *Time of and Place for Filing Notice:* The Form 1023 must be filed with the Ohio District Office (Covington, Kentucky) within 27 months from the end of the month of its organization, which is the date it becomes an organization described in I.R.C. § 501(c)(3). Treas. Regs. § 1.508-1(a)(2)(i), (iii). If the organization fails to file Form 1023 or files late, it will not be treated as exempt for any period prior to the filing of the notice. Treas. Regs. § 1.508-1(a)(1)(i); Rev. Rul. 77-207, 1977-1 C.B. 152. A substantially completed filing begins the running of the 270-day period in which the IRS must rule on the application. (See discussion below as to "substantially complete" Form 1023.)

a. *Extension of Time to File:* Under the newly revised Form 1023, there is no extension of time to file for 1023.

b. *Incomplete Submission:* If an organization submits an incomplete Form 1023 within the required time period for filing, and files such additional information as the Internal Service may request within the additional time period set by the Internal Revenue Service, even though beyond the 15-month filing deadline, the organization is deemed to have met the requirements of I.R.C. § 508(a). Treas. Regs. § 1.508-1(a)(2)(ii).

c. *Requirement to Make Substantial Changes to Articles:* If the organization is required to alter its activities or to make substantial amendments to its articles of organization, the ruling or determination letter recognizing exemption will be effective as of the date of the change.

d. *Nonsubstantive Changes:* If non-substantive amendments are required to be made to the articles of organization, the exemption is normally recognized retroactively to the date of formation. Rev. Proc. 90-27, 1990-1 C.B. 514.

e. *District Director's Failure to Rule Within 270 day period:* If a ruling is not issued by the key District Director within the 270 day period, the organization can seek a declaratory judgment.

f. *Substantially Complete Form 1023:* A substantially complete Form 1023 contains the following:

1) The signature of an authorized individual;
2) The organization's employer identification number or a completed Form SS-4, Application for Employer Identification Number;
3) Information concerning previously filed federal income tax and exempt organization returns;
4) Statement of receipt and expenditures and a balance sheet for the current year and the three preceding years (or for the number of years of the organization's existence, if less than four years). [Note: If the organization has not yet commenced operations or completed one accounting period, financial data for the current year and proposed budgets for the two succeeding accounting periods are sufficient.]
5) Statement of actual and proposed activities, Treas. Regs. § 1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures.
6) A copy of the Articles of Organization, trust indenture or other organizational or enabling document signed by a principal officer or accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original. Any articles of organization must indicate compliance with any applicable local recording statute.
7) If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;
8) Form 2848, Power of Attorney and Declaration of Representative, if applicable;
9) User fee payment for determination letter request: a check made payable to the United States Department of Treasury in payment of the user fee applicable to the organization. The user fee is $850.00 for initial applications for exempt status for organizations seeking exemption under I.R.C. § 501(c) whose actual or anticipated annual gross receipts exceed $10,000. Applications for exempt status (other than

pension and profit sharing plans) that have had annual gross receipt averaging not more than $10,000 during the preceding four years, or new organizations anticipating gross receipt averaging not more than $10,000 during their first four years must pay a user fee of $400.00. If the organization does not include the correct user fee with the application, the application will be returned.

The Internal Revenue Service often requests additional information from the organization seeking exempt status. An organization must timely and completely furnish any additional information requested or subject itself to dismissal of its petition for declaratory relief for failure to exhaust its administrative remedies. Rev. Proc. 90-27, 1990-1 C.B. 514.

B. Local Applications:

Application should also be made to state and local taxing authorities for exemption from franchise taxes, real and personal property taxes, rent taxes and sales taxes. Application should be made to the Texas Comptroller of Public Accounts for exemption from the Texas franchise tax and sales and use tax based on the foundation's status as a I.R.C. §501(c)(3) organization. The application is available on the Comptroller's website (http://www.window.state.tx.us/). Property tax exemptions are not based on Section 501(c)(3) status but are rather based on satisfaction of requirements in the Texas Property Tax Code. Public charities should be aware that qualification for property tax exemption in Texas is much narrower than qualification for exemption from federal income tax under Section 501(c)(3). Application for exemption from property tax is made to the local county tax assessor.

C. Registration With Charities Bureaus:

The organization should determine whether registration with the charities bureaus of the Attorney General's Office (or other State Department) is required either by virtue of its status as a private foundation or due to its intent to solicit.

D. Application for Trademark:

Application for trademark for name should be pursued, if desirable.

E. Annual Filings:

1. *Form 990-PF/Form 990*: Return of Private Foundation or Return of Organization Exempt from Income Tax.

2. *State Reports*: In addition to furnishing the Attorney General with a copy of form 990-PF, the Foundation should file the following, if applicable:

   a. *Texas Corporation Franchise Tax Report*: A public charity organized as a Texas nonprofit corporation or limited liability company will be required to file this report until such time as the organization has applied for and received exemption from the franchise tax. Note: Limited liability companies that are single member LLC's but do not have separate exemption status are not eligible for franchise tax exemption and will be required to file even if no tax is due.
   b. *BOC 22.357 Report*: Every four years, the foundation may be required to file with the Texas Secretary of State a report which states the name of the corporation, its address, the name and address of its registered agent and the names and addresses of its officers and directors.
   c. *Texas Workforce Commission Status Report*: If the organization has employees, it must complete a Texas Workforce Commission Status Report and file it with the Tax Department of the Texas Workforce Commission (formerly Texas Employment Commission).
   d. *Employer Returns:* If the foundation has employees, it must withhold, deposit, pay and report federal income taxes, social security taxes, and federal unemployment taxes, unless specifically excluded by statute.

F. Substantiation Documentation:

A charitable organization must issue substantiation letters to its donors where the donation has a value of $250 or more and the donor desires to claim a charitable income tax deduction for the donation. The substantiation must be in writing and must be obtained before filing the tax return for the tax year in which the deduction is claimed. Because the charitable organization does not seek a charitable deduction under I.R.C. § 170, it is not required to obtain and retain substantiation letters from the charities it supports. (Private Foundations, however, are required to exercise expenditure responsibility under certain circumstances, described above). Note that donors who itemize deductions must have a bank record or a written communication from the charity to substantiate any monetary contribution (cash, check or other monetary gift), regardless of the amount, effective January 1, 2007. Additionally, if the gift received is appreciated property and is sold within 3 years of acquisition, the foundation must prepare and file Form 8282. Publication 1771, Charitable Contributions – Substantiation and Disclosure Requirements, explains the federal tax law for organizations such as charities and churches that receive tax-deductible charitable contributions and for taxpayers who make contributions; however, it has not yet been updated to include provisions effective with the Pension Protection Act of 2006 such as the requirement for cash contributions discussed above. Publication 1771 allows written acknowledgement to be provided electronically, such as via e-mail addressed to the donor

XIII. ISSUES APPLICABLE TO ALL CHARITABLE ORGANIZATIONS - UNRELATED BUSINESS TAXABLE INCOME ("UBTI"):

A. UBTI, In General

UBTI generally arises in two situations: 1) when the charitable organization has income from an unrelated trade or business; or, 2) when the charitable organization has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1); § 514(a)(1); and § 514(a)(2).

B. Income From an Unrelated Trade or Business:

A charitable organization must include in its unrelated business income and pay income tax on the gross income from any regularly conducted trade or business which is not substantially related to the performance of the organization's exempt function. Treas. Reg. § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105, (1986). This includes income when an exempt organization is a partner, limited or general, in a partnership which carries on a trade or business wholly unrelated to the exempt organization's purposes, regardless of whether or not the income from the trade or business is actually distributed. See I.R.C. § 512(c)(1); Treas. Reg. § 1.681(a)-2(a). See also, *Service Bolt & Nut Co. Profit Sharing Trust v. Comr.*, 78 T.C. 812 (1982). "Unrelated trade or business" does not include: 1) any trade or business in which substantially all the work in carrying on the trade or business is performed for the exempt organization without compensation; 2) any trade or business carried on by an I.R.C. § 501(c)(3) organization or by an I.R.C. § 511(a)(2)(B) governmental college or university, primarily for the convenience of its members, students, patients, officers or employees; or 3) any trade or business which consists of selling merchandise, substantially all of which is received by the organization as gifts or contributions. I.R.C. § 513(a). The income and deductions are subject to the modifications under I.R.C. § 512(b).

C Exclusion of Items from UBTI:

Some items excluded from UBTI are dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, income from research for the U.S., income of a college, university or hospital, or income for fundamental research. I.R.C. § 512(b).

1. Example 1:

If the charitable organization holds a pass-through interest (for income tax purposes) in a factory, which is an operating business, the charitable organization will have UBTI to the extent it has income from the operation of the factory.

2. Example 2

If the charitable organization holds an interest in a partnership which owns rental real property, exclusively, and there is no debt related to the property, the charitable organization will not have UBTI because the income is from passive rental real property.

D. Income or Deductions Incurred With Respect to "Debt-Financed Property":

A charitable organization has unrelated business income and must pay income tax if it has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1), § 514(a)(2). "Debt-financed property" includes any property held to produce income (including gains from disposition of property) and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property or the property secures the debt) at any time during the taxable year. I.R.C. §514 (b)(1); Treas. Reg. § 1.514(b)-1.

"Acquisition indebtedness" is generally the indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of the acquisition. See I.R.C. § 514(c)(1); Treas. Reg. § 1.514 (c)-1. If proceeds from the debt financed property are used to acquire or improve property, the debt is considered to be "acquisition indebtedness" related to "debt financed property" even if the debt is not secured by the property. Deeds of trust, conditional sales contracts, chattel mortgages, security interests under the Uniform Commercial Code, pledges, agreements to hold title in escrow and tax liens not subject to I.R.C. § 514(c)(2) are all treated as similar to mortgages for purposes of applying I.R.C. § 514(c)(2)(A).

E. Exclusions from "Debt-Financed Property":

1. Property used by an organization in performing its exempt function, I.R.C. § 514(b)(1)(A).

2. Debt-financed property used in an unrelated trade or business to the extent that the income from the property is taken into account in computing the gross income of the unrelated trade or business so as to prevent double taxation of a single item of income as both income from an unrelated business under I.R.C. § 514(a)(1) and debt-financed income under I.R.C. § 514(b)(1)(B).

3. Property used to derive research income, I.R.C. §514(b)(1)(C); Treas. Reg. §1.514(b)-1.

4. Property used in certain excepted trades or businesses [not including any property to the extent that the property is used in a trade or business subject to the volunteer exception, the convenience exception or the donations exception]. I.R.C. § 514(b)(1)(D).

5. Life income contracts. Treas. Reg. § 1.514(b)-1(c)(3)(i).

6. Property acquired for prospective exempt use. Treas. Reg. §1.514(b)-1(d).

7. Although a very limited exclusion, I.R.C. § 514(c)(9)(A) provides that indebtedness incurred in acquiring or improving any real property is excluded from the application of I.R.C. § 514, subject to the exceptions outlined in I.R.C. § 514(c)(9)(B). The four "qualified organizations" eligible to use the exception under I.R.C. § 514(c)(9) are as follows:

   a. Educational organizations described in I.R.C. §170(b)(1)(A)(ii);

b. Affiliated support organizations described in I.R.C. § 509(a)(3) of educational organizations described in I.R.C. § 170(b)(1)(A)(ii);

c. Qualified trusts under I.R.C. § 401 that consist of a trust that forms part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of employees and their beneficiaries; and,

d. Multiple-parent title holding organizations described in I.R.C. § 501(c)(25).

XIV. OTHER STATUTES APPLICABLE TO §501(c)(3) ORGANIZATIONS ORGANIZED IN TEXAS

A. Uniform Prudent Management of Institutional Funds Act ("UPMIFA"):

1. The UPMIFA is one of the most important Texas statutes affecting the standards of care in investing charitable assets (Texas Property Code §163.000 et. seq.). It took effect in the State of Texas on September 1, 2007 replacing the Uniform Management of Institutional Funds Act ("UMIFA") which had been adopted in 1989. UPMIFA provides for greater flexibility in the management of investments by charitable organizations with purposes including modernizing rules, articulating prudence standards, providing guidance and authority for the management and investment of charitable funds, and providing rules on spending from endowments.

2. UPMIFA applies to the entities covered by UMIFA, i.e. all organizations that manage and invest institutional funds exclusively for charitable purposes regardless of how organized. However, UPMIFA also applies to private foundations. UPMIFA does not apply to trusts with commercial or individual trustees unless a charitable institution serves as trustee.

3. UPMIFA provides for great latitude for donors to supersede the UPMIFA default rules so long as donors do not control the management of the institution. UPMIFA includes rules of construction to allow institutions to make determinations as to donor intent.

4. Whereas UMIFA included a historic dollar value limitation on endowment spending, under UPMIFA the test is one of prudence allowing the institution to spend or accumulate in such manner as they determine to be prudent, taking into account donor intent, the duration of the fund, general economic conditions, the preservation of the endowment fund, and the purposes of the institution. However, UPMIFA also contains presumptions as to imprudence in an effort to guide institutions and protect the institutions against spending an endowment too quickly.

5. UPMIFA allows delegation to outside investment managers so long as such delegation is made in good faith and exercising the standard of care of an ordinary prudent person in selecting the agent, establishing the scope and terms of delegation, and making periodic review and supervision of the agent. Once delegation is made, the agent has a duty to use reasonable care.

6. UPMIFA is codified at Chapter 163 of the Texas Property Code. Because of the significance of UPMIFA and its adoption in Texas, practitioners are encouraged to investigate more closely the terms of UPMIFA which go beyond the scope of this paper.

B. Texas Charitable Immunity and Liability Act of 1987:

Although principles of tort law apply to foundations, the Texas "Charitable Immunity and Liability Act of 1987" eliminates the liability of volunteers acting in the course and scope of duties as an officer, director or trustee, limits employee liability for damages based on an act or omission in the course and scope of employment to $500,000 for each person and $1M for each single occurrence of injury to property, and limits the foundation's liability to the same amount of money damages. The limitations on liability do not apply in various circumstances including: i) intentional or willful acts or acts done with conscious indifference or reckless disregard for the safety of others; and ii) if the organization does not have liability insurance coverage in effect of the same amount as the maximum liability for any act or omission covered by state statute.

C. Volunteer Protection Act of 1997:

The Volunteer Protection Act of 1997 (42 U.S.C. 14501, et. seq.) is a federal law which preempts state law, except where the state law provides additional protection from liability relating to volunteers or to any category of volunteers in the performance of services for a nonprofit organization or governmental entity. Generally, the Act provides that no volunteer of a nonprofit organization or governmental entity shall be liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity if:

1. The volunteer was acting within the scope of his or her responsibilities at the time of the act or omission;

2. If appropriate or required, the volunteer was properly licensed, certified, or authorized in the state in which the harm occurred, where the activities were or practice was undertaken within the scope of the volunteer's responsibilities;

3. The harm was not the result of willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious flagrant indifference to the rights or safety of the individual harmed by the volunteer; and,

4. The harm was not caused by the volunteer's operation of a motor vehicle, vessel, aircraft or other vehicle for which the state requires the operator or the owner of the vehicle, craft or vessel to a)possess an operator's license or b) maintain insurance.

Generally punitive damages may not be awarded against a volunteer in an action brought for harm based on the action of a volunteer acting within the scope of the volunteer's responsibilities to a nonprofit organization or governmental entity unless the claimant establishes by clear and convincing evidence that the harm was proximately caused by an action of such volunteer which constitutes willful or criminal misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed. The limitations on liability do not apply to any misconduct that:

1. constitutes a crime of violence (as defined in Section 16 of Title 18, United States Code) or act of international terrorism (as that term is defined in Section 2331 of Title 18), for which the defendant has been convicted in any court;

2. constitutes a hate crime (as that term is used in the Hate Crime Statistics Act (28 U.S.C. 534);

3. involves a sexual offense, as defined by applicable state law, for which the person has been convicted in any court;

4. involves misconduct for which the defendant has been found to have violated a federal or state civil rights law; or,

5. where the person was under the influence (as determined under applicable state law) of intoxicating alcohol or any drug at the time of the misconduct.

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