CHAPTER THREE-B

CATEGORIES OF TAX-EXEMPT ORGANIZATIONS

July 2002

by Dorothy K. Foster, Esq.

FOSTER LAW GROUP, P.L.L.C.

Seattle Office:
705 Second Avenue, Suite 1200
Seattle, Washington 98104

Bainbridge Island Office:
355 Erickson Avenue, Suite 410
Bainbridge Island, Washington 98110

Phone/Fax: (206) 686-6862
E-mail: dfoster@fosterlawgroup.com

Dorothy K. Foster is a member of the Seattle and Bainbridge Island law firm of Foster Law Group, P.L.L.C., where she practices in the areas of charitable giving, estate planning and probate, with emphases in private foundations/ supporting organizations and international estate planning. She holds a master's degree in English from Washington State University and a master's degree in Linguistics from the University of Colorado. She graduated with distinction from the University of Nebraska School of Law where she was a Regents Law Scholar, a member of the Order of Coif and Research Editor of the Nebraska Law Review. Ms. Foster is a certified mediator, a Trustee of the King County Bar Foundation, and a member of the planned giving advisory boards of the Nature Conservancy of Washington and Providence Hospital Foundation. She is a member of the Taxation, Real Property/Probate and International sections of the Washington State and American Bar Associations.

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> Nearly one million charitable, educational, religious, health and social welfare organizations create, nurture and sustain the values that frame American life. They promote altruism in a society that reinforces self-interest; community, in a society that rewards individual achievements; and pluralism, in a society sometimes threatened with divisions. They provoke, challenge and question. They also teach, mediate and heal.[1]

Internal Revenue Code § 501(a) exempts from income taxation organizations described in Code § 501(c). Generally, all organizations described in Code § 501(c) are organized on a not-for-profit basis, such that earnings of the organization not inure to the benefit of the members or founders. Certain of these Code § 501(c) organizations receive the additional tax benefit of the deductibility of contributions to the organization on the donor's tax return. These "§ 501(c)(3)" organizations are organized and operated for charitable purposes. The activities of non-§ 501(c)(3) organizations do not reach this charitable level, and the organizations are distinguished in not affording their donors charitable contribution deductions.

I. HYPOTHETICALS

1. Edelweiss is a nonprofit organization established and funded by one individual and organized and operated to provide retreat facilities for women fine artists. Edelweiss provides the artists room and board in a rural retreat setting for a period of up to three months. Participating artists are chosen by a selection committee independent of both the organization's creator and principal contributors. Some artists are eligible to receive travel grants. Edelweiss expends all of its income on these charitable undertakings.

2. Chuck Chang and Connie Lotus are a married couple in their thirties who have spent the last ten years working in and receiving stock from a profitable software company. They now have a fund of highly appreciated, publicly traded securities that they wish to direct to charitable purposes. Rather than making outright contributions, they wish to control the timing of the distributions from an endowment. They will not be able to access their stock until February 2003. They also have very specific charitable goals: They wish to benefit their two alma maters

[1] Why Tax Exemption? "The public service role of American Independent Sector." (Washington D.C.: The Independent Sector), p. 1.

and the state University that Connie attended for graduate school. Beyond that, they have the general purpose of benefiting the education of children in the State of Washington.

3. John Weinmaker III, a venture capitalist, is the fourth generation of a family of philanthropists. Though benefiting himself from a private education and immersion in the arts and classical culture, he wishes to direct his philanthropic energies elsewhere. He is interested in business--both within the United States and in foreign countries. His interest is in the "cutting edge" of philanthropy, and he wishes to translate his venture capitalist skills to the Third Sector by investing in staff-up businesses. With five million dollars in highly appreciated, publicly traded securities, he wants to begin his charitable enterprise this year. He has no interest in involving others on his board.

4. Monya Mott, Kendra Kennedy and "Dawni" are musicians specializing in the performance of "New Age music." They feel that the power of their music is misunderstood and misrepresented in the community. They are appalled that there is not even a radio station in the King County area committed to the performance of their art. Monya, Kendra and Dawni want to put Seattle in touch with real New Age music, and they are convinced that they themselves are the best representatives of their art. But first they need cash (and synthesizers)!

5. Shirley Shoute and Tim Wynette can't stand what is happening to our country. They want to do something about it, so they plan to spend their mutual Uncle Snodgrass's legacy. They intend to bring our country back to its patriotic roots. How often does one hear the Star-Spangled Banner anymore? What children can even repeat the words? They want every American child of our fathers to sing the Star-Spangled Banner at the beginning of their educational endeavors. Uncle Snodgrass's legacy is just a start—but at least it will get them to Washington D.C. Then they will see some changes made.

6. Mr. and Mrs. Tarvinen are citizens of the United States and were born and raised in Lithuania. They each fled with their families when the Soviet Union occupied their country. They would like to create a museum in Lithuania to remind succeeding generations of that event. They will donate the finds necessary to establish the museum, and because of their fear of the Soviet influences in their homeland, they want to keep control of it.

7. George Lewis is a lawyer with inherited wealth. He would like to practice law for the benefit of charity. But he wants that charity to be his own and doesn't want to solicit from others. He doesn't want to practice law for just anyone: he wishes to take on those cases that represent significant public civil rights issues.

II. NON CHARITABLE ORGANIZATIONS

A. SUMMARY LISTING OF NONCHARITABLE ORGANIZATIONS

Those non-charitable organizations recognized as exempt under Code § 501(c) (other than § 50l(c)(3)) organizations are the following:

1. Corporations which are instrumentalities of the United States, §50l(c)(l);

2. Title-holding corporations serving other exempt organizations, § 501(c)(2);

3. Civic leagues and social welfare organizations, § 501(c)(4);

4. Labor, agricultural, or horticultural organizations, § 501(c)(5);

5. Business leagues, § 501(c)(6);

6. Pleasure and recreation clubs, § 501(c)(7);

7. Fraternal benefit societies, orders or associations, § 5.0l(c)(8);

8. Volunteer employees' beneficiary association, § 501(c)(9);

9. Domestic fraternal societies, orders, or associations operating under the lodge system, § 501(c)(10);

10. Teacher's retirement fund association, §501(c)(11);

11. Certain benevolent life insurance associations and similar organizations, § 501 (c)(12);

12. Cemetery companies, § 501(c)(13);

13. Mutual credit unions, § 501(c)(14);

14. Certain non-life insurance companies or associations, § 501(c)(15);

15. Crop operation financing corporations, § 501(c)(16);

16. Supplemental unemployment compensation benefit trusts, § 501(c)(17);

17. Pre-6/26/59 pension plan trusts, 501(c)(18);

18. Veterans and similar organizations, § 501(c)(19);

19. Qualified group legal services plan organizations, § 501(c)(20);

20. Black Lung Act Trusts, § 501(c)(21);

21. ERISA Trusts, § 501(c)(22);

22. Pre-1880 Veterans' Benefit Associations, § 501(c)(23);

23. ERISA § 4049 Trusts, § 501(c)(24);

24. Certain real property holding corporations or trusts, § 501(c)(25).

B. A FEW EXAMPLES.

1. Social Welfare Organizations: § 501(c)(4). A nonprofit organization operated exclusively for the promotion of social welfare qualifies for an exemption from income tax under Code § 501(c)(4). An organization of this type is operated primarily to further the common good and general welfare of the community. Examples of this type of organization are civic associations and volunteer fire companies. Generally, membership in the organization must be open to all members of the community--not primarily a private group. The organization may participate to some extent in political activity but is generally prohibited from engaging in campaigns on behalf of or in opposition to any candidate for public office.

The term "community" generally refers to a geographical area recognizable as a subdivision or housing development. If social activities comprise the primary activities of the organization, then it should receive its authorization for exemption as a social club under Code § 501(c)(7).

2. Social Recreation Clubs; § 50l(c)(7). Even if an organization's purposes are not for the benefit of the entire community's welfare, it still will be recognized as tax exempt as an organization not engaged in profit. Examples of this sort of organization are college alumni associations, country clubs and hobby clubs. Membership in the club must be expressly limited and the club's facilities should not be open to the general public. Pleasure, recreation and other nonprofit purposes must be the principal objectives of the organization, and the members must be "bound together by a common objective" towards these purposes.

There are some restrictions on the operations of such a club, however. It will not be recognized as tax exempt if its governing instrument contains provisions that discriminate against any person on the basis of race, color or creed. Further, no part of the net earnings of the organization may inure to the benefit of any member.

3. Business Leagues: § 501(c)(6). A third example of a non-§ 501(c)(3) tax exempt organization is the business league. Such an organization is not organized to engage in profit, but it may engage in certain insubstantial activities ordinarily carried on for profit. The purpose of the business league is to promote the common interests of persons having

a common business interest and not to engage in a business itself. Trade associations and professional associations are examples of such an organization.

The organization's purpose generally must be the improvement of business conditions. Thus, it may promote higher business standards and methods, promote interest in the business community by educating the public in the use of credit, operate a trade publication intended to benefit an entire industry, or encourage the use of goods and services of an entire industry (such as a lawyer-referral service). As with other § 50 1(c) organizations, no part of the organization's net earnings should benefit any private individual or shareholder.

III. CHARITABLE ORGANIZATIONS; § 501(c)(3)

An organization organized and operated exclusively for the following purposes--charitable, religious, educational, scientific, literary, testing for public safety, fostering national or international amateur sports competition or the prevention of cruelty to children or animals--qualifies for exemption from Federal income tax under Code §50 1(a). Further, contributions to domestic organizations of this type are deductible as charitable contributions on the donor's Federal income tax return. I.R.C. Code § 170(c) and Code § 5 09(a) subdivides these organizations into "private foundations" and those commonly known as "public charities." Code § 509(a) defines "private foundations," by exclusion, as those organizations other than the four types set forth in Code §§ 509(a)(1) through (4).

Code § 509(a)(1) organizations are those which conduct certain types of charitable activities, Code § 509(a)(2) organizations are those which receive a substantial part of their support from the general public and governmental bodies; Code § 509(a)(3) organizations are those which are closely associated with another Code § 501 (c)(3) public charity; and Code § 509(a)(4) organizations arc those organized and operated exclusively to test for public safety. Any charitable organization which does not inform the Internal Revenue Service (the "Service") on its application for recognition of exemption (Form 1023) that it is a public charity will generally be presumed to be a private foundation. Code § 508(b).

A. PUBLIC CHARITIES

A public charity is an organization qualifying under Code Section 50l(c)(3) which also satisfies the support requirements of either Code § 509(a)(1), § 509(a)(2), or §509(a)(3).

1. **Broad Public Support; Section 509(a)(1)**. An organization may qualify as a "publicly supported organization" under either of two support tests: (i) the 33-1/3% (or "mechanical") test; or (ii) the 10% (or "facts and circumstances") test.

(a) The "Mechanical" (33-1/3%) Test. An organization qualifies as a Code § 509(a)(l) organization if its support from the general public and government equals at least one third of its aggregate total support. Treas. Reg. § 1.l70A-9(e)(2). "Support" for these purposes includes: (i) gifts, grants, contributions and membership fees; (ii) net income from unrelated business activity; (iii) gross investment income; (iv) tax revenues levied for the organization's benefit and paid to or expended for the organization; and (v) the

value of services or facilities furnished without charge to the organization by a governmental unit. Code § 509(d). Gross receipts from any activity included in an organization's charitable function are not included in the calculation. Treas. Reg. § 1.170A- 9(e)(7)(i).

"Total support" includes all of the following: (i) gifts, grants, contributions or membership fees; (ii) net income from business activities unrelated to the exempt function; (iii) gross investment income; (iv) tax revenues levied for the organization's benefit; and (v) the value of services or facilities furnished without charge to the organization by a governmental unit. Code §509(d).

"Qualifying support from governmental units and/or the general public" includes support from qualifying sources in any of the forms (i) through (v) listed above. Qualifying public support also includes support from individuals, trusts or corporations.

Support from any one entity is not considered as qualifying support to the extent that it exceeds 2% of the organization's total support. This 2% limitation is designed to ensure broad-based public support.

(b) <u>The "Facts and Circumstances" (10%) Test.</u> If an organization fails to meet the mechanical test, it may still qualify as a Code § 509(a)(1) organization if its combined public support and support from governmental units is at least ten percent (10%) of its total support; and the organization meets several "facts and circumstances" requirements establishing that it serves broad-based public interests. Treas. Reg. § 1.170A-9(e)(3).

First, the organization must be organized and operated to attract new and additional public or governmental support on a continuous basis. Thus, support must be broadly based. Second, the organization's governing body should represent the broad interests of the public rather than the personal interests of a few donors. The Regulations set forth further requirements. Treas. Reg. § 1,170A-9(e)(3).

As under the 33-1/3% test, only contributions by any particular individual, trust, or corporation which do not exceed 2% of the organization's total support are included in "public support" (though there is provision for the exclusion of "unusual grants").

(c) <u>Unusual Grants</u>. Unusual grants to the organization (i.e., grants which are exceptional in amount, unexpected, and which would adversely affect the organization's ability to meet the support tests) are excluded both from "public support" and from "total support." Treas. Reg. § 1.170A-9(e)(6)(ii). Thus, characterization of a grant as "unusual" is beneficial to an organization's qualification status.

2. **<u>Public Support from Exempt Activity: § 509(a)(2)</u>**. An organization which receives a substantial portion of its support as receipts from the general public for its exempt activity, rather than through donations, may qualify as a public charity under Code § 509(a)(2). Such an organization: (i) must normally receive <u>no greater</u> than one-third of its support each year from gross investment income and unrelated business income; and

(ii) at least one-third of its support must come from the general public as gifts, grants, contributions, membership fees, gross receipts from admissions and other related activities.

(a) One-Third Gross Investment Income Test, Under the one-third gross investment income test, no greater than one-third of the organization's total support can consist of the sum of "gross investment income" plus the excess of unrelated business taxable over the tax on that unrelated business income. I.R.C. § 511; 509(a)(2)(B). "Gross investment income" is defined as the gross amount of income from interest, dividends, rents and royalties, to the extent such income is taxable as unrelated business income. I.R.C. § 509(e).

(b) One-Third Public Support Test. The organization must meet a one-third public support test equivalent to the mechanical test applicable to public charities under Code § 509(a)(l). Gross receipts from performance of services which are related to the exempt function may be included in the calculation for purposes of determining the qualifying support from governmental units and/or the general public and total support. Gross receipts from any person, or from the bureau of a governmental unit, are excluded, however, to the extent that they exceed the greater of $5,000 or 1% of the amount of total support. Further, "qualifying support" does not include income from: (i) a "disqualified person" under Code § 4946; (ii) a governmental unit; or (iii) other organizations described in Code § 170(b)(1)(A).

3. Supporting Organizations: § 509(a)(3). An organization which is not publicly supported but which is responsive to public concerns because of its relationship with other public charities may still qualify as a "public charity." 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 specified organizations" described in Code § 509(a)(l) or (2). It must be "operated, supervised, or controlled by or in connection with one or more organizations" described in Code § 509(a)(1) or (2); and it must not be "controlled directly or indirectly by one or more disqualified persons (as defined in Code § 4946) other than foundation managers and other than one or more organizations" described in Code 509(a)(l) or (2).

(a) The Organizational Test. The governing instrument of a supporting organization must satisfy all four of the following requirements to satisfy the organizational test:

(i) The governing instrument must limit the purposes of the organization to one or more of the purposes set forth in Code § 509(a)(3)(A);

(ii) It must not expressly empower the supporting organization to engage in activities not in furtherance of the purposes referred to in Code 509(a)(3)(A);

(iii) It must designate the supported organizations on whose behalf the organization is to be operated; and

(iv) It must not expressly empower the organization to operate to support or benefit any organization other than the specified supported organizations.

(b) Operational Test. The supporting organization must be "operated exclusively" for the support of the specified supported organizations; but that support may include payments to or for the use of, or the providing services or facilities to, individual members of the charitable class benefited by the specified "public charities."

The supporting organization need not pay over all its income to the supported organizations, however. It may satisfy the test otherwise by using its income to carry on "an independent activity or program which supports or benefits the specified publicly supported organizations."

(c) The Relationship Test. One of three types of permissible relationships between the supporting and supported organizations is necessary to satisfy the requirements of Code § 509(a)(3).

(i) **Type 1: "Operated. Supervised, or Controlled By."**

(A) General Requirements. The distinguishing feature of the "operated, supervised, or controlled by" relationship is the presence of a "substantial degree of direction by the "supported" organizations over the "supporting" organization." This relationship is comparable to that of a parent and subsidiary.

(B) Governing Body. The existence of the "operated, supervised, or controlled by" relationship is usually established by the fact that 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 publicly supported organizations."

(C) Purpose Requirements. For purposes of the organizational test described in section 3(a) above , the supporting organization's purposes as set forth in its 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 Requirements.

Supporting organizations which are "operated, supervised, or controlled by" publicly supported organizations may "specify" the publicly supported organizations in one of three ways:

- The Articles of the supporting organization can designate each of the specified organizations by name;
- The governing instrument of the supporting organization can require that the organization be operated to support or benefit one or more beneficiary

organizations designated by a class or purpose closely related in purpose or function to a specified "principal" supported organization; or

- The governing instrument need not name the specified organizations if two conditions are satisfied:
  - there has been an historic and continuing relationship between the supporting organization and the supported organization; and
  - by virtue of such relationship, there has developed a substantial identity of interest between such organizations.

(ii) **Type 2: "Supervised or Controlled in Connection With."**

(A) General Requirements. In order for a supporting organization to be considered "supervised by or controlled in connection with" one or more supported public charities, there must exist "common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to ensure that the supporting organization is responsive to the needs and requirements of the supported organizations." Thus, "the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations":

(B) Other Requirements. The requirements relating to the "purposes" requirement and the specific organization requirement of the organizational test may be satisfied by a "supervised or controlled in connection with" supporting organization in the same manner as an "operated, supervised or controlled by" organization.

(iii) **Type 3: "Operated in Connection With."** In order to be considered an organization "operated in connection with" one or more publicly supported organizations, the supporting organization must meet both of two tests: (i) the responsiveness test; and (ii) the integral part test.

(A) Responsiveness Test. The responsive test is satisfied if the supporting organization "is responsive to the needs or demands of the publicly supported organizations." In order to meet the responsiveness test, the supporting organization must meet either of the following requirements:

(1) The governing bodies of the supported organizations must have a significant voice in the investment policies of the supporting organization, the timing and making of grants, the selection of recipients, and in otherwise directing the use of income or assets of the supporting organization. In addition, the supporting organization must meet any one or more the following requirements: (AA) one or more members of the governing body of the supporting organization must be elected or appointed by the governing body of the publicly supported organizations; (BB) one or more of

the members of the governing bodies of the publicly supported organizations must also be members of the governing body of the supporting organization; or(CC) the governing body of the supporting organization must maintain a close and continuing working relationship with the governing bodies of the supported organizations.

(2) Alternatively, the supporting organization must satisfy all three of the following requirements to meet the responsiveness test: (AA) the supporting organization must be a charitable trust under state law; (BB) each supported organization must be a named beneficiary under the charitable trust's governing instrument; and (CC) the supported organization must have the power to enforce the trust and to compel an accounting under state law.

(B) Integral Part Test. The integral part test is deemed satisfied if the supporting organization maintains a significant involvement in the operations of one or more supported organizations and each supported organization is in turn dependent upon the supporting organization for the type of support which it provides.

In order to meet the integral part test, the supporting organization must satisfy either of the following conditions:

(1) the activities engaged in by the supporting organization must be activities to perform the functions of, or carry out the purposes of, the supporting organizations; and but for the involvement of the supporting organization, these activities would normally be engaged in by the supported organizations themselves; or

(2) the supporting organization must make payments of substantially all of its income to or for the use of one or more of the supported organizations. In addition, the amount of support received by such supported organizations must be sufficient to insure the attentiveness of the organizations to the operations of the supporting organization. A substantial amount (at least 85%) of the total support of the supporting organization must also be paid to the publicly supported organizations.

4. Public Safety: § 509(a)(4) Organizations. Code § 509(a)(4) excludes from classification as private foundations those organizations that are organized and operated for the purpose of testing products for public safety. Generally, these organizations are of the type that tests consumer products.

B. PRIVATE FOUNDATIONS

Those organizations which are not excluded by Code § 509(a) are private foundations.

1. In General. A private foundation is a charitable organization established by an individual donor for the purpose of controlling the donor's charitable contributions to public charities and directly to charitable recipients. A foundation is often established to allow the donor to manage the timing of his charitable contributions and to engage in charitable purposes beyond those normally undertaken by established public charitable

organizations. Those purposes are defined in the foundation's organizational documents so as to reflect and maintain the founder/donor's philanthropic values.

Contributions of appreciated property to a private foundation may be deducted to the extent of 20% of a donor's income base (basically, his adjusted gross income). Contributions of cash may be deducted up to 30% of that amount. Thus, in one year, a donor may contribute assets with a value of no more than 30% of the donor's income base for that year. This contribution limitation is more restricted than the limitations placed upon direct contributions to a public charity (deductible at 50% and 30% rates), but it is generally not significant for most donors who may easily plan a series of contributions over the course of several years.

Contributions of appreciated property to a private foundation rather than to a public charity are limited by a further factor. Appreciated property is deductible at its full fair market value when contributed to a public charity; when contributed to a private foundation, on the other hand, the measure of the contribution deduction is equal only to the property's cost basis. This rule has been modified by legislation to allow contributions of certain qualified stock (basically, publicly traded securities) to be deductible at full fair market value. Contributions of real property, on the other hand, are deductible only at cost basis. The existing restriction fails to be prohibitive, however, for a donor with significant charitable intent.

2. Limitations. Since private foundations are perceived as more likely to generate tax abuses than other charitable organizations, Chapter 42 of the Code places various restrictions and limitations upon them. A private foundation is subject to strict operational guidelines as well as excise taxes, and it may be subject to penalty taxes for failing to comply with federal regulations. These special rules are designed to prevent self-dealing between a foundation and its donors, to limit ownership of private businesses by foundations, to ensure that a foundation not invest in speculative investments, and to ensure that a foundation use its income only for the charitable purposes for which it was granted its original tax exemption.

A significant burden placed upon private foundations is an excise tax of 2% of the value of the foundation's net investment income. This tax is reduced to 1%, however, if a foundation maintains certain distribution patterns. The foundation also must annually distribute 5% of its assets for charitable purposes. A foundation engaged in active grantmaking should have no problem meeting any of these requirements.

a. Code § 4940: Tax on Investment Income. Private foundations are subject to a 2% tax on net investment income. The term "net investment income" is defined as the amount by which: (i) the sum of gross investment income and the capital gain net income exceeds (ii) allowable deductions. The term "gross investment income" is defined as the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties, except to the extent these revenues constitute unrelated business taxable income ("UBTI"). Deductions in computing "net investment income" are allowed for all ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the management, conservation, or maintenance of property held for the production of such income. I.R.C. § 4940(c).

A reduced 1% tax is available if certain distribution requirements are met. This 1% tax applies if the amount of "qualifying distributions" (as defined in Code § 4942(d)) made by the foundation during the taxable year exceeds the sum of: (i) an amount equal to the assets of the foundation for the taxable year, multiplied by the "average percentage payout" for the "base period"; plus (ii) 1% of the net investment income of the foundation for the taxable year. I.R.C. § 4940(e). In addition, no tax under Code § 4942 must have been payable in any year in the "base period." I.R.C. § 4940(e)(2)(B). The "average percentage payout" is defined as the average of the percentage payouts for taxable years in the "base period." The "percentage payout" is defined as the percentage determined by dividing: (i) the amount of the qualifying distributions made by the foundation for the taxable year, by (ii) the foundation's assets for the taxable year. The "base period" is defined as the five taxable years preceding the current taxable year. If the organization has not been in existence throughout the base period, then the base period is defined as those taxable years during which the foundation has been in existence. I.R.C. § 4940(e).

b. Code § 4941: Self-Dealing. Acts of "self dealing" between a private foundation and a "disqualified person" are subject to a penalty excise tax of 5% of the self-dealing expenditures, with a further 200% penalty if the self-dealing act is not corrected within the permissible period. A "disqualified person" is a substantial contributor to or foundation manager (i&., officers and directors) of the foundation. I.R.C. 4946(a).

"Self-dealing" includes: (i) the sale or lease of property; (ii) the lending of money where interest is charged; (iii) under certain circumstances, the furnishing of goods, services or facilities; (iv) the payment of excessive compensation; and (v) the transfer to a disqualified person of foundation income or assets.

c. Code § 4942: Failure to Distribute Income. Private foundations which fail to make "qualifying distributions" of their income are subject to a 15% tax (and, if the income remains undistributed after the permissible period, an additional 100% tax). LR.C. § 4942(a), (b). The term "qualified distribution" is defined as: (A) any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more of the foundation's exempt purposes (excluding any contribution to a controlled organization or a private foundation); or (B) any amount paid to acquire an asset held for use in carrying out one or more of the foundation's exempt purposes. I.R.C. § 4942(g)(1).

d. Code § 4943: Excess Business Holdings. Code § 4943 imposes an initial excise tax of 5% of the value of the private foundation's excess business holdings and an additional tax of 200% of the value of such holdings still held after the imposition of the initial tax. "Excess business holdings" are defined as the "amount of stock or other interest in the enterprise which the foundation would have to dispose of to a person other than a disqualified person in order for the remaining holdings...to be permitted." I.R.C. § 4943(c)(1).

A private foundation may hold corporate stock in a corporation only to the extent of 20% of the voting stock, minus the percentage of voting stock owned by all disqualified persons. I.R.C. § 4943(c)(2)(A). A private foundation may hold any percentage of nonvoting stock, if all disqualified persons together hold no more than 20% of the voting stock in the corporation. I.R.C. § 4943(c)(2). "Disqualified persons" for these purposes include the

following: (i) a substantial contributor, as defined in Code § 509(d)(2); (ii) a foundation manager (i&. an officer, director, or trustee); (iii) an owner or more than a 20% interest in a business enterprise which is a substantial contributor; and (iv) a member of the family of (i) through (iii) above. I.R.C. § 4946(a).

e. Code § 4944: Jeopardizing Investments. If a private foundation makes investments deemed to jeopardize its exempt purposes, it is subject to a tax of 5% of the amount involved (25% if the investment is "not removed from jeopardy" within the permissible period). L.R.C. § 4944(a). "Jeopardizing investments" include trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of "puts," "calls," and "straddles," the purchase of warrants and selling short. Treas. Reg. § 53.4944-I(a)(2)(i).

f. Code § 4945(a): Taxable Expenditures. A "taxable expenditures" by a private foundation is subject to a penalty excise tax of 10% of the amount of the expenditure (100% of the expenditure if it is not corrected within the permissible time). I.R.C. § 4945. "Taxable expenditures" include amounts paid (1) to carry on propaganda or otherwise attempt to influence legislation; (ii) to influence the outcome of a public election or to carry on a voter registration drive, with certain exceptions; (iii) grants to individuals for travel or study unless the grant satisfies certain requirements; (iv) grants to an organization other than a public charity or an exempt operating foundation (unless the granting foundation exercises "expenditure responsibility" with respect to the grant); and (v) any other non-exempt purpose. I.R.C. §4945(d).

C. ACTIVE PHILANTHROPY

1 Foreign Activities

Unlike an individual, a private foundation may make charitable contributions to foreign entities or individuals. The purpose of the grant or distribution must be charitable, but permissible recipients include a U.S. public charity operating overseas, a "Friends Of" organization, a foreign government, a foreign entity with 501(c)(3) status from the Internal Revenue Service, a foreign equivalent of a U.S. public charity, a foreign equivalent of a U.S. private foundation, a foreign qualifying individual, and even a foreign organization which does not qualify as equivalent to a U.S. 501(c)(3).

Grantmaking to foreign entities requires additional contracting and record keeping. Generally, the farther removed a foreign organization is from bona fide U.S. 501(c)(3) public charity status, the greater the amount of documentation a private foundation must maintain to establish the qualifying nature of a grant.

Foster Law Group assists foundations with necessary affidavits, contracts and grant letters, with the expectation that the private foundation managers will be empowered to make similar foreign grants without additional "lawyering." The documentation requirements, although onerous when first encountered, are often expressions of the kind of due diligence one would normally take when giving money to someone without established credit. A review of

the organization's financial records, an annual report that accounts for the expenditure of the funds, and a pledge to maintain the foundation's gift in a bank account separate from the organization's other funds can assure the foundation (and, hence, the I.R.S) that the funds are being expended for truly charitable purposes. We are fortunate in that our government affords donors to U.S. private foundations a U.S. income and/or estate tax deduction for funds that will be expended outside of the United States. The tax code—and the legislation that preceded it—contemplated philanthropy on an international scale.

2. Grants to Individuals

Also unlike U.S. individual taxpayers, a private foundation is entitled to characterize as part of its distribution amount grants to private individuals. Grants of this nature fall into basically two categories: grants for scholarship, research, study or travel, and grants that are not for scholarship, research, study or travel.

Grants in the first category require advance approval from the I.R.S. That is, a foundation that contemplates making a grant for these purposes must prepare scholarship selection criteria and application procedures and must submit them to the I.R.S. before any grant is made. The foundation must establish that the criteria are nondiscriminatory and select from candidate pool of sufficient breadth as not unfairly to benefit one individual or class of individuals. Once the grant is made, the foundation must carry out investigations to establish that the grant was indeed used for its intended purposes. Generally, an individual who receives a grant for these purposes may exclude the amount from his income for income tax purposes.

Grants in the second category do not require the advance approval of the I.R.S. Grants of this type include prizes and awards (not related to study or travel) as well as grants to individual for economic relief. Generally, the purpose of this type of individual grant is to recognize or relieve past behavior or circumstances with no obligatory oversight required by the foundation regarding the use of the funds.

Prizes and awards are considered taxable income to the recipient (with the exception of certain qualifying "charitable achievement awards"). Grants that are not prizes or awards (nor intended for scholarship, study or travel) and are made to an individual for economic relief are considered gifts and are not taxable income to the individual. Yes, a private foundation may make grants to needy individuals and need not establish that that individual "out-qualified" all other needy individuals in order to qualify for aid.

Such grants must be made on an objective and non-discriminatory basis; but, unlike donations to public charities (by an individual) that are earmarked for a particular individual or family, a grant from a private foundation may be made directly to benefit an individual or family chosen by the foundation. Foundations must take care not to violate certain rules that forbid them from making grants to individuals who are closely related to the foundation. Generally, however, a financially impoverished person (even if just recently so) may receive grants for healthcare, rebuilding a home or meeting basic living expenses. In all cases, the grant recipients must demonstrate financial need.

D. ENTREPRENEURIAL PHILANTHROPY

"Entrepreneurial Philanthropy" is a coined term. We use it at Foster Law Group to refer to foundation grantmaking carried out on a business model. Just as a private foundation may make grants to foreign entities that have not received I.R.C. 501(c)(3) status, so may the foundation make grants to U.S. entities that are not 501(c)(3) qualified. The documentation process is similar to that required for grants to foreign entities, and, again, models the due diligence steps one would normally undertake when dealing with a "credit risk".

(1) Foundation-to-Foundation Grants

A private foundation may, indeed, make grants to other private foundations. The recipient foundation must pledge, however, to expend the funds for its charitable purposes by the end of the year following the year of receipt of the grant. The donor foundation must carry out due diligence regarding the recipient foundation and require annual reporting as to the use of the funds. A foundation-to-foundation grant, then, may not be used to increase the recipient foundation's endowment.

(2) Grants to Non-charities

Likewise, a foundation may make a grant to an organization that doesn't have 501(c)(3) status of any sort (is neither a public charity, a supporting organization nor a private foundation). If the donor foundation can demonstrate that the recipient organization will use the funds for charitable purposes, a grant to that organization is a qualifying expenditure. Demonstration of that charitable use, again, is made by means of contracting, due diligence and record keeping. There is no requirement that the recipient organization keep the funds in a segregated account. A favorite use of this type of grant is the funding of a new start-up public charity. A private foundation may provide the funds necessary for the charity to gain its 501(c)(3) status.

(3) Program Related Investments

The epitome of entrepreneurial philanthropy is the "program related investment". Through a program related investment, a foundation loans money to or takes an equity interest in a for-profit enterprise. In this sort of grant, the private foundation need not establish that the recipient organization is carrying out a charitable activity; but, rather, that the making of the grant itself will result in a charitable goal held by the foundation.

Establishing a program-related investment program enables a foundation to undertake philanthropy through encouraging entrepreneurship. If the foundation can demonstrate that investing in a for-profit enterprise would lead to some charitable benefit to the community (and is within the foundation's charitable purposes), the investment will count as a "grant" for purposes of the foundation's annual 5% distribution requirement. In order to qualify the grant as a program related investment, the foundation must generally demonstrate that no commercial funds were available to assist the for-profit and that "no principal purpose" of the foundation's investment was the making of profit.

The foundation can loan or invest money to accomplish such goals as minority entrepreneurship and job creation. Funds can be invested to improve dilapidated community areas; to fund the creation of a product that will benefit, say, children's education; to build low-income housing; to support a venture capital fund working in a depressed area; or to provide a bridge loan to public charities or community organizations with cash short falls. If a foundation's purpose is education, any sort of educational endeavor that has failed to attract commercial funding should qualify as a program-related investment. If foundation's purpose is community development, it can function as its own community development bank and avoid having to work through established organizations.

Program related investments may be carried out overseas, as long as the foundation's organizing instrument allows foreign grantmaking. Of course, careful due diligence and documentation is necessary; but the foundation need not get advance approval from the I.R.S. before making a program related investment either domestically or overseas. In addition, once foundation staff have experience in making program related investments, they often can proceed with further investing without additional legal advice.

What if the investment makes a profit? A foundation is not required to divest itself of the investment, but may simply move the investment over on its balance sheet from "grants" to "portfolio investment." While the investment is used to satisfy the foundation's distribution requirement, some continuing monitoring is required to ensure that the investment still serves the foundation's charitable purposes. Generally, however, a foundation may quite easily carry out philanthropy in the guise of venture capital. Investing in start-up businesses broadens a foundation's ability to contribute to its community by allowing foundation assets to "be recycled" into new projects as old ones accomplish their charitable purpose.

E. PRIVATE OPERATING FOUNDATIONS

Private operating foundations are defined in Code § 4942(j)(3). "Hybrids" of sorts, they are treated as public charities for purposes of the charitable contribution deduction, but are subject to many of the restrictions placed on private foundations.

Private operating foundations differ from private foundations in that though supported by substantial endowments from a small number of individuals, they are more active in the conduct of their own charitable operations than in grantmaking. Though classified as private foundations for the purposes of most private foundation rules and excise taxes, private operating foundations are not subject to the undistributed income tax of Code § 4942.

To qualify as a private operating foundation, an organization must meet two tests: 1) the "income test"; and 2) either the "assets test," the "endowment test," or the "support test." Treas. Reg. § 53-4942(b)-l(a)(l).

1. The Income Test. The income test requires the organization to make "qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated. These distributions must be equal to substantially all of the lesser of: i) the organization's adjusted net income; or ii) its minimum investment return. I.R.C. § 4942(j)(3)(A).

Qualifying direct distributions include amounts paid to acquire assets for use in a foundation's exempt function, reasonable administrative expenses necessary to conduct that function, and amounts set aside to purchase the assets held for direct use in the exempt function. Grants or scholarships to individuals are considered direct expenditures if the foundation "otherwise maintains some significant involvement in the active programs in support of which such grants, scholarships, or other payments were made or awarded." Treas. Reg. § 53.4942 (b)-1 (b)(2)(i).

The Regulations define "substantially all" to mean 85% or more of the lesser of the foundation's adjusted net income or its "minimum investment return." Treas. Reg. § 53.4941(b)-1(c). Code § 4942(1) defines "adjusted net income" as the gross income for the year minus certain deductions. A foundation's minimum investment return is equal to 5% of the value of its assets not used directly in carrying out its exempt function, minus any acquisition indebtedness. I.R.C. § 4942(e)(l). This is the same definition that is used in determining the 5% distribution requirement for a non-operating foundation under Code § 4942.

2. Additional Tests. One of the three following additional tests must be met:

(a) Assets Test. Under the assets test, "substantially more than half' of the foundation's assets must be held for use in the foundation's exempt function activities. I.R.C. § 4942(j)(3)(B)(i).

(b) Endowment Test. Under the endowment test, the foundation must distribute at least two-thirds of its minimum investment return (that is 3-1/3% of its endowment) for direct charitable purposes. I.R.C. § 4942(j)(3)(B)(ii). "Endowment" is defined in Regulation § 53.4942(a)-2(c) as the fair market value of the foundation's assets used for non-exempt purposes minus acquisition indebtedness.

(c) Support Test. Under the support test: 1) at least 85% of the operating foundation's support, other than gross investment income, must be from the general public and five or more exempt organizations; 2) not more than 25% of support other than gross investment income may be from any one exempt organization; and 3) not more than 50% of the support may be from gross investment income. J.R.C. § 4942(j)(3)(B)(iii). "Support" is defined under the Regulations to include gifts, grants, contributions, membership fees, gross receipts from admissions, etc. I.R.C. § 509(d).

Private operating foundations qualify for the 50% charitable contribution deduction limitation. I.R.C. § l70(b)(1)(A)(vii). Thus, contributions of ordinary income property are deductible to the extent of 50% of the donor's contribution base; contributions of long-term capital gain property are deductible at fair market value to the extent of 30% of the donor's contribution base.

F. CONDUIT FOUNDATIONS

A "conduit foundation" is a private foundation that makes qualifying distributions of 100 percent of all contributions the foundation received in a year. This type of foundation is not described in IRC § 501, but is described only in provisions of the Code and Regulations describing the income tax consequences of a charitable donation. IRC § 170(b)(1)(D)(ii); Treas. Reg. § 1.170A-9(g)(1). The distributions must be made not later than the fifteenth day of the third month after the close of the tax year in which the contributions were received and the private foundation must not have any remaining undistributed income for the year. See, The Law of Tax Exempt Organizations, Bruce R. Hopkins (John Wiley & Sons, 1992).

The distributions are treated as made first out of contributions of principal and then out of contributions of cash received by the private foundation in the year involved. The distributions cannot be made to an organization controlled directly or indirectly either by the private foundation or by one or more disqualified persons with respect to the private foundation or to any private foundation that is not a private operating foundation.

Charitable contributions to conduit private foundations of cash or short-term capital gain property qualify for the 50 percent limitation. Contributions of long-term capital gain property qualify for the 30 percent limitations. The Donor is entitled to deduct ordinary income property at its fair market value. These limitations correspond, then, to those available for contributions to a public charity. The donor must obtain adequate records or other sufficient evidence from the private foundation showing that the private foundation made the qualifying distributions.

G. "PUBLIC INTEREST LAW FIRMS"

A Public Interest Law Firm ("PILE") is a type of 501(c)(3) and 509(a)(1) or (3) charity. Public interest law firms provide legal representation for important public interests that are unrepresentative because the cases are not economically feasible for private firms. These interests typically involve environmental policies, the tax system, freedom of information, food regulation, and drug regulation interests that inevitably pit the public interest law firms against the "establishment", with resulting "political" consequences. See, The Law of Tax Exempt Organizations, Bruce R. Hopkins (John Wiley & Sons, 1992). Organizations that otherwise qualify as public interest law firms are regarded "as charities because they provide a service which is of benefit to the community as a whole, with "[c]haritability...also dependent upon the fact that the service provided by public interest law firms is distinguishable from that which is commercially available." Rev. Rul. 75-78.

The IRS issued guidelines for advance exemption rulings for public interest law firms. These guidelines state that the "engagement of the organization in litigation can reasonably be said to be in representation of a broad public interest rather than a private interest." In addition to § 501(c)(3) requirements, the IRS guidelines require the following: (1) it may accept fees for services rendered but only in accordance with specific IRS procedures; (2) it may not have a program of "disruption of the judicial system, illegal activity, or violation of the applicable canons of ethics"; (3) it files with its annual information return (Form 990) a description of cases litigated and the "rationale for the determination that they would benefit the public generally"; (4) its policies and programs are the responsibility of a "board or committee

representative of the public interest," not controlled by its employees or those who litigate on its behalf nor by noncharitable organizations; (5) it is not operated so as to create (identification or confusion with a particular private law firm"; and (6) "[t]here is no arrangement to provide, directly or indirectly, a deduction for the cost of litigation which is for the private benefit of the donor." Rev. Proc. 92-59, 1992-29 I.R.B.K.

The IRS promulgated procedures for the acceptance of attorneys' fees: they (1) generally forbid a firm from seeking attorneys' fees from clients; (2) allow the acceptance of attorneys' fees where paid by opposing parties under court or agency award; (3) require the firm to use awarded fees solely to defray normal operating expenses, with no more than one half of such costs (calculated over five years) so defrayed; and (4) require the firm to file with its annual information return a report of all fees sought and recovered.

IV. SUGGESTED "ANSWERS" TO HYPOTHETICALS

1. Private Operating Foundation;

2. Supporting Organization, Type 1 "Controlled By;"

3. Private Foundation that undertakes Program-related Investments in U.S. and foreign companies;

4. Section 509(a)(2) public charity;

5. Section 501 (c)(4) Social Welfare Organization;

6. Private operating foundation or private foundation converting to a Type 3 supporting organization with Lithuanian 501(c)(3) public charity as the supported organization and a U.S. public charity benefiting the Balkan states as second supported organization; and

7. George can create a Type I supporting organization naming as supported organizations that class of public charities that pursue civil rights issues for the benefit of the public. He chooses two organizations to name in his Articles of Incorporation but because he has chosen a class of organizations he may direct his support to other organizations.

TAX EXEMPT ORGANIZATIONS
CHOICE OF ENTITY ALGORITHM