Counseling a client about choice of entity for a nonprofit or charitable enterprise is a multilayered process. First, clients need to understand that not all nonprofits are charities. They may be mutual benefit entities like credit unions. Even if the enterprise is nonprofit and charitable in nature that does not necessarily mean the enterprise is tax (or even can be) tax exempt. Once these distinctions are made, attorneys need to counsel clients about the subtle advantages and disadvantages of four major types of entities, all formed under state law. Then there is the distinct issue of how that entity is classified for federal tax purposes. – a public charity, a private foundation of one type or another, a donor-advised fund or a supporting organization. Each comes with its own subtle tradeoffs.

- Choice of entity considerations for nonprofits enterprise
- Understanding the differences among nonprofit, charitable and tax exempt organizations
- Management, tax, and other tradeoffs among corporations, unincorporated associations, LLCs, and LPs for nonprofits
- Review of benefits and drawbacks of private foundations v. public charities v. donor-advised funds v. supporting organizations
- Restrictions on the activities and investments of each type of entity, including joint ventures with profit-making organizations
- Real world guide to obtaining tax exempt status from the IRS
- Practical considerations for the donees and donors in choice of entity – source of donated funds, donor control, distributions and other considerations
- Growing popularity of not choosing an entity – using a single member LLC or utilizing a long-dormant entity

Speakers:

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NONPROFITS: CHOICE OF ENTITY
TAX CLASSIFICATION OF ENTITY

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I. Distinction between Public Charities and Private Foundations.

A. Classification under Section 509(a)(3). All section 501(c)(3) organizations are subject to further classification under Internal Revenue Code section 509(a). There are essentially four types of section 501(c)(3) charitable organizations under Internal Revenue Code section 509(a):

1. private foundations;
2. organizations engaging in inherently public activity;
3. publicly supported organizations; and
4. supporting organizations.\(^1\)

B. Presumed Classification as Private Foundation. A section 501(c)(3) organization is presumed to be a private foundation unless it can establish to the satisfaction of the Internal Revenue Service that it meets one of the other classifications.\(^2\)

C. Preferred Classification as Public Charity. As a general rule, most charitable organizations, other than family or corporate foundations, prefer tax classification as other than a private foundation, because of the special rules that apply to private foundations. As will be discussed more thoroughly below, these rules limit the allowable income tax charitable deduction for contributions to a private foundation,\(^3\) impose a two-percent excise tax on a private foundation’s net investment income,\(^4\) impose an excise tax on self-dealing transactions, jeopardy investments, excess business holdings, and taxable expenditures,\(^5\) prohibit any lobbying activities,\(^6\) and impose a mandatory distribution requirement in each year for charitable purposes.\(^7\)

II. Types of Public Charities.

A. Public Charities under Internal Revenue Code Section 509(a)(1). Organizations classified as public charities under Internal Revenue Code section 509(a)(1) include those organizations described in Internal Revenue Code section 170(b)(1)(A)(i) through (vi) that generally engage in activities that are considered to be inherently public in nature. These inherently public charities include churches, qualified educational institutions, such as schools, colleges, and universities, qualified hospitals,  

\(^1\) I.R.C. § 509(a).
\(^2\) I.R.C. § 509(a).
\(^3\) I.R.C. § 170(b)(1)(B)(i), (D)(i).
\(^4\) I.R.C. §4940.
\(^5\) I.R.C. §§ 4941, 4943, 4944 & 4945.
\(^6\) I.R.C. § 4945.
\(^7\) I.R.C. § 4942.
certain organizations that support a college or university, and governmental units. In addition, organizations that normally receive at least one-third of their annual support from donations from members of the general public are treated as public charities under Internal Revenue Code section 509(a)(1). These types of organizations are considered public charities by virtue of the nature of their exempt purposes and activities or the sources of their support.

B. Publicly Supported Charities under Internal Revenue Code Section 509(a)(2). To be classified as a public charity under Internal Revenue Code section 509(a)(2), an organization must meet two support tests. First, the organization’s investment income cannot exceed one-third of its total support. Second, the organization must receive over one-third of its total support from certain sources such as gifts, grants, contributions, and membership dues from non-disqualified persons, admission fees to exempt function facilities or performances, fees for the performance of exempt function services, and sales of goods related to the organization’s activities. It is important that an investment manager be aware of the limitation on investment income support when working with an organization classified as a public charity under Internal Revenue Code section 509(a)(2). If it is anticipated that the organization’s investment income will exceed one-third of the organization’s total support, the charitable organization will need to seek to obtain public charity classification under another provision of Internal Revenue Code section 509(a) to avoid reclassification of the organization as a private foundation.

C. Supporting Organizations under Internal Revenue Code Section 509(a)(3). A supporting organization is a tax-exempt organization described in Internal Revenue Code section 501(c)(3) that supports one or more tax-exempt organizations described in Internal Revenue Code sections 509(a)(1) or 509(a)(2) (hereinafter referred to as the “supported organizations”). A tax-exempt organization under Internal Revenue Code section 501(c)(3) seeking non-private foundation status as a supporting organization under Internal Revenue Code section 509(a)(3) must meet three tests: (a) the organization must be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more supported organizations; (b) the organization must be operated, supervised, or controlled by or in connection with one or more supported organizations; and (c) the organization must not be controlled directly or indirectly by one or more disqualified persons (other than foundation managers) within the meaning of Internal Revenue Code section 4946. If the organization can establish

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that it meets all three of these requirements, it will be classified as a supporting organization and not a private foundation for federal tax purposes even though it is not engaged in activities that are considered inherently public and regardless of its level or sources of support.\footnote{Treas. Reg. § 1.509(a)-4(a)(1).}

1. Because of the different types of relationships under Internal Revenue Code section 509(a)(3)(B), supporting organizations are further delineated into Type I, Type II, and Type III supporting organizations.

2. A Type I supporting organization is one that is operated, supervised, or controlled by the public charity or charities it supports.\footnote{Treas. Reg. § 1.509(a)-4(f)(2).} Essentially, this type of relationship is comparable to that of a parent and subsidiary in which the subsidiary is under the direction of and accountable or responsible to the parent. The “operated, supervised, or controlled by” test is met if a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more public charities.\footnote{Treas. Reg. § 1.509(a)-4(g)(1)(i).}

3. A Type II supporting organization is one that is supervised or controlled in connection with the public charity or charities it supports.\footnote{Treas. Reg. § 1.509(a)-4(h)(1).} This relationship test is met by establishing that the control or management of the supporting organization is vested in the same persons that control or manage the public charity or charities it supports.\footnote{Treas. Reg. § 1.509(a)-4(f)(2).} This type of relationship is similar to “brother-sister” corporations in the for profit corporate context.

4. A Type III supporting organization is one that is operated in connection with the public charity or charities it supports.\footnote{Treas. Reg. § 1.509(a)-4(f)(2).}

   a. The distinguishing feature of a Type III supporting organization is “that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization.”\footnote{Treas. Reg. § 1.509(a)-4(f)(4).} The “operated in connection with” test allows the most flexibility in the relationship between the supporting organization and the public charity or charities it supports. But, it is also the most subjective test, and therefore it can be more difficult
to establish that the requirements of the test are met. Under this test, it is not necessary that the supporting organization be controlled by the supported public charity or charities. Rather, there must be sufficient ties between the supporting organization and the public charity or charities it supports. To meet this relationship test, the supporting organization must establish that it satisfies a responsiveness test and an integral part test.  

b. The Type III supporting organization rules have been modified in final and temporary regulations issued in response to changes made to Internal Revenue Code section 509(a)(3) by the Pension Protection Act of 2006 (the “2006 Act”). The final and temporary regulations were issued on December 28, 2012.

5. Additional Requirements for Type III Supporting Organizations Under the 2006 Act.

a. Notification. For each tax year beginning after Aug. 17, 2006, a Type III supporting organization must provide each supported organization with such information as the IRS may require to ensure that the supporting organization is responsive to the needs of the supported organization. This information is intended to include a copy of the supporting organization’s governing documents and any amendments thereto, the Form 990, the Form 990-T if any and an annual report. These requirements became effective upon issuance of the final regulations on Dec. 28, 2012.

b. Foreign Organizations. A Type III supporting organization cannot support an organization that is not organized in the United States. (This rule does not apply until the first day of the organization’s third tax year beginning after Aug. 17, 2006, for existing organizations operated in connection with a foreign organization.)

c. Distribution Requirements. The 2006 Act directed the IRS to issue new regulations on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations that will require these organizations to make distributions of either a percentage of either income or assets to supported organizations in order to ensure that a “significant amount” is paid to such organizations. A functionally integrated

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20 Treas. Reg. § 1.509(a)-4(i)(1)(i).
Type III supporting organization is defined as a Type III supporting organization that is not required under regulations to be issued by the IRS to make payments to supported organizations because the activities of the organization are related to performing the functions of, or carrying out the purposes of, such supported organizations.

6. **Provisions of the Final and Temporary Regulations on the 2006 Act Changes Affecting Type III Supporting Organizations.**

a. The final and temporary regulations, which are generally effective as of Dec. 28, 2012, the date of publication in the Federal Register, address the relationship test as it applies to Type III supporting organizations following the enactment of the 2006 Act. This relationship test for a Type III supporting organization mandates that a Type III supporting organization be “operated in connection with” one or more public charities and must meet three requirements: a notification requirement, a responsiveness test and an integral part test. A Type III supporting organization that fails to meet these requirements and otherwise fails to meet the requirements of any other provisions for classification as a public charity will be reclassified as a private foundation.

b. **Annual Notification to Supported Organizations.**

(1) A Type III supporting organization must provide certain information to its supported organization(s) to ensure that the organization is responsive to the supported organization’s needs. The final regulations require that a Type III supporting organization annually provide the following information to each of its supported organizations:

(a) Written notice addressed to a principal officer of the supported organization identifying the supporting organization and describing the amount and type of support it provided to it during the taxable year immediately preceding the taxable year in which the written notice is provided (and during any other taxable year ending after Dec. 28, 2012, for which support information has not previously been provided).
(b) A copy of the supporting organization’s most recently filed Form 990 or other return required to be filed under federal tax law as well as any return for any other taxable year of the supporting organization ending after Dec. 28, 2012, that has not been previously provided to the supported organization, but the organization may redact the names and addresses of any contributors in the copy provided, consistent with the Form 990 public disclosure rules.

(c) A copy of the supporting organization’s governing documents, including its articles of organization and bylaws, if any, and any amendments to such documents, unless previously provided to the supported organization.

(2) The required notice, which may be provided by electronic media, must be postmarked or electronically transmitted by the last day of the fifth month after the close of the supporting organization’s tax year. Recognizing that organizations frequently obtain an extension for filing their annual returns, the final regulations clarify that the return to be included in the notification is the one most recently filed. The preamble to the final regulations contains the following example: “[I]f a Type III supporting organization reporting on a calendar year basis has not filed its 2013 Form 990 by May 31, 2014, because it requested an extension, it can satisfy the Form 990 portion of its notification requirement for 2013 (which it needs to meet by May 31, 2014) by providing a copy of the 2012 Form 990 that it filed in 2013.”

(3) The final regulations define a “principal officer” as the person who, regardless of title, has ultimate responsibility for (a) implementing the decisions of the governing body of the supported organization; (b) supervising the management, administration or operation of the supported organization; or (c) managing the finances of the supported organization (such as a CFO or treasurer).
c. Responsiveness Test.

(1) The responsiveness test for classification as a Type III supporting organization remains largely unchanged and requires that the supporting organization be responsive to the needs or demands of a supported organization. The final regulations confirm the 2006 Act’s elimination of the alternative responsiveness test for charitable trusts.

(2) This responsiveness test requires that the officers, directors or trustees of the supported organization(s) have a significant voice in (but not control of) the supporting organization’s investment policies, the timing of grants, the manner of making grants, the selection of recipients and direction of the use of the income or assets of the supporting organization. This significant voice must occur by one of three relationships between the supporting organization and the supported organization:

(a) One or more officers, directors or trustees of the supporting organization are elected or appointed by the officers, directors, trustees or membership of the supported organization;

(b) One or more members of the governing body of the supported organization are also officers, directors or trustees of, or hold other important offices in, the supporting organization; or

(c) The officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the supported organization.

d. Integral Part Test.

(1) The final regulations make significant revisions to the integral part test to reflect the changes made by the 2006 Act. The 2006 Act created two categories of Type III supporting organizations, those that are “functionally integrated” and those that are not (referred to as “non-functionally integrated”).
Significantly, a functionally integrated Type III supporting organization will not be subject to the distribution requirement discussed below.

(2) **Functionally Integrated Type III Supporting Organizations.** On Aug. 2, 2007, the IRS issued an Advance Notice of Proposed Rulemaking (Advance Notice) defining a functionally integrated Type III organization as one that is not required to make payments to supported organizations because the activities of the organization are related to performing the functions, or carrying out the purposes of, such supported organizations. See 72 Fed. Reg. 42335 (Aug. 2, 2007).

(a) Under the Advance Notice, the definition of a functionally integrated Type III supporting organization encompassed organizations that met the “but for” prong of the integral part test as set forth in the former supporting organization regulations and an expenditure test and an assets test similar to those that apply for determining if an organization is a private operating foundation under Internal Revenue Code section 4942.

(b) The final regulations provide that a Type III supporting organization is functionally integrated if it:

(i) Meets the “but for” test;

(ii) Is the parent of each of its supported organizations; or

(iii) Supports a governmental supported organization.

(c) The final regulations provide additional guidance on what activities directly further the exempt purposes of a supported organization for purposes of the but for test, as well as the definition of a “parent.” Rules regarding organizations that support a governmental supported organization, which were included in the proposed regulations in 2009, have been eliminated, however, and
reserved for future guidance. The IRS stated in the preamble to the final regulations that this guidance will be issued sufficiently in advance of the beginning of the full implementation of the functional integration rules under the transitional rules discussed below to enable Type III supporting organizations to determine whether they are functionally integrated.

(d) “But For” Test. The final regulations confirm that a Type III supporting organization may be considered “functionally integrated” if it engages in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s) and which, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s). The final regulations do not include an expenditure or assets test.

(i) Under the final regulations, in determining whether “substantially all” of the supporting organization’s activities directly further the supporting organization’s exempt purposes, all pertinent facts and circumstances will be considered.

(ii) Activities “directly further” the exempt purposes of the supported organization(s) only if they are conducted by the supporting organization and not by the supported organization. Holding title to and managing exempt-use property are activities that directly further the supported organization’s exempt purposes. Fundraising, making grants (to either the supported organization or third parties), and investing and managing
non-exempt-use property are not activities that directly further the supported organization’s exempt purposes. The payment of grants, scholarships or other payments to individual beneficiaries who are members of the charitable class benefited by the supported organization, however, is treated as an activity that directly furthers the exempt purposes of the supported organization if:

(a) The individual grantees are selected on an objective and nondiscriminatory basis;

(b) The officers, directors or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making payments and the selection of the grantees; and

(c) The making or awarding of such individual grants is part of an active program of the supporting organization that directly furthers the exempt purposes of the supported organization and in which the supporting organization maintains significant involvement within the meaning of the private foundation minimum distribution regulations.

(iii) Finally, the final regulations also add to the “but for” test a requirement that a functionally integrated Type III supporting organization’s activities must directly further the exempt purposes of the supported organizations to which it is
responsive under the responsiveness test.

(iv) Under transitional rules set forth in the final regulations, a Type III supporting organization can qualify as functionally integrated under the “but for” test set forth in the former supporting organization regulations until the first day of its second taxable year beginning after Dec. 28, 2012. Thus, an organization on a calendar year tax year may be considered to be functionally integrated under the old “but for” test until Jan. 1, 2014. Beginning on Jan. 1, 2014, however, it will have to meet the new requirements set forth in the final regulations in order to be considered functionally integrated.

(e) Parent Test. The final regulations also provide that a Type III supporting organization will be functionally integrated if it is the “parent” of each of its supported organizations. To be a “parent,” the Type III supporting organization must oversee or facilitate the operation of an integrated system, such as a hospital system, by exercising a substantial degree of direction over the policies, programs and activities of the supported organization. In addition, a majority of the officers, directors or trustees of the supported organization must be appointed or elected, directly or indirectly, by the officers, governing body or members of the governing body of the supporting organization. The IRS, however, believing this definition of “parent” to be “insufficiently specific,” intends to issue proposed regulations in the near future to provide a new definition specifically addressing the power to remove and replace officers, directors and trustees.

(3) Non-Functionally Integrated Type III Supporting Organizations. The 2006 Act introduced the
concept of a “non-functionally integrated” Type III supporting organization and directed the Treasury to issue regulations imposing a distribution requirement on these organizations and requiring them to meet an attentiveness requirement. Under the final regulations, an organization that otherwise meets the requirements of the responsiveness test as a Type III supporting organization but does not meet the integral part test for a functionally integrated Type III supporting organization may meet the integral part test and be considered non-functionally integrated if it satisfies either (a) a distribution requirement and an attentiveness requirement or (b) the requirements for a pre-Nov. 20, 1970, trust.

(a) Distribution Requirement. The proposed regulations issued in 2009 had imposed a 5 percent distribution requirement on non-functionally integrated Type III supporting organizations. The final regulations continue to impose a distribution requirement on these organizations, but reserved for future guidance the distributable amount. The IRS issued temporary regulations simultaneously with the final regulations that define the distributable amount as the greater of (a) 85 percent of the organization’s adjusted net income as determined under the private foundation minimum distribution rules of Internal Revenue Code section 4942 for the taxable year immediately preceding the taxable year of the required distribution and (b) the organization’s “minimum asset amount” for the immediately preceding taxable year, reduced by the amount of any taxes imposed on the supporting organization during the immediately preceding taxable year. An organization’s “minimum asset amount” is defined as 3.5 percent of the excess of the aggregate fair market value of the supporting organization’s non-exempt-use assets in that immediately preceding taxable year over the acquisition indebtedness with respect to such non-exempt-use assets increased by:
(i) amounts received or accrued during the immediately preceding taxable year as repayments of amounts that were taken into account in a prior year to meet the minimum distribution requirement;

(ii) amounts received or accrued during the immediately preceding taxable year from the sale or other disposition of property to the extent that the acquisition of such property was taken into account by the organization to meet the minimum distribution requirement for a prior year; and

(iii) any amount “set aside” to the extent it is determined during the immediately preceding taxable year that such set-aside is not necessary for the purposes for which it was set aside and such set-aside was taken into account by the organization to meet the distribution requirement in a prior year.

(b) The temporary regulations also set forth rules for the valuation of non-exempt-use assets and provide that the value is to be determined under the private foundation minimum distribution rules of Internal Revenue Code section 4942. The value of the non-exempt-use assets may not be reduced by any set-aside. Non-exempt-use assets are all assets of the supporting organization other than:

(i) any future interest of the supporting organization in the income or corpus or any real or personal property, until all intervening interests in, and rights to the actual possession or enjoyment of, such property have expired, or, although not actually reduced to the supporting organization’s possession, until such future interest
has been constructively received by the supporting organization, or otherwise made available so that the supporting organization may acquire it at any time or could have acquired it if notice of intention to acquire had been given;

(ii) the assets of an estate until such time as such assets are distributed to the supporting organization, or due to a prolonged period of administration, such estate is considered terminated for federal income tax purposes;

(iii) any present interest of the supporting organization in any trust created by and funded by another person;

(iv) any pledge to the supporting organization of money or property (whether or not the pledge may be legally enforced); and

(v) exempt-use assets, which are assets used or held for use to carry out the exempt purposes of the supporting organization’s supported organization(s) by either the supporting organization or one or more supported organizations, but only if the supporting organization makes the asset available to the supported organization(s) at no cost or nominal rent to the supported organization(s).

(c) The provisions of the temporary regulations defining the distributable amount and the minimum asset amount and setting forth the rules for valuing non-exempt-use assets are effective as of Dec. 28, 2012, and expire on or before Dec. 21, 2015.

(d) The distributable amount must be distributed to or for the use of one or more supported organizations on or before the last day of the
taxable year. Subject to certain transitional rules, the distributable amount for the first year in which an organization is treated as a non-functionally integrated Type III supporting organization is zero. In the case of a disaster or emergency, the IRS may, by publication in the Internal Revenue Bulletin, provide for a temporary reduction in the distributable amount.

(e) The final regulations include guidance on what distributions count toward the distribution requirement and add provisions requested by commentators that allow certain set-asides to count toward the distribution requirement similar to the private foundation rules as well as certain expenditures on activities that directly further the exempt purposes of the supported organization(s). Generally, the amount of a distribution is the amount of cash distributed or the fair market value of property distributed as of the date of distribution. The amount of distributions is determined solely on the cash receipts and disbursements method of accounting. Distributions that count include, but are not limited to:

(i) Any amount paid to a supported organization to accomplish the supported organization’s exempt purposes.

(ii) Any amount paid by the supporting organization to perform an activity that directly furthers the exempt purposes of the supported organization(s) within the meaning of the integral part test for functionally integrated Type III supporting organizations, but only to the extent such amount exceeds any income derived by the supporting organization from the activity.

(iii) Any reasonable and necessary administrative expenses paid to
accomplish the exempt purposes of the supported organization(s), which do not include expenses incurred in the production of investment income.

(iv) Any amount paid to acquire an “exempt-use” asset.

(v) Any amount “set aside” for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive.

(f) Like the private foundation minimum distribution rules, any excess distributions can be carried forward to reduce the distributable amount in any of the five taxable years immediately following the taxable year in which the excess distribution is made. An excess created in a taxable year can be carried forward for only five taxable years. There is an excess amount for any taxable year beginning after Dec. 28, 2012, if the total distributions made in that taxable year that count toward the distribution requirement exceed the supporting organization’s distributable amount for that taxable year. With respect to any taxable year to which an excess is carried over, in determining whether there is an excess distribution in that taxable year, the distributable amount is first reduced by any excess amounts carried over (with the oldest excess amounts applied first) and then by any distributions made in that taxable year.

(g) If a non-functionally integrated Type III supporting organization fails to meet its distribution requirement, it will not be reclassified as a private foundation for the taxable year in which this occurs if the organization can establish to the satisfaction of the IRS that:

(i) The failure was due solely to unforeseen events or circumstances
that are beyond the organization’s control, a clerical error or an incorrect valuation of assets;

(ii) The failure was due to reasonable cause and not due to willful neglect; and

(iii) The distribution requirement is satisfied within 180 days after the organization is first able to distribute its distributable amount notwithstanding the unforeseen events or circumstances or 180 days after the date the incorrect valuation or clerical error was or should have been discovered.

(h) **Attentiveness Test.** The final regulations also require that a non-functionally integrated Type III supporting organization distribute one-third or more 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. A supported organization is considered to be attentive to the supporting organization if at least one of the following requirements is met:

(i) The supporting organization provides 10 percent or more of the supported organization’s total support (or, in the case of a particular department or school of a university, hospital or church, the total support of the department or school) received during the supported organization’s last taxable year ending before the beginning of the supporting organization’s taxable year.

(ii) The amount of support received from the supporting organization is necessary to avoid the interruption of a particular function or activity of the
supported organization. The amount of the support is necessary if the supporting or supported organization earmarks the support for a particular program or activity of the supported organization, even if such program or activity is not the supported organization’s primary program or activity, as long as such program is a substantial one.

(iii) Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and the supporting organization, and the purpose to which the funds are put, the amount of support received from the supporting organization is a sufficient part of a supported organization’s total support (or, in the case of a particular department or school of a university, hospital or church, the total support of the department or school) to ensure attentiveness. Under the requirement of the attentiveness of the supported organization to the operations of the supporting organization (including the nature and yield of the supporting organization’s investments), evidence of actual attentiveness is of almost equal importance to the amount paid in terms of a percentage of the total support. But a supported organization will not be considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

(iv) Any distributions by the supporting organization to a donor-advised fund held by the supported organization are disregarded in determining
whether the supported organization will be attentive. Also, the preamble to the final regulations makes it clear that grants to organizations other than the supported organization will not ensure the attentiveness of the supported organization. Type III supporting organizations are generally not permitted to make grants to organizations other than their supported organizations and may not satisfy the attentiveness test by making distributions to third-party organizations.

III. Private Foundations.

A. Overview. Any organization that is not able to establish that it is a public charity or a supporting organization is classified as a private foundation. While some organizations that are publicly supported will convert to private foundation status if they fail to meet the public support test, many charitable organizations are established as private foundations because of their limited sources of support. Most family and corporate foundations are private foundations. As a general rule, private foundations are endowed by a single individual or family, corporation, or small group of private donors who wish to retain control over the use and management and investment of donated assets. The private foundation’s endowment may initially be established through outright contributions or distributions from a trust, such as a charitable lead trust. Ongoing funding is derived primarily from additional contributions, investment income, and growth in the foundation’s underlying assets. Unlike public charities, a private foundation generally makes grants to other charitable organizations rather than actively conducting charitable programs and services. In the case of family foundations, the donor and the donor’s family usually control all decisions. This allows participation by younger family members and perpetuates family control. Because of the lack of public oversight and participation in these foundations, they are closely regulated under the Internal Revenue Code to safeguard against operation for private benefit and ensure operation in furtherance of charitable purposes.

B. Excise Taxes Imposed on Prohibited Activities of Private Foundations. The Internal Revenue Code restricts the operation of a private foundation through the imposition of excise taxes on the foundation, and sometimes on individuals with operational responsibility for the foundation. In addition to the initial excise taxes, the Internal

21 I.R.C. § 509(a).
Revenue Service may impose further excise taxes at confiscatory rates for failure to remedy the prohibited activity giving rise to the initial excise tax.

1. **Tax on Net Investment Income.** Even though private foundations are tax exempt under Internal Revenue Code section 501(c)(3), the Internal Revenue Code imposes a two-percent excise tax on the net investment income of a tax-exempt private foundation in each tax year. The two percent excise tax may be reduced to one percent for certain tax years in which the foundation’s payout rate is increased.

   a. The net investment income of a private foundation is its gross investment income and net capital gain less allowable deductions. For purposes of these rules, gross investment income includes interest, dividends, rents, payments with respect to securities loans, and royalties.

   b. These items of income are taxed regardless of source. This means that this type of income is subject to tax whether it is earned on investment assets or exempt function assets.

   c. The Pension Protection Act of 2006 expanded the definition of gross investment income for purposes of computing the tax imposed on a private foundation’s net investment income. Net investment income now also includes income from sources that are similar to those set forth in section 4940, such as annuities, notional principal contracts, and similar investment income.

   d. The rules applicable to capital gains and losses are also different for purposes of the tax on net investment income than the rules that apply to the capital gains and losses of individuals. For purposes of the tax on net investment income, no amount of any net capital losses can be used to reduce other investment income. That is, capital losses can only be used to offset capital gains. Further, a private foundation is not allowed to carryover any unused net capital losses to be applied against capital gains in a

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22 I.R.C. § 4940(a).
23 I.R.C. § 4940(e).
24 I.R.C. § 4940(c)(1).
25 I.R.C. § 4940(c)(2).
27 I.R.C. § 4940(c)(1).
28 I.R.C. § 4940(c)(4)(C).
As a result of changes made by the Pension Protection Act of 2006, capital gain now includes gains from the sale of property held for the production of gross investment income and not just property held for the production of interest, dividends, rents, and royalties. Private foundations are now also able to exclude capital gain from net investment income for exempt use property if the property has been used in an exempt purpose for at least one year before its disposition and is exchanged for like-kind property under rules similar to those set forth in the like-kind exchange provisions of Internal Revenue Code section 1031.

For purposes of the tax on net investment income, a private foundation is allowed to deduct from its gross investment income and net capital gains all of the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income and for the management, conservation, or maintenance of property held for the production of income. For purposes of this deduction, the private foundation may include that portion of its operating expenses that are paid for the production or collection of gross investment income. Operating expenses include compensation paid to officers and other employees, fees for outside professionals, such as lawyers and accountants, and rent or taxes paid on property used by the private foundation in its activities. If certain operating expenses relate to both investment activities and tax-exempt purposes, the expenses, including compensation and salaries, must be allocated between the two activities (with the expense allocable to the investment activities being deductible for purposes of determining the foundation’s net investment income). As a general rule, a private foundation cannot deduct the expenses attributable to its grant-making or other charitable activities.

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29 I.R.C. § 4940(c)(4)(C).
30 I.R.C. § 4940(c)(4)(A).
31 I.R.C. § 4940(c)(4)(D).
34 Treas. Reg. § 53.4940-1(e)(1)(i).
2. **Self-Dealing.** The Internal Revenue Code prohibits acts of direct or indirect “self-dealing” between a private foundation and a disqualified person.\(^{37}\)

a. Disqualified persons include substantial contributors (generally, anyone contributing more than $5,000 to the foundation); a foundation manager (any officer, director, trustee, or employee of the foundation); any 20 percent owner of a business that is a substantial contributor to the foundation; any family member of the persons described above; any corporation, partnership, trust, or estate in which persons described above have more than a 35 percent interest; and any government official.\(^{38}\)

b. Although there are a number of statutory and regulatory exceptions, acts of self-dealing generally include: (i) any sale, exchange, or leasing of property between a private foundation and a disqualified person; (ii) any lending of money or other extension of credit between a private foundation and a disqualified person; (iii) any furnishing of goods, services, or facilities by a private foundation to a disqualified person; (iv) the payment of compensation or expenses by the private foundation to a disqualified person; (v) any transfer to, or use by, a disqualified person of the private foundation’s income or assets; and (vi) any agreement to make any payment of money to a government official.\(^{39}\)

c. The major exceptions to self-dealing include payment of reasonable compensation and reimbursement of reasonable expenses by a private foundation to disqualified persons or employees for services rendered and gratuitous transfers of property by a disqualified person to the private foundation.\(^{40}\)

d. The penalty imposed on an act of self-dealing is a two-tier excise tax that can be imposed on a foundation manager, as well as the disqualified person. There is no self-dealing tax imposed on the private foundation. The self-dealing excise tax increases dramatically with each failure to correct the act of self-dealing within the time allotted under the Internal Revenue Code. The Pension Protection Act of 2006 increased the initial tax imposed on the disqualified

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\(^{37}\) I.R.C. § 4941.

\(^{38}\) I.R.C. § 4946.

\(^{39}\) I.R.C. § 4941(d)(1).

\(^{40}\) I.R.C. § 4941(d)(2)(E).
person from five percent to 10 percent of the amount involved and increased the tax from two and a half percent to five percent for a foundation manager who participates in an act of self-dealing with an aggregate cap on all foundation managers of $20,000 instead of $10,000.\footnote{I.R.C. § 4941(a), (c)(2).} If the act of self-dealing is not corrected, an additional tax of 200 percent of the amount involved is imposed on the disqualified person,\footnote{I.R.C. § 4941(b)(1).} and an additional tax of 50 percent of the amount involved is imposed on foundation managers who participate in the transaction with an aggregate cap of $20,000.\footnote{I.R.C. § 4941(b)(2), (c)(2).}

3. \textbf{Minimum Distribution Requirements.} A private foundation must make minimum distributions of income annually for its exempt purposes to avoid an excise tax on undistributed income.\footnote{I.R.C. § 4942.}

   a. The distributions that count towards satisfaction of this minimum distribution requirement are called “qualifying distributions.” Qualifying distributions include (i) any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more exempt purposes, and (ii) any amount paid to acquire an asset used (or held for use) directly in carrying out one or more exempt purposes.\footnote{I.R.C. § 4942(g)(1).}

   b. Distributions to other private nonoperating foundations and controlled organizations do not qualify.\footnote{I.R.C. § 4942(g)(1)(A).} In addition, under the changes made by the Pension Protection Act of 2006, distributions do not qualify if made to a non-functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization.\footnote{I.R.C. § 4942(g)(4).}

   c. Certain administrative expenses are qualifying distributions and count towards satisfaction of a private foundation’s minimum distribution requirements.\footnote{I.R.C. § 4942(g)(1).} Under current law,
there is no limitation on the amount of administrative expenses that can be counted as qualifying distributions. Administrative expenses allocable to management of assets held for the production of income, such as investment advisory fees, are not considered allocable to the private foundation’s exempt activities and cannot be treated as qualifying distributions. To be a qualifying distribution, an administrative expense must be reasonable and necessary to the accomplishment of the private foundation’s exempt purposes.\(^{49}\) If an administrative expense is incurred for both charitable and noncharitable activities (such as the salary of an individual whose job description includes grant-making as well as investment management activities), the expense must be allocated between the two activities.

d. To avoid an excise tax, the foundation must distribute at least five percent of the average fair market value of its noncharitable assets (cash, securities, etc.) each year.\(^{50}\) The minimum distributable amount is calculated each year on the foundation’s annual return (Form 990-PF). A foundation is essentially given two taxable years in which to make the required amount of qualifying distributions: the year for which the minimum distributable amount is calculated and the subsequent taxable year.\(^{51}\) Provisions exist that permit a foundation to carry forward any excess qualifying distributions in a given year for five additional years.\(^{52}\) Failure to comply with the minimum distribution requirement results in an initial excise tax equal to 30 percent of the amount of income that should have been, but was not, distributed.\(^{53}\) If the required distributions are not made within the appropriate period, an additional excise tax is imposed equal to 100 percent of the amount remaining undistributed at the close of such period.\(^{54}\)

4. **Excess Business Holdings.** Internal Revenue Code section 4943(a)(1) imposes an excise tax on the excess business holdings of any private foundation in a business enterprise during any tax year. The tax is 10 percent of the value of the excess business holdings.\(^{55}\) There is an additional tax of 200 percent if the private foundation does not dispose of the excess business holdings within

\(^{49}\) Treas. Reg. § 53.4942(a)-3(a)(2)(i).
\(^{50}\) I.R.C. § 4942(d) & (e).
\(^{51}\) I.R.C. § 4942(a).
\(^{52}\) I.R.C. § 4942(i).
\(^{53}\) I.R.C. § 4942(c).
\(^{54}\) I.R.C. § 4942(b).
\(^{55}\) I.R.C. § 4943(a)(1).
a certain period of time following the imposition of the initial 10-percent tax.\textsuperscript{56}

\textbf{a.} The excess business holdings rules can only apply if there is an excess business holding in a “business enterprise.” The term “business enterprise” is not specifically defined, but does not include a functionally related business or a trade or business at least 95 percent of the gross income of which is derived from passive sources.\textsuperscript{57} Generally, under the excess business holdings rules, the “permitted holdings” of a private foundation in any incorporated business enterprise are 20 percent of the voting stock of such business enterprise, reduced by the percentage of the voting stock owned by all disqualified persons.\textsuperscript{58} In the case of a partnership or joint venture, reference is made to the profits interest held by the foundation and disqualified persons rather than the voting stock.\textsuperscript{59} In all other cases, reference is made to the beneficial interest owned by the foundation and disqualified persons.\textsuperscript{60}

\textbf{b.} The term “excess business holdings” means the amount of stock or other holdings that the private foundation would have to dispose of to a person other than a disqualified person in order for the foundation’s holdings in the business enterprise to be “permitted holdings.”\textsuperscript{61} There is a de minimis rule that provides that the private foundation will not be treated as having an excess business holding if it does not own more than two percent of the voting stock and not more than two percent in value of all of the outstanding shares of all classes of stock in a business enterprise.\textsuperscript{62}

\textbf{c.} For purposes of Internal Revenue Code section 4943, the percentage of voting stock held by any person in a corporation is normally determined by reference to the power of stock to vote for the election of directors. Treasury stock and stock that is authorized but unissued is disregarded.\textsuperscript{63} Also, a higher voting requirement for extraordinary corporate actions is disregarded for this

\textsuperscript{56} I.R.C. § 4943(b).
\textsuperscript{57} I.R.C. § 4943(d)(3).
\textsuperscript{58} I.R.C. § 4943(c)(2)(A).
\textsuperscript{59} I.R.C. § 4943(c)(3)(A).
\textsuperscript{60} I.R.C. § 4943(c)(3)(C).
\textsuperscript{61} I.R.C. § 4943(c)(1).
\textsuperscript{62} I.R.C. § 4943(c)(2)(C).
\textsuperscript{63} Treas. Reg. § 53.4943-3(b)(1)(ii).
Permitted holdings in a corporation also include any share of nonvoting stock in the business enterprise in any case in which disqualified persons hold, actually or constructively, no more than 20 percent of the voting stock in the corporation. Evidences of indebtedness (including convertible indebtedness) and warrants or other options or rights to acquire stock are not considered equity interests.

d. There are also special rules that apply when a private foundation receives holdings in a business enterprise by gift or bequest. If a private foundation acquires holdings in a business enterprise other than by purchase by the private foundation or disqualified persons with respect to the foundation and the acquisition causes the private foundation to have an excess business holding, the foundation has five years to dispose of sufficient holdings to eliminate the excess business holdings. The rule works essentially by treating the excess business holdings of the private foundation as being held by a disqualified person for this five-year period rather than by the private foundation.

e. In certain cases, the 20 percent amount in the definition of permitted holdings can be increased to 35 percent. This increase is available if (a) the private foundation and all disqualified persons together do not own more than 35 percent of the voting stock of an incorporated business enterprise, and (b) the foundation establishes to the satisfaction of the Internal Revenue Service that effective control of the corporation is in one or more persons who are not disqualified persons with respect to the private foundation.

5. Jeopardy Investments. If a private foundation invests its assets in a manner that will jeopardize the accomplishment of its exempt purposes, the foundation and possibly its managers will be subject to certain excise taxes.

a. In general, an investment jeopardizes the exempt purposes of a foundation if the foundation manager, in making the investment, fails to exercise ordinary business care and

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64 Treas. Reg. § 53.4943-3(b)(1)(ii).
67 I.R.C. § 4943(c)(6).
68 I.R.C. § 4943(c)(2)(B).
69 I.R.C. § 4944.
prudence in providing for the long and short term financial needs of the foundation in carrying out its exempt purposes.\textsuperscript{70} The Pension Protection Act of 2006 increased the amount of the tax imposed on the foundation from five percent to 10 percent of the amount invested.\textsuperscript{71} Any foundation manager (i.e., a director or officer) who participated in making the investment knowing that it jeopardized the foundation’s exempt purposes is subject to a tax equal to 10 percent of the amount invested unless such participation was not willful and was due to reasonable cause.\textsuperscript{72}

b. Program-related investments are not jeopardy investments.\textsuperscript{73} A program-related investment is an investment the primary purpose of which is to accomplish an exempt purpose under Internal Revenue Code section 170(c)(2)(B) and no significant purpose of which is the production of income or the appreciation of property.\textsuperscript{74}

6. Taxable Expenditures. Private foundations are generally prohibited from making the following types of expenditures, referred to as “taxable expenditures”: (a) expenditures to carry on propaganda or otherwise to attempt to influence legislation; (b) expenditures to influence the outcome of any specific public election or to carry on, directly or indirectly, any voter registration drive; (c) grants to an individual for travel, study, or other similar purposes unless the grant is awarded on an objective and nondiscriminatory basis and is approved in advance by the Internal Revenue Service; (d) grants to an organization that is not a public charity described in Internal Revenue Code section 509(a)(1), (2), or (3), or a private operating foundation; or (e) expenditures for any purpose other than a charitable, religious, scientific, literary, or educational purpose.\textsuperscript{75}

a. Expenditures that will not be treated as taxable expenditures include the acquisition of investments to generate income to be used in furtherance of the foundation’s charitable purposes as well as reasonable

\textsuperscript{70} Treas. Reg. § 53.4944-1(a)(2).
\textsuperscript{71} I.R.C. § 4944(a)(1).
\textsuperscript{72} I.R.C. § 4944(a)(2).
\textsuperscript{73} I.R.C. § 4944(c).
\textsuperscript{74} I.R.C. § 4944(c).
\textsuperscript{75} I.R.C. § 4945(d).
expenses with respect to the foundation’s investment activities.\textsuperscript{26}

\textbf{b.} If a private foundation makes a taxable expenditure, the foundation will be subject to a 20 percent excise tax (increased from 10 percent by the Pension Protection Act of 2006).\textsuperscript{77} As a general rule, a private foundation’s investment activities are unlikely to cause any issues under the taxable expenditure rules. But, if the compensation paid to managers is excessive or unreasonable, the payment of this excessive compensation could be a taxable expenditure.

\section*{IV. Donor Advised Funds.}

\subsection*{A. Definition of Donor-Advised Fund.}

\textbf{1.} A donor-advised fund is a fund or account (1) which is separately identified by reference to contributions of a donor or donors, (2) which is owned and controlled by a sponsoring organization, and (3) with respect to which a donor (or any person appointed or designated by the donor) has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the assets of the fund by reason of the donor’s status as donor.\textsuperscript{78}

\textbf{2.} A donor-advised fund does not include any fund or account that makes distributions only to a single identified organization or governmental entity or with respect to which a donor or person appointed or designated by the donor advises as to which individuals receive grants for travel, study, or other similar purposes if the advisory committee for such fund is composed only of members that are appointed by the sponsoring organization and is not controlled by the donor or persons appointed or designated by the donor and grants are awarded on an objective and nondiscriminatory basis in accordance with procedures meeting requirements for similar grants by private foundations that have been approved in advance by the board of the sponsoring organization.\textsuperscript{79}

\textbf{3.} The Internal Revenue Service also is granted the authority to exempt other funds or accounts from the definition if the fund or account is advised by a committee not directly or indirectly controlled by the donor or any person appointed or designated by

\textsuperscript{26} Treas. Reg. § 53.4945-6(b)(1).
\textsuperscript{77} I.R.C. § 4945(a)(1).
\textsuperscript{78} I.R.C. § 4966(d)(2)(A).
\textsuperscript{79} I.R.C. § 4966(d)(2)(B).
4. A sponsoring organization is any organization that is described in section 170(c) (other than section 170(c)(1) and without regard to section 170(c)(2)(A)), is not a private foundation, and maintains one or more donor advised funds.\textsuperscript{81}

B. Tax on Taxable Distributions.

1. A 20 percent excise tax is imposed on a sponsoring organization that makes a taxable distribution. The tax is imposed on the amount of the taxable distribution.\textsuperscript{82}

2. There is also a five percent excise tax imposed on any fund manager of the sponsoring organization who agreed to the making of the distribution (but the maximum tax in the aggregate that can be imposed on fund managers is $10,000).\textsuperscript{83}

3. A fund manager is defined as an officer, director, or trustee of the sponsoring organization or an individual having similar powers or responsibilities and, with respect to any act or failure to act, the employees of the sponsoring organization having authority or responsibility with respect to such act (or failure to act).\textsuperscript{84}

4. A taxable distribution is any distribution from a donor-advised fund to an individual or any other person if the distribution is for other than an exempt purpose under section 170(c)(2)(B) or the sponsoring organization does not exercise expenditure responsibility with respect to such distribution.\textsuperscript{85}

5. A taxable distribution does not include a distribution to any organization described in section 170(c)(2)(B) (other than a grant to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if the donor or anyone appointed or designated by the donor for the purpose of advising the donor-advised fund directly or indirectly controls a supported organization). It also does not include any grant to the sponsoring organization or any other donor-advised fund.\textsuperscript{86}

\textsuperscript{80} I.R.C. § 4966(d)(2)(C).
\textsuperscript{81} I.R.C. § 4966(d)(1).
\textsuperscript{82} I.R.C. § 4966(a)(1).
\textsuperscript{83} I.R.C. § 4966(a)(2), (b).
\textsuperscript{84} I.R.C. § 4966(d)(3).
\textsuperscript{85} I.R.C. § 4966(c)(1).
\textsuperscript{86} I.R.C. § 4966(c)(2).
C. **Taxes on Prohibited Benefits.**

1. Internal Revenue Code section 4967 imposes a 125 percent excise tax if any donor, donor advisor, or related person provides advice to a sponsoring organization that causes a distribution from a donor-advised fund that results in that person or any other donor, donor advisor, or related person to receive, directly or indirectly, a more than “incidental benefit.” The tax is paid by any such person who advises as to the distribution or who receives a benefit as a result of the distribution.\(^{87}\)

2. Any fund manager who agrees to the making of the distribution, knowing that it would confer a prohibited benefit, is also subject to a 10 percent excise tax (with a cap on the total tax for fund managers of $10,000).\(^{88}\)

3. These taxes do not apply if the transaction results in a tax under the excess benefit transaction rules of section 4958.\(^ {89}\)

D. **Application of Excess Benefit Transaction Rules to Donor-Advised Funds and Sponsoring Organizations.**

1. The Pension Protection Act of 2006 modifies the excess benefit transaction provisions of section 4958 to treats donors, donor advisors, and investment advisors to donor advised funds and family members of such persons or entities 35 percent controlled by them or family members as disqualified persons with respect to the sponsoring organization under the excess benefit transaction rules of section 4958. An investment advisor is any person compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor-advised funds owned by the sponsoring organization.\(^ {90}\)

2. The new rules treat any amount distributed to a donor, donor adviser, or person related to a donor or donor adviser as an automatic excess benefit transaction and any correction amount cannot be held in or credited to the donor advised fund.\(^ {91}\)

E. **Application of Excess Business Holdings Rules to Donor-Advised Funds.** The Pension Protection Act of 2006 applies the private

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\(^{87}\) I.R.C. § 4967(a)(1).

\(^{88}\) I.R.C. § 4967(a)(2).

\(^{89}\) I.R.C. § 4967(b).

\(^{90}\) I.R.C. § 4958(c)(2), (f)(7) & (8).

\(^{91}\) I.R.C. § 4958(c)(2).
foundation excess business holdings rules of section 4943 to donor-advised funds.92

1. A disqualified person includes any person who is a disqualified person for purposes of the new rules imposing an excise tax on prohibited distributions from a donor-advised fund, as well as family members of such individuals and 35-percent controlled entities.93

2. The provision also adopts certain transitional rules that had applied to private foundations after the enactment of section 4943 to allow a period of time to dispose of these excess business holdings.94

V. Factors for Consideration in Choice of Charitable Donee.

A. Donor’s willingness to relinquish control over management, investments, or grantmaking.

B. Donor’s relationship (or lack thereof) with one or more public charities.

C. Amount of assets to be contributed to charitable donee.

D. Availability of investment management.

E. Nature of assets to be contributed to charitable donee.

F. Limitations on income tax charitable deduction associated with gifts of certain types of property to private foundation.

G. Potential application of excess business holdings rules to assets to be contributed.

H. Donor’s desire to have family involvement on board and length of time of involvement.

I. Donor’s desire for charitable donee to employ family members.

J. Donor’s current need for an income tax charitable deduction without certainty of ultimate charitable donee.

K. Donor’s desire to use the charitable donee as a vehicle for coordinated family philanthropy.

92 I.R.C. § 4943(e)(1).
93 I.R.C. § 4943(e)(2).
94 I.R.C. § 4943(e)(3).
L. Donor’s desire to use the charitable donee as a training vehicle to promote good stewardship and investment management among younger generations of the family.

M. Donor’s expectation that funds may be raised from third parties (i.e., the general public).

N. Donor’s desire for future generations to have a vehicle to continue the family’s philanthropic tradition.

O. Donor’s desire for anonymity or privacy (in connection with funding or in connection with grants awarded).

P. Tax on investment income.

Q. Minimum distribution requirements.

R. Donor’s expectations that charitable donee will carry on a direct charitable activity, such as operation of an art museum.

S. Donor’s desire to defer funding until death.

T. Donor’s desire to use planned giving vehicles, such as charitable remainder trusts or charitable lead trusts to fund the charitable donee.

U. Donor’s willingness to bear cost and burden of administration, tax filings, and management of charitable organization.

V. Nature and location of anticipated grantees of charitable donee.

W. Donor’s desire for charitable donee to make scholarship grants to individuals.

X. Donor’s desire for grantmaking support and advice.

VI. Practical Tips on Filing an Exemption Application for a Charitable Organization.

A. **Form 1023.** Once an organization is formed, it is not entitled to receive tax deductible contributions until it notifies the Internal Revenue Service. The organization must file a Form 1023-Application for Recognition of Exemption if it is seeking exemption under Internal Revenue Code section 501(c)(3).

B. **Due Date of Form 1023.** The Form 1023 must be filed within 15 months after the end of the month in which the organization is formed. A trust is deemed to have been formed when it receives assets. A corporation is deemed to have been formed on the date it is incorporated. The
exemption, however, will be retroactive to the date of formation. Under a current rule of the Internal Revenue Service, all organizations have a 12-month automatic extension to file the Form 1023, thus, organizations actually have 27 months from the date of formation to file the Form 1023 and have retroactive recognition of the organization's exempt status.

C. **Organizations Not Required to File Form 1023.** Churches, organizations with gross revenue normally under $5,000 that are not private foundations, and subordinate organizations covered by a group exemption are not required to file a Form 1023. Exemption is automatic for these organizations.

D. **Information Required to Complete Form 1023.**

1. The Corporation’s business address, telephone number, and website address, if any.

2. The month the Corporation’s annual accounting period ends.

3. A narrative discussing the Corporation’s principal activities.

4. A list of the names, mailing addresses, titles and total compensation (including benefits, deferred compensation, etc.) of all directors and officers of the Corporation.

5. A list of the names, mailing addresses, titles, and total compensation of any employees or independent contractors who will be paid more than $50,000 per year (highly compensated persons).

6. For each officer or director and each highly compensated person, a list of their qualifications, duties, and hours worked.

7. A description of any family or business relationships or planned contracts, arrangements, or transactions between:

   a. Officers, directors, or highly compensated persons,

   b. The Corporation and any officer, director, or highly compensated person,

   c. The Corporation and any other organization from which an officer, director, or highly compensated person receives compensation, or

   d. The Corporation and any organization in which an officer, director, or highly compensated person owns more than a 35 percent interest.
8. A statement whether the Corporation will engage in any of the following with any officer, director, or highly compensated person or any individual or organization related to any officer, director, or highly compensated person:
   a. Payment of non-fixed compensation such as bonuses or commissions,
   b. Purchase or sale of goods or services,
   c. Leases, loans, contracts, or similar arrangements; or
   d. Provision of goods or services.

9. A description of the process by which the terms of any compensation, contract, or transaction involving an officer, director, or highly compensated person are determined (include copies of any compensation policies).

10. A list of the Corporation’s anticipated sources of financial support in order of size.

11. A description of any assets or income that will be transferred to the Corporation by its officers or directors, such as any gift of land, buildings, or equipment.

12. Copies of any proposed or current contracts, leases, or agreements to be entered into by the Corporation (such as employment agreements, leases of land or buildings, etc.).

13. The details of any type of planned fund-raising activities for the Corporation including:
   a. The types of contributions that will be sought (e.g., contributions from individuals, gifts in kind, foundation grants)
   b. The manner in which contributions will be solicited (e.g., mailings, website, etc.),
   c. The states in which the Corporation intends to solicit,
   d. Any plans to engage in charitable bingo or gaming, and
   e. If the Corporation will employ professional fundraisers or will share fundraising with another organization, the details of the arrangement and copies of contracts.
14. Copies of any brochures or newsletters that the Corporation has used or intends to use.

15. A list of directors or officers who are expected to contribute more than $5,000 to the Corporation.

16. A list of all corporations or other entities that are expected to contribute more than $5,000 to the Corporation and in which a director has more than a 20 percent ownership interest.

17. A description of any arrangements or affiliations with other persons or organizations (such as agreements for another person to manage or develop any of the Corporation's facilities, plans to share employees, or joint ventures) and copies of any related contracts or agreements.

18. A list of any charges that recipients would have to pay for the Corporation’s services, benefits, or products, if any, with an explanation of how such charges were calculated.

19. An explanation of the manner in which benefits, services, or products of the Corporation, if any, are limited to specific individuals or classes of individuals, if applicable.

20. A statement whether the Corporation will engage in any of the following, and a detailed description of any activity for which the answer is "yes."

   a. Take over the assets or activities of another organization.

   b. Have rights in any intellectual property.

   c. Make grants to organizations or engage in operations in a foreign country.

21. A budget for any completed tax years of the Corporation and projected budgets for succeeding years, for a total of four tax years. This should include a fairly detailed list of income and expenses and a current balance sheet. If the Corporation has already received funding, actual income and expense figures should be used for the current period. Actual financial data must be current within 60 days of the filing of Form 1023.

22. A statement whether the Corporation will be financially accountable to any other organization.

23. A statement whether the Corporation will be controlled by or controls any other organization.
24. A statement whether the Corporation will attempt to influence legislation.

25. A statement describing the Corporation’s plans to engage in tax-exempt bond financing during the next two years.

26. The names of any directors who are public officials.
VII. CHARACTERISTICS OF CHARITABLE DONEES.

<table>
<thead>
<tr>
<th>Source of Funding</th>
<th>PRIVATE FOUNDATION</th>
<th>PRIVATE OPERATING FOUNDATION</th>
<th>TYPE I OR II SUPPORTING ORGANIZATION</th>
<th>TYPE III SUPPORTING ORGANIZATION</th>
<th>DONOR ADVISED FUND</th>
</tr>
</thead>
<tbody>
<tr>
<td>Donor Able to Control</td>
<td>Yes</td>
<td>Yes</td>
<td>No, but board participation allowed</td>
<td>No, but board participation allowed</td>
<td>Advisory rights only</td>
</tr>
<tr>
<td>Income Tax Deduction</td>
<td>Yes, but limitations apply</td>
<td>Yes</td>
<td>Yes, unless supported organization controlled by donor</td>
<td>Yes, unless supported organization controlled by donor</td>
<td>Yes, if sponsoring organization is qualifying charity</td>
</tr>
<tr>
<td>Transfer Tax Deduction</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Tax on Investment Income</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Minimum Distribution Requirement</td>
<td>Yes (5%)</td>
<td>No</td>
<td>No</td>
<td>Expected to have 5% distribution requirement if nonfunctionally integrated upon issuance of final regulations</td>
<td>No</td>
</tr>
<tr>
<td>Jeopardy Investment Rules Apply</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Tax on</td>
<td>Yes for taxable</td>
<td>Yes for taxable</td>
<td>No</td>
<td>No</td>
<td>Yes on taxable</td>
</tr>
<tr>
<td></td>
<td>PRIVATE FOUNDATION</td>
<td>PRIVATE OPERATING FOUNDATION</td>
<td>TYPE I OR II SUPPORTING ORGANIZATION</td>
<td>TYPE III SUPPORTING ORGANIZATION</td>
<td>DONOR ADVISED FUND</td>
</tr>
<tr>
<td>--------------------------</td>
<td>--------------------</td>
<td>------------------------------</td>
<td>--------------------------------------</td>
<td>----------------------------------</td>
<td>-------------------</td>
</tr>
<tr>
<td><strong>Impermissible Distributions</strong></td>
<td>expenditures</td>
<td>expenditures</td>
<td>No, unless supported organization controlled by supporting organization’s donors</td>
<td>Yes</td>
<td>distributions and prohibited benefits</td>
</tr>
<tr>
<td><strong>Excess Business Holdings Rules Apply</strong></td>
<td>Yes</td>
<td>Yes</td>
<td></td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Excess Benefit Transaction Rules Apply</strong></td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes, with special rules applicable to donor, donor advisor, and investment advisor</td>
</tr>
<tr>
<td><strong>Self-Dealing Rules Apply</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td><strong>Able to Support Unlimited Qualifying Charities</strong></td>
<td>Yes</td>
<td>Not generally applicable</td>
<td>No</td>
<td>No</td>
<td>Yes, but subject to control by sponsoring organization</td>
</tr>
<tr>
<td><strong>Able to Provide Scholarships</strong></td>
<td>Yes</td>
<td>Maybe</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Able to Involve Family Members in Management</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Maybe</td>
</tr>
<tr>
<td><strong>Able to Employ Family Members</strong></td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td></td>
<td>PRIVATE FOUNDATION</td>
<td>PRIVATE OPERATING FOUNDATION</td>
<td>TYPE I OR II SUPPORTING ORGANIZATION</td>
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<td>DONOR ADVISED FUND</td>
</tr>
<tr>
<td>------------------------------</td>
<td>--------------------</td>
<td>------------------------------</td>
<td>--------------------------------------</td>
<td>---------------------------------</td>
<td>--------------------</td>
</tr>
<tr>
<td>Able to Involve Future Generations</td>
<td>Yes</td>
<td>Yes</td>
<td>Maybe</td>
<td>Maybe</td>
<td>Advisory privileges usually for 2 to 3 generations</td>
</tr>
<tr>
<td>Annual Tax Filing Required</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Exemption Application Required</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>
CHOICE OF ENTITY CONSIDERATIONS FOR NON-PROFITS

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I. FRAMEWORK OF ENTITY CHOICES

A. Not-for-Profit vs. Tax-Exempt vs. Charitable

Some preliminary terminology points; the above three terms are regularly used almost interchangeably, but that is not correct.

1. Not-for-profit: this is a state law matter. It does NOT mean that no profit can be earned as an accounting matter, it just means that the profit is not for private persons – sometimes this is called the “nondistribution constraint.

2. Tax-Exempt: this is an IRS matter and it may or may not require that the entity be a not-for-profit entity under applicable state law.

3. Charitable: This can be a state law matter, an IRS matter, or both. There is substantial overlap, but not identity.
   (a) Many non-charitable not-for-profit organizations exist. Distinction is usually between mutual benefit organizations (i.e., for the benefit of the organization’s members but not necessarily the broader public) and public benefit organizations.
   (b) California expressly uses the mutual benefit/public benefit terminology. New York uses the concept of Type A and Type B corporations. Delaware makes no distinction.

B. Choices for Entity

Until recently, practitioners focused on three entity forms: charitable trust, unincorporated association and not-for-profit corporation. As a result of continuing favorable developments in the law, there are now four legitimate choices: Charitable Trust, Not-for-Profit Corporation, Unincorporated Association and, Limited Liability Company. General and Limited Partnerships typically cannot be not-for-profit and in any event the IRS will not recognize them as tax-exempt.

1. Charitable Trust
   (a) Governed by a declaration of trust or trust agreement.
(b) Regulatory approval to form generally not required.
(c) Governed by one or more trustees.

2. Not-for-Profit Corporations
   (a) Created by filing Certificate of Incorporation with a secretary of state.
   (b) Regulatory approval required to incorporate in some jurisdictions, e.g., Attorney General and/or state licensing agencies.
   (c) Governed by a board of directors (sometimes called trustees, but such persons are still corporate law directors).

3. Unincorporated Associations
   (a) Created by articles of organization (sometimes called a constitution).
   (b) Regulatory approval usually not required to form.
   (c) No specific form of governing body.

4. Limited Liability Companies (LLCs)
   (a) Created by articles of organization (sometimes called a certificate of formation).
   (b) Regulatory approval usually not required to form.
   (c) Can be governed by members or by a board of managers.
   (d) If the LLC has a single member, it is by default disregarded as an entity separate from its single member for federal income tax purposes. If the LLC has two or more members, it is by default disregarded as a partnership for federal income tax purposes. In either case, the LLC may elect to be treated as a corporation for federal income tax purposes.
   (e) Created by articles of organization (sometimes called a certificate of formation).
   (f) Regulatory approval usually not required to form.
Single member LLCs that are disregarded as entities are clearly now eligible to receive tax-deductible contributions – see IRS Notice 2012-52.

LLCs that seek independent tax-exempt status must follow a number of currently informal IRS criteria designed largely to ensure that their ownership is perpetually limited to tax-exempt owners.

5. Note that some provisions of the Internal Revenue Code mandate, in whole or in part, the corporate form, and other Code provisions (particularly in the employee plan context) mandate the trust form.

(a) Corporate form required by Code § 501(c)(1), 501(c)(2) and 501(c)(16);

(b) Trust form required by Code § 501(c)(17) and 501(c)(18).

C. A Few Points on Advantages and Disadvantages of Each Form

1. Advantages of Charitable Trust

(a) Simpler to create and operate.

(b) Fewer requirements concerning:

(i) Trustees/Directors;

(ii) State filings;

(iii) Committee requirements, e.g., no audit committee as required under California’s Non-profit Integrity Act of 2004; and

(iv) Regularity of meetings.

(c) Possibly lower taxes for any unrelated business income.

(d) Formation instrument might not be public.

(e) No filing fees.

2. Disadvantages of Charitable Trusts

(a) Less flexibility than not-for-profit corporation, e.g., court approval required for any changes to trust agreement.
3. Advantages of Not-for-Profit Corporations
   (a) Corporations offer a great deal of flexibility, e.g., revising governing documents is relatively easy.
   (b) Flexibility allows corporations to change direction by changing charitable purposes.
   (c) Corporations generally provide directors with protection from personal liability.
   (d) Continue to be most used form for charitable organizations.

4. Disadvantages of Not-for-Profit Corporations:
   (a) More formal operating requirements.
   (b) Certain requirements apply to corporations that don’t apply to trusts, e.g., California rule requiring an audit committee (if revenue levels are met).
   (c) Periodic filings requirements not applicable to trusts.

5. Advantages of Unincorporated Associations.
   (a) Easily created by articles of organization.
   (b) Very informal re: operation and organization.
   (c) Formation instrument might not be public.

6. Disadvantages of Unincorporated Associations
   (a) Since it is not a legal entity separate from the persons who control it, liability is personal to members.
   (b) Very little regulatory oversight.
(c) Use of unincorporated associations has dwindled in recent years thanks to the availability of LLCs.

7. Advantages of LLCs
   (a) Easily created by articles of organization.
   (b) Very informal re: operation and organization.
   (c) Use of LLCs continues to expand, meaning that virtually everyone has become comfortable with this form of entity.

8. Disadvantages of LLCs
   (a) Many jurisdictions have not yet acknowledged LLCs, even if federally tax-exempt, as eligible for local tax exemptions such as property tax exemptions.
   (b) Some donors/foundations still uncomfortable with or unable to deal with LLCs.

D. A Few Points on Choice of Jurisdiction for Corporations:

   New York vs. Delaware

1. New York:
   (a) Governed by Not-for-Profit Corporation Law usually
       (i) Special laws: education, religious, private housing finance
       (ii) Hostility to foreign corporations?

2. Delaware:
   (a) Has no special not-for-profit corporation law
   (b) Delaware law is notoriously flexible, but the GCL has some gaps

3. Comparison:
   (i) Cannot have a Delaware nonstock without members
(ii) NY offers clear use of non-member corporations

(iii) NY has “subventions” as a tool of corporate finance

(iv) Dissolution, amendment, sale of assets harder in NY

(v) NY AG is more active than Delaware

E. A Few Points on Choice of Jurisdiction for LLCs

New York vs. Delaware

1. New York: Does not allow LLCs to be formed for nonprofit purposes. This makes the use of New York LLCs quite limited in the world of tax-exempt organizations.

2. Delaware: Specifically permits LLCs to be formed for nonprofit purposes. Several other states (i.e., California) likewise allow LLCs to be formed for nonprofit purposes.

II. JOINT VENTURES OF TAX-EXEMPT ORGANIZATIONS WITH FOR-PROFIT ORGANIZATIONS

A. The Two Main Considerations

There are two main things to bear in mind when thinking about joint ventures involving tax-exempt organizations and for-profit organizations.

1. First, an organization is deemed, for federal tax purposes, to be undertaking the activities conducted by a joint venture that is a partnership for federal income tax purposes (as is almost always the case). Thus, a tax-exempt organization participating in a joint venture is deemed to be undertaking the activities conducted by the joint venture for federal tax purposes.

2. Second, an organization qualifies for Section 501(c)(3) status if (a) it is both organized and operated "exclusively" for "charitable" purposes (or certain other exempt purposes) and (b) it is not operated primarily to serve "public rather than "private" interests. In this context, “exclusively” means "primarily". See Treasury Regulation Section 1.501(c)(3)-1(c)(1), which provides that an organization will be operated “exclusively” for one or more exempt purposes if it engages primarily in activities that accomplish charitable purposes.
3. Putting those two considerations together leads to the following: a tax-exempt organization can participate in joint ventures with for-profit organizations so long as the activities of the joint venture, as imputed to the tax-exempt organization, do not cause it to be regarded as NOT primarily engaged in activities that accomplish charitable purposes.

(a) A corollary to this is that even if the activities of the joint venture do not violate tax-exempt status, the tax-exempt organization may still be engaged in an unrelated trade or business through the joint venture, and be subject to tax on its share of the joint venture’s profits.

B. Possible Scenarios

The principles discussed above should produce one of these possible tax consequences for any particular activity undertaken by a Section 501(c)(3) organization through a joint venture:

1. The activity furthers charitable purposes.

   Example: An organization that operates a hospital that satisfies Revenue Ruling 69-545.

   Example: The organization also operates a pharmacy that sells drugs only to hospital patients. There is nothing inherently charitable about operating a pharmacy, but because this activity is dedicated to patients of the hospital, it substantially furthers the hospital's charitable purposes.

2. The activity is a business activity subject to UBIT, but the activity is not "substantial" in relation to the organization's charitable activities. The activity has no effect on the organization's Section 501(c)(3) status, but the activity does generate UBIT and the organization will pay tax on its net profits from the activity.

   Example: The pharmacy in the previous example sells drugs to both patients and non-patients. Profits from sales to non-patients would be subject to UBIT.

3. The activity is a business activity subject to UBIT and the activity is "substantial" in relation to the organization's charitable activities. In this case, the organization loses its Section 501(c)(3) status.

   Example: Sales to non-patients in the previous example become the dominant part of the hospital's overall business.
C. Key IRS Guidance

1. IRS guidance on joint ventures is not as comprehensive as one would desire – consisting primarily of two Revenue Rulings, 98-15 and 2004-51.

2. Revenue Ruling 98-15 is sometimes known as the “whole hospital” joint venture ruling – it addressed a situation in which a hospital corporation transferred all of its assets to a joint venture.

   (a) In this case, the IRS focused primarily on the hospital’s ability to control all aspects of the joint venture – programs, governance, finances.

3. Revenue Ruling 2004-51 is sometimes known as the “ancillary” joint venture – it addressed a situation in which a university conducted a relatively minor activity through a joint venture.

   (a) In this case, the IRS focused primarily on the university’s ability to influence the content of the programs offered by the joint venture – control over other aspects of the joint venture did not seem to be significant.

4. The $64,000 question, of course, is whether either of these precedents will apply to any potential joint venture. Transactions exactly like Revenue Ruling 98-15 are quite rare. Transactions like Revenue Ruling 2004-51 are apparently common – assuming one can comfortably come to grips with whether the activities in the joint venture are not substantial.

   * * * *