Donor Philanthropy: One Size Doesn't Fit All

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Buchanan Ingersoll & Rooney PC

2019 Planned Giving Day Conference
Philadelphia
October 30, 2019

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<u>Talking Points Outline</u>

- **Choices in Charitable Giving: Furthering Donor Intent and Optimizing Tax Benefits**

TYPE OF GIFT	AVAILABLE OPTIONS
Deferred Giving	Private Foundations (Non-Operating and Operating), DAFs, Funds at Community Foundations, and Supporting Organizations
Outright Gifts	Lifetime, Testamentary, Unrestricted, Restricted, Endowments, Naming Rights, Gift Agreements, Charitable IRA Rollovers, Use of Single Member LLCs
Income Interest Retained by Donor or Family Member – Remainder to Charity	Charitable Remainder Trust (CRAT, CRUT, NICRUT, and NIMCRUT) – Lifetime or Testamentary - and Charitable Gift Annuity
Income Interest Given to Charity – Remainder to Donor's Family	Charitable Lead Trust (CLAT and CLUT) – Lifetime or Testamentary - and Pooled Income Fund
Contribution of Remainder Interest in Personal Residence	Deed of Remainder Interest and Agreement with Charity
Donor-Managed Investment Account	Donor Agreement with Charity Regarding Donor Retaining Limited Power to Manage Accounts
Non-Wholly Charitable Trusts	Include a Provision to Distribute Gross Income to Charity to Avail of the 100% Charitable Income Tax Deduction under Section 642(c)

- **Consideration of Taxes: Tax Status of Donee and Nature of Contributed Asset (See below, under "Tax Issues Related to Donor Options")**

    - Acknowledgment and Appraisals
    - AGI Limitations
    - Deduction Based on Fair Market Value or Income Tax Basis
    - Effect of Restrictions on Valuation
    - Private Foundation Taxes May Prevent Certain Business Interest From Being Owned by Private Foundation
    - Partial Interest Rule

- **Some Donor Examples**:

    - Contribution of Philadelphia Inquirer to Charity (see attached article in materials: ***"Local Newspapers Turn to Philanthropy in Face of Financial Struggles,"*** Taxation of Exempts, September/October 2019) (Richard L. Fox).

    - Make Donor Intent Crystal Clear: Was an Endowment Created? -- Debate Between Donor and College

    - Contribution of Yacht (Tangible Personal Property) – Driven by Donor Intent and Taxes

    - Effect of Donor Restrictions on Charitable Deduction? Contribution of Artwork Subject to Donor Restrictions May Cause Decrease in Value.

    - Know Your Charity:

        - The Donor Advised Fund That Ignored the Donor

        - Lawsuit Alleging Improper Timing of Sale of Contributed Assets to DAF

    - Contribution of Business and Land to Charity

- **Tax Issues Related to Donor Options.**

  - The **charitable income tax deduction** (Form 1040, Schedule A, Itemized Deductions) available to donor generally depends on (i) **donor contribution base**, (ii) the **type of organization** to which the contribution is made, (iii) the **type of property** contributed, and (iv) whether the contribution was made **to** or **for the use of** the donee organization.

  - Deductible amount is generally **fair market value** of contributed property except (i) **ordinary income** property (if sold would result in short-term capital gain or ordinary income) and (ii) **tangible personal property** unrelated to organization's exempt purpose are limited to basis.

  - Contributions to private foundation limited to tax basis except for "qualified appreciated securities."

  - **Donor contribution base** is important.

    - Deduction is generally limited to **prescribed percentage** of the taxpayer's **contribution base:** Adjusted gross income without deducting any net operating loss carryback to that year.

    - Amounts not deductible in a given year because of limit may be **carried over** and deducted in subsequent **five years**.

    - Exception: **No limit** for certain **disasters** (Hurricanes Harvey, Irma and Maria).

  - **Type of charity** is important.

    - "**50% Charities.**" Generally what are considered **public charities** for federal tax purposes, *e.g.*, churches, educational organizations, hospitals, publicly supported organizations, private operating foundations.

    - **"30% Charities."** Certain other charitable organizations that are not public charities, *e.g.*, war veterans' organizations, fraternal orders, **most private nonoperating foundations** (grantmaking).

  - **Type of property** is important.

    - Cash.

      - From **now through 2025**, the limit for deductions of **cash** contributions by individuals to **50% charities** is to **60%** of contribution base. Starting in 2026, limit is **50%** of **contribution base**.

- The limit for deductions of **cash** contributions by individuals to 3**0% charities** is to **30%** of contribution base.

- Non-cash.

  - The ceiling for deductions of **non-cash** contributions by individuals to **50% charities** is to **50%** unless property is **appreciated capital gain property**.

  - Deduction limit for gifts of certain **appreciated capital gain property** to **50% charities** is generally limited to **30%** of the individual's contribution base. **However** an individual may elect to reduce the amount of the contribution to the individual's basis in such property (in which case the **50%** ceiling applies). Basically, taxpayer may elect to **increase ceiling** by **reducing the amount** of the contribution.

  - Individual generally may deduct up to **30%** of contribution base for contribution to **30% charities** unless property is **appreciated long term capital gain property.**

  - Deduction limit for gifts of **appreciated long-term capital gain property** to **30% charities** is generally limited to **20%** of the individual's contribution base.

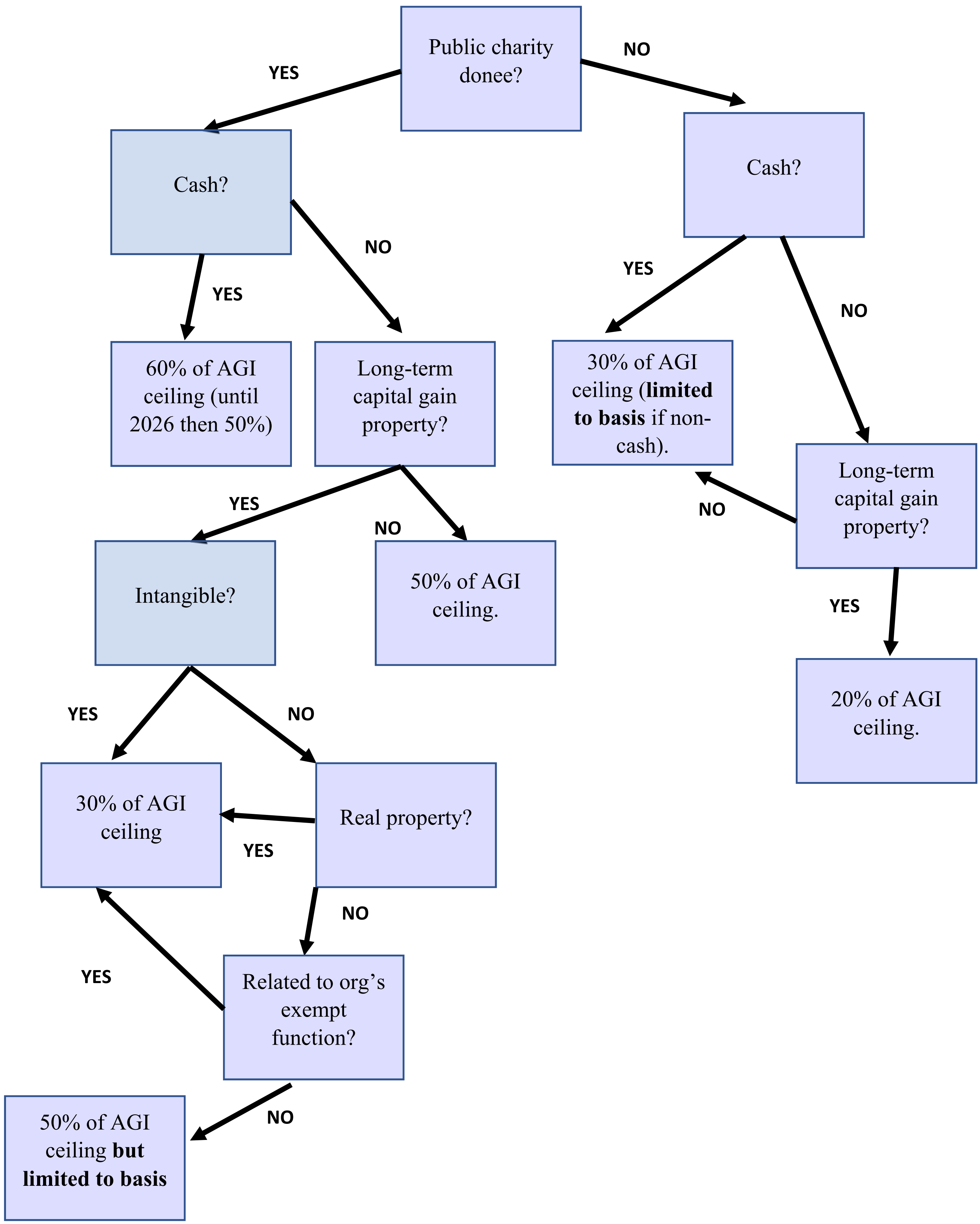
  - Deduction for **tangible personal property** generally limited to basis unless property related to organization's **tax-exempt function**.

- Whether contribution is **to** or **for the use of** charitable organization is important.

  - Individuals may deduct up to **30%** of their contributions **for the use of** (*i.e.* indirect as opposed to directly to) **50% charities**.

  - Individuals may deduct up to **30%** of contribution bases for contributions for the use of **30% charities** (same as for contributions "to" **30% charities**, so does not matter for them in reality).

- **High level** flow chart on next page (many important exceptions omitted for simplicity).


Public charity donee?
YES
NO
Cash?
Cash?
YES
NO
YES
NO
60% of AGI ceiling (until 2026 then 50%)
Long-term capital gain property?
30% of AGI ceiling (**limited to basis** if non-cash).
Long-term capital gain property?
YES
NO
NO
Intangible?
50% of AGI ceiling.
YES
20% of AGI ceiling.
YES
NO
30% of AGI ceiling
Real property?
YES
NO
Related to org's exempt function?
YES
50% of AGI ceiling **but limited to basis**
NO

- **Transferring Businesses (or Business Profits) to Charity – The Newman's Own Model**

    - "The 100-Percenters" – Businesses That Donate All Net Profits to Charity.

        - See Chronicle of Philanthropy article – June 2019.

        - Not tax-exempt entities although all profits go to charity – see Section 502 ("Feeder Organizations") – an organization operated for primary purpose of operating a trade or business is not exempt from taxation on the ground that all of its profits are payable to one or more tax-exempt entity."

    - Newman's Own – all profits to charity.

    - The Newman's Own Exception to the "Excess Business Holdings Rules" Application to Private Foundations – allows the Newman's Own Foundation to Hold 100% of Stock of Newman's Own, a for-profit corporation.

    - See attached article with materials: ***"Private Foundations Can Now Own 100% of Business Enterprises,"*** Estate Planning, November 2018 (Richard L. Fox).

- **A Changing Landscape: The Zuckerberg LLC Model.**

    - Background.
        - Mark Zuckerberg, Chairman and CEO of Facebook, announced in 2015 that he is contributing during his lifetime 99 percent of his shares in Facebook, valued at approximately $45 billion
        - December 1, 2015 letter to their newborn daughter, Max – "The Chan Zuckerberg Initiative."
            - "Personalized learning, curing disease, connecting people and building strong communities."
        - Note that this is an unenforceable pledge/public commitment, not an actual gift by the Zuckerberg family.

    - Description of entity and operations.
        - Delaware limited liability company.
        - Primary asset Facebook stock.
        - Zuckerberg and wife will continue to own stock indirectly through LLC.
        - Not seeking 501(c)(3) exemption, so no charitable deduction for Facebook stock contributed to it and no income tax exemption for the LLC.
        - Flow-through entity, tax attributes flow through to owners (Zuckerbergs).
        - Personal income tax on any dividends (unlikely from Facebook) and gains from sale.

- Personal income tax deduction for Zuckerberg equal to fair market value of contributed property when LLC later contributes to charitable organizations or causes (presumably including a private foundation Zuckerberg will create in the future and perhaps other public charities).
- Much greater flexibility for lobbying activities compared to charitable organization.
  - Letter cited participation in "policy and advocacy to shape debates" as a tool to move human society forward.
- Much greater flexibility for distributions (not limited to charitable purposes).
- No minimum distribution requirement (5% of $45B is $2.25B).
- Much greater secrecy relative to charitable organization (annual tax returns not available to the public, no attorney general oversight).

- Criticism.
  - Initial public outcry, vilification.
  - Some criticism is unfair. Zuckerbergs are forgoing tax benefits in exchange for this flexibility. Not a "tax dodge."
  - Main purpose is avoiding all of the restrictions that come with the traditional tax exempt charitable organization.
  - While condemnation is unfair at this point, this structure is not necessarily deserving of praise yet.
  - Wait to see if Zuckerberg fulfills his commitment and how LLC operates in practice.

- Future implications.
  - If successful, it is possible to see others use non-exempt entities to pursue charitable and other goals.

- **Charitable Trust Issues – Forgoing Charitable Deduction to Avoid Tax Restrictions**

  - Ruling on CRT – donor voluntarily forgoing income tax and gift tax charitable deductions causes trust not to be subject to Section 4947(a)(2) ("split-interest trust" rules)

  - Same position may be taken for wholly charitable trust under Section 4947(a)(1), although not as certain.

  - See attached article with materials: ***"Plan Now to Avoid Private Foundation Excise Tax Rules,"*** Taxation of Exempts, May/June 2018 (Richard L. Fox).

Enclosure 2

Speaker Bios;

Selected Publications and Speeches

SPEAKER BIOS

Richard L. Fox, Esq. is a shareholder in the Philadelphia office of the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of charitable giving, private foundations, tax-exempt organizations, estate planning, trusts and estates, and family planning. Mr. Fox is the author of the treatise, Charitable Giving; Taxation, Planning and Strategies, a Warren, Gorham and Lamont publication, writes a national quarterly bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy. He is a Fellow of the American College of Trust and Estate Counsel. He is a member of the advisory board of the Estate Planning Journal and BNA Tax Management and is a commentator for Leimberg Information Services, Inc. He is also a member of the American College Chartered Advisor in Philanthropy Board of Advisors, where he previously headed the Chartered Advisor in Philanthropy Program as the Sallie B. and William B. Wallace Chair in Philanthropy. Mr. Fox, who holds an LL.M. degree in taxation from New York University School of Law, is a frequent contributor to the Estate Planning Journal the Journal of Taxation. He was has been named by Worth Magazine as one of the Top 100 Attorneys in the country representing affluent families and individuals, including in the areas of estate planning, private foundations and philanthropy, as well as a Pennsylvania Super Lawyer in these areas.

Josh D. Headley, Esq. is an associate in the Washington, DC office of the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of tax, wealth and succession planning and nonprofit organizations. Josh also regularly works with fiduciaries on estate and trust administration matters. On the nonprofit side, Josh works closely with donors and exempt organizations in structuring planned giving vehicles to achieve both charitable and tax planning objectives. Josh holds a J.D. degree with a concentration in taxation from Antonin Scalia Law School and is a member of the Washington D.C. Estate Planning Council. Josh is also a member of the bars of the U.S. Bankruptcy Courts for the Eastern District of Virginia and the Western District of Virginia.

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Richard L. Fox, Esq. is a shareholder with the law firm of Buchanan Ingersoll & Rooney PC. He concentrates his practice in the areas of charitable giving, private foundations, tax-exempt organizations, estate planning, trusts and estates, and family planning. Mr. Fox is the author of the treatise, *Charitable Giving; Taxation, Planning and Strategies,* a Warren, Gorham and Lamont publication, writes a national quarterly bulletin on charitable giving, and writes and speaks frequently on issues pertaining to nonprofit organizations, estate planning and philanthropy. He is a Fellow of the American College of Trust and Estate Counsel. He is a member of the advisory board of the *Estate Planning Journal* and is a commentator for Leimberg Information Services, Inc. He previously headed the Chartered Advisor in Philanthropy Program at the American College as the Sallie B. and William B. Wallace Chair in Philanthropy. Mr. Fox, who holds an LL.M. degree in taxation from New York University School of Law, is a frequent contributor to the periodicals *Estate Planning* and the *Journal of Taxation.* He has been named by *Worth Magazine* as one of the Top 100 Attorneys in the country representing affluent families and individuals, including in the areas of estate planning, private foundations and philanthropy, as well as a *Pennsylvania Super Lawyer* in these areas. Mr. Fox has also been selected for inclusion in *The Best Lawyers in America.*

Publications by Richard L. Fox

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- *RERI Holdings I: DC Court of Appeals Affirms Denial by Tax Court of $33 Million Claimed Charitable Income Tax Deduction for Failure to Include Information on Tax Basis on IRS Form 8283*, Steve Leimberg's Charitable Planning Newsletter, July 1, 2019.
- *IRS Final Regulations Deal Fatal Blow to SALT Limitation Workarounds*, Bloomberg Tax, Daily Tax Report, Parts 1, 2 and 3 (June 27, June 28 and July 1, 2019); Bloomberg Law, Tax Management Memorandum (July 8, 2019); and Bloomberg Law, Estates, Gifts and Trusts Journal (July 3, 2018).
- *Recent Case of Tarpey v. U.S. Provides Important Reminder to Donors and Appraisers Alike to Ensure that Appraisals of Contributed Property Are Qualified Appraisals Performed by Qualified Appraisers*, Steve Leimberg's Charitable Planning Newsletter, May 23, 2019.
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- *Private Foundations Can Now Own 100% of Business Enterprise,* Estate Planning, November 2018.

- *New IRS Proposed Regs. Nullify SALT Limitations Workaround Attempts,* Wealth Management, September 4, 2018; *IRS Proposed Regulations Nullify $10,000 Annual SALT Limitation Workaround Attempts,* Leimberg Charitable Planning Newsletter, September 27, 2018.
- *'Newman's Own' Exception to Excess Business Holdings Rule Allows Private Foundations to Own 100% of a Business Enterprise*, Bloomberg Tax, Daily Tax Report, September 17, 2018; Tax Management Memorandum, October 1, 2018.
- *Is the Charitable Deduction a Double-Edged Sword for a Nonexempt Trust?,* Bloomberg Tax, Tax Management, Estates, Gifts and Trusts Journal, July 12, 2018
- *Proposals by States to Recast SALT Payments as Charitable Contributions, Are These a Valid End-Run Around the New $10,000 Limitation*?, Trusts & Estates, June 2018.
- *North Carolina Supreme Court Declares Tax on Accumulated Trust Income Unconstitutional,* Bloomberg BNA, Daily Tax Report, June 25, 2018
- *Plan Now to Avoid the Private Foundation Excise Tax Rules,* Estate Planning, February 2018.
- *The Tax Cuts and Jobs Act – What Nonprofits Need to Know*, Philanthropy Journal News, January 29, 2018.
- *Are Proposals by States to Recast SALT Payments as Charitable Contributions a Valid End-Run Around the New $10,000 Limitation?,* Bloomberg BNA, Insight, Daily Tax Report, January 18, 2018.
- *IRS Provides New Guidance to Simplify Foreign Grant Making by Private Foundations*, Bloomberg BNA, Insight, Daily Tax Report, October 30, 2017.
- *Trustee's Failure to Administer Charitable Remainder Unitrust in Accordance with Governing Instrument Proves Costly*, Bloomberg BNA, Tax Management Estates, Gifts and Trusts Journal, September 14, 2017.
- *IRS Provides Guidance to Avoid 5% Probability Test for Charitable Remainder Annuity Trusts, Journal of Taxation,* June 2017.
- *Settlor Not Claiming Charitable Deduction Allows Charitable Remainder Trust to Escape Private Foundation Excise Tax Rules*, Leimberg Charitable Planning Newsletter, May 2017.
- *Planning for Charitable Contributions by Estates and Trusts,* Estate Planning, January 2017.
- *New Valuation Rules for NICRUT/NIMCRUT Early Termination*, Estate Planning, July 2016.
- *Dieringer v. Com'r;* Estate Tax Charitable Deduction Reduced by Post-Death "Shenanigans" - A Flawed Result, Steve Leimberg's Charitable Planning Newsletter, April 6, 2016.
- *Final Regulations Revise Rules on Grants to Foreign Charities by Private Foundations, Journal of Taxation*, March 2016.
- *Shield Donations From Bankrupt Charities Creditors, Estate Planning Journal*, January 2016.

- *Tax Court Issues Opinion on Valuing Remainder Interest in NIMCRUT for Purposes of 10% Remainder Interest Requirement, Net Income Limitation Must be Ignored*, Steve Leimberg's Charitable Planning Newsletter, August 2015.
- *Avoid Unintentional Self-Dealing With Private Foundations*, Estate Planning, August 2015.
- *Recent Cases Denying Charitable Income Tax Deduction Provide Reminder of Need to Strictly Adhere to Statutory Requirements for Deductibility of Façade Easements*, Steve Leimberg's Charitable Planning Newsletter, April 2015.
- *Chief Counsel Advice Applies Substance-Over-Form Doctrine in Disallowing Deduction for Charitable Contribution of Partnership Units*, Planned Giving Design Center, March 2015.
- *CCA 201443019 Provides a Reminder That Fair Market Value Deduction Not Available for Donor Deemed to Be a Dealer of Property Contributed to Charity*, Steve Leimberg's Charitable Planning Newsletter, February 2015.
- *President Obama Signs Charitable Extenders Bill, Only Days Left to Utilize IRA Charitable Rollover for 2014*, Steve Leimberg's Charitable Planning Newsletter, December 2014.
- *Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trust,* Journal of Taxation, September 2014.
- *IRA Charitable Rollovers During Legislative Limbo,* Estate Planning, September 2014.
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- *New Jersey Appeals Court Requires Refund of Contribution Where Charity Unilaterally Decides Not to Honor the Donors' Originally Expressed Purpose,* Steve Leimberg's Charitable Planning Newsletter, July 2014.
- *Lawsuit Against Johns Hopkins Alleging Violation of Donor Intent Finally Comes to an End as Maryland's Highest Court Lets Stand Decisions of Lower Courts in Favor of Johns Hopkins,* Steve Leimberg's Charitable Planning Newsletter, July 2014.
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- *Compliance Tips for Type III Supporting Organizations,* Estate Planning, March 2014.
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- *Private Foundations Get Expanded Program-Related Investment Options*, Estate Planning, January 2013.
- *Streamlined Method for a Private Foundation to Make Grants to Foreign Charities,* Steve Leimberg's Charitable Planning Newsletter, November 2012.

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- *Proposed Regulations Clarify That Program-Related Investments May Be Made by Private Foundations to Accomplish a Wider Variety of Charitable Purposes Through a Wider Range of Investment Vehicles,* Steve Leimberg's Charitable Planning Newsletter, June 2012.
- *Tax Court Rescues Tax Deductions for a Charitable Cat Lady*, Estate Planning, May 2012.
- *The Life Span of a Private Foundation: Perpetual or Limited*, Estate Planning Journal, September 2011.
- *Nevada Supreme Court Lets Donor-Advised Fund Ignore Donor's Advice*, Estate Planning, May 2011.
- *Nevada Supreme Court Addresses Issue of First Impression for Donor-Advised Funds*, Steve Leimberg's Charitable Planning Newsletter, February 2011.
- *Breach of Trust: VA Violates Its Duty To Use Land As A Home For Veterans*, The Strawberry Gazette, Vol. 1-Special Issue: Evidence of Home, Issue 7, January 2011.
- *Help for Charitable Trusts That Made Erroneous Conversions*, Estate Planning, January 2011.
- *A Case Study In Transformative Philanthropy: Strawberry Flag,* The Strawberry Gazette, Vol. 1-Harvest, Issue 6, November 2010.
- *Validity of Shark-Fin CLATs Remains in Doubt Despite IRS Guidance*, Estate Planning, October 2010.
- *Proposed Regulations Provide New Guidelines for Type III Supporting Organizations*, Estate Planning, March 2010.
- National Heritage Foundation Debacle Offers Lesson About Donor-Advised Funds, The Chronicle of Philanthropy, February 2010 (opinion piece).
- *Recent DAF Cases Raise Issues of Charities Facing Financial Difficulties,* Estate Planning Journal, January 2010.
- *Charitable Gift Annuities Sold In Scheme Not Exempt From Securities Regulations Under Philanthropy Protection Act of 1995*, Steve Leimberg's Charitable Planning Newsletter, November 2009.
- *IRS Argument That Control by Donor of Private Foundation Disallows Charitable Income Tax Deduction a Loser in Court*, Steve Leimberg's Charitable Planning Newsletter, November 2009.
- *Recent Events Raise Issues About Donor-Advised Funds*, Steve Leimberg's Charitable Planning Newsletter, September 2009.
- *Yeckel – An Important Decision Involving Private Foundations & Excessive Compensation,* Steve Leimberg's Charitable Planning Newsletter, July 2009.
- *Planning and Strategies for Nonexempt Charitable Trusts Part II,* Taxation of Exempts, July/August 2009.

- *Planning and Strategies for Nonexempt Charitable Trusts Part I,* Taxation of Exempts, May/June 2009.
- *Guide to IRS Sample Charitable Lead Trust Forms*, Steve Leimberg's Charitable Planning Newsletter, May 2009.
- *A Guide to the IRS Sample Charitable Lead Trust Forms Part II*, Estate Planning, May 2009.
- *A Guide to the IRS Sample Charitable Lead Trust Forms Part I*, Estate Planning, April 2009.
- *Ray Styles v. Friends of Fiji: Big Winner at Slots a Big Loser with Nevada Charity,* Steve Leimberg's Charitable Planning Newsletter, March 2009.
- *Princeton and Robertson Family Settle Bitter and Long-Standing Litigation over Donor Intent,* Steve Leimberg's Charitable Planning Newsletter, February 2009.
- *Revenue Ruling and Final Regulations Affecting Charitable Remainder Trusts in Detail*, Steve Leimberg's Charitable Planning Newsletter, August 2008.
- *Changes in Rules in Charitable Gifts of Intangible Personal Property*, Steve Leimberg's Charitable Planning Newsletter, January 2008.
- *IRS Continues Ban on Applications for Functionally Integrated Type III Supporting Organizations Except for Those Meeting Advance Notice,* Steve Leimberg's Charitable Planning Newsletter, November 2007.
- *Big Changes In Store for Type III Supporting Organizations*, Steve Leimberg's Charitable Planning Newsletter, August 2007.
- *IRS Guidance Allows Foundations and Donor-Advised Funds to Rely on Third Parties for Determination of Charity Status,* Steve Leimberg's Charitable Planning Newsletter, April 2007.
- *Charitable Limitations and Reforms of the Pension Protection Act*, Part 2, Estate Planning, December 2006.
- *Charitable Limitations and Reforms of the Pension Protection Act*, Part 1, Estate Planning, November 2006.
- *Donor Advised funds, Supporting Organizations, and Private Foundations – Impact of PPA 2006*, Steve Leimberg's Charitable Planning Newsletter, October 2006.
- *New Charitable Giving Incentives and Reforms Have Significant Impact on Donors and Charities*, Steve Leimberg's Charitable Planning Newsletter, October 2006.
- *PLR 200202032 Paints Picture of Success for Restrictions on Charitable Bequests of Art*, Steve Leimberg's Charitable Planning Newsletter, February 2006.
- *A Guide to the IRS Sample Charitable Remainder Trust Forms*, Estate Planning, January 2006.
- *REG-111257-05 Regulations Linking Tax-Exempt Status and Excess Benefit Transactions*, Steve Leimberg's Charitable Planning Newsletter, October 2005.
- *Planning for Contributions to Foreign Charities by Individuals and Foundations*, Estate Planning, July 2005.
- *Practical Charitable Planning for Employee Stock Options*, Estate Planning, May 2005.

- *New Prop. Regs. On Distributions From CRTs Provide Opportunity*, Estate Planning, April 2004.
- *Is a Basis Step-Up Available On Foundation Founder's Death*?, Estate Planning, February 2004.
- *Planning for Donor Control and Other Strings Attached to Charitable Contributions,* Estate Planning, September 2003.
- *Restrictions on Charitable Bequests of Art: Recent Ltr. Rul. Paints a Picture*, Estate Planning, September 2002.
- *Responsible Person and Lender Liability for Trust Fund Taxes - Sections 6672 and 3505*, BNA Tax Management, Inc., Portfolio No. 639
- *Compelled Production of Documents and Testimony in Tax Examinations*, BNA Tax Management, Inc., Portfolio No. 123.

Speeches by Richard L. Fox

- *News in the News, Current Issues in Nonprofit Journalism,* American Bar Association Section of Taxation Meeting, May 10, 2019.
- *Funding Local News: The Philadelphia Experience,* 2019 Knight Media Forum, February 26, 2019, Miami, Florida.
- *Protecting Endowment and Restricted Funds to Further Donor Intent,* 2018 Planned Giving Day Conference, October 25, 2018, Planned Giving Council of Greater Philadelphia.
- *New Models in Philanthropy,* Neumann University, The Center for Leadership, December 6, 2017.
- *Not-for-Profits and Investments: Doing Well While Doing Good*, Bryn Mawr Trust Company, Merion Cricket Club, November 15, 2016.
- *The Creation of the Institute for Journalism in New Media*, Financial Planners Association of Philadelphia’s 29th Annual Spring Symposium, St. Joseph’s University, May 11, 2016.
- *Grantmaking and Fundraising in the Digital Age,* Neumann University, The Center for Leadership, April 9, 2016.
- *Charitable Giving and Tax-Exempt Organization Changes Under the PATH Act of 2015*, Webinar, Advisors in Philanthropy, February 16, 2016.
- *Charitable Contribution of Philadelphia Newspapers to Newly Formed Institute for Journalism in New Media,* Temple University Beasley School of Law Media & Communications Law Society, February 9, 2016.
- *The Nuts and Bolts of Charitable Remainder and Charitable Lead Trusts: Tax Rules, Drafting Guidelines, and Creative Planning Ideas*, The 50th Annual Heckerling Institute on Estate Planning (University of Miami Law School), January 14, 2016.
- *Charities in Distress, Bankruptcy and Impact on Restricted Gifts*, Mid-Atlantic Regional Meeting of the American College of Trust and Estate Counsel (ACTEC), September 12, 2015.

- *Selected Topics in Philanthropic Planning*, Princeton Area Community Foundation, May 7, 2015.
- *Private Foundations: Tools to Add to Your Planning Arsenal to Achieve Your Clients' Goals*, The International Association of Advisors in Philanthropy, April 28, 2015.
- *Tax Law: Issues Relating to Memberships, Donations and Benefits and Other Nonprofit Concerns*, Independence Foundation, March 24, 2015.
- *Gifts of Property - Do You Know What You Don't Know?*, The Univest Foundation, May 1, 2014.
- *2014 Charitable Giving in America: The Tax Update*, The Community Foundation of South Jersey, March 4, 2014.
- *The Top Ten Ways Private and Family Foundations Get into Trouble*, The Philadelphia Foundation, Private and Family Foundation Seminar, October 1, 2013.
- *Nonprofit and Philanthropic Tax Issues,* Pennsylvania Institute of Certified Public Accountants, Annual Tax Form, November 8, 2012.
- *Selected Topics in Philanthropy & Tax-Exempt Organizations*, Philadelphia Bar Association - Probate and Trust Section, Tax Committee, September 24, 2012.
- *What Every Estate Planner Needs to Know About Tax-Exempt Organizations and Charitable Gift Planning,* The 46th Annual Heckerling Institute on Estate Planning (University of Miami Law School), January 11, 2012.
- *Private Foundations: Perpetual or Limited Lifespan,* The Philadelphia Foundation, November 4, 2011.
- *Creating Nonprofit Organizations, Daytime With Donna Radio Show, TOGINET Radio,* July 15, 2011.
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- *Question and Answer Panel, Ethics and Law Course Presentation*, New York University Heyman Center for Philanthropy and Fundraising, April 26, 2011.
- *Charitable Planning in a Time of Low Interest Rates*, ALI-ABA Seminar, December 2010.
- *Doing Well By Doing Good*, Or Hadash Synagogue, March 2010.
- *Private Foundations: Governance, Duration and Other Hot Topics,* Not for Profit Organization Symposium, Washington D.C., November 2008.
- *Nonprofit Governance and NFP Professionals Serving on Boards,* Not For Profit Organization Symposium, Washington D.C., November 2008.
- *The Art of Philanthropy - Do You Know What You and Your Clients Don't Know: Tools & Techniques for Advisors and Their Clients*, Central Indiana Community Foundation, March 2008.
- *Gifts of Property - Do You Know What You Don't Know?,* Current Topics: Private Foundations and Supporting Organizations, Planned Giving Council of Houston, September 2007.
- *Using Philanthropy to Add Value to Your Clients Relationships*, Presentation at the American College, Professional Advisors' Seminar, June 2007.

- *Luncheon Speech Regarding the Sallie B. and William B. Wallace Chair in Philanthropy at the American College, Advisors in Philanthropy Conference*, Chicago, Illinois, April 2007.
- *Private Foundation Workshop, The Annenberg Foundation*, Annual Retreat, November 2006.
- *Charitable Planning Ideas*, Temple University School of Medicine Reunion Day, October 2006.
- *Donor-Created Entities to Support Public Charities* Planned Giving Council of Greater Philadelphia, 2006 Planned Giving Day Conference, Greater Philadelphia Planned Giving Council, October 2006.
- *Gifts of Property - Do You Know What You Don't Know*, Planned Giving Council of Greater Philadelphia, September 2006.
- *Getting to the Heart of Charitable Giving*, Temple University Planned Giving Day, April 2006.
- *Donor-Created Entities to Support Public Charities*, Lorman Educational Services and Penn State University 60th Annual Tax Conference, March and May 2006.
- *Hot Topics for Academic and Nonprofit Institutions: Essential Issues in Executive Compensation*, Dilworth Paxson LLP Seminar, February 2005.

4850-2456-0695, v. 3
4850-2456-0695, v. 3

Enclosure 3

General Outline

Donor Philanthropy – One Size Doesn't Fit All

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Buchanan Ingersoll & Rooney PC

2019 Planned Giving Day Conference
Philadelphia
October 30, 2019

<u>General Outline</u>

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1. **CHOICES IN CHARITABLE GIVING.**

a. Individuals have a variety of choices in furthering their philanthropic giving. Modest gifts are usually made outright to a public charity and deducted for federal income tax purposes under the provisions of Section 170. For more significant charitable contributions, individuals often prefer to utilize a philanthropic vehicle over which some degree of control may be retained after the contribution is initially made.

b. Among these vehicles are a donor advised fund maintained at a local community foundation (or some other public charity sponsoring donor advised funds) or a private foundation that generally takes the form of a nonprofit corporation. The sponsoring organization of a donor advised fund and a private foundation are both tax-exempt organizations under Section 501(c)(3) pursuant to an IRS determination. Contributions to these entities still qualify for a current income tax deduction under Section 170, but allow contributions to be made over time to various charities selected by the donor or family members of the donor.

c. Donors may also choose to utilize a wholly charitable trust as a vehicle for philanthropic giving, where all of the unexpired interests of the trust are dedicated exclusively to Section 170(c)(2)(B) purposes, which includes religious, charitable, scientific, literary, and educational ones. Even if a wholly charitable trust does not seek to obtain an IRS determination classifying it as a Section 501(c)(3) tax-exempt entity, contributions to it will still qualify for a charitable deduction and it may essentially be equivalent to a Section 501(c)(3) tax-exempt entity by virtue of the unlimited charitable income tax deduction available to a trust under Section 642(c).

d. Donors seeking to blend their philanthropic intentions with their financial needs or those of family members may also utilize a so-called "split-interest" trust, such as a charitable remainder trust ("CRT") or a charitable lead trust ("CLT"), where the financial benefits of the trust are split between charitable and noncharitable interests.

e. An organization that has been determined by the IRS to be a Section 501(c)(3) tax-exempt organization that is not classified as a public charity under Section 509(a) is classified as a private foundation, generally considered the least favorable tax classification in the world of Section 501(c)(3) tax-exempt organizations. In addition to subjecting donor contributions to significant limitations on the available charitable income tax deduction, private foundation status triggers the application of the complex and particularly onerous excise tax provisions under Chapter 42 of the Internal Revenue Code (the "Code"). The scope of the private foundation tax regime extends beyond organizations that are classified as such in an IRS determination letter. These include nonexempt charitable trusts described in Section 4947(a)(1), which may arise under a number of different circumstances, and split-interest trusts described in Section 4947(a)(2).

f. The private foundation excise tax rules may be considered to be so restrictive that an individual creating a philanthropic vehicle may seek to avoid such rules if at all possible, even at the expense of forgoing both a charitable deduction and the tax-exempt status of the entity.

2. ZUCKERBERG LLC FOR CHARITABLE PURPOSES A NEW MODEL FOR PHILANTHROPY?

a. Background

i. As has been widely publicized, Mark Zuckerberg, Chairman and CEO of Facebook, recently announced that he is contributing during his lifetime 99 percent of his shares in Facebook, valued at approximately $45 billion. Instead of donating the shares to a private foundation, the model traditionally used by philanthropists, including Bill Gates who transferred shares of Microsoft to the Bill and Melinda Gates Foundation ("Gates Foundation"), the largest private foundation in the country, Zuckerberg is transferring his Facebook shares to a newly formed Delaware limited liability company ("LLC") known as the Chan Zuckerberg Initiative (hereinafter the "Zuckerberg LLC"), formed by Zuckerberg and his wife, Dr. Priscilla Chan, as a vehicle for advancing "philanthropic, public advocacy and other activities for the public good."

ii. In a December 1, 2015 letter to their newborn daughter, Max, in which the charitable commitment was first announced, Chan and Zuckerberg stated the following:

> As you begin the next generation of the Chan Zuckerberg family, we also begin the Chan Zuckerberg Initiative to join people across the world to advance human potential and promote equality for all children in the next generation. Our initial areas of focus will be personalized learning, curing disease, connecting people and building strong communities. We will give 99% of our Facebook

shares -- currently about $45 billion -- during our lives to advance this mission. We know this is a small contribution compared to all the resources and talents of those already working on these issues. But we want to do what we can, working alongside many others.

iii. Although an LLC can qualify as a Section 501(c)(3) tax-exempt entity, in which case it would be classified as a private foundation where there are only one or a few donors, the newly created Zuckerberg LLC is not going to be classified as a Section 501(c)(3) tax-exempt entity and, therefore, will not be a private foundation. Unless it elects to be treated as a corporation, which is certainly not going to be the case, it will be treated as a pass-through entity for tax purposes. Therefore, although it is formed to further philanthropic purposes, the Zuckerberg LLC but will be treated for tax purposes like any other LLC, where all of its tax attributes flow through to its member or members. It will also avoid the highly restrictive federal tax regime first imposed upon private foundations by Congress under the Tax Reform Act of 1969 including, but not limited to, an annual distribution requirement generally mandating that a private foundation distribute five percent of the fair market value of its assets for charitable purposes each and every year.

iv. Assuming $45 billion of assets, the Zuckerberg LLC will not have to meet the private foundation five percent distribution requirement of $2.25 billion each year and, in fact, is actually not required to make any charitable distributions. In contrast, the Gates Foundation, having assets exceeding $40 billion and which is subject to the private foundation five percent annual distribution requirement, reported on its 2013 Form 990-PF that it made grants for charitable purposes during 2013 in excess of $3.3 billion.

v. Because it is not a private foundation, contributions to the Zuckerberg LLC are not deductible for charitable income tax purposes, although such a deduction is only meaningful to the extent that the donor has significant income. This is the case because in any given year, a charitable income tax deduction for a contribution of appreciated securities to a private foundation is limited to 20 percent of the donor's adjusted gross income. Despite his great wealth from his holdings of Facebook shares, which do not pay dividends, Zuckerberg's income may actually be relatively modest, as his official salary last year was $1. Because of the 20 percent annual adjusted gross income cap (with a maximum five-year carryover period), Zuckerberg could never use the full tax deduction he would otherwise be entitled to even if contributions of the $45 billion of Facebook stock to the Zuckerberg LLC were tax deductible.

vi. Because the Zuckerberg LLC is not exempt from income tax, any of its taxable income flows through to its member or members, who report such income on their own income tax returns. But, with Facebook currently not paying dividends, the Zuckerberg LLC may generate little, if any, taxable income, making the absence of a tax exemption under Section 501(c)(3) of little value. And, if its wants to make contributions to charity to further its mission, the Zuckerberg LLC could actually make gifts of appreciated Facebook stock, which produces a charitable income tax deduction at fair market value and, as the same time, does not trigger any capital gain recognition upon the contribution. Not triggering capital gain tax upon a contribution of appreciated securities to charity should be contrasted from the situation where the securities are first sold, and then the cash proceeds are contributed to charity, where capital gain is recognized in this situation.

b. **What Benefits Does the LLC Model Have Over the Private Foundation Model?**

i. The benefits of the LLC model over the private foundation model is that the LLC avoids the multitude of restrictions and requirements applicable to private foundations, both at the federal and state level, thereby making the LLC a much more flexible vehicle that can engage in a wide variety of activities and make investments and expenditures that would be prohibited if it were a private foundation. Therefore, in choosing an LLC, Zuckerberg and Chan have more leeway in the types of causes they want to support and the investments they want to make, and obtain anonymity that is not available with a private foundation. At the same time, like a donor who establishes a private foundation, they retain control over the operations of the LLC and can make decisions regarding its investments, contributions, expenditures, and all of its other activities.

ii. Unlike in the case of a private foundation, the assets contributed to an LLC are not permanently restricted for charitable purposes, but can be used for any permissible purposes under state law. Typically, an LLC can be dissolved and liquidated, with the assets then held by the LLC distributed back to its member or members. Therefore, unlike a private foundation, the assets of an LLC are not subject to State Attorney General oversight, who has authority over the administration of assets dedicated to charitable purposes. Moreover, an LLC avoids the multitude of private foundation restrictions and limitations contained in the Internal Revenue Code, its substantial penalty regime for lack of compliance, and the IRS that comes with any organization being classified as a private foundation. As a result of not being subject to the private foundation rules, an LLC is not subject to the following requirements applicable to a private foundation and its penalty regime for lack of compliance:

1. The requirement to file an annual Form 990-PF, Return of Private Foundation, with the IRS (and the State Attorney General). This form, which discloses virtually all information about a private foundation, is open for public inspection and most include the names

of the donors and the amounts contributed, as well as its investments, expenditures and a host of other information about the entity, all publicly available.

2. The five percent annual distribution requirement under Section 4942.

3. The "excess business holdings rule" of Section 4943, which limits the amount of stock and other interests in business enterprise that can be held, and would not permit the Zuckerberg LLC to hold all of the stock in Facebook that is being contributed to it.

4. The "jeopardy investment rule" of Section 4944, which limits the type of investments that can be made, particularly speculative investments in start-up companies.

5. The "self-dealing rules" of Section 4941, which would limit transactions from taking place with the founders.

6. The "taxable expenditure rules" of Section 4945, which prohibits various expenditure from being made, including those for political and lobbying purposes.

c. **What Benefits Does the Private Foundation Model Have Over the LLC Model?**

The benefits of the private foundation model over the LLC model are tax advantages. Charitable contributions to the foundation are deductible for income tax purposes in the year of the contribution, although actual distributions from the foundation to other charitable organizations may be deferred over a period of time well beyond the year in which the contribution is first made to the foundation. The income earned on the assets of the foundation is exempt from federal income tax and, therefore, can be invested and grow on a tax-free basis. A private foundation is often created upon a donor realizing a significant amount of income in a particular year, with the donation to the foundation substantially reducing the tax on such income.

d. **Should the Zuckerberg LLC Model Be Criticized or Praised?**

i. Interestingly, the Zuckerberg LLC model has been the subject of criticism. In "How Mark Zuckerberg's Altruism Helps Himself," by Jesse Eisinger, Pro Publica (December 3, 2015), for example, the author is highly critical of the Zuckerberg LLC model and questions its charitable intent, and starts with the following passage: "Mark Zuckerberg did not donate $45 billion to charity. You may have heard that, but that was wrong. Here's what happened instead: Mr. Zuckerberg created an investment vehicle. Sorry for the slightly less sexy headline." And, specifically with respect to the transfer of the $45 billion of Facebook stock to the Zuckerberg LLC, the article states:

> "In doing so, Mr. Zuckerberg and Dr. Chan did not set up a charitable foundation, which has nonprofit status. He created a limited liability company, one that has already reaped enormous benefits as public relations coup for himself. His P.R. return-on-investment dwarfs that of his Facebook stock. Mr. Zuckerberg was depicted in breathless, glowing terms for having, in essence, moved money from one pocket to the other.
>
> An L.L.C. can invest in for-profit companies (perhaps these will be characterized as societally responsible companies, but lots of companies claim the mantle of societal responsibility). An L.L.C. can make political donations. It can lobby for changes in the law. He remains completely free to do as he wishes with his money. That's what America is all about. **But as a society, we don't generally call these types of activities "charity."**

ii. In response to criticism of the of the LLC model, an article in Forbes, "Mark Zuckerberg And His Charitable Plan Should Be Followed, Not Criticized," Danielle and Andy Mayoras (December 9, 2015), defended the Zuckerberg LLC model. The article notes that the LLC model is perfectly legal, there are a wide variety of vehicles that can be used to further philanthropy, and that the LLC model is just one of many and that "Mark Zuckerberg and Priscilla Chan deserve applause, not scorn" for creating and funding the Zuckerberg LLC. Mr. Zuckerberg himself has explained his choice of use of the LLC model, in lieu of the traditional private foundation vehicle, as follows:

> The Chan Zuckerberg Initiative is structured as an LLC rather than a traditional foundation. This enables us to pursue our mission by funding non-profit organizations, making private investments and participating in policy debates -- in each case with the goal of generating a positive impact in areas of great need. Any net profits from investments will also be used to advance this mission. By using an LLC instead of a traditional foundation, we receive no tax benefit from transferring our shares to the Chan Zuckerberg Initiative, but we gain flexibility to execute our mission more effectively. In fact, if we transferred our shares to a traditional foundation, then we would have received an immediate tax benefit, but by using an LLC we do not. And just like everyone else, we will pay capital gains taxes when our shares are sold by the LLC.

iii. While Mr. Zuckerberg notes above that if he has used the traditional private foundation model, he would have received an immediate tax benefit, this presupposes that that he would have sufficient income to utilize any available deduction. As indicated above, since charitable deductions for contributions of appreciated securities to a private foundation are capped each year at 20 percent of adjusted gross income (with a maximum five-year carryover period), Zuckerberg could never use the full tax deduction he would otherwise be entitled to if the contribution of $45 billion of Facebook stock to the Zuckerberg LLC was tax deductible. In addition, while it is true that any capital gain realized upon a sale of Facebook stock by the LLC would be subject to capital gain tax, this tax can be avoided if Facebook stock is actually used as the currency to make charitable contributions, where the fair market value of the stock can be deducted without triggering any capital gain.

iv. Interestingly, the use of LLCs as a vehicle to advance philanthropic goals is not new. LLCs have previously been used to engage in philanthropic ventures, including the Emerson Collective, an LLC created by Laurene Powell Jobs, the widow of the late Steve Jobs, and the LLC formed as a part of the Omidyar Network by eBay founder Pierre Omidyar and his wife, Pam Omidyar.

v. In a May 24, 2013 article in the New York Times, "Laurene Powell Jobs and Anonymous Giving in Silicon Valley," Claire Cain Miller reported that one of the main ways Ms. Powell Jobs keeps her donations anonymous is by cleverly making her organization, Emerson Collective, a limited liability company, and notes the increasing popularity of LLCs being used as philanthropic vehicles. The article states:

> [The LLC] strategy is becoming more common, as people seek flexibility, freedom and anonymity in their investments, said Laura Arrillaga-Andreessen, who teaches philanthropy at Stanford, runs her own philanthropy and is a close friend of Ms. Powell Jobs. "The beauty of having an LLC in today's world is No. 1, you have the ability to act and react as nimbly as need be to create change, and you have the ability to invest politically, in the for-profit sector and the nonprofit sector simultaneously," she said. "And the reality is," she added, "we are now seeing a blurring of the lines between the sectors in a way that was not even discussed ten years ago. The way that we are going to solve social problems is by working with multiple different types of investing." Ms. Powell Jobs said that Emerson did not need the tax structure of a foundation, and that "doing things anonymously and being nimble and flexible and responsive are all things we value on our team."

vi. As noted in a December 23, 2015 article by Stephen Foley in the Financial Times, "How to give away $1bn," the world's 1,826 billionaires, many of them relatively newly minted moguls reared in the world of Silicon Valley, are exploring new avenues to pursue social agendas, challenging traditional foundation and donation models in ways that could redefine philanthropy, and stating that "they are engaging in philanthropic endeavor at an intriguing time, as old ways of giving are being challenged and even the definition of what it means to be a philanthropist appears to be expanding." The article examines emerging ways that today's mega-donors are crafting their philanthropy, including the hybrid structures adopted by eBay founder Pierre Omidyar and Mark Zuckerberg, who, the article notes, set up limited-liability companies that make impact investments as well as grants to nonprofits. The article quotes Pierre Omidyar from 2003 as saying it was "no-brainer" when he decided to reject the traditional model of U.S. philanthropy and not use a charitable foundation for his giving. According to the article, there would be an extra tax bill of $1 million or $2 million a year for doing so, but in the context of spending $100 million annually on philanthropic works, Omidyar considered that a small price to pay for what, years later, he called 'the flexibility to use every possible tool to improve the world'."

e. **Conclusion**.

i. While there is certainly still a place for the use of the traditional private foundation to carry out an individual's philanthropy, and private foundations continue to enjoy growing popularity, the use of an LLC may be a compelling alternative, and one that should be considered when determining an appropriate philanthropic model, particularly where tax benefits are not a significant concern and where the proposed activities and expenditures are not permitted by a private foundation. Although an LLC has its advantages, unlike a private foundation, contributions to an LLC are not tax deductible and the income realized by an LLC is not exempt from income tax, two significant advantages of private foundation status.

ii. The LLC approach apparently works for Mark Zuckerberg, who opted for an LLC in lieu of the traditional private foundation approach, as well as others who have decided to engage in philanthropy using the more flexible and less restricted LLC model. As long as it allows a donor's philanthropic intent to be accomplished, and any reduction of taxes offered by a private foundation is not considered compelling, any criticism aimed at using an LLC as a philanthropic vehicle is not well-founded. In addition, there is no prohibition upon a donor using both an LLC and a private foundation, in tandem, for philanthropic purposes.

3. CHARITABLE TRUSTS AVOIDING PRIVATE FOUNDATION STATUS: A NEW MODEL?

Recently issued Ltr. Rul. 201713003 suggests an intriguing alternative to avoiding the application of the private foundation rules to a wholly charitable or split-interest trust by a donor voluntarily forgoing the available charitable deductions. In this ruling, the IRS determined that a CRT did not fall under Section 4947(a)(2) and therefore was not subject the private foundation excise tax rules because, although the deductions were allowable, no charitable deductions were ever claimed by the settlor under any provision of the Code for a contribution of property to the trust.

See Attached Article Planning to Avoid The Private Foundation Excise Tax Rules

4. **CAUTION FOR DAFS SELLING NON-LIQUID ASSETS.**

a. In a complaint (the "Complaint") filed on August 18, 2018 in U.S. District Court in the Northern District of California (Case No: 3:18-cv-4881) brought by Emily and Malcolm Fairbairn against Fidelity Investments Charitable Gift Fund ("Fidelity Charitable"), the donors have accused Fidelity Charitable of "making false promises to secure a $100 million donation … and then outrageously mishandling the donation, costing the Fairbairns millions of dollars and severely impairing their ability to support important charitable causes."

b. The donors in this case, Emily and Malcolm Fairbairn, sought to contribute in late December 2017 $100 million, including 1.93 million shares in a publicly traded stock called Energous (which trades under the ticker symbol "WATT"), to fund a donor advised fund ("DAF"), much of which would be dedicated to fighting Lyme disease – a disease that had recently stricken their entire family. The donors were angel investors in Energous and would continue to hold significant shares even after their proposed contribution. The 1.93 million shares represented just under 10% of all of the outstanding stock of the company. The share price of Energous spiked 39% over the course of December 27, 2017, as a result of the FCC approving the core technology behind the company, prompting the donors, who apparently realized a large capital gain during 2017, to seek to make the charitable contribution prior to the end of 2017 based upon the increased value of the stock.

c. According to the Complaint, the donors could have made the donation of the stock to a JP Morgan DAF, with whom the donors already had a relationship and where they already established a $20 million DAF. The alternative to a JP Morgan DAF was a Fidelity Charitable DAF and "Fidelity Charitable aggressively promoted itself as the best chose for the Fairbairns' charitable giving in 2017." Given the large black of stock in Energous that they donors were considering donating, they were very concerned about the liquidation process of the contributed shares. The Complaint states that "Liquidating a large block of stock can be a delicate process; if not executed according to best practices, it can cause the stock's value to crash." Among the most important consideration in a stock liquidation are the timing and rate at which shares are sold off.

d. According to the Complaint, JP Morgan's standard written policy was that donors can specify "the timing and rate at which the donated securities are liquidated." Fidelity Charitable apparently has no such policy and its guidelines simply state that it will liquidate stock "at the earliest possible date." Given the lack of built-in protections at Fidelity Charitable for circumstances requiring a liquidation strategy more sophisticated than "the earliest date possible," the Fairbairns had three principal concerns about Fidelity Charitable handling the Energous stock liquidation, as follows:

i. First, a botched liquidation would mean they had less money to direct to the fight against Lyme disease;

ii. Second, if the "earliest date possible" for liquidation was the same day the stock was donated, it could significantly reduce the size of the Fairbairns' own tax deduction. That is because the size of the deduction for donated stocks turns on the stock's fair market value on the day the charitable organization receives it. And fair market value is calculated by averaging the daily high and low prices for the stock. Thus, a botched liquidation that happened on the same day as the donation could have significant tax consequences; and

iii. Third, as angel investors and continued stakeholders in Energous, the Fairbairns were concerned that a botched liquidation would damage the company going forward.

e. The concerns of the Fairbairns regarding the policy of Fidelity Charitable to liquidate contributed stock "at the earlier possible date" cause the Fairbairns to reconsider making their donation through Fidelity Charitable and instead to strongly consider a JP Morgan DAF. According to the Complaint, to convince the Fairbairns to contribute to a Fidelity Charity DAF, Fidelity Charitable made the following personalized promises, although nothing to this effect was put in writing:

i. It would employ sophisticated, state-of-the-art methods for liquidating large blocks of stock;

ii. It would not trade more than ten percent of the daily trading volume of Energous shares;

iii. It would allow the Fairbairns to advise on a price limit (i.e., a point below which it would not sell without first consulting the Fairbairns); and

iv. It would not liquidate any shares until the beginning of 2018.

f. The Fairbairns asserted that in reliance of this promises, although apparently not made in writing, the Fairbairns made their donation of a total of 1.93 million shares of Energous to Fidelity, 700,000 shares on December 28, 2017 and the remaining 1.2 million shares on December 29, 2017. The Complaint further alleges that following the donation of the shares, Fidelity Charitable breached it promises and immediately liquidated the donated shares, with the Complaint stating as follows:

g. But after the Fairbairns donated the 1.93 million shares, Fidelity Charitable promptly—and egregiously—broke each of its promises. It (1) liquidated the entire block of shares in a three-hour window on December 29, [2018] (2) accounting for 16% of the day's exchange-traded volume and an incredible 35% of the volume over the three-hour trading window, (3) using inappropriate methodologies that caused its own trades to compete against each other and drive the share price down still further, (4) without even telling the Fairbairns it was happening, let alone allowing them to advise on a price limit … The catastrophic result was a 30% run-down of the stock's value—leaving the Fairbairns with tens of millions less to direct to charitable causes, and reducing the size of their tax deduction by millions more.

h. The Complaint alleges that Fidelity Charitable sold all of the shares on the day they were donated, which the Fairbairns claim caused the share price to drop from $28 per share (when the selling started) to $20.61 per share (when the last tranche of shares were sold), resulting in a loss of approximately $5 million. This mass sale, according to the Fairbairns, also negatively affected the value the company and, thereby, the value of the shares they still owned. In the Complaint, the Fairbairns are suing Fidelity Charitable for breach of contract, misrepresentation and negligence, and are seeking, among other things, to have Fidelity Charitable make the Fairbairns whole with respect to the charitable income tax deduction, i.e., pay the Fairbairns the difference between their actual deduction and the deduction they would have received had Fidelity Charitable honored its promises, and to make the Fairbairns whole with respect to their donation, i.e., restore to the Fairbairns' DAF account the amount of money that a reasonably competent liquidation (adhering to the promises made) would have yielded.

i. A motion to dismiss the suit was filed by Fidelity Charitable on September 24, 2018, was denied on October 26, 2018, and Fidelity Charitable filed its Answer to the Complaint on December 17, 2018. The case is still ongoing and has accordingly yet to be decided by the court.

j. Although this case is essentially a breach of contract case, it does raise an interesting issue regarding whether a sponsoring organization can give control to a donor to a DAF over the timing and rate at which contributed assets may subsequently be sold by the supporting organization. One of the basic requirements of a DAF is that the fund be "owned and controlled" by the sponsoring organization, in this case Fidelity Charitable. IRC § 4966(d)(2)(A)(ii). And, under IRC § 170(f)(18), a donor to a DAF may not claim a charitable income tax deduction unless the donor obtains a contemporaneous written acknowledgment from the sponsoring organization "that such organization has exclusive control over the assets contributed." Although the sponsoring organization must have exclusive control over the DAF, the donor "has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in such fund or account by reason of the donor's status as a donor." IRC § 4966(d)(2)(A)(iii). Such advisory privileges would appear to include donor advice regarding the timing and rate at which contributed assets are sold provided, however, that it is merely advice and not legally binding upon the sponsoring organization of a DAF.

k. Where, however, a donor retains a legal right to determine when contributed assets are sold and at what price, thereby eliminating the element of control over these decisions by the sponsoring organization, such a right may cause the contribution to be incomplete for income tax purposes, and may cause the purported DAF not to qualify for DAF treatment under IRC § 4966(d)(2) but to, instead, cause the fund to be treated as a private foundation. It would appear, however, that a sponsoring organization could, as a condition of a donor funding a DAF, make binding representations to the donor as to the manner in which it will liquidate contributed assets, without the sponsoring organization being considered to cede control over the fund to the donor, although an agreement by a charity as to the manner in which it will liquidate contributed assets could have an impact on the valuation of those assets for income tax purposes if the terms of such agreement would impact the price for which a willing buyer would otherwise purchase the assets.

5. SUPPORTING ORGANIZATIONS: STILL IN PLAY.

a. Introduction.

i. The "Type III supporting organization" (SO), which first came into existence as a result of the enactment of Section 509(a)(3) under the Tax Reform Act of 1969, is one of the most complex and difficult to understand forms of Section 501(c)(3) tax-exempt organizations. The legislative history to Section 509(a)(3) indicates that the reason for the creation of SOs was so that the Milton Hershey School Trust, which supports the Milton Hershey School, would be classified as a public charity, even though it would otherwise be considered a private foundation because it does not receive public support sufficient for it to be classified as a public charity.

ii. Although a Type III SO may often bear a striking resemblance to a private foundation, particularly in the case of a charitable trust whose sole purpose is to make payments to one or more publicly supported organizations, a Type III SO is classified as a public charity and is therefore not subject to the strict and burdensome tax regime, chock-full of potential excise tax penalties, applicable to private foundations. Over the years, both Congress and the IRS have struggled with the treatment of Type III SOs, particularly in light of their perceived abuses, from considering eliminating them altogether to subjecting them to rules more akin to private foundations.

iii. After years of debate and dialogue, including congressional hearings on the subject, the Pension Protection Act of 2006 ("PPA") made a vast array of changes to Type III SOs that were intended to curb perceived abuses, while continuing to bestow public charity status on these entities. This new statutory framework did not, however, contain a precise set of rules defining the new requirements for Type III SO status, as the PPA opted instead to direct the Department of the Treasury and the IRS to issue regulations to provide such guidance. As a result, after the enactment of the PPA, there was uncertainty as to whether existing Type III SOs, including charitable trusts, could continue to qualify as Type III SOs and what measures such entities should take in order to maintain their status in a post-PPA Type III SO tax regime.

iv. Indeed, as a result of such uncertainty, many existing charitable trusts that were historically classified as Type III SOs opted simply to convert, albeit sometimes erroneously, to private foundation status, rather than chance running afoul of the new requirements. Pending the issuance of the regulations required by the PPA, the IRS took steps to provide interim guidance on the new requirements applicable to Type III SOs in the form of an advanced notice of proposed rulemaking and proposed regulations. Although these measures were not effective until either final or temporary regulations were promulgated, they provided an indication of the changes to come, gave taxpayers time to prepare for such changes, and allowed for taxpayer comment before temporary or final regulations were issued.

v. More than six years after the enactment of the PPA (and more than three years after the issuance of the proposed regulations), the IRS issued both temporary and final regulations providing guidance on Type III SOs, although the Preamble to the regulations indicates that additional guidance in this area is anticipated. The regulations clarify the requirements for Type III SO status that had been lacking under the statutory regime put in place under the PPA. The regulations also make significant changes to the historical requirements for Type III SO status and add complexity to an already complicated tax regime, presenting substantial challenges to organizations seeking to achieve or maintain such status. This article addresses the requirements for an organization to qualify for Type III SO status in a post-PPA tax regime, as implemented by the temporary and final regulations issued by the Treasury and the IRS.

b. **Overview of SOs.**

i. An SO is one of the most complex, technical, and least understood of all Section 501(c)(3) tax-exempt organizations. It has also been one of the most controversial and scrutinized tax-exempt organizations. An SO is excluded from the definition of a private foundation and is, therefore, classified as a public charity, essentially on a derivative basis by virtue of its support of, and relationship with, the one or more public charities that it supports. An SO can be formed as a nonprofit corporation or as a charitable trust and is a separate and distinct legal entity from the charities it supports. In order to qualify as an SO, the organization must meet each of the following three statutory requirements under Section 509(a)(3):

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 publicly supported organizations.

To ensure that a public charity has the ability and motivation to properly oversee its activities, the organization must have one of three possible relationships with one or more publicly supported organizations which, depending on the type of relationship, results in the organization being known as a Type I, Type II, or Type III SO. The three alternative types of relationships are where the SO is (1) "operated, supervised or controlled by" (Type I); (2) "supervised or controlled in connection with" (Type II); or (3) "operated in connection with" one or more publicly supported organizations (Type III).

The organization must not be controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946) other than foundation managers with respect to such organization and other than the one or more publicly supported organizations the organization supports.

6. **SINGLE MEMBER LLCs.**

a. **Introduction**

i. Over the years, the IRS has steadfastly declined to rule on the deductibility of a contribution to a disregarded single member limited liability company (LLC) that is owned and controlled by a U.S. tax-exempt organization, notwithstanding that the tax-exempt organization itself can receive tax deductible contributions directly and its single member LLC is disregarded for federal income tax purposes.

ii. After years of refusing to rule or otherwise provide any guidance, and therefore leaving taxpayers and charities alike in the dark on this issue, the IRS has now issued Notice 2012-52, advising taxpayers that so long as all other requirements of IRC § 170 are met, the IRS will treat a contribution to the disregarded single member LLC as a tax-deductible contribution to the charity for federal income tax purposes.

iii. The treatment of the contribution as being made to the charity itself subjects the charity, not the single member LLC, to the disclosure requirements of IRC §§ 170(f)(8) and 6115. The percentage limitations under IRC § 170(b) also apply as though the contribution was made to the charity itself. This announcement is welcome news for charities, as they can now assure their donors that a contribution to a single member LLC owned and controlled by the charity is tax-deductible.

iv. Notice 2012-52 provides definitive guidance that has been sought for years. Interestingly, under this notice, even if the LLC is formed solely to engage in an unrelated trade or business (that is not significant enough to cause the loss of the charity owning and controlling the LLC to lose its tax-exempt status) and does not engage in activities aimed at furthering a tax-exempt purpose, a contribution to the LLC will be treated as a tax-deductible charitable contribution provided that all requirements under IRC § 170 are met.

b. **Background: IRS Refuses to Rule on Deductibility of Contributions to Single-Member LLCs Owned and Controlled by Domestic Section 501(c)(3) Organizations.**

i. Over the years, the IRS has steadfastly declined to rule on the deductibility of a contributions to single-member LLCs owned and controlled by domestic Section 501(c)(3) organizations. Charities may want to form a single member LLC that they own and control so that the activities conducted by the LLC do not subject the charity to liability.

ii. In Ltr. Rul. 200150027, for example, a donor desired to contribute real property to a community foundation, but due to environmental concerns and possible associated liability issues, the foundation proposed to create a single member LLC, of which the foundation was the sole member. To further avoid liability issues, the foundation would not be the manager of the LLC, but would appoint an unrelated individual to serve in that capacity. It was represented that the real property to be contributed to the LLC would be used in a manner furthering the charitable purposes of the foundation.

iii. Consistent with Announcement 99-102, the IRS ruled that the LLC would be disregarded as an entity separate and distinct from the foundation. Accordingly, the LLC was not required to submit an application for exemption from tax and would be encompassed within the foundation's own income tax return.

iv. The IRS, however, declined to rule on the deductibility of the contribution of the real estate under IRC § 170, citing section 5.15(3) of Revenue Procedure 2002-1, 2002-1 CB 2002-4 ("ISSUE CANNOT BE READILY RESOLVED BEFORE A REGULATION OR ANY OTHER PUBLISHED GUIDANCE IS ISSUED").

v. A subsequent article contained in the IRS Continuing Professional Education Text for fiscal year 2001 ("Limited Liabilities Companies As Exempt Organizations—Update") provides as follows: "Ann. 99-102 clearly allows the disregarded entity (which includes a single member LLC) to be treated as part of its exempt owner for purposes of Subchapter F (IRC 501 et seq.), Chapter 42 and UBIT reporting purposes. However, the Service is considering whether the same treatment applies for purposes of IRC 170. If not, then a contribution to a disregarded entity would not be deductible as a charitable contribution unless the disregarded entity either qualified in its own right under IRC 170(c), or qualified as an agent of the exempt owner under the facts and circumstances [test]. Guidance on this issue will be forthcoming in the near future."

c. **Notice 2012-52: Contributions to Single Member LLC Deductible**

i. The guidance promised by the IRS on "this issue" back in 2001 never came "in the near future" (and didn't actually come until the issuance of Notice 2012-52 on July 31, 2012). Given that the IRS declined to rule on deductibility under IRC § 170 in Ltr. Rul. 200150027 and the lack of any IRS guidance on this issue, taxpayers and charities alike exercised caution when contemplating a donation to an LLC having a tax-exempt organization as its sole member. And, because of the lack of published guidance in this area, where the dollars at stake were substantial, prudence often dictated donors insisting on contributing property to an entity that had obtained a separate IRS determination classifying it as a tax-exempt organization eligible to receive tax deductible contributions.

ii. On July 31, 2012, the Internal Revenue Service released Notice 2012-52, which advises taxpayers that, if all other requirements of IRC § 170 are met, the IRS will treat a contribution to a U.S. disregarded single-member limited liability company, wholly owned and controlled by a U.S. charity, as a charitable contribution to a branch or division of the U.S. charity. For purposes of complying with IRC §§ 170(f)(8) (contemporaneous donee acknowledgment rules for contributions of $250 or more) and 6115 (the "quid pro quo" disclosure rules for contributions in excess of $75), the charity, not the disregarded entity, is treated as the donee organization. Notice 2012-52 is effective for charitable contributions made on or after July 31, 2012. However, taxpayers may rely on this notice prior to its effective date for taxable years for which the period of limitation on refund or credit under IRC § 6511 has not expired. Specifically, the notice states as follows:

iii. If all other requirements of § 170 are met, the Internal Revenue Service will treat a contribution to a disregarded SMLLC that was created or organized in or under the law of the United States, a United States possession, a state, or the District of Columbia, and is wholly owned and controlled by a U.S. charity, as a charitable contribution to a branch or division of the U.S. charity. The U.S. charity is the donee organization for purposes of the substantiation and disclosure required by §§ 170(f) and 6115. To avoid unnecessary inquiries by the Service, the charity is encouraged to disclose, in the acknowledgment or another statement, that the SMLLC is wholly owned by the U.S. charity and treated by the U.S. charity as a disregarded entity. The limitations of § 170(b) apply as though the gift were made to the U.S. charity.

7. **CONTRIBUTIONS BY INDIVIDUALS AND PRIVATE FOUNDATIONS TO FOREIGN CHARITIES**

a. **Introduction**.

i. International charitable giving by Americans has increased dramatically in recent years and is evolving as a tax planning area of significant importance.

ii. Contributions by individuals and private foundations to or for the benefit of foreign charities are subject to complex tax rules, often presenting formidable obstacles in making such contributions.

iii. There are a number of alternatives available to effectuate international charitable giving, however, while ensuring tax deductibility and compliance with the tax laws.

iv. Due consideration must also be given to various sanctions and best practices adopted in the aftermath of September 11, 2001, aimed at preventing the funding of terrorism.

v. Finally, where a contribution is made to a foreign charity to fund activities to be performed in the U.S., it is important to ensure compliance with the available exemptions from U.S. tax withholding obligations that otherwise apply.

b. **Contributions to Foreign Charities by Individuals.**

i. **No Deduction for Contributions to Foreign Charities.**

1. An individual making a contribution to a charitable organization is entitled to an income tax deduction under Section 170(a) only if the organization is "created or organized in the United States or in any possession thereof, or under the laws of the United States, any State, the District of Columbia, or any possession of the United States."

2. Thus, contributions by individuals to a charity created or organized under foreign law are not deductible for income tax purposes.

3. Interestingly, the charitable contribution deduction provided under the Revenue Act of 1917, under which the federal income tax was

first imposed, allowed an individual to deduct a contribution to charitable organizations created or organized anywhere in the world.

4. The original predecessor to the present-day Section 170, therefore, contained no provision limiting deductibility to contributions to domestic charities. Subsequently, however, under the Revenue Act of 1938, the income tax deduction available to individuals contributing to charitable organizations was limited, for the first time, to domestic charitable organizations and such limitation has remained in the Internal Revenue Code ever since.

5. The explanation for the imposition of this limitation under the Revenue Act of 1938 is contained in the reports of the House Ways and Means for the Revenue Act of 1938, in relevant part as follows:

> The exemption from taxation of money or property devoted to charitable and other purposes is based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and the benefits resulting from the promotion of general welfare. The United States derives no such benefit from gifts to foreign institutions, and the proposed limitation is consistent with the above theory. If the recipient, however, is a domestic organization, the fact that some portion of its funds is used in other countries for charitable and other purposes (such as missionary and educational purposes) will not affect the deductibility of the gift.

ii. **Deduction Allowed For Contribution to Domestic Entity For Foreign Charitable Work.**

1. As the last sentence in the above-quoted language indicates, Congress did not intend to limit deductibility for a contribution to a domestic charity that, in turn, uses such funds to further its charitable purposes in foreign countries.

2. Moreover, the Treasury Regulations explicitly address this situation, specifically providing that a "charitable deduction by an individual to an organization described in Section 170(c) is deductible even though ***all***, or some portion, of the funds of the organizations may be used in foreign countries for charitable or educational purposes."

3. Similarly, Rev. Rul. 63-252 provides that the limitation under Section 170(c) "relates only to the place of creation of the charitable organization to which contributions may be made and does not

restrict the area in which deductible contributions may be used." Deductibility turning on the laws under which a donee charity is created or organized has been interpreted quite literally.

4. In *Welti v. Comm.*, for example, the court held that a contribution was not deductible because it was made to a church that was organized as a corporation under the laws of Switzerland, notwithstanding that it was for all intents and purposes merely a branch of a U.S. church organized under the laws of Massachusetts.

5. In *Bilingual Montessori School of Paris v. Comm.*, contributions to an educational organization incorporated under the laws of Delaware were held to be deductible, although all of its activities took place in France and it had no assets or employees within the U.S.

6. An individual desiring to further a program conducted abroad by a domestic charity can earmark a contribution specifically for that program (but not for a specified foreign charitable organization), so long as that program is subject to the control of the domestic charity.

7. This is the case because a donor can determine which of a qualified organization's charitable purposes will receive the exclusive benefit of a contribution to the organization. Where an individual desires to make contributions specifically for the benefit of a particular foreign charitable organization, however, certain alternatives are available, as discussed below, to accomplish this on a tax deductible basis, notwithstanding that the intended donee organization is not a domestic charity and a contribution directly to such organization is not otherwise deductible.

c. **U.S. "Friends" Organizations.**

i. There are a multitude of U.S. "friends" organizations that are formed to support a specific foreign charity, such as, for example, the American Friends of the Paris Opera, the American Friends of the London Business School, and the American Friends of the Tel Aviv University. Although these domestic charities are established specifically for the purpose of raising funds in the U.S. that will ultimately be distributed to the foreign charities they support, they are organized to meet the legal requirements for contributions to be deductible for U.S. tax purposes. Contributions to these organizations are generally deductible under Section 170 if the U.S. "friends" organization exercises control and discretion as to the use of the contributions received. Where, however, a contribution is earmarked specifically for the foreign organization or the domestic organization otherwise lacks control and discretion over the use of the contributed funds, the foreign charity will be considered the real donee and the contribution will not be deductible.

1. In Rev. Rul. 63-252, the IRS addressed alternative factual situations regarding the deductibility of contributions to U.S. “friends” organizations. In the first example, a foreign organization caused a U.S. organization to be formed to conduct a U.S. fund-raising campaign, pay the administrative expenses from the collected funds and remit any balance to the foreign organization. The second example provides that U.S. persons, desirous of furthering a foreign organization’s work, form a U.S. organization whose charter provides that it will receive contributions and send them, at convenient intervals, to the foreign organization.

2. The IRS, citing *S.E. Thompson v. Comm.*, stated that the inquiry as to the deductibility of a contribution does not stop once it is determined that an amount has been paid to a qualifying domestic organization; rather, if the amount is earmarked for a foreign charity, then it is appropriate to look beyond the fact that the immediate recipient is a qualifying organization to determine whether the payment constitutes a deductible contribution. Similarly, if an organization is required for other reasons, such as a specific provision in its charter, to turn over contributions to a foreign charity, or if the contributions are otherwise inevitably committed to go to a foreign charity, the IRS stated that the real donee is the ultimate foreign recipient.

3. On this basis, the IRS concluded that the contributions to the domestic charity in examples one and two are not deductible.

4. Similarly, in example three of the ruling, where the domestic organization represents to prospective contributors that the contributions it receives will be turned over to a foreign organization, the IRS determined that the contributions are not deductible. In these examples, the foreign charity was considered the real donee, with the domestic charity considered merely a conduit. Example three of this ruling was subsequently amplified, however, by Rev. Rul. 66-79, whereby the IRS ruled that contributions to a domestic charity which are solicited for the specific project of a foreign charitable organization will be deductible under IRC Section 170 provided, however, that the domestic charity reviews and approves the project as being in furtherance of its own exempt purposes and has control and discretion as to the use of the contributions. As a general rule, if a U.S. “friends” organization is listed in the Cumulative List of Organizations described in Section 170(c), Publication 78, a

contribution to the organization will be deductible for income tax purposes. Deductibility under Section 170(c) will be jeopardized only where a contribution to a U.S. "friends" organization listed in Publication 78 is specifically earmarked by an individual donor for a foreign charity.

d. **International Donor-Advised Funds Formed In The United States.**

i. Donor-advised funds within community foundations and those sponsored by a multitude of mutual fund and brokerage companies generally prohibit recommendations of grants to foreign charities made by donor advisors and, accordingly, any such recommendations will not be approved.

ii. A number of domestic public charities, however, operate international donor-advised fund programs, such as United Way International, Charities Aid Foundation America, the King Baudouin Foundation and the International Community Foundation, that do make grants to foreign charities on the basis of recommendations made by the advisor to a donor-advised fund.

iii. Prior to approving such recommendations, these organizations conduct their own due diligence to ensure that the foreign charity recommended by a donor advisor is a bona fide charity that is otherwise in compliance with applicable foreign law governing charitable organizations and generally impose reporting obligations with respect to grants made to a foreign charity.

iv. Contributions to these domestic public charities are not considered earmarked for a foreign charity because any grant recommended to a foreign charity is subject to the final review and approval of the domestic public charity operating the donor-advised fund program, just as the case with donor-advised funds within community foundations and those sponsored by mutual fund and brokerage companies. As such, contributions to these organizations are deductible, notwithstanding that they ultimately may be directed to foreign charities by the donor advisor.

v. Individuals considering making substantial gifts to an international donor-advised fund should, however, confirm that the administrators of the public charity operating the fund will, in fact, establish adequate screening processes related to donor recommendations. Absent such a screening process, grants to foreign charities pursuant to donor recommendations may be considered as being made by an individual directly to a foreign charity, in which case no deduction would be allowable.

e. **Private Foundations.**

No prohibition exists on a domestic private foundation making grants to foreign charities provided, however, that the foundation complies with the applicable Chapter 42 excise tax requirements with respect to foreign grants. An individual desiring to make significant grants to foreign charities, therefore, may be better served by creating and funding a domestic private foundation which, in turn, can engage in grantmaking to foreign charities selected by the individual. Specific rules govern grants by private foundations to foreign charities, which are discussed below under the heading "Contributions to Foreign Charities by Private Foundations."

i. **Contributions to Foreign Charities by Private Foundations**

1. Unless a foreign charity has been determined by the IRS to be a public charity for U.S. tax purposes (which is unusual because very few foreign charities seek such recognition), a domestic private foundation must comply with very specific requirements in order to make a grant to a foreign charity without running afoul of the Chapter 42 requirements applicable to private foundations.

2. There are basically two methods to accomplish this.

    a. First, a domestic private foundation can make an "equivalency determination" that the foreign grantee is the equivalent of a U.S. charity, which historically has been considered the only method available to accomplish a grant to a foreign charity.

    b. The second method, announced pursuant to an IRS general information letter dated April 18, 2001, allows for the domestic private foundation to exercise "expenditure responsibility," which includes the requirement that the foreign grantee maintain the grant funds in a separate fund dedicated to charitable purposes.

ii. **Equivalency Determination of Status of Foreign Charity**

1. An equivalency determination requires that the domestic private foundation make a good faith determination regarding the status of a foreign grantee under U.S. tax law based on either an affidavit of the foreign charity or an opinion of counsel.

2. Rev. Proc. 92-94 sets out the requirements for relying upon an affidavit and describes the multitude of quantitative and qualitative information that the foreign charity is required to provide. Among the information required by the affidavit is a copy of the foreign charity's governing documents (which must be translated into

English), several years of financial data, a description of activities and various statements regarding local law or customs. <u>**NOTE: Under recently issued final regulations, affidavits may no longer be used for good faith equivalency determination.**</u>

3. Although this revenue procedure was intended to provide a "simplified procedure" to meet the good faith equivalency determination, compliance with the affidavit requirements is often quite burdensome, if not impossible, for many foreign organizations, with the exception of larger foreign organizations receiving substantial funding from U.S. foundations that often receive requests for currently qualified affidavits and can generally comply with little difficulty.

4. An alternative is to obtain an opinion of counsel. The information that an attorney must generally review in order to issue an opinion is largely that required for the foreign grantee affidavit which is required by Rev. Proc. 92-94, such that obtaining an opinion of counsel may be expensive and not justified for smaller grants. Assuming that a good faith determination is made by the domestic charity, by way of an affidavit or opinion of counsel, establishing that the foreign grantee is the equivalent of a public charity under U.S. tax laws, the grant to the foreign charity is treated as a qualifying distribution and the exercise of expenditure responsibility is not required. If the foreign grantee, however, is determined to be the equivalent of a U.S. private foundation because it is not described in IRC Section 509(a), the domestic private foundation must exercise expenditure responsibility with respect to the grant as prescribed by Section 4945(h) and the regulations thereunder, and a qualifying distribution is generally not available.

iii. **IRS Information Letter: Equivalency Determination No Longer Required Provided Expenditure Responsibility is Exercised and Separate Fund is Maintained.**

1. On April 18, 2001, following a two-year effort by the Council on Foundations ("Council") to streamline international grantmaking by U.S. private foundations, the Internal Revenue Service issued a general information letter to the Council concluding that nothing in the IRC or the regulations thereunder requires a private foundation to inquire or evaluate whether it can make a good faith determination that a foreign charitable grantee organization is the equivalent of an IRC Section 501(c)(3) organization and a public charity under IRC §509(a).

2. Under the IRS general information letter, a U.S. private foundation, therefore, is not required to make an "equivalency determination" with respect to a proposed foreign grantee by obtaining an affidavit or an opinion of counsel, thereby avoiding a process that is often complex, expensive and time-consuming.

3. Rather, as long as the domestic private foundation complies with the exercise expenditure responsibility requirements and requires the maintenance of a separate fund in which the grant funds are held, it may make a grant to a foreign charity.

4. While general information letters are advisory in nature and have no binding effect on the IRS, they are intended to provide clarification of well-established interpretations of law. The Council has stated that it believes that all U.S. private foundation grant-makers "may be confident that the information letter obtained by the Council faithfully describes the IRS's views on expenditure responsibility" with respect to foreign grants.

5. This conclusion appears to be absolutely correct given that this methodology would otherwise be available for a grant by a domestic private foundation to a noncharitable organization. Moreover, the IRS has since issued private letter rulings confirming that adherence to the procedures set forth in the information letter will ensure that a grant by a U.S. private foundation to a foreign organization will be treated as a qualifying distribution and not a taxable expenditure.

6. Specifically, under the IRS general information letter, a private foundation may treat a grant to a foreign grantee as a qualifying distribution and not as a taxable expenditure if the private foundation: (i) elects "to treat a foreign grantee as not being described in IRC §501(c)(3);" and (ii) exercises expenditure responsibility with respect to the grant as prescribed under Section 4945(h) and the regulations thereunder. This includes the requirement that the grantee organization must agree to continuously maintain the grant funds in a separate fund dedicated to one or more purposes described in Section 170(c)(2)(B).

7. A private foundation's ability to use the "equivalency determination" rules of the Treasury Regulations is not affected by the IRS information letter.

8. A private foundation may, therefore, still utilize either the affidavit or opinion of counsel approach to determine that a foreign charity is the equivalent of a Section 501(c)(3) organization and a public charity, in which case no expenditure responsibility would be

required and the grant funds would not be required to be held by the foreign charity in a separate fund.

8. **PROGRAM-RELATED INVESTMENTS AND MISSION RELATED INVESTMENTS.**

a. The IRS has issued Notice 2015-62, which confirms that foundation managers of private foundations may consider the relationship of a proposed investment to the foundation's charitable purpose when determining whether a proposed investment is prudent. Under this guidance, private foundations may make investments that further their charitable mission, i.e., so called "mission-related investments" ("MRIs"), even if they provide a lower rate of return than might otherwise be achieved through other investments and they do not otherwise constitute program-related investments ("PRIs"). Notice 2015-16 now aligns the prudent-investor standard for jeopardy investments under IRC § 4944 with state standards applicable to charitable investments under the Uniform Prudent Management of Institutional Funds Act. The IRS notice came out just a few days before the Kresge Foundation's announcement that it would put ten percent of its endowment, or $350-million, into MRIs by 2020, one of the largest such commitments by a private foundation.

b. **Background on Excise Tax on Jeopardy Investments Made by Private Foundations.**

i. As part of the Tax Reform Act of 1969, Congress enacted the jeopardy investment excise tax provisions under IRC § 4944 in order to deter private foundations from engaging in speculative investment practices that could jeopardize the carrying out of a private foundation's tax-exempt purposes. Under these rules, a private foundation is prohibited from making investments that jeopardize its ability to accomplish its exempt purposes. To enforce this prohibition, IRC § 4944 subjects private foundations and, under certain conditions, foundation managers, to a two-tier excise tax regime for investing any amount in such a manner as to jeopardize the carrying out of any of the foundation's exempt purposes. IRC §§ 4944(a) and (b).

ii. Treas. Reg. Section 53.4944-1(a)(2)(i) provides specific guidance as to jeopardy investment rules. Generally, the jeopardy investment prohibition is violated if it is determined that the foundation managers, in making an investment, failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. In the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return).

c. The determination of whether an investment jeopardizes the carrying out of the foundation's exempt purposes is made on an investment-by-investment basis, in each case taking into account the foundation's entire portfolio. Investments that are considered "high risk" may be closely scrutinized to determine whether the foundation managers have met the requisite standard of care. However, once an investment has been determined not to jeopardize the carrying out of the foundation's exempt purposes, the investment will not later be considered a jeopardy investment, even if the foundation subsequently realizes a loss as a result of the investment.

d. Exception for Program-Related Investments from Jeopardy Investment Tax Regime

   i. Under an important exception under the jeopardy investment excise tax regime, program-related investments ("PRIs") are not subject to the jeopardy investment excise tax rules otherwise applicable to investments made by private foundations. Instead, pursuant to IRC § 4944(c), PRIs "shall not be considered as investments which jeopardize the carrying out of exempt purposes." Therefore, as long as an investment is a PRI, there is no exposure to the jeopardy investment excise tax rules notwithstanding that the investment may otherwise be considered imprudent purely from an investment standpoint.

   ii. PRIs are mission-driven investments that closely resemble grants because their primary purpose must be to further tax-exempt purposes. The idea behind a PRI is that the investment would not have been made but for the fact that it will further the foundation's charitable mission. Specifically, a PRI is defined as an investment:

      1. Whose primary purpose is to accomplish one or more of the purposes described in IRC § 170(c)(2)(B), which includes religious, charitable, scientific, literary, and educational purposes.

      2. No significant purpose of which is the production of income or the appreciation of property.

      3. No purpose of which is to attempt to influence legislation or for political purposes.

e. PRIs can play an important role in a private foundation's philanthropy. In addition to not being subject to the jeopardy investment excise tax rules, they are:

i. Treated as qualifying distributions under IRC § 4942 for purposes of meeting a private foundation's five percent annual minimum distribution requirement.

ii. Excluded from the assets taken into account in calculating the five percent annual minimum distribution requirement under IRC § 4942.

iii. Not treated as excess business holdings under IRC § 4943.

iv. Not treated as taxable expenditures under IRC § 4945, as long as the private foundation exercises expenditure responsibility when it is required to do so.

f. Notice 2015-62 specifically notes that "Questions have arisen about whether an investment made by a private foundation that furthers its charitable purposes, but is not a PRI because a significant purpose of the investment is the production of income or the appreciation of property, is subject to tax under section 4944."

g. As indicated above, under the regulations, an investment made by a private foundation will not be considered to be a jeopardy investment if, in making the investment, the foundation managers exercise ordinary business care and prudence (under the circumstances prevailing at the time the investment is made) in providing for the long-term and short-term financial needs of the foundation to carry out its charitable purposes. Although the regulations list some factors that managers generally consider when making investment decisions, Notice 2015-62 states that "the regulations do not provide an exhaustive list of facts and circumstances that may properly be considered." In particular, the regulations do not address whether an investment that furthers a charitable purpose of a private foundation may be properly considered in determining whether a proposed investment is prudent for purposes of the jeopardy investment rule.

h. Notice 2015-62 now specifically provides that a private foundation may take into account the relationship between the investment and the foundation's charitable purposes in determining whether foundation managers have exercised ordinary business care and prudence in making an investment, specifically stating as follows:

> When exercising ordinary business care and prudence in deciding whether to make an investment, foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence under the facts and circumstances prevailing at the time of the investment in making investment decisions that support, and do not jeopardize, the furtherance of the private foundation's charitable purposes. For example, a private foundation will not be subject to tax under section 4944 if

foundation managers who have exercised ordinary business care and prudence make an investment that furthers the foundation's charitable purposes at an expected rate of return that is less than what the foundation might obtain from an investment that is unrelated to its charitable purposes.

i. Notice 2016-52 notes that this standard is consistent with investment standards under state laws, which generally provide for the consideration of the charitable purposes of an organization or certain factors, including an asset's special relationship or special value, if any, to the charitable purposes of the organization, in properly managing and investing the organization's investment assets. *See, e.g.,* Unif. Prudent Mgmt. of Institutional Funds Act. §§ 3(a), 3(e)(1)(H) and accompanying comments, 7A pt. III U.L.A. 21-22 (Pocket Pt. 2015).

Comment: In a time of increasing popularity of MRIs, Notice 2015-62 is welcome news because it specifically provides that foundation managers of private foundations may consider the relationship between an investment and the foundation's mission in determining whether an investment is prudent. The Notice also provides that MRIs will not be considered imprudent because they provide an expected return that is less than what could be earned on other investments. Notice 2015-62 opens the doors to a private foundation investing in mission-driven investments that it might have previously not have made because the investment would not be considered a PRI and its anticipated investment returns are less than what otherwise could be earned on non-mission-driven investments.

Enclosure 4

Private Foundations Can Now Own 100% of Business Enterprise,
Estate Planning Journal, Nov 2018

EXCESS BUSINESS HOLDINGS

Private Foundations Can Now Own 100% of Business Enterprise

Private foundations, like the owner of the Newman's Own food company, get a legislative assist from a new exception to the excess business holdings rule.

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Since the enactment of the "excess business holdings" rule of Section 4943 under the Tax Reform Act of 1969 (the "1969 Act"), [1] a private foundation could not under any circumstances be used to maintain sole ownership of a business enterprise. [2] This absolute prohibition is now no longer in place as a result of the enactment of the Philanthropic Enterprise Act of 2017 as part of the Bipartisan Budget Act of 2018, [3] under which an exception to the excess business holdings rule was created to allow a private foundation to own 100% of an operating business provided, however, certain rather stringent requirements are met under new Section 4943(g) . [4]

Contrary to rules that have been in place since the 1969 Act, if the requirements under the new exception are met, owners of companies that want to devote all profits from their businesses to charity may now put their companies under the sole ownership of a private foundation and permanently devote all of their profits for charitable purposes. [5] This new exception creates what is, in essence, a "philanthropic business enterprise" that is exempt from the excess business holdings rule.

The new exception to the excess business holdings rule, effective for tax years beginning after 2017, was championed by the Newman's Own Foundation, a private foundation to which famed actor and philanthropist Paul Newman bequeathed the sole ownership interest of a for-profit company that produces and sells the Newman's Own line of food products. [6] While Section 4943(g) was intended to provide a life-line to the Newman's Own Foundation by allowing it to indefinitely maintain 100% ownership of the for-profit company founded by Paul Newman, [7] and indeed the exception has been commonly referred to as the "Newman's Own exception," meeting the requirements of this new provision, particularly the independence requirement, may prove quite challenging, if not insurmountable, in most situations. And, even if a private foundation can meet the new requirements of Section 4943(g) , the foundation must still have sufficient liquidity to meet the 5% annual payout requirement under Section 4942 with respect to the fair market value of its interest in the for-profit company, thereby creating another possible significant obstacle to a foundation's 100% ownership of a business enterprise.

While Section 4943(g) will likely have only limited application, it does add one more tool in the toolbox of potential private foundation planning opportunities that should be considered where a donor seeks to transfer control and ownership

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of a business enterprise to a private foundation. This article discusses the Newman's Own exception under new Section 4943(g) and certain other issues in connection with the possible transfer of an interest in an operating business to a private foundation, including planning alternatives to the new exception that may be considered.

Excess business holdings rule

Prior to the 1969 Act, the Internal Revenue Code did not deal directly with the subject of foundation ownership of business interests, although excess business involvement by a foundation presumably could become so significant as to result in loss of tax-exempt status under Section 501(c)(3) . [8] The excess business holdings rule of Section 4943 was enacted as part of the 1969 Act to address concerns of Congress at that time regarding the number of private foundations that were being used to maintain control of business interests, rather than for the purpose of furthering charitable purposes. The House Report stated, in relevant part, as follows: [9]

> The use of foundations to maintain control of businesses, particularly small family corporations, appears to be increasing.... Those who wish to use a foundation's stock holdings to retain business control in some cases are relatively unconcerned about producing income to be used by the foundation for charitable purposes. Even when the foundation attains a degree of independence from its major donor, there is a temptation for the foundation's managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties. Where the charitable purposes predominate, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from their businesses. To deal with these problems, your committee has concluded it is desirable to limit the extent to which a business may be controlled by a private foundation.

The Senate Report [10] regarding the limits on excess business holdings cited the following three examples directly from the relevant section of a report submitted in early 1965 by the Treasury Department to the Senate Finance Committee: [11]

> The Treasury Department in its 1965 study of private foundations included the following examples of where business, and not charitable, purposes appeared to predominate in foundation activities:
>
> Example 1.-The A foundation holds controlling interests in 26 separate corporations, 18 of which operate going businesses. One of the businesses is a large and aggressively competitive metropolitan newspaper, with assets reported at a book value of approximately $10,500,000 at the end of 1962 and with gross receipts of more than $17 million for that year. Another of the corporations operates the largest radio broadcasting station in the State. A third, sold to a national concern as of the beginning of 1965, carried on a life insurance business whose total assets had a reported book value of more than $20 million at the end of 1962. Among the other businesses controlled by the foundation are a lumber company, several banks, three large hotels, a garage, and a variety of office buildings.

Concentrated largely in one city, these properties present an economic empire of substantial power and influence.

Example 2.-The B foundation controls 45 business corporations. Fifteen of the corporations are clothing manufacturers; seven conduct real estate businesses; six operate retail stores; one owns and manages a hotel; others carry on printing, hardware, and jewelry businesses.

Example 3.-The C foundation has acquired the operating assets of 18 different businesses, including dairies, foundries, a lumber mill, and a window manufacturing establishment. At the present time it owns the properties of seven of these businesses. Its practice has been to lease its commercial assets by short-term arrangements under which its rent consists of a share of the profits of the leased enterprise. By means of frequent reports and inspections, it maintains close check upon its lessees' operations.

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The Senate Report also noted a newspaper advertisement by a private foundation that sought out business acquisition opportunities as evidence that this type of foundation behavior was a continuing trend, and not merely historical. [12]

Applicable to private foundations, donor advised funds, certain supporting organizations, and trusts. Section 4943 generally applies only to organizations that are classified as private foundations. [13] These are organizations that are tax-exempt under Section 501(c)(3) and are not classified as public charities under Section 509(a) . Private foundations generally have one major source of funding, typically comprised of contributions from one individual or members of a single family, and are used principally to make grants to other charitable organizations, rather than to engage in direct charitable activities. [14] Foundations are separate and distinct legal entities, generally taking the form of nonprofit corporations formed under state law, although they may also be organized as charitable trusts under trust law or even as limited liability companies. A primary advantage of a private foundation compared to other alternatives to furthering one's philanthropy is, in a word, "control."

Depending on the form of the foundation and applicable state law, this control may be maintained by having the donor and his or her family members comprise the board of directors or trustees of the foundation. The donor may also serve as the president and chief executive officer of the foundation, and family members may hold other officer positions. Therefore, in addition to providing an immediate income tax benefit associated with contributions to the foundation and the foundation not being subject to income tax, [15] a private foundation allows the donor to retain the

ultimate control over the contributed funds. [16]

Although, as originally enacted, the excess business holdings rule generally applied only to private foundations, the scope of Section 4943 has since been expanded to include other entities. [17] Under Section 4943(e)(1) , a donor advised fund "shall be treated as a private foundation" for purposes of Section 4943 . [18] Similarly, under Section 4943(f)(1) , a non-functionally integrated Type III supporting organization also "shall be treated as a private foundation" for purposes of the excess business holdings rule. [19] In addition, the excess business holdings rule applies to a wholly charitable nonexempt trust described in Section 4947(a)(1) that is deemed to be a private foundation, [20] as well as certain split-interests trusts described in Section 4947(a)(2) to the extent not excluded from the purview of Section 4943 under Section 4947(b)(3) .

Excise tax imposed on excess business holdings. The excise taxes imposed under Section 4943 are confiscatory, making it prohibitive for a private foundation to have excess business holdings in the first instance. [21] Under the Section 4943 excise business holdings tax regime, a private foundation is subject to an initial excise tax equal to 10% of the value of its "excess business holdings" in a business enterprise for each tax year for which it has such holdings. And, if the foundation still has such excise business holdings (i.e., because it does not dispose of such excess holdings) by the close of what is known as the "taxable period," [22] a 200% additional excise tax is imposed on such excess business holdings. [23]

Excess business holdings rule applies only to a "business enterprise." The concern of Congress in enacting Section 4943 was a private foundation's ownership of companies that engaged in actual business activities rather than those engaging in mere passive activities or those activities that further tax-exempt purposes. The scope of the excess business rule, therefore, extends only to a "business enterprise," and a private foundation's investment in a business that is not considered a business enterprise can never be excess business holdings.

A business enterprise generally includes a business engaged in the active conduct of a trade or business that does not relate to carrying out a charitable purpose. [24] A business that derives more than 95% of its gross income from "passive sources" also is not a business enterprise within the meaning of Section 4943 . [25]

Definition of excess business holdings. Once a private foundation is determined to have holdings in a "business enterprise," a further determination must then be made as to whether such holdings constitute "excess business holdings" within the meaning of Section 4943(c) . The "excess business holdings" is equal to the excess of a foundation's holdings in a business enterprise over its "permitted holdings" in such enterprise. [26] The permitted holdings of a private foundation in a corporation is equal to (1) 20% of the voting stock of the corporation minus (2) the percentage of voting stock actually or constructively owned by all disqualified persons, a broad category of individuals and entities described in Section 4946(a)(1) . [27] As such, the combined holdings of voting stock of a foundation and its disqualified persons may equal up to 20%. In any case in which all disqualified persons together do not own more than 20% of the voting stock of a corporation, nonvoting stock held by the private foundation, no matter how great in amount, is treated as permitted holdings.

If it can be established to the satisfaction of the IRS that effective control of a corporation is in the hands

of one or more third persons who are not disqualified persons, the foundation and all disqualified persons together may own up to 35% of the corporation's voting stock. [28]

Under a *de minimis* rule, a foundation is not treated, in any event, as having excess business holdings in any corporation in which it (together with certain other related foundations) owns not more than 2% of the voting stock and not more than 2% of the value of all outstanding shares of all classes of stock. [29]

For purposes of Section 4943 , "voting stock" is determined by reference to the power of stock to vote for the election of directors. [30] Thus, for example, if a private foundation holds 20% of the shares of one class of stock in a corporation, which class is entitled to elect three directors, and the foundation holds no stock in the other class of stock, which is entitled to elect five directors, the foundation is treated as holding 7.5% of the voting stock because the class of stock it holds has 37.5% of such voting power by reason of being able to elect three of the eight directors, and the foundation holds 20% of the shares of such class. [31] The fact that extraordinary corporate action may require a favorable vote of more than a majority of the directors, or of more than a majority of the outstanding voting stock, does not alter the determination of the voting power of stock for purposes of Section 4943 . [32]

There are analogous excess business holding rules applying the 20% and 35% limitations in the holdings of a business enterprise that is not incorporated. [33] When the business enterprise is a partnership or joint venture, the "profits interests" is substituted for "voting stock" and the "capital interest" is substituted for "nonvoting stock." [34] A private foundation is not permitted to have any holdings in a business enterprise that is a sole proprietorship. [35]

Special five-year rule (possibly extended to ten years) for gifts and bequests of stock causing private foundation to have excess business holdings. Section 4943(c)(6) provides relief, in certain cases, where there is a change in holdings of a business enterprise, other than by purchase by the foundation or by a disqualified person, [36] that causes a private foundation to have excess business holdings. Thus, if a foundation receives a bequest of an interest in a business enterprise causing it to have excess business holding, Section 4943(c)(6) will provide relief from the imposition of excise tax. This provision treats the interest of the foundation in such enterprise as being held by a disqualified person for five years after the change in holdings, thereby giving the foundation a five-year grace period to dispose of the excess holdings. Under certain circumstances where the foundation has made diligent efforts to dispose of excess business holdings during the initial five-year grace period but disposition during such period has not been possible, the period may be extended by the IRS to ten years. [37]

5% annual distribution requirement of Section 4942

In response to situations where a donor to a private foundation received a substantial tax benefit but mainstream charity received little or no benefit from the foundation, a minimum annual distribution requirement was adopted by Congress under the 1969 Act, as codified under Section 4942 . Section 4942 subjects a private foundation to substantial excise taxes if it fails to annually make a specified minimum amount of "qualifying distributions." [38] Qualifying distributions generally include expenditures made to further the exempt purposes of the foundation. [39] These include, for example, grants to public charities and other expenditures made in furtherance of the foundation's charitable, educational, or other purposes forming the basis for the foundation's tax-exemption, including reasonable and necessary administrative expenses.

By subjecting a private foundation to an excise tax regime for a failure to meet minimum annual distribution requirements, Section 4942 essentially compels a private foundation to make annual distributions of a minimum amount of its assets for charitable and other exempt purposes. The general minimum distribution requirement is 5% of the net aggregate fair market value of all of the assets of the foundation, exclusive of those assets that are used or held for use in furtherance of its exempt purposes. Under this general rule, for example, a private foundation having assets consisting solely of $10 million in marketable securities (and no debt) generally must make $500,000 ($10,000,000 × 5%) in qualifying distributions each year in order to avoid the imposition of excise taxes under Section 4942 . The actual determination of a private foundation's annual minimum distribution requirement is made under a complex regime, as there are a multitude of rules that must be taken into account in determining the precise amount of the minimum distribution requirement for each tax year of a foundation. [40]

Determination of fair market value. Because the minimum required annual distribution of a private foundation is based on the net fair market value of the foundation's assets (other than those used or held for exempt purposes), the fair market value of the foundation's assets must

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be determined, including the value of any interest in a business enterprise. Specific rules contained in the regulations under Section 4942 must be applied for purposes of valuing securities for which market quotations are readily available. [41] Holdings in closely held companies must be appraised annually based on commonly accepted methods of valuation. [42] Valuations made in accordance with the principles stated in the regulations under Section 2031 are acceptable methods of valuation. [43]

Newman's Own exception to the excess business holdings rule

Apparently, during the year 2008, the Newman's Own Foundation received a 100% ownership interest in the for-profit corporation owning the Newman's Own line of food products as a result of a bequest made upon the death of its founder, Paul Newman. But for the five-year grace period provided for bequests under Section 4943(c)(6) , the 100% ownership interest in the for-profit corporation would have caused the foundation to become subject to the excise tax provisions under the excess business holdings rule of Section 4943 . The foundation was apparently able to obtain an additional five-year extension under Section 4943(c)(7) to dispose of the excess business holdings, thereby giving the foundation a grace period extending until 2018 before the excess business holdings rule excise tax would be triggered if it did not dispose of the excess holdings. During the ten-year grace period provided under Section 4943 , Robert Forrester, the president and chief executive office of Newman's Own Foundation, had spent years building support for a legislative solution to the excess business holdings rule that would allow the Newman's Own Foundation to continue to indefinitely retain 100% ownership of the for-profit Newman's Own brand company. [44]

The solution: enactment of new Section 4943(g) . Section 4943(g) provided a solution to the excess business holdings rule plaguing the Newman's Own Foundation by permitting a private foundation to hold 100% ownership of a business enterprise provided, however, that certain rather stringent requirements are met. While this new exception was championed by the Newman's Own Foundation, it applies, of course, to any private foundation meeting its requirements, although it was clearly fashioned for the Newman's Own Foundation situation. The purpose of new Section 4943(g) , as expressed by the House Ways and Means Committee, is as follows: [45]

> In recent years, a new type of philanthropy has combined private sector entrepreneurship with charitable giving, such as through the donation of a private company's after-tax profits to charity. The Committee believes it is appropriate to encourage this form of philanthropy by eliminating certain legal impediments to its use, while also ensuring that private individuals cannot improperly benefit from amounts intended for a charitable purpose or inappropriately manage a taxable business. The Committee therefore believes it is appropriate to create an exception to the present-law private foundation excess business holdings rules for certain philanthropic business holdings. By so doing, the law will permit private philanthropists to bequeath an entire business to a private foundation, provided that the after-tax profits of the business will be paid to the foundation and certain other requirements are satisfied, while also ensuring that the donor's heirs cannot improperly benefit from the arrangement.

The provisions of Section 4943(g) are aimed at addressing the concerns of Congress in originally enacting Section 4943 that the foundation managers of a private foundation would divert their interest to the maintenance and improvement of the business enterprise and away from their charitable duties, and that the business enterprise would be operated primarily for the benefit of family members of the donor to the foundation.

Under the Newman's Own exception under Section 4943(g) , the excess business holdings rule "shall not apply with respect to the holdings of a private foundation in any business enterprise" if the following requirements are met:

- The foundation meets an ownership requirement, generally requiring the foundation to own 100% of the voting stock of the business enterprise and for all of the foundation's ownership interests in such enterprise to be acquired other than by purchase.
- All profits of the business enterprise must be distributed to the foundation no later than 120 days after the close of the tax year.
- The business enterprise is operated independently from the private foundation.

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Ownership requirement. Under the ownership requirement, 100% of the voting stock in the business enterprise must be held by the private foundation at all times during the tax year. Also, all the private foundation's ownership interests, which would include both voting and nonvoting interests, in the business enterprise must have been acquired by the foundation by means "other than by purchase." [46] Interestingly, under previous versions of bills containing the Newman's Own exception, the ownership requirement used the heading "Exclusive Ownership" and required that "all ownership interests in the business enterprise are held by the private foundation at all times during the taxable year." Such ownership interests also had to be acquired "under the terms of a will or trust upon the death of the testator or settlor, as the case may be," [47] thereby limiting the exception only to testamentary transfers.

This is in contrast to the ownership requirement ultimately enacted under the Philanthropic Enterprise Act of 2017, [48] which uses the heading "Ownership" and requires only that "100 percent of the voting stock in the business enterprise is held by the private foundation at all times during the taxable year." And, rather than limiting the new exception to ownership interests passing to a private foundation upon death of the testator or settlor, such interests need only be acquired by the foundation "other than by purchase," [49] so that the Newman's Own exception is available for both *inter vivos* and testamentary gratuitous transfers.

Although the ownership requirement is couched in terms of "100 percent of the voting stock of a business enterprise"-and a "business enterprise" for purposes of Section 4943 includes a corporation, a partnership, joint venture, and sole proprietorship-because voting stock is issued only by a corporation, [50] the new exception appears limited only to a private foundation's holdings of a corporation. Also, it would appear that because the 100% ownership requirement applies only to voting stock, the private foundation need not own any nonvoting stock issued by the corporation so that there can be other shareholders besides the private foundation, although such shareholders must own only nonvoting stock.

While this conclusion seems valid based on the language of the ownership requirement set forth under Section 4943(g)(2) , it appears to run afoul of the requirement under Section 4943(g)(3) , discussed below, that all profits of the business enterprise must be distributed to the private foundation. Therefore, even though nonvoting stock apparently could be issued to shareholders other than the private

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foundation, such stock could not pay dividends. That would seem to leave room only for the possible issuance to shareholders other than the private foundation of a class of nonvoting stock having no rights to dividends, essentially constituting only an equity or capital interest in the corporation.

Distribution of profits requirement. Under the distribution of profits requirement, the corporation must, not later than 120 days after the close of the tax year, distribute an amount equal to its net operating income for such tax year to the private foundation. [51] The "net operating income" for this purpose is defined as an amount equal to the gross income of the corporation for the tax year, reduced by the sum of:

(1) The income tax deductions allowed for the tax year which are directly connected with the production of such income.

(2) The income tax imposed on the corporation for the tax year.

(3) An amount for a reasonable reserve for working capital and other business needs of the business enterprise. [52]

Presumably, regulations will be issued to provide guidance on meeting the distribution-of-profits requirement, including what is a reasonable reserve for working capital and other business needs. Because a private foundation is exempt from income tax under Section 501(a) , dividends received by the foundation would not be subject to income tax, [53] but would be subject to the net investment excise tax under Section 4940 .

As discussed above, under the general 5% annual distribution requirement under Section 4942 , a foundation must make qualifying distributions with respect to the value of stock held in a corporation. This is a major issue when considering contributing to a foundation a 100% ownership interest in a corporation having substantial value. Although the corporation must distribute all of its profits to the foundation under the Newman's Own exception, such profits may not provide sufficient liquidity for the foundation to make qualifying distributions to meet the minimum annual distribution requirements under Section 4942 .

If the profits of the corporation are not sufficient to meet the 5% distribution requirement, and the foundation does not otherwise have sufficient assets to satisfy such requirement, the foundation could find itself facing substantial excise tax under Section 4942 . Therefore, even if a private foundation can meet the stringent requirements of the exception to the business holdings rule under new Section 4943(g) , the Section 4942 distribution requirement may create a significant obstacle to a foundation's 100% ownership of a business enterprise.

Independent operation requirement. Under the independent operation requirement, at all times during the tax year:

(1.) No substantial contributor to the private foundation or family member of such a contributor is a director, officer, trustee, manager, employee, or contractor of the corporation (or an individual having powers or responsibilities similar to any of the foregoing). [54]

(2.) At least a majority of the board of directors of the private foundation are persons who are not either:

- Directors or officers of the corporation.
- Family members of a substantial contributor to the private foundation. [55]

(3.) There is no loan outstanding from the business enterprise to a substantial contributor to the private foundation or to any family member of such a contributor.

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The independent operation requirement, while apparently workable in the Newman's Own Foundation situation, has a lot of teeth, creating perhaps an insurmountable challenge to meet in most situations. Under the first prong of this requirement, the corporation owned by the foundation must be independent of the donor family, such that a substantial contributor to the foundation and any family member can have no connection to the corporation in any capacity. So, for example, for a founder of a private foundation who is the sole stockholder of a corporation for which he or she is also a director and officer and who desires to maintain that position during his or her lifetime, a lifetime gift of stock to the foundation would not be workable. A testamentary transfer would still not work if the founder's family members will be directors, officers, employees, or contractors of the corporation after the founder's death. For a family-run business, therefore, unless there is a substantial change in the governance and operations of the company, which in most cases is likely not realistic, the Newman's Own exception is not a viable option. The more likely candidate is a company that is operated by professional management, unrelated to the founder of the foundation, where family members also do not participate in company affairs in any capacity.

Assuming that a substantial contributor and family members of such contributor are not connected to the corporation so as not to disqualify the foundation under the first prong of the independent operation requirement, under the second prong, the foundation must be considered independent from both the corporation it owns, as well as family members of a substantial contributor. As indicated above, this is achieved where at least a majority of the board of directors of the foundation are not (1) directors or officers of the corporation, or (2) family members of a substantial contributor. It would be permissible, therefore, for a minority of the board of directors of the foundation to be (1) directors or officers of the corporation (provided they are not family members of a substantial contributor) and (2) family members of a substantial contributor. Provided this prong of the requirement is met, there is nothing that prevents family members of a substantial contributor from constituting the majority of the officers of the foundation, if the directors are so inclined to appoint them.

Depending upon state law under which a foundation is governed, it may also be possible for a substantial contributor or family members to retain the right to appoint the directors of the foundation. [56] Therefore, while family members of a substantial contributor cannot be a majority of the directors of a private foundation, they may be able to retain significant control over the foundation by retaining the right to appoint its directors. Similarly, while a majority of the board of directors of the private foundation cannot be directors or officers of the corporation, the foundation, as the 100% voting stockholder, has the right to appoint the directors of the corporation and, depending on state law, have approval rights over fundamental transactions of the corporation. Still, given that family members cannot comprise the majority of the directors of the foundation, or, as in many cases with private foundations, comprise the entire board, a private foundation seeking to satisfy the independent operation requirement will not have the same degree of control typically accorded family members of a private foundation.

Certain deemed private foundations excluded. The new exception from the excess business holdings rules under Section 4943(g) does

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not apply to the following entities which, as in the case of a private foundation, are also subject to the excess business holdings rule of Section 4943 : [57]

(1) A donor advised fund or a non-functionally integrated Type III supporting organization.

(2) A wholly charitable trust described in Section 4947(a)(1) .

(3) A split-interest trust described in Section 4947(a)(2) .

Newman's own exception and five-year grace period. Nothing under Section 4943(g) affects the availability of the five-year grace period under Section 4943(c)(6) or the ability to extend such period to ten years under Section 4943(c)(7) . Therefore, even when it is contemplated that the Newman's Own exception is to be used, the exception need not be met during the grace periods provided for a gratuitous transfer of stock to a private foundation. The exception need only be met at the end of such periods.

Alternatives to Newman's Own exception

As discussed above, meeting the requirements of the Newman's Own exception may prove challenging, if not impossible, and even if it can be met, a private foundation may not have sufficient liquidity to meet the 5% minimum distribution requirement under Section 4942 with respect to the value of a business enterprise transferred to it. Transferring the business enterprise to a public charity avoids these issues as, unlike private foundations, public charities are not subject to either the excess business holdings rule or the 5% minimum distribution requirement. As discussed above, a donor advised fund and a non-functionally integrated Type III supporting organization, although having public charity status, are treated as private foundations for purposes of the excess business holdings rule, so these entities are not workable alternatives.

The transfer of a business enterprise to a single-member limited liability company (SMLLC) owned and controlled by a public charity, such as a community foundation, is a possible alternative. The SMLLC is a disregarded entity, so it is treated essentially as a division or branch of the public charity. [58] Thus, the SMLLC is not subject to the excess business holdings rule or the 5% minimum distribution requirement applicable to a private foundation. The SMLLC could be formed for grant-making purposes similar to a private foundation, and members of the donor's family could serve as managers of the SMLLC. While members of a donor's family presumably could be a majority of the board of managers, even if they are not, they are in no less a control position than a private foundation meeting the Newman's Own exception under which family members of a substantial contributor cannot be a majority of the foundation's board.

A Type I supporting organization, where the supported organization is a community foundation, may also be an alternative. Similar to an SMLLC of a public charity, the excess business holdings rule and 5% minimum distribution requirement application to private foundations do not apply to a Type I supporting organization. While family members of a donor to a Type I supporting organization may not be in control [59] and therefore cannot comprise a majority of the board, they can still serve on the board and have no less control than they would have under the Newman's Own exception.

Where a donor and family members ultimately desire to hold a business enterprise in a private foundation are unable or unwilling to comply with the requirements of Section 4943(g) , and the 5% minimum annual distribution requirement is not an impediment, the use of nonvoting stock of a corporation should be considered to maximize the ownership of a business enterprise by the foundation without running afoul of the excess business holdings rule. Under Section 4943(c)(2) , [60] a foundation's ownership of a corporation can be significantly increased through the use of nonvoting shares where all disqualified persons together do not own more than 20% of the voting stock of a corporation, in which case nonvoting stock held by the private foundation, no matter how great in amount, is treated as permitted holdings under Section 4943 .

This could be accomplished, for example, by transferring at least 80% of the voting stock to a non-disqualified person. In Ltr. Rul. 201303021 , for example, the IRS determined that the excess business holdings rule did not apply where the nonvoting shares of a corporation were transferred to a private foundation and the voting shares were transferred to trusts that were not disqualified persons. Because disqualified persons did not own more than 20% of the voting stock in this ruling, it was permissible for the foundation to hold any number of shares of nonvoting stock. In Ltr. Rul. 201311035 , 80% of the voting stock was transferred to a public charity described in Sections 170(b)(1)(A)(vi) and 509(a)(1) , which by its nature is not a disqualified person, thereby resulting in the excess business holdings rule not applying to the nonvoting shares held by a donor advised fund. [61]

In this ruling, the voting shares transferred to the public charity were actually subject to a voting trust that conferred on the trustee, who himself was a disqualified person, the right to vote the stock and otherwise act for the beneficial owners of the stock, subject to the trustee's fiduciary duties to those beneficial owners as holders of the voting trust certificates. Citing Section 4943(d)(1) , the IRS stated that that the stock held by the voting trust is considered to be owned proportionately by or for its beneficiary of the trust and, in this case, therefore, the public charity would be treated as owning 80% of the voting stock of the corporation for purposes of Section 4943 .

Conclusion

The Newman's Own exception to the excess business holding rule under new Section 4943(g) offers a planning opportunity for a donor seeking to transfer 100% ownership of a business enterprise to a private foundation and to ensure that all profits of the business are devoted for charitable purposes. The requirements to meet the exception, however, are quite stringent and, while apparently workable in the Newman's Own situation, may create an insurmountable challenge. Even if the requirements can be met, the foundation must still have sufficient liquidity to meet the 5% annual payout requirement under Section 4942 with respect to the fair market value of the business enterprise, thereby creating another possible significant obstacle to a foundation's 100% ownership of a business enterprise.

In cases where the Section 4943(g) exception is not an option, to maximize the foundation's ownership of a business, consideration could be given to funding the foundation with nonvoting shares and having non-disqualified persons own at least 80% of the voting stock. As an alternative to a private foundation, in order to avoid both the excess business holdings rule and the 5% annual payout requirement, the business could be contributed to a vehicle that is a public charity where family members can serve on the board.

[1] Pub. L. No. 91-172.

[2] For a background on the private foundation tax regime, including the application of the private foundation excise tax provisions under Subchapter A ("Private Foundations") of Chapter 42 ("Private Foundations and Certain Other Tax-Exempt Organizations") of the Internal Revenue Code, which include Section 4943 , see Fox and Blattmachr, "Plan Now to Avoid the Private Foundation Tax Rules," 45 ETPL 3 (February 2018). See also Fox, *Charitable Giving: Taxation, Planning, and Strategies, 2nd Ed* (Thomson Reuters, 2018), Volume 2, Chapter 30.

[3] Pub. L. No. 115-123.

[4] The exception was originally included in the House bill of the Tax Cuts and Jobs Act (H.R. 1) that was passed by the House on 11/16/2017, but no such provision was included in the Senate bill. Ultimately the exception was not included in the final version of the legislation that was signed into law on

12/22/2017 as Pub. L. No. 115-97. Prior to the provision's ultimate enactment as part of the Bipartisan Budget Act of 2018, several bills were introduced over the years in both the House of Representatives and the Senate that contained the exception. See, e.g., H.R. 3732 (10/9/2015); H.R. 5007 (4/20/2016); H.R.3035 (6/23/2017); S.2750 (4/6/2016); S.1343 (6/13/2017).

[5] A company operated for the primary purpose of carrying on a trade or business that distributes all of its profits to one or more tax-exempt entities (otherwise known as a "feeder organization"), including to a private foundation, is not itself exempt from tax under Section 501(a) . See Section 502(a) and Reg. 1.502-1(a) . Perhaps, the most high-profile example of where a donor placed control of a for-profit corporation in the hands of a charity is the Milton Hershey School (which has an endowment exceeding $12 billion), to which Milton S. Hershey transferred control over what is now known as the "Hershey Company," which to this day is still controlled by the school. Because the Milton Hershey School is an educational organization described under Section 170(b)(1)(A)(ii) (and therefore a public charity under Section 509(a)(1)), it is not a private foundation and, therefore, is not subject to the excess business holdings rule of Section 4943 or any other private foundation excise tax provision.

[6] The new exception, codified under Section 4943(g) under the Philanthropic Enterprise Act of 2017, was signed into law on 2/9/2018 as part of the Bipartisan Budget Act of 2018. The enactment of Section 4943(g) was preceded by an announcement by the Newman's Own Foundation on 2/1/2018 where the foundation announced the milestone of having donated $500 million to charities since it was created some 35 years earlier in 1982.

[7] The Newman's Own, Inc. website indicates that its sole owner is the Newman's Own Foundation and states: "It's always a privilege to share the Newman's Own story-our history, who we are, what we do, and the values that have guided us since our founding. The "we" in the story includes Newman's Own, Inc., a food and beverage company founded in 1982, and its sole owner, the Newman's Own Foundation, an IRS-recognized charitable corporation, which carries on Paul Newman's commitment to use all the money it receives (royalties and profits) from the sale of Newman's Own products for charitable purposes." See www.newmansown.com/100-percent-profits-to-charity/.

[8] See, e.g., GCM 35719 ("After referring to the increasing use of foundations to maintain control of businesses, particularly small family corporations, the [House and Senate] Committee Reports noted the Service difficulty in determining at what point such noncharitable business purposes become sufficiently great as to violate the 'operated exclusively' requirements of Code §501(c)(3).").

[9] H.R. Rep. No. 91-413, 1969-3 CB 200, 218.

[10] S. Rep. No. 91-552, 1969-3 CB 423, 449-450.

[11] The 1965 Treasury Department Report was entitled "Treasury Department Report on Private Foundations" and the Senate Finance Committee then published the report for informational purposes.

[12] For further background on the legislative history of Section 4943 , see Schmalbeck, "Reconsidering Private Foundation Investment Limitations," 58 Tax Law Review 59 (2004).

[13] Section 4943(a)(1) and (2) (specifically indicating that the imposition of excess tax is on "excess business holdings of any private foundation").

[14] For a short history of the American private foundation, see Marsh, "A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities," 22 Va. Tax Rev. 137 (Summer 2002). Private "operating foundations," which do engage in direct charitable activities, represent only a small minority of private foundations.

[15] A private foundation, unlike a public charity, is subject to a net investment excise tax under Section

4940 .

[16] Of course, such control must be exercised in accordance with the applicable restrictions imposed on private foundations under Section 501(c)(3) , Chapter 42 of the Internal Revenue Code and applicable state law. In one case, TCMemo 2009-203 , the IRS took a rather curious position with respect to the income tax deductibility of contributions made to a private foundation by its founder, Ron H. Bell, on the basis that he continued to maintain control over the foundation following the contributions. As stated by the court, the IRS "disallowed the charitable contribution deductions to the foundation because Mr. Bell controls the foundation." The Tax Court, in allowing the income tax charitable deduction, summarily rejected the position asserted by the IRS, stating that "respondent has not cited any authority in support of his contention that merely having control over the foundation disqualifies the Bells from claiming the charitable contribution deductions for the contribution of the shares of Northeast Investors Trust to the foundation. Although the foundation is a private foundation controlled by the Bells, control alone is not sufficient to defeat the deduction to the Bells."

[17] The expansion of the scope of Section 4943 beyond private foundations occurred as a result of the enactment of the Pension Protection Act of 2006, P.L. No. 109-280. See Fox, "Charitable Limitations and Reforms of the Pension Protection Act," 33 ETPL 3 (December 2006).

[18] A donor advised fund is defined in Section 4966(d)(2) . A donor advised fund closely resembles a private foundation although, unlike a private foundation, a donor advised fund is not a separate and distinct legal entity, but is a component part of a public charity that sponsors a donor advised fund program. While resembling a private foundation, a donor advised fund does not provide the same degree of control to a donor as a private foundation, although it offers the advantages of a public charity.

[19] See Section 4943(f)(3) for a further description of supporting organizations that are subject to Section 4943 . See also Murphy, Damron, and Goller, "What Type III Supporting Organizations Need to Know about Excess Business Holdings," 21 Tax'n of Exempts 43 (July/August 2009).

[20] A wholly charitable nonexempt trust described in Section 4947(a)(1) , while not a Section 501(c)(3) tax-exempt entity, is treated as if it were a private foundation unless it can qualify as a public charity. For a discussion of a trust described in Section 4947(a)(1) , see Fox, "Planning and Strategies for Nonexempt Charitable Trusts-Part 1," 20 Tax'n of Exempts 18 (May/June 2009); and Fox, "Planning and Strategies for Nonexempt Charitable Trusts-Part 2," 21 Tax'n of Exempts 15 (July/August 2009).

[21] As discussed below, where a foundation has excess business holdings in an enterprise as a result of receiving an interest in a business enterprise "other than by purchase," such as a gift or bequest, the foundation generally has a five-year grace period, which may be extended for another five years under certain circumstances, during which excise tax under Section 4943 will not be imposed. A foundation generally is also not subject to excise taxes under Section 4943 on excess business holdings, acquired other than by purchase, if it disposes of such excess holdings within 90 days from the date on which it knows, or has reason to know, of the event that caused it to have the excess. The period is extended to include any time during which a foundation is prevented by federal or state securities laws from disposing of the excess business holdings. Regs. 53.4943-2(a)(1)(ii) and (iii).

[22] Under Section 4943(d)(2) , the term "taxable period" means, with respect to any excess business holdings of a private foundation in a business enterprise, the period beginning on the first day on which there are excess holdings and ending on the earlier of (1) the date of mailing of a notice of deficiency by the IRS under Section 6212 with respect to the initial 10% excise tax or (2) the date on which such initial excise tax is assessed by the IRS. Section 4943(d)(2) .

[23] Section 4943(a)(1) (10% initial tax) and Section 4943(b) (200% additional tax).

[24] Section 4943(d)(3)(A) (excluding a "functionally related business" as defined in Section 4943(j)(4) from the definition of business enterprise). See also Reg. 53.4943-10(b) (excluding program-related investments as defined in Section 4942(j)(5) from business enterprise classification). For a discussion of

program-related investments, a rather hot topic in the world of private foundations, see Fox, "Private Foundations Get Expanded Investment Options," 40 ETPL 23 (January 2013) .

[25] Section 4943(d)(3)(B) . Gross income from passive sources generally includes dividends; interest; payments with respect to securities loans; royalties; rents; and gains from the sale, exchange, or disposition of certain property (generally, property other than inventory or stock in trade). Under Section 4943(d)(3) , passive-source income also includes income from the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate the sale of, or maintain inventories in such goods.

[26] Section 4943(c)(1) .

[27] Section 4943(c)(2) .

[28] "Effective control" generally means the power to direct or cause a change in the direction of the management and policies of a business enterprise. See Reg. 53.4943-3(b)(3)(ii) .

[29] Section 4943(c)(2)(C) .

[30] Reg. 53.4943-3(b)(ii).

[31] *Id*.

[32] *Id*.

[33] Section 4943(c)(3) .

[34] Section 4943(c)(3)(A) . Under Reg. 53.4943-3 (c)(2), the interest in profits of a partnership is determined in the same manner as its distributive share of partnership taxable income and, in the absence of a provision in the partnership agreement, the capital interest in a partnership is determined based on its interest in the assets of the partnership which would be distributable upon withdrawal from the partnership, or upon liquidation of the partnership, whichever is the greater.

[35] Section 4943(c)(3)(B) .

[36] The "other than purchase" language limits the application of Section 4943(c)(6) to gratuitously acquired stock, which includes stock acquired by gift, devise, bequest, legacy, or intestate succession. Reg. 53.4943-6(a)(2) .

[37] Section 4943(c)(7) .

[38] Section 4942(a) (imposing an initial excise tax of 30%) and Section 4942(b) (imposing an additional tax of 200%).

[39] Section 4942(g) .

[40] Technically, the minimum amount of "qualifying distributions" that a private foundation must make each year under Section 4942 is defined in terms of its "distributable amount" for the year, defined under Section 4942(d) , which must be distributed in the form of qualifying distributions before the first day of

the second year following the end of such year.

[41] Reg. 53.4942(a)-2(c)(4)(i)(a) .

[42] Reg. 53.4942(a)-2(c)(4)(iv)(c) .

[43] *Id.*

[44] See Daily Tax Report (8/17/2016).

[45] House Ways and Means Committee Reports on H.R. 1 (11/13/2017).

[46] Section 4943(g)(2)(A) (100% of voting stock requirement) and (B) ("other than by purchase" requirement").

[47] The actual language in prior bills introduced was as follows: "EXCLUSIVE OWNERSHIP-The exclusive ownership requirements of this paragraph are met if-

> (A) all ownership interests in the business enterprise are held by the private foundation at all times during the taxable year, and
>
> (B) all the private foundation's ownership interests in the business enterprise were acquired under the terms of a will or trust upon the death of the testator or settlor, as the case may be."

[48] The actual ownership language ultimately adopted in Section 4943(g)(2) is as follows: "Ownership-The requirements of this paragraph are met if-

(A) 100 percent of the voting stock in the business enterprise is held by the private foundation at all times during the taxable year, and

(B) all the private foundation's ownership interests in the business enterprise were acquired by means other than by purchase.

[49] Using the "other than purchase" language under the ownership requirements is consistent with the five-year grace period provided under Section 4943(c)(6) , which applies only in the case of a change in the business holdings of a private foundation "other than by purchase."

[50] As discussed above, for purposes of Section 4943 , "voting stock" is determined by reference to the power of stock to vote for the election of directors, a concept unique to incorporated entities.

[51] Section 4943(g)(2)(A) .

[52] Section 4943(g)(2)(B) .

[53] Section 512(b)(1) (excluding dividends from unrelated business taxable income).

[54] For this purpose, a "substantial contributor" is defined under Section 4958(c)(3)(C) (generally a person who contributed more than $5,000 and such amount is more than 2% of the total contributions to the organization). A family member is defined under Section 4958(f)(4) , under which an individual's family is determined under Section 4946(d) (spouse; ancestors; children; grandchildren; great-grandchildren; and the spouses of children, grandchildren, and great-grandchildren), except that

such members are broadened under Section 4946(d) to also include the brothers and sisters of the individual and their spouses.

[55] It is interesting that this provision does not include a "substantial contributor," but only includes family members of a substantial contributor." Based on this language, although family members of a substantial contributor cannot comprise a majority of the board of the foundation, substantial contributors and members of their family presumably could collectively be a majority of the board of the foundation. Query whether this was an oversight, as not including a substantial contributor within this category is not consistent with the other provisions of the independent operation requirement, or whether the provision was based on the assumption that the substantial contributor would only transfer the corporation by a testamentary transfer to the foundation, as was the case with the Newman's Own Foundation.

[56] Certain states allow nonprofit corporations to be formed as a membership or stock corporation, where individuals or a trust may be a member or stockholder of the corporation. Although a member or stockholder cannot have any economic rights with respect to a private foundation, a member or stockholder may have the power to appoint and remove the directors of the foundation and have certain rights regarding fundamental transactions. It may be possible to transfer the membership or stock interest in the corporation to a trust, where only family members are the trustees.

[57] Section 4943(g)(5) . Note that the excess business holdings rule does not apply in the first instance to a split-interest trust described in Section 4947(b)(3) .

[58] Notice 2012-52, 2012-35 IRB 317 .

[59] Section 509(a)(3)(C) .

[60] See Section 4943(c)(2) ("In any case in which all disqualified persons together do not own more than 20 percent of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall also be treated as permitted holdings").

[61] As discussed above, a donor advised fund, like a private foundation, is subject to the excess business holdings rule so that the outcome of Ltr. Rul. 201311035 would have been the same in this ruling if a private foundation, rather than a donor advised fund, held the nonvoting stock.

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Enclosure 5

Plan Now to Avoid the Private Foundation Excise Tax Rules,
Taxation of Exempts (WG&L), May/Jun 2018

PRIVATE FOUNDATIONS

Plan Now to Avoid the Private Foundation Excise Tax Rules

Private foundations can provide donors with control over the use of their charitable gifts, but excise taxes set limits on foundation operations.

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Individuals have a variety of choices in furthering their philanthropic giving. Modest gifts are usually made outright to a public charity and deducted for federal income tax purposes under the provisions of Section 170 .[1] For more significant charitable contributions, individuals often prefer to use a philanthropic vehicle over which some degree of control may be retained after the contribution is initially made.

Among these vehicles are a donor-advised fund maintained at a local community foundation (or some other public charity sponsoring donor-advised funds) or a private foundation that generally takes the form of a nonprofit corporation. The sponsoring organization of a donor-advised fund and a private foundation are both tax-exempt organizations under Section 501(c)(3) pursuant to an IRS determination. Contributions to these entities still qualify for a current income tax deduction under Section 170 , but allow contributions to be made over time to various charities selected by the donor or family members of the donor.[2]

Donors may also choose to use a wholly charitable trust as a vehicle for philanthropic giving, where all of the unexpired interests of the trust are dedicated exclusively to Section 170(c)(2)(B) purposes, which includes religious, charitable, scientific, literary, and educational ones. Even if a wholly charitable trust does not seek to obtain an IRS determination classifying it as a Section 501(c)(3) tax-exempt entity, contributions to it will still qualify for a charitable deduction and it may essentially be equivalent to a Section 501(c)(3) tax-exempt entity by virtue of the unlimited charitable income tax deduction available to a trust under Section 642(c) .

Donors seeking to blend their philanthropic intentions with their financial needs or those of family members may also use a "split-interest" trust, such as a charitable remainder trust (CRT)[3] or a charitable lead trust (CLT),[4] where the financial benefits of the trust are split between charitable and noncharitable interests.

An organization that has been determined by the IRS to be a Section 501(c)(3) tax-exempt organization that is not classified as a public charity under Section 509(a) is classified as a private foundation , generally considered the least favorable tax classification in the world of Section 501(c)(3) tax-exempt

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organizations.[5] In addition to subjecting donor contributions to potentially greater restrictions and limitations on the available charitable income tax deduction, private foundation status triggers the application of the complex and particularly onerous excise tax provisions under Chapter 42 of the Internal Revenue Code. The scope of the private foundation tax regime extends beyond organizations that are classified as such in an IRS determination letter. These include nonexempt charitable trusts described in Section 4947(a)(1) ,[6] which may arise under a number of different circumstances, and split-interest trusts described in Section 4947(a)(2) .

The private foundation excise tax rules may be considered to be so restrictive that an individual creating a philanthropic vehicle may seek to avoid such rules if at all possible, even at the expense of forgoing both a charitable deduction and the tax-exempt status of the entity. Indeed, Mark Zuckerberg, Chairman and CEO of Facebook, recently caught the eye of the philanthropic world by announcing that he is contributing during his lifetime 99% of his shares in Facebook, valued at approximately $45 billion at the time, to advance his philanthropy. Zuckerberg avoided the private foundation tax regime by transferring his Facebook shares to a newly formed Delaware limited liability company as a vehicle for advancing "philanthropic, public advocacy and other activities for the public good." Zuckerberg acknowledged that in creating an entity that is not a traditional private foundation , he received no tax benefit from the transferred shares and that any sale of the shares would be taxable, but that the structure afforded him "more flexibility to execute our mission more effectively."

Recently issued Ltr. Rul. 201713003 [7] suggests an intriguing alternative to avoiding the application of the private foundation rules to a wholly charitable or split-interest trust by a donor voluntarily forgoing the available charitable deductions. In this ruling, the IRS determined that a CRT did not fall under Section 4947(a)(2) and therefore was not subject to the private foundation excise tax rules because, although they were allowable, no charitable deductions were ever claimed by the settlor under any provision of the Code for a contribution of property to the trust.

This article explores certain planning options to avoid the application of the private foundation excise tax regime and the related tax consequences to be considered in this context.

Background on the private foundation tax regime

The private foundation [8] is one of the oldest and most popular forms of Section 501(c)(3) tax-exempt entities [9] used to further the philanthropic interests of an individual or family. Private foundations generally have one major source of funding, typically comprised of contributions from one individual or members of a single family, and are used principally to make grants to other charitable organizations, rather than to engage in direct charitable activities. [10]

Foundations are separate and distinct legal entities, generally taking the form of nonprofit corporations formed under state law, although they may also be organized as charitable trusts under trust law, or even as limited liability companies. [11] Donors typically use a private foundation as a vehicle to carry out their charitable giving primarily because:

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- Charitable contributions to the foundation are deductible for income tax purposes in the year of the contribution, although actual distributions from the foundation to other charitable organizations may be deferred over time. Therefore, an upfront income tax charitable deduction is available, notwithstanding that the contributed funds are simply transferred to the donor's private foundation , remain subject to the continuing control of the donor, [12] and may be used to make distributions over a long period of time well beyond the year in which the contribution is first made to the foundation . In addition, contributions of appreciated assets to the foundation , such as marketable securities, do not cause the donor to recognize capital gain. [13]
- The income earned on the assets of the foundation is exempt from federal income tax under Section 501(a) because of the Section 501(c)(3) tax-exempt status of the foundation and, therefore, can be invested and grow on a tax-free basis. [14]
- Donors may retain control over the funds contributed to the foundation , including making decisions regarding the use of contributed funds for charitable purposes, their investment, and the operation and activities of the foundation . [15]
- The control over the foundation can be passed on to future generations, thereby perpetuating the foundation and a family giving legacy for many years to come. [16]

The most common form of private foundation is the private *nonoperating* foundation , [17] which generally receives its funding from only a limited source of donors, such as an individual, various family members, or a corporation. Unlike "public charities" and "operating foundations ," [18] private nonoperating foundations , as a general rule, do not conduct charitable programs, do not engage directly in charitable activities or provide services, and do not engage in fund-raising activities. Instead, their activities are generally limited to making grants to other tax-exempt organizations that are classified as "public charities," such as hospitals, museums, and religious and educational organizations.

A major advantage of a private foundation as a philanthropic vehicle is that it allows the founder and his or her family members to maintain control over the contributed funds, thereby allowing such individuals to be in a position of making all decisions regarding the foundation , including grant-making, investments, and other matters pertaining to the administration, activities, and operation of the foundation . Private foundations , however, subject donors to more limited income tax benefits for charitable contributions (as compared to the more favorable tax benefits accorded charitable contributions to public charities and private operating foundations), are subject to a multitude of limitations and restrictions under a special excise tax regime under Chapter 42 of the Code, [19] and traditionally have been the least-favored philanthropic vehicle from a tax standpoint.

Given the complex tax regime applicable to private foundations , they are fraught with complications and traps for the unwary. [20] For that reason, it is recommended that donors use a private foundation only when they intend to commit substantial dollars

to the foundation and understand that professional legal and accounting services are often required in the context of administering a private foundation so as to ensure compliance with applicable tax rules.

Limitations on income tax deductibility of contributions. Charitable contributions to a private foundation are subject to significant limitations on income tax deductibility. With the exception of contributions of "qualified appreciated stock," as defined in Section 170(e)(5)(B) , contributions of appreciated property may be deducted only to the extent of the tax basis of the property and not the higher fair market value of the property that generally may be deducted for contributions to tax-exempt organizations that are public charities. [21]

The gross income limitations on the deductibility of contributions made to a private foundation are more limited than in the case of contributions to public charities. As a general rule, contributions of cash by an individual to a private foundation are deductible for any given tax year only up to 30% of the individual's adjusted gross income and only up to 20% of adjusted gross income for contributions of property, [22] as compared to the gross income limitations of 50% and 30%, respectively, that applies to such contributions when made to a public charity. [23]

Summary of the Chapter 42 excise tax regime. Following a multitude of congressional hearings, debates, and conferences-and concerns of Congress that reached back for more than two decades-Congress enacted the Tax Reform Act 1969 (1969 Act), [24] which for the first time defined the term "private foundation " and contained a series of strict excise tax provisions under Chapter 42 of the Code that continue to largely apply with respect to the private foundation of today. These excise tax provisions were enacted in response to a vast array of perceived abuses that had occurred within the private foundation area whereby certain foundations were considered to be used for private exploitation and tax avoidance purposes, rather than to further public and charitable purposes.[25] The provisions under the 1969 Act made sweeping changes to the tax rules applicable to private foundations , resulting in the creation of a restrictive tax regime governing private foundations and imposing substantial penalties (in the form of excise taxes) on foundations and their managers who violated its provisions.

The Chapter 42 tax provisions set forth various requirements applicable to private foundations , such as annual minimum distributions requirements, prohibitions on certain transactions between the foundation and "disqualified persons"[26] with respect to the foundation , restrictions on certain types of transactions, and restrictions on certain types of investments. The violation of any provision contained in Chapter 42 subjects the foundation , as well as certain foundation managers and disqualified persons, to substantial excise taxes, which are intended to discourage the violation of the Chapter 42 provisions in the first instance.

In each case, a "first-tier tax" is imposed on the violation, and if the violation is not "corrected" (i.e., undone), a "second-tier tax" is imposed. In addition to excise tax provisions applicable, in essence, to the governance of private foundations , an excise tax is also imposed on the net investment income of the foundation , thereby subjecting the investment income of a private foundation to tax,[27] notwithstanding that it is otherwise exempt from income tax under Section 501(a) .

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The Chapter 42 excise taxes, and the applicable Code sections under which the taxes are imposed, are summarized generally below:

1. Excise tax on failure to make minimum annual distributions. Section 4942 generally provides that a private foundation must make qualifying distributions, which include grants to public charities, of at least 5% of the aggregate net fair market value of the foundation's investment assets (i.e., assets that are not used directly to carry out the foundation's exempt purposes). Generally, grants to other private foundations and certain supporting organizations do not count as qualifying distributions.

2. Excise tax on self-dealing transactions. Subject to certain exceptions, Section 4941 in essence provides that a private foundation cannot engage in any "self-dealing" transactions with disqualified persons. Prohibited transactions generally include, but are not limited to:

- Direct or indirect selling or leasing property.
- Loaning assets.
- Furnishing goods, services, or use of the foundation's facilities.

An exception permits payment of reasonable compensation to a disqualified person only if (a) the compensation is for personal services actually rendered to the foundation and (b) the services are reasonable and necessary to the accomplishment of the foundation's exempt purposes.

Benefits to the donor or to any other disqualified person that are more than incidental and tenuous can also trigger these self-dealing excise taxes. The self-dealing rules are highly complex and can inadvertently be triggered by either direct or indirect transactions involving a foundation and its disqualified persons. [28]

3.Excise tax on excess business holdings. The "excess business holdings" rule of Section 4943 was enacted under the 1969 Act to address the concerns of Congress regarding the number of private foundations being used to maintain control of business interests, rather than for furthering charitable purposes. Under Section 4943 , a private foundation may own the stock or other ownership interest of a business enterprise only up to a permitted level, which is generally 20% less the percentage of ownership by disqualified persons with respect to the foundation . [29]

The excess business holdings rules provide for a five-year disposal period for excess holdings acquired by gift or bequest, which may be extended by the IRS for another five years.

4.Excise tax on jeopardy investments. Under Section 4944 , a private foundation cannot invest its funds in ways that could jeopardize the foundation's ability to carry out its charitable purposes. Generally, the jeopardy investment prohibition is violated if it is determined that the foundation managers, in making an investment, failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long- and short-term financial needs of the foundation to carry out its exempt purposes. [30]

Under an important exception, "program-related investments" (PRIs) are not subject to the jeopardy investment excise tax rules otherwise applicable to investments made by private foundations . Instead, pursuant to Section 4944(c) , PRIs "shall not be considered as investments which jeopardize the carrying out of exempt purposes." [31] Therefore, as long as an investment is a PRI, there is no exposure to the jeopardy investment excise tax rules notwithstanding that the investment may otherwise be considered imprudent purely from an investment standpoint.

5.Excise tax on taxable expenditures. Under Section 4945 , a private foundation cannot make a "taxable expenditure." The term "taxable expenditures" includes:

- Payments for political campaigns and lobbying.
- Certain scholarship and travel grants to individuals.
- Distributions of funds for and grants to other private foundations .
- Grants to certain supporting organizations and foreign charities.
- Distributions for any purpose other than one specified in Section 170(c)(2)(B) .

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Exceptions allow certain distributions that would otherwise be a taxable expenditure but only if the grantmaking foundation exercises what is known as "expenditure responsibility." If the private foundation intends to make certain grants to individuals for travel, study, and similar purposes, advance approval of the selection procedures must be obtained from the IRS. [32]

Nonexclusive taxes. The excise taxes imposed under each provision of Chapter 42 are not exclusive. [33] For example, if a foundation purchases a sole proprietorship in a business enterprise within the meaning of Section 4943(d)(3) , in addition to tax under Section 4943 for an excess business holding, the foundation may be liable for tax under Section 4944 if the investment jeopardizes the carrying out of any of its exempt purposes.

Nonexempt charitable trusts and split-interest trusts

Although the provisions under Chapter 42 of the Code were primarily aimed at regulating private foundations , Congress was concerned about another class of charitable organizations-nonexempt charitable trusts and split-interests trusts-that could be used to avoid the private foundation rules. Section 4947 was enacted as part of the 1969 Act to address this concern by subjecting these trusts to some or all of the private foundation excise tax provisions. In addressing both nonexempt charitable trusts and split-interest trusts, Reg. 53.4947-1(a) states as follows:

> Section 4947 subjects trusts which are not exempt from taxation under section 501(a), all or part of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B), and which have amounts in trust for which a deduction was allowed under section 170 , 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522

to the same requirements and restrictions as are imposed on private foundations . The basic purpose of section 4947 is to prevent these trusts from being used to avoid the requirements and restrictions applicable to private foundations .

For purposes of this section, a trust shall be presumed (in the absence of proof to the contrary) to have amounts in trust for which a deduction was allowed under section 170 , 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522 if a deduction would have been allowable under one of these sections. Also for purposes of this section and §53.4947-2 , the term "purposes described in section 170(c)(2)(B) " shall be treated as including purposes described in section 170(c)(1) .[34]

Reg. 53.4947-1(a) indicates that it applies equally to both:

- Nonexempt charitable trusts (those trusts where "all" of the unexpired interests in which are devoted to one or more of the purposes described in Section 170(c)(2)(B)) and which hold amounts for which a charitable deduction was allowed.
- Split-interest trusts (those trusts where "part" of the unexpired interests in which are devoted to one or more of the purposes described in Section 170(c)(2)(B)) and which hold amounts for which a charitable deduction was allowed.

Nonexempt charitable trusts and split-interest trusts operate differently, however, and require separate consideration. Indeed, notwithstanding the purported application of Reg. 53.4947-1(a) to both nonexempt charitable trusts and split-interest trusts, these trusts are subject to separate regulatory provisions which, as discussed below, further complicate planning to avoid the application of the private foundation rules to these vehicles.

Nonexempt charitable trusts described in Section 4947(a)(1) . A nonexempt charitable trust described in Section 4947(a)(1) may arise under different circumstances beyond an *inter vivos* or testamentary transfer. For example:

- A CRT described under Section 664(a) may become a nonexempt charitable trust under Section 4947(a)(1) if, in lieu of an outright distribution of all of the remaining trust assets on the expiration of the noncharitable annuity or unitrust interests, all or a portion of the remaining assets continue to be held in trust for Section 170(c)(2)(B) purposes.[35]

- An estate from which the executor or administrator is required to distribute all the net assets in trust to charitable beneficiaries, or free of trust to such beneficiaries, may be considered a nonexempt charitable trust under Section 4947(a)(1) if the estate administration has been unreasonably prolonged.[36]
- A revocable trust that becomes irrevocable on the death of the decedent in which all the unexpired interests are charitable and under the terms of the governing instrument of which the trustee is required to hold some or all the net assets in trust after becoming irrevocable solely for charitable beneficiaries may be considered a nonexempt charitable trust under Section 4947(a)(1) after the expiration of a reasonable period of settlement after becoming irrevocable.

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Nonexempt charitable trusts described in Section 4947(a)(1) are generally able to obtain Section 501(c)(3) tax-exempt status by filing a Form 1023, Application for Recognition (and, therefore, no longer be nonexempt charitable trusts). Nothing under the Code, however, requires a trust that could otherwise qualify under Section 501(c)(3) to apply for exemption from tax under Section 501(a) . Of course, even if a nonexempt charitable trust does seek to obtain tax-exempt status under Section 501(c)(3) , it will be classified as a private foundation unless it can qualify for public charity status, which likely may not be possible.

Although a nonexempt charitable trust is not exempt from income tax because it does not apply for tax-exempt status and never is granted such status by the IRS, it may essentially be the equivalent of a Section 501(c)(3) tax-exempt entity by virtue of the special rules pertaining to a charitable income tax deduction available to a trust. Specifically, under Section 642(c) , a trust is entitled to a charitable income tax deduction for its gross income paid pursuant to the terms of its governing trust instrument for a charitable purpose described in Section 170(c) . Under this provision, a nonexempt charitable trust may reduce its taxable income to zero through contributions for charitable purposes because, unlike in the case of an individual, the deduction under Section 642(c) is not subject to any percentage limitation,[37] thereby potentially rendering its failure to obtain Section 501(c)(3) tax-exempt status irrelevant.

In addition, the charitable deduction for trusts is not dependent on the type of charitable organization that receives the contribution, as it is for individuals, and Section 642(c) does not distinguish between contributions to public charities and private foundations . Furthermore, a trust is entitled to the deduction for a charitable purpose even if it is not made to a domestic (U.S.) charitable organization, as is required for individuals.

Although the Chapter 42 excise tax provisions were primarily intended to apply to private foundations , when it first enacted these provisions under the 1969 Act, Congress was concerned that a charitable trust might seek to avoid the private foundation rules simply by not applying for tax exemption with the IRS. [38] To prevent nonexempt charitable trusts from being used to escape the requirements and restrictions imposed on Section 501(c)(3) organizations, particularly those applicable to private foundations , Congress included Section 4947(a)(1) as part of its changes under the 1969 Act. [39] As described below, but for the enactment of Section 4947(a)(1) , donors would be able to deduct charitable contributions to a nonexempt charitable trust, the trust could be the equivalent of a Section 501(c)(3) tax-exempt entity by virtue of the unlimited Section 642(c) charitable deduction available to it, and the trust would avoid the private foundation excise tax rules.

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Under its statutory provisions, for a trust to be considered a nonexempt charitable trust described in Section 4947(a)(1) , [40] and therefore become subject to the private foundation tax regime, it must be one which is:

- "a trust which is not exempt from taxation under section 501(a) ,
- all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B),
- and for which a deduction was allowed under section 170 , 545(b)(2) , 642(c), 2055 , 2106(a)(2) , or 2522 ."

Section 4947(a)(1) specifically provides that a nonexempt charitable trust described in that section "shall be treated as an organization described in section 501(c)(3) ," although it is not exempt from income tax under Section 501(a) and, indeed, is a taxable entity. [41] As indicated above, as an entity treated as a Section 501(c)(3) organization, a nonexempt charitable trust described under Section 4947(a)(1) is treated as either a public charity or a private foundation , [42] although there is a presumption that the trust is a private foundation . [43]

As such, a Section 4947(a)(1) nonexempt charitable trust will be treated as a private foundation unless it meets the requirements for one of the exclusions under Section 509(a) that classifies it as a public charity. Section 509(a)(3) , under which an organization is classified as a "supporting organization," is virtually the only Section of the Code under which a nonexempt charitable trust could qualify as a public charity rather than a private foundation . Therefore, unless the trust meets the requirements of a supporting organization (or any other possible "public charity provision"), it will be subject to the private foundation excise tax regime. [44]

Because all the unexpired interests in a nonexempt charitable trust are devoted to charitable or other exempt purposes under Section 170(c)(2)(B) , a taxpayer may claim a deduction from income, gift, or estate taxes for a charitable contribution to a nonexempt charitable trust. [45] There is no requirement that a nonexempt charitable trust apply for and receive an IRS determination letter regarding its status under Section 4947(a)(1) . [46] Unless it is determined to be a public charity, income tax deductions for *inter vivos* contributions to the trust will be subject to the same tax basis and percentage limitations imposed under Section 170 that apply to contributions to an organization that has actually been determined by the IRS to be a private foundation .

Split-interest trusts described in Section 4947(a)(2) . Under its statutory provisions, for a split-interest trust, including a CRT or CLT, to fall within the purview of Section 4947(a)(2) , and therefore become subject to certain private foundation excise tax provisions, it must be one which is:

- "a trust which is not exempt from tax under section 501(a) ,
- not all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) , and
- which has amounts in trust for which a deduction was allowed under section 170 , 545(b)(2) , 642(c) , 2055 , 2106(a)(2) , or 2522 ." [47]

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A trust described in Section 4947(a)(2) is generally subject to the following private foundation excise tax provisions:

(1) Section 4941 (relating to taxes on self-dealing).
(2) Section 4943 (relating to excess business holdings).
(3) Section 4944 (relating to investments, which jeopardize charitable purposes).
(4) Section 4945 (related to taxable expenditures).

Under special rules provided under Section 4947(b)(3) , Sections 4943 and 4944 do not apply to a CRT. Nor do they apply to a CLT where the charitable deduction allowed does not exceed 60% of the value of the initial trust assets.

Income, gift, and estate tax charitable deductions are available for the present value of the charitable remainder interest in the CRT, with the availability of the income tax deduction affected by whether the charitable remainder beneficiaries are limited to public charities or may include a private foundation . [48] Gift and estate tax charitable deductions are available for the present value of the lead interest in a CLT, although an income tax charitable deduction is available only upon the funding of a CLT if it is classified as a grantor trust for federal income tax purposes. [49]

Where an income tax deduction is taken up front for a contribution to a CLT classified as a grantor trust, [50] the trust is not entitled to any Section 642(c) deduction throughout the term of the trust (as it is ignored for federal income tax purposes) [51] and the settlor is taxed on all income of the CLT, without any further charitable income tax deduction. For this reason, most CLTs are structured as non-grantor trusts. [52]

Avoiding private foundation excise tax rules

The next section of this article explores strategies to avoid the application of the private foundation excise tax rules by forgoing available charitable deductions for transfers to nonexempt charitable trusts and split-interest trusts.

Split-interest trusts. As indicated above, under its specific statutory language, in order for a split-interest trust to be described under Section 4947(a)(2) , the trust must be one "which has amounts in trust for which a deduction was allowed under section 170 , 545(b)(2) , 642(c) , 2055 , 2106(a)(2) , or 2522 ." Absent the allowance of such a deduction, the trust will not be subject to Section 4947(a)(1) and, therefore, will not be subject to the private foundation excise tax rules. It is important to note in this context that Section 4947(a)(2) enumerates a multitude of charitable deduction provisions under the Code, including not only the income tax charitable deduction but the estate and gift tax charitable deductions as well.

In recently issued Ltr. Rul. 201713003 , a CRT was able to avoid the application of the private foundation excise tax rules that are otherwise applicable under Section 4947(a)(2) because the settlor voluntarily chose to forgo any claim to a charitable deduction, although such a deduction was otherwise allowable. By the settlor intentionally not claiming a charitable deduction, the CRT was shielded from the technical and often harsh private foundation excise tax regime. The ruling did not indicate why the settlor sought to avoid the application of the private foundation rules to the CRT. One likely possibility is that the settlor wanted the CRT to sell the contributed property to an otherwise disqualified person which, were the foundation excise tax rules to apply, would have been an act of self-dealing under Section 4941(d)(1)(A) and subject the disqualified person to tax under Section 4941(a) .

In this ruling, the grantor created an *inter vivos* charitable remainder unitrust (CRUT) providing unitrust payments to the settlor for a period of 20 years, with the remainder to be distributed to a charitable beneficiary described in Section 501(c)(3) . The CRUT apparently met the requirements to qualify under Section 664 and, therefore, under Section 664(c)(1) , would not be subject to income tax. The ruling specifically stated that the "Grantor has not claimed a deduction under section 170 , 545(b)(2) , 642(c) , 2055 , 2106(a)(2) , or 2522 of the Code with respect to the Trust, for any tax year, since its inception." The IRS, equating the word "allowed" with the word "taken," ruled that Section 4947(a)(2) did not apply, stating that:

> Because no deduction has ever been taken (allowed) under section 170 , 545(b)(2) , 642(c) , 2055 , 2106(a)(2) , or 2522 , the Trust is not subject to section 4947(a)(2) of the Code , *even though a deduction under section 170 , 545(b)(2) , 642(c) , 2055 , 2106(a)(2) , or 2522 was allowable.* For future tax years, the burden will be on the taxpayer to keep the records to show, through the life of the unitrust, that no deduction is ever taken. Without this proof, that no deduction has ever been taken, section 53.4947-1(a) of the regulations would cause section 4947(a)(2) of the Code to be applied. [Emphasis added.]

While the facts set forth in Ltr. Rul. 201713003 , albeit briefly stated, indicate that the trust qualified as a CRT under Section 664 , there was no ruling to that effect, as the only ruling was that the trust was not subject to Section 4947(a)(2) . Interestingly, for purposes of Section 664 , Reg. 1.664-1(a)(1)(iii)(a)

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provides that the term "charitable remainder trust" means "a trust with respect to which a deduction *is allowable* under section 170 , 2055 , 2106 , or 2522 ." (Emphasis added.) The "allowable" language in Reg. 1.664-1(a)(1)(iii)(a) is in contrast to the "allowed" language under Section 4947(a) . The difference in language, however, appears entirely appropriate given the difference in the nature of the two statutes.

In *Virginian Hotel Corp.of Lynchburgv. Helvering*, [53] the Supreme Court held that "allowed" meant that the taxpayer had taken the deduction and the IRS had not challenged it. Noting that there was "no machinery for formal allowances of deductions from gross income," the Court stated that a deduction being claimed and going unchallenged by the IRS is the only way in which a deduction could be "allowed." Therefore, a charitable contribution deduction is considered allowed when the contribution is actually deducted and not challenged, even where the deduction is not otherwise permissible under the applicable provisions of the Code. To the contrary, a charitable contribution deduction is "allowable" when it is actually permitted to be deducted under the Code, notwithstanding that the taxpayer does not actually claim the deduction.

In recently issued Ltr. Rul. 201714002 , for example, the IRS determined that Section 4747(a)(2) was applicable to a split-interest trust, a flawed CRT, because a charitable contribution deduction was taken by the settlor and was not challenged by the IRS. Under the reasoning of *Virginian Hotel Corp.,* notwithstanding that the charitable deduction was technically not allowable, the IRS ruled that the charitable deduction under Section 170 was considered "allowed" for purposes of Section 4947(a)(2) . Thus, although the trust did not qualify as a CRT under Section 664 and the charitable deduction claimed by the taxpayer was not permissible, the trust was determined to be subject to Section 4947(a)(2) and, therefore, to the private foundation excise tax rules.

Given that Section 664 operates to exempt income of a CRT from income tax, it is logical to impose a requirement under that section that a deduction for contributions to the trust actually be "allowable." Otherwise, a settlor improperly claiming a charitable deduction for a contribution to a trust could attain the benefits of Section 664 . Unlike Section 664 , which provides favorable taxpayer treatment, Section 4947(a) imposes requirements and restrictions, not just on CRTs but on all split-interest trusts described in that section. It would simply not be logical to permit a trust to escape these provisions because a charitable deduction "allowed" to the settlor for a contribution to the trust was not actually "allowable" in the first instance. That is, if the settlor funding a split-interest trust obtains the benefits of a charitable deduction, even if not actually entitled to it, the taxpayer should face the burdens of Section 4947(a)(2) . Moreover, had Congress wanted Section 4947(a) to apply to charitable deductions that were either "allowed or allowable," it could have done so, just as it has done with other sections of the Code where it saw fit to include such language. [54]

Ltr. Rul. 201713003 , therefore, appears to offer a valid escape hatch from the private foundation excise tax rules for a Section 4947(a)(2) split-interest trust, including a CRT and CLT, by the settlor simply choosing not to claim any charitable deduction, in which case the trust will not hold assets for which a charitable deduction has been "allowed." In the case of the particular trust at issue in the ruling (i.e., an *inter vivos* trust), this would have meant forgoing both an income and gift tax charitable deduction, thereby necessitating the use of the settlor's unified credit or, the payment of gift taxes if no further unified credit was available to the settlor. [55]

In the case of a CRT, the present value of the remainder interest is often structured to be equal to 10% of the value of the property contributed, the minimum remainder requirement. [56] In that situation, the loss of a charitable gift tax deduction (as well as an income tax deduction) may be relatively insignificant. In the alternative, the settlor of the CRT may retain the right to substitute the charitable remainder beneficiary, which will cause the gift of the remainder interest to be incomplete for gift tax purposes. [57] A CLT is typically structured to maximize

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the present value of the charitable lead interest, so that the gift to the noncharitable remainder beneficiaries is minimized or, in the case of the "zeroed-out" charitable lead annuity trust, eliminated entirely. In such a case, the loss of the charitable gift tax deduction would likely be more significant, thereby making the voluntary forfeiture of the available gift tax deduction a much more relevant consideration. [58]

Because Ltr. Rul. 201713003 dealt with a CRT, which (assuming all annuity and unitrust recipients were noncharitable as is typically the case) would not seek to claim a charitable income tax deduction during its term, the ruling did not address the issue of whether any subsequent Section 642(c) charitable income tax deduction taken by the trust would trigger Section 4947(a)(2) . This, however, would be an issue for a non-grantor CLT, initially not described in Section 4947(a)(2) , that makes distributions of its gross income to charity pursuant to the terms of the trust for which it would claim a Section 642(c) deduction. The statutory and regulatory provisions of Section 4947(a)(2) appear to make it clear that claiming a subsequent Section 642(c) deduction in this situation would not cause the CLT to become subject to Section 4947(a)(2) .

The statutory language of Section 4947(a)(2) , in describing a trust subject to that section, specifically refers to a trust "which has amounts in trust for which a deduction was allowed under section 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2522," indicating that the focus is on the charitable deductions claimed for property funding the trust. Reg. 53.4947-1(a) similarly states that the application of Section 4947 is to trusts "which have amounts in trust for which a deduction was allowed under section 170 , 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522 ." Finally, Reg. 53.4947-1(c) , the regulation under Section 4947 that specifically deals with Section 4947(a)(2) split-interest trusts, similarly refers to a trust which has amounts in trust for which a deduction was allowed ... under section 170 , 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522 ."

There is no indication under the statutory or regulatory provisions of Section 4947(a)(2) that a deduction taken under Section 642(c) by a split-interest trust itself could trigger the application of Section 4947(a)(2) . The only reference to Section 642(c) for Section 4947(a)(2) purposes is in Reg. 53.4947-1(c) , which states that a "trust is one which has amounts in trust for which a deduction was allowed under section 642(c) within the meaning of section 4947(a)(2) once a deduction is allowed under section 642(c) to the trust for any amount permanently set aside." [59]

Treating a Section 642(c) permanent set-aside deduction as one that is a charitable deduction for purposes of determining the applicability of Section 4947(a)(2) seems appropriate given that the gross income for which a Section 642(c) charitable deduction is claimed in this situation remains within the corpus of the trust and, therefore, would cause the trust to hold funds for which a charitable deduction was allowed. [60] That, however, is not the case where a trust claims a Section 642(c) deduction by distributing its gross income to charity because, although a charitable deduction is allowed in this situation, the trust no longer holds those funds for which the charitable deduction is claimed.

Nonexempt charitable trusts. As indicated above, under its specific statutory language, in order for a nonexempt charitable trust to be described in Section 4947(a)(1) , the trust must be one "for which a deduction was allowed under section 170 , 545(b)(2) , 642(c) , 2055 , 2106(a)(2) , or 2522 ," which constitute a multitude of charitable deduction provisions under the Code, including the estate, gift, and income tax charitable deductions. Absent such a deduction being allowed, the trust will not be subject to Section 4947(a)(1) and, therefore, will not be subject to the private foundation excise tax rules. As with a split-interest trust, consideration should be given to the estate and gift tax consequences of not claiming a charitable deduction in order to avoid the application of Section 4947(a)(1) , including applying the unified credit or structuring an inter vivos transfer to be incomplete.

The reference to the charitable deduction under Section 4947(a)(1) , while similar to that contained in Section 4947(a)(2) , is not identical. Section 4947(a)(1) refers to a trust "*for which a deduction was allowed*," whereas Section 4947(a)(2) refers to a trust "*which has amounts in trust for which a deduction was allowed.*" The only distinction in these two phrases is that Section 4947(a)(2) contains the words "which has amounts in trust" before the words "for which a deduction was allowed."

As discussed above, it appears clear that a trust not initially subject to Section 4947(a)(2) will not become subject to that section because it subsequently claims a Section 642(c) deduction for a distribution of its gross income to charity. The question raised under Section 4947(a)(1) is whether the absence of the "*which has amounts in trust*" language of Section 4947(a)(2) will cause a nonexempt charitable trust holding property for which a charitable deduction was never allowed and therefore not initially described in Section 4947(a)(1) , to subsequently be described in Section 4947(a)(1) by virtue of the trust claiming a Section 642(c) deduction.

Nothing in the statutory language of Section 4947(a)(1) specifically indicates that this would be the case, and the difference in language between Section 4947(a)(1) and (a)(2) may simply be a difference without a distinction. [61] As indicated above, Reg. 53.4947-1(a) specifically states that the application of Section 4947 is to trusts "*which have amounts in trust for which a deduction was allowed* under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522." The charitable deductions described under this regulation would not extend to a Section 642(c) deduction subsequently taken by a trust distributing its gross income to a charity because it would not cause the trust "to have amounts in trust for which a [charitable] deduction was allowed." (Emphasis added.)

Nonetheless, the difference in the "charitable deduction language" under Section 4947(a)(1) and Section 4947(a)(2) may support a conclusion that a Section 642(c) deduction taken by a nonexempt charitable trust does trigger the application of Section 4947(a)(1) . Indeed, Reg. 53.4947-1(b)(1)(i) , [62] a regulation specifically addressing nonexempt charitable trusts, reaches that conclusion, stating that a "trust is one for which a deduction was allowed under section 642(c), within the meaning of section 4947(a)(1), once a deduction is allowed under section 642(c) to the trust for any amount paid or permanently set aside." IRM 7.26.15.2.3 (04-08-1999) takes a similar approach that a Section 642(c) charitable deduction taken by a nonexempt charitable trust may trigger Section 4947(a)(1) , stating:

> In order for a trust to be described in IRC 4947(a)(1) , a charitable deduction must have been allowed under IRC 170 , 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522 . Deductions allowed under IRC 642(c) include deductions allowed a trust with respect to its own income as well as deductions allowed for a payment to another trust. [63]

It is interesting that notwithstanding the authority cited above, in private letter rulings issued in the context of Section 4947(a)(1) , the IRS has not relied upon, or even cited, Reg. 53.4947-1(b)(1)(i) , which was issued on 8/20/1976, long before the date of these private letter rulings. Such was the case in Ltr. Rul. 9726009 where, although a testamentary trust was wholly devoted to charitable purposes, the IRS ruled that the trust was not described in Section 4947(a)(1) because no charitable deduction was ever taken with respect to amounts transferred to the trust. In this ruling, a trust was created by a retired school teacher on 4/22/1992. She then died on 5/26/1995, and the trust became irrevocable upon that event. The value

of the decedent's estate was significantly less than the federal estate tax exemption at that time, and no federal estate tax return was required to be filed.

The principal purpose of the trust following the death of the decedent was to assist persons in obtaining higher education. Specifically, the trust provided that its assets "shall be used for the sole purpose of assisting persons in obtaining a college education in one or both of the fields of teaching and bookkeeping, and to assist persons in obtaining an education in the field of carpentry." The ruling indicated that the trust assets were solely attributable to the assets received from the decedent and that no charitable deduction was ever taken by the decedent under Section 170 . The ruling also stated that no charitable deduction was ever taken by the decedent's estate as either an estate tax charitable deduction under Section 2055 or as an income tax deduction under Section 642(c) . It was further represented that the trust would not seek to be classified under Section 501(c)(3) . The IRS, citing only Reg. 53.4947-1(a) , ruled that the trust was not subject to Section 4947(a)(1) , concluding:

> Based on your trustee's representations that no deductions were ever taken in connection with the amounts in trust and on the condition that no deductions will be taken in regard to those amounts, we rule that you are not described in section 4947(a)(1) of the Code . Accordingly, you are not subject to the same requirements and restrictions as are imposed on private foundations . You need not file Form 990-PF but your trustee must continue to file the fiduciary income tax return, Form 1041, as required.

Similarly, in Ltr. Rul. 9209016 , the absence of any charitable deduction for the transfer of assets to a wholly charitable trust resulted in the trust not being subject to Section 4947(a)(1) . In this ruling, two individuals, X and Y, the owners of all the outstanding voting common stock of an entity, transferred all the stock to A, a wholly charitable trust. Their purpose was to avoid the fragmentation of management control of the entity and to encourage and promote educational, scientific, and charitable activities. The sole beneficiary of the trust was a charitable foundation classified under Section 501(c)(3) , which was entitled to receive all the net income of the trust.

The ruling stated that "Gift tax and subsequent trust income tax returns have been filed on a timely basis. X and Y did not take a deduction under section 2522 of the Code on their gift tax return with respect to the stock transferred to A. In addition, no person or entity has or will take a deduction under section 545(b)(2) , 556(b)(2), 642(c) , 2055 , or 2106(a)(2) of the Code *with respect to the transfer of stock.*" (Emphasis added.) The IRS, again only citing Reg. 53.4947-1(a) and focusing solely on whether a deduction was taken with respect to assets transferred to the trust, ruled that the trust was not subject to Section 4947(a)(1) , stating:

> Based on representation[s] that X or Y did not take a deduction under section 170 of the Code , nor any person or entity has or will take a deduction under section 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522 , with respect to the transfer of stock, we rule that A is not a nonexempt charitable trust under section 4947(a)(1) and therefore, the private foundation rules of Chapter 1, Subchapter F, Part II, and Chapter 42, Subchapter A are not applicable.

The basis of the IRS in Ltr. Ruls. 9726009 and 9209016 in determining that Section 4947(a)(1) did not apply was that no charitable deduction had been taken with respect to the property transferred to the trust. It is interesting that Ltr. Rul. 9726009 , which involved a testamentary transfer to a wholly charitable trust, specifically noted that the estate did not claim any charitable deduction under Section 642(c) for any transfer to the trust, thereby supporting the conclusion that Section 4947(a)(1) was not applicable. The focus of the IRS on whether the estate claimed any charitable deduction under Section 642(c) for a transfer to the trust, and not on whether the trust would subsequently claim a charitable deduction under Section 642(c) , is consistent with Reg. 53.4947-1(a) , which specifically provides that Section 4947 applies to trusts "which have amounts in trust for which a deduction was allowed under section 170 , section 545(b)(2) , 556(b)(2), 642(c) , 2055 , 2106(a)(2) , or 2522 ."

Note that in Ltr. Ruls. 9726009 and 9209016 , the taxpayers did not specifically request a ruling that a subsequent Section 642(c) deduction would not trigger Section 4947(a)(1) and, therefore, there was no specific ruling by the IRS on this issue. It seems unlikely, however, that the IRS would issue rulings that the trusts in Ltr. Ruls. 9726009 and 9209016 were not described in Section 4947(a)(1) because no charitable deduction was ever taken for amounts transferred to

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the trusts, without indicating that once the trusts ever claimed a Section 642(c) deduction (which, like any other trust making distributions of gross income pursuant to its governing instrument, they would invariably do), the trusts would become subject to Section 4947(a)(1) and the wide array of private foundation excise tax provisions. The whole point of obtaining those rulings was to gain certainty that the trusts would not be described in Section 4947(a)(1) and therefore not be subject to the private foundation rules, so long as no deduction was ever taken for amounts transferred to the trusts.

This position that only a charitable deduction taken for property transferred to a trust triggers the application of Section 4947(a)(1) appears to be supported by more recent guidance by the IRS in this area. Internal Revenue Manual (IRM) 4.76.5.3 (04-13-2015), in discussing the requirements for a charitable trust to be described in Section 4947(a)(1) , specifically notes the requirement that the "trust holds amounts for which charitable contributions were allowed under" Sections 170 , 545(b)(2) , 642(c), 2055, 2016(a)(2), and 2522. IRM 4.76.5.3 further states that because a trust described in Section 4947(a)(1) "doesn't necessarily distribute all of the income collected for charitable purposes," it reports certain income each year as taxable, and because it "isn't tax-exempt, any income it receives and doesn't subsequently distribute for charitable purposes is taxable under Subtitle A, regardless of the source."

Clearly, the IRS recognizes in this provision of the IRM that a nonexempt charitable trust is eligible for a charitable income tax deduction for distributions of its income to charity. Notwithstanding, there is no indication in IRM 4.76.5.3 that a nonexempt charitable trust claiming a Section 642(c) deduction for a distribution of its own income to charity causes the trust to fall within Section 4947(a)(1) , as its focus is solely on the trust holding amounts for which a charitable deduction was allowed. Granted, however, nothing in IRM 4.76.5.3 specifically states that a Section 642(c) deduction taken by a trust itself for a distribution of its own gross income does not trigger Section 4947(a)(1) .

Consistent with Ltr. Ruls. 9726009 and 9209016 , courts that have considered Section 4947(a)(1) have focused only on whether a charitable deduction has been taken for amounts transferred to the trust. In *Peters*, [64] the taxpayer asserted that Section 4947(a)(1) did not apply to a trust that was originally a CRT but became a wholly charitable trust upon the noncharitable beneficiary's death. The basis for the taxpayer's argument was that the requirement that a charitable deduction be allowed for purposes of Section 4947(a)(1) means that the charitable deduction must be based on the charitable status of the trust receiving a transfer of property, not the charitable remainder beneficiary.

The taxpayer asserted that because the charitable deduction was allowed only for the remainder interest in the trust, not the trust itself, the trust was not a trust for which a charitable deduction was allowed. The court disagreed, stating that "Plaintiffs' reading is exceedingly strained. *The natural reading is that there* *must be amounts in trust for which a charitable deduction was allowed.* Clearly that is the case here." (Emphasis added.)

In *Hammond*,[65] the court, in determining the applicability of Section 4947(a)(1) , stated that for a trust to be described in Section 4947(a)(1) , it must meet three requirements:

> (1) It must not be an exempt organization under Section 501(a) .
> (2) All beneficial interests in the trust which have not yet expired under the terms of the trust instrument must be devoted to one or more of the purposes described in Section 170(c)(2)(B) .
> (3) *"A charitable deduction must have been allowed with respect to amounts transferred to the trust.*" (Emphasis added.)

In this case, the court actually determined the language contained in Reg. 53.4947-1(a) that "the term 'purposes described in section 170(c)(2)(B) ' shall be treated as including purposes described in section 170(c)(1)" invalidly broadened the scope of Section 4947(a)(1) . In support of its conclusion, the court stated:

> Congress plainly could have extended section 4947(a)(1) to encompass trusts created for the "public purposes" described in section 170(c)(1), but did not do so expressly. The IRS is not at liberty to "broaden" the scope of a Code provision, in other words, to exercise the legislative function entrusted to Congress-by the promulgation of regulations. The attempt to equate "public purposes" with "charitable purposes" in Treasury Regulation section 53.4947-1(a) must fail because, to put the matter simply, it is at odds with the plain language of section 4947(a)(1). [T]he statute always remains the primary authority and to the extent [the Commissioner] legislates, thereby exceeding his authority to interpret the statute, his promulgation is void. [Citations omitted.]

The language in Reg. 53.4947-1(b)(1)(i) indicating that a subsequent Section 642(c) deduction taken by a nonexempt charitable trust will be an allowed charitable deduction for purposes of Section 4947(a)(1) was not cited in Ltr. Ruls. 9726009 and 9209016 or in IRM 4.76.5.3. Indeed, in those rulings and the IRM, the issue of the trusts subsequently

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taking a Section 642(c) deduction was not even addressed in the determination of whether the trusts were described in Section 4947(a)(1) . And, rather than leaving the issue in doubt, Congress could have clearly indicated within the statutory framework of Section 4947(a)(1) that a Section 642(c) deduction taken by a nonexempt charitable trust for distributions of its own gross income to charity is a deduction that triggers the application of Section 4947(a)(1) . In the absence of such clarity within the statute itself, the validity of Reg. 53.4947-1(b)(1)(i) is questionable as is any IRS guidance in this area that relies on the regulation.

Moreover, a Section 642(c) deduction is not limited to wholly charitable trusts, as such a deduction is available to any complex trust that makes distributions of gross income to charity pursuant to the terms of its governing trust document. A trust that would otherwise be a wholly charitable trust except for the existence of a single discretionary noncharitable beneficiary would not fall under Section 4947(a)(1) because not all of the unexpired interests in the trust would be devoted to charity.

Such a trust, however, could take a Section 642(c) deduction for the distribution of all of its gross income to charity (and could therefore be the equivalent of a tax-exempt entity) and would not be subject to the private foundation excise tax rules. There would appear to be no justifiable reason for a nonexempt charitable trust that is not otherwise described in Section 4947(a)(1) to become subject to the Section 4947(a)(1) tax regime simply as a result of taking the same charitable deduction under Section 642(c) that is available to any other trust, including those with both noncharitable and charitable beneficiaries.

Notwithstanding the authority focusing only on deductions for contributions of amounts transferred to a trust, based on the language in Section 4947(a)(1) referring to a trust "*for which a [charitable] deduction was allowed*," as opposed to Section 4947(a)(2) referring to a trust "*which has amounts in trust for which a [charitable] deduction was allowed,*" an argument could certainly be made that a subsequent Section 642(c) deduction taken by a trust triggers Section 4947(a)(1) and that Reg. 53.4947-1(b)(1)(i) is not an invalid extension of Section 4947(a)(1) .

Indeed, the distinction in language might lead a court to conclude that a trust, at least one that is wholly charitable, is subject to the Chapter 42 private foundation rules, if it takes a Section 642(c) deduction even though it does not and will not hold assets in the trust for which a charitable deduction has been allowed. The fact that a wholly charitable trust, like a tax-exempt private foundation , holds assets solely dedicated to charitable purposes and, by virtue of the unlimited Section 642(c) deduction, may be equivalent to a tax-exempt entity, may further support such a conclusion.

In the face of Reg. 53.4947-1(b)(1)(i) , and the lack of a clear resolution of the matter, prudence would dictate that a private letter ruling be obtained to gain assurance that a subsequent charitable deduction claimed under Section 642(c) will not cause a wholly charitable trust that is not initially subject to Section

4947(a)(1) to become subject to such provision. Of course, while it appears to have been ignored in the context of private letter rulings issued in this area, the very existence of Reg. 53.4947-1(b)(1)(i) may make obtaining such a ruling impossible. There are, however, other alternatives to consider in this context besides seeking a private letter ruling that may not even be obtainable.

Given that the focus under Section 4947(a)(1) is not whether a charitable deduction is allowable, but whether it is allowed, forgoing the Section 642(c) deduction by a nonexempt charitable trust otherwise not described in Section 4947(a)(1) would avoid triggering Section 4947(a)(1) . But, that would be at the expense of forfeiting what might very well be a valuable income tax deduction, given that a trust is entitled to deduct all of its gross income (other than "unrelated business income") that is distributed to charity. To minimize the loss of such a deduction, the trust could invest in non-income producing assets or assets that produce income that is exempt from tax, which may necessitate special trust provisions to allow for this in light of the applicable state law prudent person investment requirements.

The trust could also use its assets as a means of making distributions to charity, including appreciated securities, given that a contribution of such securities does not trigger capital gain. [66] Having to forgo the Section 642(c) deduction may, however, make an alternative vehicle a better fit, including the Zuckerberg model, discussed below or, perhaps intentionally making the trust a grantor trust during the donor's lifetime in which case the trust would not take a Section 642(c) deduction, or even making it a revocable trust during the donor's lifetime.

Perhaps a better alternative to consider in this context, however, is to simply add a discretionary

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noncharitable beneficiary to an otherwise wholly charitable trust recognizing, of course, that the addition of such a beneficiary might require a distribution other than to charity or, subject the trustee to defending not making a distribution to a discretionary noncharitable beneficiary. By adding a discretionary noncharitable beneficiary, however, the trust will not be one in which "all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) ," and therefore will not fall under Section 4947(a)(1) or (a)(2). In this situation, because the trust is not wholly charitable, the donor to the trust would not be allowed a charitable deduction for contributions to the trust in any event, rather than the donor voluntarily forgoing a charitable deduction. But, the trust in this situation would be entitled to the available unlimited charitable deduction under Section 642(c) without exposing the trust to classification under either Section 4947(a)(1) or (a)(2) or to the private foundation excise tax rules.

Interestingly, in recently issued Ltr. Rul. 200714025 , the taxpayer requested a ruling that a complex trust under which a trustee could make discretionary distributions to charity was not subject to Section 4947(a)(2) . In this ruling, the trustee had the power under the terms of the trust to "distribute part or all of [its] income to charitable organizations, as selected by the trustees." The trust was not a wholly charitable trust because distributions could be made to noncharitable beneficiaries. The ruling noted that the trust "is not exempt from tax under section 501(a) of the Code , and a deduction has not been allowed under sections 170, 545(b)(2), 642(c), 2055, 2106(a)(2), or 2422 for any amounts contributed or retained in the trust."

The IRS ruled that based on representations that the trust "does not hold amounts in trust devoted to charitable purposes for which a deduction was previously allowed under section 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), or 2522," the "distribution of [the trust's] income to charitable organizations in excise of the trustees' power to make discretionary distributions will not result in [the trust] being described as a trust coming under or within the provisions of section 4947(a)(2) of the Code ." Although Ltr. Rul. 200714025 contains no reference to it, there was no indication that the distributions of income to charity would not be deducted under Section 642(c) and, indeed, it seems clear that such a deduction would be allowable.

Adding a discretionary noncharitable beneficiary to an otherwise wholly charitable trust where no charitable deduction is ever taken for amounts transferred to the trust should result in the same treatment apparently accorded the trust in Ltr. Rul. 200714025 . That is, the trust would not be described in Section 4947(a)(2) (or, of course, in Section 4947(a)(1)), the private foundation rules would not apply to the trust, and the distributions of gross income to charity would be deductible under Section 642(c) .

The Zuckerberg model

As has been widely publicized, Mark Zuckerberg, Chairman and CEO of Facebook, recently announced that he is contributing during his lifetime 99% of his shares in Facebook, valued at approximately $45 billion to advance his philanthropy. [67] Instead of donating the shares to a private foundation , the model traditionally used by philanthropists, including Bill Gates who transferred shares of Microsoft to the Bill and Melinda Gates Foundation ("Gates Foundation "), the largest private foundation in the country, Zuckerberg is transferring his Facebook shares to a newly formed Delaware limited liability company (LLC) known as the Chan Zuckerberg Initiative (hereinafter the "Zuckerberg LLC"), formed by Zuckerberg and his wife, Dr. Priscilla Chan, as a vehicle for advancing "philanthropic, public advocacy and other activities for the public good."

In a 12/1/2015 letter to their newborn daughter, Max, in which the charitable commitment was first announced, Chan and Zuckerberg stated the following:

> As you begin the next generation of the Chan Zuckerberg family, we also begin the Chan Zuckerberg Initiative to join people across the world to advance human potential and promote equality for all children in the next generation. Our initial areas of focus will be personalized learning, curing disease, connecting people and building strong communities. We will give 99% of our Facebook shares-currently about $45 billion-during our lives to advance this mission. We know this is a small contribution compared to all the resources and talents of those already working on these issues. But we want to do what we can, working alongside many others.

Entity choice. Although an LLC can qualify as a Section 501(c)(3) tax-exempt entity, [68] in which case it would be classified as a private foundation where there is only one or a few donors, the newly created Zuckerberg LLC is not seeking classification as a Section 501(c)(3) tax-exempt entity with the IRS and therefore will not be determined by the IRS to be a private foundation . And because it is not

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described in Section 4947(a)(1) , it will not be treated as an organization described in Section 501(c)(3) or as a private foundation . As a result, the private foundation excise tax regime would not apply to the LLC.

Unless it elects to be treated as a corporation, an unlikely scenario, it will be treated as a pass-through entity for tax purposes. Therefore, although it is formed to further philanthropic purposes, the Zuckerberg LLC will be treated for tax purposes like any other LLC, where all of its tax attributes, including its taxable income and deductions, flow through to its member or members, who will report such items on their own income tax returns. It will also avoid the highly restrictive federal excise tax regime first imposed upon private foundations by Congress under the 1969 Act.

Ramifications of using LLC. Assuming $45 billion of assets, the Zuckerberg LLC will not have to meet the annual 5% distribution requirement of $2.25 billion that would otherwise be required if it were a private foundation and, in fact, is actually not required to make any charitable distributions. In contrast, the Gates Foundation , which is subject to the private foundation 5% annual distribution requirement, reported on its

2015 Form 990-PF that the fair market value of its assets was approximately $40 billion and reflected a 5% distribution requirement of nearly $3.3 billion.

Because it is not a private foundation , contributions to the Zuckerberg LLC are not deductible for charitable income tax purposes, although such a deduction, of course, is only meaningful where the donor has significant income. Despite his great wealth from his holdings of Facebook shares, which do not pay dividends, Zuckerberg's income may actually be relatively modest, as his official annual salary from Facebook is $1, presumably making any charitable income tax deduction attributable to the Facebook shares of little value to Zuckerberg.

With Facebook stock currently not paying dividends, the Zuckerberg LLC may generate little, if any, taxable income, making the absence of a tax exemption under Section 501(c)(3) of little concern. And, if it wants to make contributions to charity to further its mission, the Zuckerberg LLC could actually make gifts of appreciated Facebook stock, which produces a charitable income tax deduction at fair market

value and, as the same time, does not trigger any capital gain recognition upon the contribution.

Not triggering capital gain tax upon a contribution of appreciated securities to charity should be contrasted from the situation where the securities are first sold, and then the cash proceeds are contributed to charity. In that situation, capital gain is recognized.

The benefits of the LLC model over the private foundation model is that the LLC avoids the multitude of restrictions and requirements applicable to private foundations , both at the federal and state level, thereby making the LLC a much more flexible vehicle that can engage in a wide variety of activities and make investments and expenditures that would be prohibited if it were a private foundation . Therefore, in choosing an LLC, Zuckerberg and Chan have more leeway in the types of causes they want to support and the investments they want to make, and provides anonymity that is not available with a private foundation . At the same time, like a donor who establishes a private foundation , they retain control over the operations of the LLC and can make decisions regarding its investments, contributions, expenditures, and all of its other activities.

Unlike in the case of a private foundation , the assets contributed to an LLC are presumably not permanently restricted for charitable purposes, but can be used for any permissible purposes under state law. Typically, an LLC can be dissolved and liquidated, with the assets then held by the LLC distributed back to its member or members. Therefore, unlike a private foundation , the assets of an LLC are not subject to State Attorney General oversight, who has authority over the administration of assets dedicated to charitable purposes.[69] Moreover, an LLC avoids the multitude of private foundation restrictions and limitations contained in the Code, its substantial penalty regime for lack of compliance, and the scrutiny of the IRS that comes with any organization being classified as a private foundation .

Public reaction. It is interesting to note that the Zuckerberg LLC model has been the subject of criticism. In "How Mark Zuckerberg's Altruism Helps Himself," by Jesse Eisinger, *Pro Publica* (12/3/2015), for example, the author is highly critical of the Zuckerberg LLC model and questions its charitable intent, and starts with the following passage: "Mark Zuckerberg did not donate $45 billion to charity. You may have heard that, but that was wrong. Here's what happened instead: Mr. Zuckerberg created an investment vehicle. Sorry for the slightly less sexy headline." And, specifically with respect to the transfer of the $45 billion of Facebook stock to the Zuckerberg LLC, the article states:

> In doing so, Mr. Zuckerberg and Dr. Chan did not set up a charitable foundation , which has nonprofit status. He created a limited liability company, one that has already reaped enormous benefits as public relations coup for himself. His P.R. return-on-investment dwarfs that of his Facebook stock. Mr. Zuckerberg was depicted in breathless, glowing terms for having, in essence, moved money from one pocket to the other.
>
> An L.L.C. can invest in for-profit companies (perhaps these will be characterized as societally responsible companies, but lots of companies claim the mantle of societal responsibility). An L.L.C. can make political donations. It can lobby for changes in the law. He remains completely free to do as he wishes with his money. That's what America is all about. But as a society, we don't generally call these types of activities "charity."

In response to criticism of the LLC model, an article in *Forbes*, "Mark Zuckerberg and His Charitable Plan Should Be Followed, Not Criticized," Danielle and Andy Mayoras (12/9/2015), defended the Zuckerberg LLC model. The article notes that the LLC model is perfectly legal, there are a wide variety of vehicles that can be used to further philanthropy, and that the LLC model is just one of many and that "Mark Zuckerberg and Priscilla Chan deserve applause, not scorn" for creating and funding the Zuckerberg LLC. Mr. Zuckerberg himself has explained his choice of use of the LLC model as follows:

> The Chan Zuckerberg Initiative is structured as an LLC rather than a traditional foundation

> . This enables us to pursue our mission by funding non-profit organizations, making private investments and participating in policy debates-in each case with the goal of generating a positive impact in areas of great need. Any net profits from investments will also be used to advance this mission. By using an LLC instead of a traditional foundation , we receive no tax benefit from transferring our shares to the Chan Zuckerberg Initiative, but we gain flexibility to execute our mission more effectively. In fact, if we transferred our shares to a traditional foundation , then we would have received an immediate tax benefit, but by using an LLC we do not. And just like everyone else, we will pay capital gains taxes when our shares are sold by the LLC.

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It is also interesting to note that the use of LLCs as a vehicle to advance philanthropic goals is not new. LLCs have previously been used to engage in philanthropic ventures, including the Emerson Collective, an LLC created by Laurene Powell Jobs, the widow of the late Steve Jobs, and the LLC formed as a part of the Omidyar Network by eBay founder Pierre Omidyar and his wife, Pam Omidyar. In a 5/24/2013 article in the *New York Times*, "Laurene Powell Jobs and Anonymous Giving in Silicon Valley," Claire Cain Miller reported that one of the main ways Ms. Powell Jobs keeps her donations anonymous is by cleverly making her organization, Emerson Collective, a limited liability company, and notes the increasing popularity of LLCs being used as philanthropic vehicles. The article states:

> [The LLC] strategy is becoming more common, as people seek flexibility, freedom and anonymity in their investments, said Laura Arrillaga-Andreessen, who teaches philanthropy at Stanford, runs her own philanthropy and is a close friend of Ms. Powell Jobs. "The beauty of having an LLC in today's world is No. 1, you have the ability to act and react as nimbly as need be to create change, and you have the ability to invest politically, in the for-profit sector and the nonprofit sector simultaneously," she said. "And the reality is," she added, "we are now seeing a blurring of the lines between the sectors in a way that was not even discussed 10 years ago. The way that we are going to solve social problems is by working with multiple different types of investing." Ms. Powell Jobs said that Emerson did not need the tax structure of a foundation , and that "doing things anonymously and being nimble and flexible and responsive are all things we value on our team."

As noted in a 12/23/2015 article by Stephen Foley in the *Financial Times*, "How to give away $1bn," the world's 1,826 billionaires, many of them relatively newly minted moguls reared in the world of Silicon Valley, are exploring new avenues to pursue social agendas, challenging traditional foundation and donation models in ways that could redefine philanthropy, and stating that "they are engaging in philanthropic endeavor at an intriguing time, as old ways of giving are being challenged and even the definition of what it means to be a philanthropist appears to be expanding." The article examines emerging ways that today's mega-donors are crafting their philanthropy, including the hybrid structures adopted by eBay founder Pierre Omidyar and Mark Zuckerberg, who, the article notes, set up limited liability companies that make impact investments as well as grants to nonprofits. The article quotes Pierre Omidyar from 2003 as saying it was "no-brainer" when he decided to reject the traditional model of U.S. philanthropy and not use a charitable foundation for his giving.

While there is certainly still a place for the use of the traditional private foundation to carry out an individual's philanthropy, and private foundations continue to enjoy growing popularity, the use of a non-exempt LLC may be a compelling alternative, and one that should be considered when determining an appropriate philanthropic model, particularly where tax benefits are not a significant concern and where the proposed activities and expenditures are not permitted by a private foundation . The LLC approach apparently works for Mark Zuckerberg, who opted for an LLC in lieu of the traditional private foundation approach, as well as others who have decided to engage in philanthropy using the more flexible and less restricted LLC model. As long as it allows a donor's philanthropic intent to be accomplished, and the tax benefits offered by a private foundation is not considered compelling, any criticism aimed at using an LLC as a philanthropic vehicle is not well-founded. In addition, there is no prohibition on a donor using both an LLC and a private foundation , in tandem, for philanthropic purposes.

Conclusion

The application of the often harsh and burdensome private foundation tax regime to a donor's philanthropic entity can present significant roadblocks and hurdles in attaining the goals and objectives of the donor. With proper planning, it may be possible to avoid this regime while at the same time furthering a donor's philanthropic mission although certain tax benefits will be forfeited.

[1] Section 170(a) .

[2] In the context of a donor-advised fund, the donor only has "advisory privileges with respect to the distribution ... of amounts held in such fund or account." Section 4966(d)(2)(A)(iii) . In contrast, a donor to a private foundation may have actual control over the distribution of funds held in the foundation , not merely advisory privileges.

[3] For a complete discussion of CRTs, including the tax issues associated with the use of these vehicles, see Fox, *Charitable Giving: Taxation, Planning, and Strategies*, 2nd Ed (Thomson Reuters, 2014), Volume 2, Chapter 25. See also Fox and Blattmachr, "Proposed Regulations Apply Special Basis Rules to Combined Sale of Interests in Charitable Remainder Trust," 121 J. Tax'n 100 (September 2014) .

[4] For the background on CLTs, see Fox, "A Guide to the IRS Sample Charitable Lead Trust Forms-Part 1," 36 EPTL 7 (April 2009); and Fox, "A Guide to the IRS Sample Charitable Lead Trust Forms-Part 2," 36 ETPL 13 (May 2009).

[5] Sponsoring organizations of donor-advised funds are public charities, not private foundations .

[6] "Nonexempt" in the context of a "nonexempt charitable trust" means that the trust has not obtained an IRS determination letter that it is classified under Section 501(c)(3) and exempt from tax under Section 501(a) .

[7] Ltr. Rul. 201713002 was also issued at the same time as Ltr. Rul. 201713003 , containing the same facts, analysis, and rulings. Under Section 6110(k)(3) , neither a private letter ruling nor a technical advice memorandum may be cited or used as precedent.

[8] The terms "private foundation " and " foundation " are interchangeably used throughout this article.

[9] A private foundation is, in the first instance, a Section 501(c)(3) tax-exempt organization. The exception to this rule is where a private foundation loses its tax-exempt status, in which case it is still considered a private foundation , subject to the special tax regime applicable to private foundations , although it is no longer classified as a tax-exempt organization under Section 501(c)(3) .

[10] For an excellent discussion of the history of the American private foundation , see Marsh, "A Dubious Distinction: Rethinking Tax Treatment of Private Foundations and Public Charities," 22 Va. Tax Rev. 137 (Summer 2002). In this article, the author notes that "While American philanthropists established only five general foundations in the nineteenth century, [Andrew] Carnegie and John D. Rockefeller not only inspired a generation of tycoon-philanthropists, but they invented the organized philanthropy of the twentieth century." See also "Philanthropy In Their Lifetimes," Wall St. J., 10/22/2017, which states, "In a matter of year, a new crop of ultra wealthy Americans has eclipsed the old guard of philanthropic titans. With names like Soros, Gates, Bloomberg, Mercer, Koch and Zuckerberg, these new megadonors are upending long-established norms in the staid world of big philanthropy."

[11] The IRS has indicated that a limited liability company may qualify under Section 501(c)(3) . See 2001 IRS EO CPE, Chapter B, "Limited Liability Companies as Exempt Organizations." See also Instructions to Form 1023, Part II, "Organizational Structure."

[12] Of course, such control is not absolute, as the funds must be dedicated and used exclusively for Section 501(c)(3) purposes and the foundation and those who run it are subject to the excise tax regime of Chapter 42 of the Code, imposing a multitude of strict requirements and restrictions (in the form of excise taxes) on the operation and activities of a private foundation .

[13] Campbell v. Prothro, 209 F.2d 331 45 AFTR 131 (CA-5, 1954); Rev. Rul. 55-410, 1955-1 CB 297 ; see also Rev. Rul. 57-506, 1957-2 CB 65 .

[14] Because it is a Section 501(c)(3) tax-exempt organization, a private foundation is exempt from federal

income tax under Section 501(a) . Notwithstanding, under Section 4940 , a private foundation is subject to an excise tax on its net investment income. In addition, as is the case with public charities, private foundations are subject to tax on "unrelated business taxable income" imposed under Section 511 .

[15] In one case, Foxworthy, Inc., TCMemo 2009-203 , the IRS took a rather curious position with respect to the income tax deductibility of contributions made to a private foundation by its founder, on the basis that he maintained control over the foundation following the contributions, albeit in connection with his official capacity with respect to the foundation . The Tax Court, in allowing the income tax charitable deduction, summarily rejected the position asserted by the IRS that the donor's control over the foundation results in the loss of a charitable income tax deduction. The conclusion reached by the court in this case is, indeed, correct in that there are no cases or other authority where an income tax charitable deduction has been disallowed on the basis of the donor, acting in a fiduciary capacity as a director or officer, controlling the donee private foundation . Indeed, if an income tax deduction was not available in this context, it would have a chilling effect on the creation and funding of private foundations , as both control over a private foundation coupled with an upfront available income tax charitable deduction are key benefits associated with creating and funding a private foundation .

[16] In Haskell and Snow, "Grant Making Isn't the Only Way," 149 Trusts & Estates 35 (August 2010), the authors state that "There are many reasons for the continuing popularity of [private foundations], including donor control over grants and investments, the ability of a family to work together toward a common philanthropic mission and using the [private foundation] as a means to transmit personal values over generations." Note, however, that many private foundations are structured to have a limited life, rather than be perpetual. See Fox and Bon, The Life Span of a Private Foundation : Perpetual or Limited?" 38 ETPL 19 (September 2011).

[17] The "private nonoperating foundation " should be contrasted from a "private operating foundation ," another type of private foundation . Unlike a private nonoperating foundation , which principally engages in grantmaking, a private operating foundation primarily engages in direct charitable activities.

[18] Public charities are Section 501(c)(3) tax-exempt organizations that qualify under Section 509(a) as "other than private foundations ."

[19] With the exception of Section 4942(a) , dealing with the minimum 5% annual distribution requirement, Chapter 42 applies to both private nonoperating foundations and private operating foundations .

[20] The private foundation tax regime is fraught with peril, particularly in the context of a foundation having a beneficial interest in an estate. See, e.g., Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," U. of Miami Est. Plan. Inst. at Chapter 10 (1992).

[21] Section 170(e)(1)(B)(ii) . This limitation does not apply to a "private nonoperating foundation ." Note too that the charitable income tax deduction for a contribution of tangible personal property to a public charity is limited to its tax basis if the property is put to a use that is unrelated to the purpose or function constituting the basis for the tax-exempt status of the donee organization. Section 170(e)(1)(B)(I)(i) .

[22] Sections 170(b)(1)(B) and (D). The actual figure on which the percentage limitations is applied is referred to under Section 170(b)(1)(G) as the "contribution base," as specifically defined therein, but generally is equal to the "adjusted gross income" of the donor.

[23] Sections 170(b)(1)(A) and (C). An exception to the tax basis and gross income limitations on deductibility of contributions to a private foundation exists under the "pass through" or "conduit" exception rules described in Section 170(b)(1)(F)(ii) where, if not later than the 15th day of the third month after the close of its tax year in which such contributions are received, the foundation makes qualifying distributions (generally distributions to public charities) which are treated as distributions out of corpus in accordance with Section 4942(h) in an amount equal to 100% of such contributions although other limitations do apply.

[24] Pub. L. No. 91-172.

[25] In one article, the author states: "To some of those who think back to it, the legislation seems an aberrant spasm of Congressional anger at foundations , generated by the unfortunate acts of a handful of individuals and organizations, without rational grounding in general realities in the foundation field." Troyer, "The 1969 Private Foundation Law: Historical Perspective on its Origins and Underpinnings," 27 Exempt Org. Tax Rev. 52 (January 2000).

[26] "Disqualified person" includes a wide range of individuals associated with the foundation , including (but not limited to) a substantial contributor and certain family members, as well as a corporation, partnership, trust, and estate in which disqualified persons have a substantial beneficial interest. See Section 4946(a)(1) .

[27] Thus, although a private foundation is exempt from income tax (other than unrelated trade or business income tax), unlike public charities, it is subject to a special excise tax on its investment income.

[28] See Fox and Blattmachr, " Avoid Unintentional Self-Dealing With Private Foundations ," 42 ETPL 3 (August 2015).

[29] Sections 4944(c)(2) and (3).

[30] Reg. 53.4944-1(b)(i). For a further discussion of jeopardy investments, see Halperin and Harris, "Investment Guidelines for Private Foundation Managers," 30 ETPL 542 (November 2003).

[31] Section 4944(c) . For a further discussion of PRIs, see Fox, "Private Foundations Get Expanded Program-Related Investment Options," 40 ETPL 23 (January 2013).

[32] Section 4945(g) .

[33] See Reg. 53.4944-1(a)(2)(iv) . See also Kermit Fischer Foundation , TCMemo 1990-300 .

[34] See also, e.g., Ltr. Rul. 200009058 ("The Trust is presumed (in the absence of proof to the contrary) to have amounts in trust for which a deduction was allowed if a deduction would have been allowable under those sections."); IRM 7.26.15.2.3(1) ("If a charitable deduction was allowable, it will be presumed to have been taken and allowed in the absence of proof to the contrary.").

[35] Reg. 53.4947-1(b)(2)(iii) .

[36] Reg. 53.4947-1(b)(2)(ii)(A) .

[37] For a further discussion of the operation of Section 642(c) and related issues, see Blattmachr, Boyle, and Fox, "Planning for Charitable Contributions by Estates and Trusts," 44 ETPL 3 (January 2017). Note that there is an exception to the unlimited charitable income tax deduction in the case of "unrelated business income," as Section 681(a) provides that in computing the deduction allowable under Section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under Section 642(c) is allowed as a deduction with respect to income of the tax year that is allocable to "unrelated business income."

[38] There is no requirement that a charitable trust seek exemption. In Reg. 53.4947-1(b)(1)(ii), Example 1 , a trust that apparently could have received exemption under Section 501(c)(3) was not tax-exempt

because the trustees did not apply for exemption (as is their option). Absent such an exemption, a trust, whether or not wholly charitable, is subject to tax under Subchapter J. Most charitable organizations do apply for an exemption from income tax by seeking to be classified as a Section 501(c)(3) tax-exempt organization. This is done by filing Form 1023, Application for Recognition of Exemption, with the IRS.

[39] See Reg. 53.4947-1(a) ("The basic purpose of section 4947 is to prevent these trusts from being used to avoid the requirements and restrictions applicable to private foundations "); Eiry Trust, 77 TC 1263 (1981) ("The intent in enacting section 4947 was to prevent such taxpayers from avoiding the private foundation restrictions by imposing the same upon the trusts. S. Rept. 91-552, 91st Cong., 1st Sess. 93 (1969), 1969-3 C.B. 423, 483."); IRS Publication 578, Tax Information for Private Foundations and Managers ("The aim of section 4947 is to prevent a trust of this nature from being used to avoid the requirements and restrictions that apply to private foundations ."); Transfer Primer, IRS 2001 EO CPE Text, at 83 ("IRC 4947 subjects trusts with charitable interests to some or all of the Chapter 42 excise taxes. It is a 'loophole' closer. Without it, narrowly controlled foundations could achieve most of the benefits of tax exempt status without the safeguards created by the Chapter 42 excise taxes.").

[40] For a further discussion of Section 4947(a)(1) , See Fox, "Planning and Strategies for Nonexempt Charitable Trusts-Part 1," 20 Tax'n of Exempts 18 (May/June 2009); and Fox, "Planning and Strategies for Nonexempt Charitable Trusts-Part 2," 21 Tax'n of Exempts 15 (July/August 2009).

[41] See also, Ltr. Rul. 200009058 ("Because the Trust Agreement contains provisions which clearly indicate that all of the Trust's unexpired interests are devoted to one or more purposes described in section 170(c)(2)(B), the Trust will be treated [under IRC §4947(a)(1)] as an organization described in section 501(c)(3) and subject to the same requirements and restrictions imposed on private foundations ."); IRM 7.20.3.2.10 (Nonexempt Charitable Trusts) ("[a] nonexempt charitable trust is treated as a private foundation described in IRC 501(c)(3) ").

[42] IRM 7.26.15.3 (IRC 4947 Trusts-Private Foundation Classification) ("Just as with IRC 501(c)(3) organizations, IRC 4947(a)(1) trusts are either public charities or private foundations .").

[43] Although Section 508(b) (Presumption That Organizations Are Private Foundations) does not apply to a nonexempt charitable trust under Section 4947(a)(1) , such a trust is treated as a private foundation unless it requests a determination from the IRS that it is a public charity. See, e.g., Rev. Rul. 76-92, 1976-1 CB 160 ("a nonexempt charitable trust is considered to be a private foundation unless it meets the requirements of section 509(a)(1) , (2), (3), or (4)"). See also See Eiry Trust, 77 TC 1263 (1981) ("Where the trust is not exempt under section 501(c)(3) , section 4947(a)(1) requires that it be tested as a private foundation under section 509(a) . If the trust is classified under section 509(a)(1) through (4), then it [is a public charity and] is not liable for the excise taxes enumerated in Chapter 42 (secs. 4940 through 4948)."). See also IRM 7.26.15.2 (2) ("If a trust is described in IRC 4947(a)(1), private foundation rules will apply unless the trust qualifies for public charity status.").

[44] A Section 4947(a)(1) trust may request a determination from the IRS under Section 509(a)(3) even though it has neither obtained nor seeks to obtain exemption from tax as an organization classified under Section 501(c)(3) . IRM 7.26.15.3 (IRC §4947 , Trusts-Private Foundation Classification), which states that an "IRC 4947(a)(1) trust may request a determination from the Service under IRC 509(a)(3) even though it has neither obtained nor seeks exemption under IRC 501(c)(3)." See also Reg. 53.4947-1(b)(3) ("If the charitable trust otherwise meets the requirements of section 509(a)(3), it may obtain recognition of its status as a section 509(a)(3) organization by requesting a ruling from the Internal Revenue Service."). Rev. Proc. 72-50, 1972-2 CB 830 , sets forth the procedure under which a nonexempt charitable trust may obtain a determination that it is a Section 509(a)(3) supporting organization and, therefore, excluded from private foundation status.

[45] Section 170(c)(2) (income tax); Section 2522(a) (gift tax); and Section 2055(a) (estate tax). See Ltr. Rul. 200302005 , where the IRS stated: "Thus, the question is whether the Foundation will be described in section 4947(a)(1) . If so, then contributions to the Foundation will be deductible regardless of when or whether the Foundation applies for recognition under section 501(c)(3). Otherwise, the Foundation would have to apply for and receive recognition of exemption for the period in which the gift is made in order for the gift to be deductible."

[46] See Reg. 53.4947-1(b)(1)(ii), Example 1 , which states that the trustees of a nonexempt charitable trust "do not give notice to the Internal Revenue Service under the provisions of section 508(a) [that they are applying exemption from income tax], and the trust will therefore not be exempt from taxation under section 501(a)." Such a trust would presumably qualify for exemption from tax under Section 501(a) as an organization described under Section 501(c)(3) because they are wholly devoted to one or more purposes described in Section 170(c)(2)(B) , which are the same purposes delineated under Section 501(c)(3) , and, in fact, there are a multitude of organizations described under Section 501(c)(3) that are formed and operated in trust form. Nothing under the Code, however, requires a trust that could otherwise qualify under Section 501(c)(3) to apply for exemption from tax under Section 501(a) . Absent such an exemption, a trust, whether or not wholly charitable, is subject to tax under Subchapter J of the Code.

[47] Sections 4947(a)(2) .

[48] For a further discussion of this issue, see Fox, "A Guide to the IRS Sample Charitable Remainder Trust Forms," 33 ETPL 13 (January 2006).

[49] Section 170(f)(2)(B) .

[50] See Sections 671 through 679 .

[51] Section 170(f)(2)(C) .

[52] For a further discussion of CLTs, including the grantor versus non-grantor trustee issue, see Fox, "A Guide to the IRS Sample Charitable Lead Trust Forms-Part 1," 36 ETPL 7 (April 2009).

[53] 319 U.S. 523 30 AFTR 1304 (1943).

[54] See, e.g., Section 1245(a)(2) (in computing "recomputed basis," deductions "allowed or allowable to the taxpayer or to any other person for depreciation or amortization" must be taken into account).

[55] As of the writing of this article, the unified credit amount is $5.6 million in 2018.

[56] Sections 664(d)(1)(D) (annuity trust) and 664(d)(2)(D) (unitrust).

[57] Reg. 25.2511-2(c) . Such a right of substitution will cause the CRT to be included in the settlor's estate under Section 2038 . If the settlor (1) retains the sole annuity or unitrust interest, or (2) retains the testamentary power to revoke the annuity or unitrust interest of all other persons provided with such an interest (whether as a current or successor beneficiary), the entire value of the trust would necessarily be included in the settlor's estate where the power to substitute the charitable remainder beneficiary is retained. See, e.g., Ltr. Rul. 9202033 (entire value of a CRUT was includable in the estate because settlor "will retain the right to revoke spouse's survivorship interest and the interests of the charitable organizations named initially and substitute other charities as remaindermen").

[58] Although a gift to the charitable lead beneficiaries of the CLT may be rendered incomplete by the settlor retaining a right to substitute charities, such a right is generally not recommended because it causes the CLT to be brought back into the settlor's estate, with most likely a limited offsetting charitable estate tax deduction. The consequences of estate tax inclusion can be potentially devastating, as the value of the entire corpus of the trust must be included in the settlor's estate, and a charitable estate tax deduction is available only for the remaining payments to charity during the lead term, thereby defeating the underlying purpose of the CLT of transferring property with minimal gift and estate tax cost. See also Rifkind, 5 Cl Ct 362 54 AFTR2d 84-6453 (Cls. Ct., 1984).

[59] Estates and certain specified trusts (generally only trusts created on or before 10/9/1969) are eligible for a special charitable income tax deduction under Section 642(c)(2) for any amount of gross income, without limitation, which pursuant to the terms of the governing instrument is, during the tax year, permanently set aside for a purpose specified in Section 170 or is to be used exclusively for certain enumerated charitable purposes. Where a deduction under Section 642(c)(2) is available, a current charitable income tax deduction is allowable, notwithstanding that the gross income will not be paid or used for a charitable purpose until some future time. The deduction available under Section 642(c)(2) is to be distinguished from the deduction available under Section 642(c)(1) , under which a deduction is allowable only for amounts that are actually currently paid by an estate or trust.

[60] Of note is that estates are always eligible for the permanent set-aside deduction under Section 642(c)(2) , whereas only a limited number of delineated trusts are eligible, which generally includes only those trusts created on or before 10/9/1969. Up until the 1969 Act, the set-aside deduction was equally available to both estates and trusts.

[61] The language under Section 4947 is not a model of consistency. For example, Section 4947(a)(1) refers to "a trust which is not exempt from *taxation* under section 501(a)," whereas Section 4947(a)(2) refers to "a trust which is not exempt from *tax* under section 501(a)." Certainly, the words "taxation" and "tax" have the same meaning under each subsection of Section 4947 , although, for no possible reason, Section 4947(a)(1) uses the word "taxation" and Section 4947(a)(2) uses the word "tax.

[62] TD 7431 , 8/20/1976.

[63] See also IRS 2003 EO CPE Text, Trusts: Common Law and IRC 501(c)(3) and 4947 , which states on page 26 that the requirement of a charitable deduction under Section 4947(a)(1) is met where "a charitable deduction was allowed to donors to the trust (or to the trust itself under IRC 642(c) in distributing or setting aside amounts for charity- Reg. 53.4947-1(b)(1)(i))." See also GCM 37485 , 3/30/1978 ("Notwithstanding this difference in character from the other deductions, however, it is clear under the regulations that the charitable payout deduction under section 642(c) is intended to be

covered by the language of section 4947(a)(1) . The final regulations at Treas. Reg. §53.4947-1(b)(1)(i) state: A trust is one for which a deduction was allowed under section 642(c) , within the meaning of section 4947(a)(1) , once a deduction is allowed under section 642(c) to the trust for any amount paid or permanently set aside.")

[64] 624 F.2d 1020 46 AFTR 2d 80-5278 (Ct Cl., 1980).

[65] 584 F. Supp. 163 53 AFTR2d 84-1528 , *aff'd*764 F.2d 88 56 AFTR2d 85-5256 (CA-2, 1985).

[66] Campbell v. Prothro, 209 F.2d 331 45 AFTR 131 (CA-5, 1954); Rev. Rul. 55-410, 1955-1 CB 297 ; see also Rev. Rul. 57-506, 1957-2 CB 65 .

[67] See "Mark Zuckerberg and Priscilla Chan to Give 99% of Facebook Shares to Charity," Wall St. J., 12/2/2015.

[68] See 2001 IRS EO CPE, Chapter B, "Limited Liability Companies as Exempt Organizations." See also Instructions to Form 1023, Part II, "Organizational Structure."

[69] There is generally nothing to prevent an LLC from being formed to limit its purposes to those otherwise described under Section 501(c)(3) and to dedicate its assets to such purposes. Certain states have actually enacted a nonprofit form of LLC specifically providing that the entity can be formed for charitable purposes and its assets restricted for such purposes under state law, in which case there would be State Attorney General oversight. See, e.g., 15 Pa. C.S. §8818(d). Absent the LLC applying for Section 501(c)(3) tax-exempt status with the IRS and having such application approved, it would not be subject to the private foundation excise tax rules. Of course, where an LLC is a disregarded single-member LLC that is owned and controlled by a private foundation , the LLC itself is considered to be, in essence, a branch or division of the private foundation . In that case, the LLC would be subject to

the private foundation excise tax rules. See Notice 2012-52, 2012-35 IRB 317 .

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Enclosure 6

Local Newspapers Turn to Philanthropy in Face of Financial Struggles, Taxation of Exempts (WG&L), Sep/Oct 2019

PHILANTHROPIC SUPPORT OF NEWSPAPERS

LOCAL NEWSPAPERS TURN TO PHILANTHROPY IN FACE OF FINANCIAL STRUGGLES

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This article discusses different avenues available to provide philanthropic support of local journalism depending upon the tax status of the newspaper providing such coverage, including support provided by individuals and private foundations.

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The importance of local newspapers across America cannot be overstated. They provide communities with a vital source of original, substantive news and information reporting and high-impact public interest investigative journalism. Their role as watchdog organizations, which provides essential oversight of fundamental institutions of our society both in the public and private sector, benefits not only their subscribers but provides value to those who never even buy a newspaper or a digital subscription.

Indeed, in recognizing the crucial role of newspapers to a functioning democratic society, Thomas Jefferson once said that "were it left to me to decide whether we should have a government without newspapers or newspapers without a government, I should not hesitate a moment to prefer the latter. [1] In a recent opinion piece, the publisher of the New York Times emphasized that "Journalism guards freedoms, binds together communities, ferrets out corruption and injustice, and ensures the flow of information that powers everything from elections to the economy." [2]

In the face of shrinking advertising revenue and significant drops in circulation, many local newspapers across the country are struggling financially and have been forced to reduce staff and the scope and depth of their coverage. An alarming number of newspapers, unable to overcome their financial struggles, have ceased operations altogether in recent years. [3]

As a result, many communities have been left without the vital local journalism traditionally supplied by local newspapers that cannot be readily replaced by other sources. In addition, while local newspapers are seeking to transition into digital businesses in an effort to save them from the decline of the printed newspaper, relevant data shows that while the national papers, like the Wall Street Journal, the New York Times, and the Washington Post, have managed to stabilize their businesses in this difficult financial environment, local newspapers are not keeping up with this transition and are facing difficulties converting readers into paying digital customers. [4]

In response to the economic crisis facing the newspaper industry, local newspapers are now turning to their communities for philanthropic support, similar to local hospitals, libraries, schools,

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museums, and other deserving organizations serving the public interest that seek donations to help support their ongoing operations and programs. Whether a newspaper is a for-profit entity or classified as a tax-exempt organization under Section 501(c)(3) , it is possible for an individual to make charitable contributions to support its public interest journalism on a tax-deductible basis. Similarly, a private foundation can make a grant to support journalism at either a for-profit or tax-exempt newspaper which, in either case, can be applied against its annual 5% minimum distribution requirement under Section 4942 .

This article discusses different avenues available to provide philanthropic support of local journalism depending upon the tax status of the newspaper providing such coverage, including support provided by individuals and private foundations.

Local newspapers turning to philanthropy

From 2010 to 2018, the Seattle Times, a for-profit newspaper, received $4 million directly from foundations, corporations, and nonprofits to support news coverage in the areas of education, traffic, and homelessness. [5] Because of its for-profit status, however, under the applicable provisions of Section 170 , donations made directly to the newspaper by individuals are not tax-deductible as charitable contributions, no matter the purpose for which such contributions are utilized or the public benefit attained.

In an effort to attract individual fundraising support on a tax-deductible basis, particularly from its readers, in April 2019, the Seattle Times created a community-funded initiative, known as the "Seattle Times Investigative Journalism Fund," with the Seattle Foundation as a fiscal sponsor, [6] to seek philanthropic support from individuals for its investigative journalism. [7] Individuals are now able to make tax-deductible contributions to the Seattle Times Investigative Journalism Fund, a fund maintained by the Seattle Foundation, a Section 501(c)(3) tax-exempt community foundation, that can receive tax-deductible donations to support investigative journalism initiatives at the Seattle Times.

Because the donations are made to the Seattle Foundation and not directly to a for-profit newspaper, contributions by individuals to the Seattle Times Investigative Journalism Fund are tax-deductible under Section 170(a) , although the ultimate recipient of the funds is a for-profit newspaper. In this situation, the for-profit newspaper is the instrument through which a tax-exempt purpose, in the form of public interest journalism, is accomplished. [8] The ultimate responsibility for ensuring that the donations are used for tax-exempt purposes and in the public interest is in the hands of the Seattle Foundation, as the entity ultimately in control of the use of the contributed funds although restricted in use for investigative journalism. [9]

In May 2019, in a similar effort to obtain funding through tax-deductible charitable contributions, the Salt

Lake Tribune announced that it would

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relinquish its for-profit status by converting to a nonprofit news organization and seeking classification with the IRS as a tax-exempt organization under Section 501(c)(3) , which would make it the first legacy newspaper to go this route. [10] If this status is approved by the IRS, the Salt Lake Tribune, like the many other news publications across the country that have attained tax-exempt status, would be eligible to directly receive tax-deductible contributions under Section 170(a) , without the need for a Section 501(c)(3) tax-exempt fiscal sponsor to act as an intermediary. [11]

To convert from a for-profit entity to a Section 501(c)(3) tax-exempt organization, the individual ownership of the Salt Lake Tribune must be relinquished, as any earnings of such an organization cannot inure to the benefit of any private shareholder or individual. Because of the prohibition on political campaign activities under Section 501(c)(3) , the newspaper must also relinquish political endorsements, something often held near and dear by many for-profit newspapers.

Moreover, as in the case of any organization seeking Section 501(c)(3) tax-exempt status, to approve its application for tax-exempt status, the IRS must be convinced that the newspaper is now both organized and operated for tax-exempt purposes under Section 501(c)(3) . [12] If approved as a tax-exempt organization, charitable contributions to the Salt Lake Tribune would be deductible under Section 170 , allowing the paper to become a community-funded enterprise that can receive tax-deductible donations directly from individuals without the need, as in the case of the Seattle Times, to partner with a charitable foundation.

Under an innovative approach utilized by the late philanthropic and cable television entrepreneur H.F. "Gerry" Lenfest, in 2016, as owner of the for-profit Philadelphia Inquirer, Mr. Lenfest donated this daily metropolitan newspaper that was founded in 1829 to what is now known as the Lenfest Institute for Journalism, a Section 501(c)(3) tax-exempt organization in partnership with the Philadelphia Foundation, Philadelphia's community foundation. [13]

The Philadelphia Inquirer remained a for-profit newspaper, but became a wholly owned taxable subsidiary of the Lenfest Institute for Journalism, and was then converted to a public benefit corporation under Delaware law. [14] The Lenfest Institute for Journalism is dedicated to supporting sustainable business models for local journalism, accelerating the transition of print newspapers to full digital integration, and engaging in grant-making and program activities to support and preserve public interest journalism nationwide. Thus, the Philadelphia Inquirer is now a public benefit corporation wholly owned by a charity focused on preserving public interest journalism, eligible to receive grants from the charity in support of its public interest journalism.

The Philadelphia Inquirer is not the only local newspaper owned by a charity. During his lifetime, Nelson Poynter owned the St. Petersburg Times, a legacy newspaper subsequently renamed the Tampa Bay Times in 2012, and upon his death in

1978 contributed the paper to the Poynter Institute for Media Studies, a nonprofit journalism school and research organization located in St. Petersburg, Florida that is classified as a tax-exempt organization under Section 501(c)(3) . Unlike the route being taken by the Salt Lake Tribune in seeking tax-exempt status, the Philadelphia Inquirer and the Tampa Bay Times, although owned by a charitable organization, remained for-profit newspapers not subject to the wide array of restrictions and limitations imposed upon Section 501(c)(3) tax-exempt organizations.

Interestingly, donors who have donated their for-profit businesses to charity historically have done so as a means to support the charity. One of the best-known examples of this was the donation by Milton S. Hershey of his famous chocolate company to the Milton Hershey School, a Section 501(c)(3) tax-exempt organization classified as an educational organization under Section 170(b)(1)(A)(ii) . As a result of its ownership of shares of stock of what is now known as the "Hershey Company" and the receipt of dividends over the years since Mr. Hershey's donation, the Milton Hershey School now has an endowment exceeding $12 billion that is used to fund its operations.

Unlike the Hershey Company, local newspapers are not the revenue-generating engines they once were and are therefore not ideal candidates to fund charities. The recent contribution of the Philadelphia Inquirer to the Lenfest Institute for Journalism was premised upon Mr. Lenfest's vision of making the Philadelphia Inquirer a "community asset," maintaining its independence and preserving local public interest journalism, rather than a means of providing financial support to the charity to which the paper was contributed.

Although Section 501(c)(3) tax-exempt organizations that are classified as private foundations, as opposed to public charities, generally cannot own 100% of a for-profit company under the excess business holdings rule of Section 4943 , under the recently enacted so-called "Newman's Own Exception," a private foundation can now own 100% of a for-profit company, including a for-profit newspaper, if it meets the requirements under this new exception, including that the company be contributed to the foundation (as opposed to the foundation acquiring the company). [15] The Newman's Own Exception was championed by the Newman's Own Foundation, a private foundation to which famed actor and philanthropist Paul Newman bequeathed the sole ownership interest of a for-profit company that produces and sells the Newman's Own line of food products.

Even where the Newman's Own Exception applies, a private foundation is still subject to all other rules applicable to private foundations, including the annual 5% minimum distribution requirement under Section 4942 , under which the value of the for-profit company must be taken into account for purposes of determining the minimum investment return in calculating the annual 5% distribution requirement. Therefore, the ownership of a for-profit company, including a newspaper, by a public charity under Section 509 is clearly preferable to its ownership by a private foundation given, among other things, that Section 4942 does not apply to a public charity.

Qualifying a newspaper as a Section 501(c)(3) tax-exempt organization

A newspaper that qualifies as a Section 501(c)(3) tax-exempt organization is eligible under Section 170 to receive tax-deductible contributions, a potentially significant funding source, including from individuals. Such status, coupled with the organization qualifying as a public charity (as opposed to a private foundation), also streamlines the ability of a private foundation to make grants and provide other funding, such as program-related investments, to a newspaper by eliminating the need of the foundation to exercise "expenditure responsibility" under Section 4945(h) , which imposes administrative burdens and can create a significant impediment to the foundation making a grant to a for-profit newspaper in the first instance. [16]

Whether in a printed or digital version, a newspaper, like any other Section 501(c)(3) tax-exempt organization, can only qualify for such status if it is both organized and operated exclusively for one or more tax-exempt purposes under Section 501(c)(3) (e.g., religious, charitable, scientific, testing for public safety, literary, or educational purposes), and its earnings do not inure to the benefit of any individual or shareholder. [17] Tax-exempt newspapers may not participate in any political campaign, thereby prohibiting the endorsement of political candidates, and no substantial part of

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their activities may constitute lobbying, thereby imposing restrictions on newspapers pushing for legislation.

Even if a newspaper is able to attain Section 501(c)(3) tax-exempt status, unless it can qualify as a public charity under the requirements of Section 509 , it will be classified as a private foundation and subject to the restrictive excise tax regime under Chapter 42 of the Internal Revenue Code. Nonprofit news organizations that attain tax-exempt status under Section 501(c)(3) are, however, generally able to meet the public support tests under either Section 509(a)(1) or (2) and therefore avoid private foundation status.

Interestingly, a Senate Bill, S. 673, known as the "Newspaper Revitalization Act," which was introduced in 2009, provided that a "qualified newspaper corporation" would be treated as described in Section 501(c)(3) and deemed the activities of such an entity to be "educational," which constitutes a tax-exempt purpose under Section 501(c)(3) .

Under S. 673, a corporation was treated as a qualified newspaper corporation if (1) the trade or business of such corporation or organization consists of publishing on a regular basis a newspaper for general circulation, (2) the newspaper published by such corporation or organization contains local, national, and international news stories of interest to the general public and the distribution of such newspaper is necessary or valuable in achieving an educational purpose, and (3) the preparation of the material contained in such newspaper follows methods generally accepted as educational in character. S. 673 still required that the newspaper not participate in any political campaign and that no substantial part of its activities constitute lobbying.

The Newspaper Revitalization Act proved to be rather controversial and never became law, so that there is currently no provision under the Internal Revenue Code providing a specific exemption to organizations publishing newspapers. Moreover, although the bill would have made it easier for a newspaper to achieve tax-exempt status, it did not make attaining such status a certainty and likely would have provided substantial obstacles to legacy newspapers converting to such status.

More recently, on 6/5/19, Congressman Mark DeSaulnier (D-Calif.) introduced a bill, H.R. 3126, known as the Saving Local Newspaper Act of 2019, [18] that would amend Section 501(c)(3) by adding the "publication (including electronic publication) of written news articles" to the listing of tax-exempt purposes delineated under that section and exclude advertising revenue for advertisements in news publications from unrelated business taxable income. A press release issued by the Congressman's office states that the bill is "to recognize newspapers as a public good and make it easier for written news organizations to become non-profits-allowing them to focus on content instead of profit margins and reduce their tax burden." Interestingly, and presumably by an oversight, the bill does not amend Section 170(c)(2)(B) , the provision of the Internal Revenue Code setting forth the purposes for which an organization must be organized and operated in order to be eligible to receive a tax-deductible charitable contribution. The bill is only in the first stage of the legislative process and has not yet been considered by the House Ways and Means Committee.

In light of the absence of any specific statute providing for the tax-exempt status of a newspaper, an organization publishing a newspaper or other news publication must look to authority interpreting the requirements under Section 501(c)(3) for a publisher of a newspaper or other similar news publication. Generally, the success of newspapers obtaining such status has depended upon the underlying facts and the application of case law and IRS rulings to such facts.

The tax-exempt purpose typically relied upon for such status is "educational," as opposed to "journalism," which is not an enumerated tax-exempt purpose under Section 501(c)(3) . In Rev. Rul. 67-4 , [19] the IRS ruled that a publication is educational in nature if (1) the content is "educational"; (2) the material was prepared by following procedures generally accepted as "educational"; (3) the publication's distribution is necessary or useful to accomplish the organization's educational purposes; and (4) the manner in which the materials is distributed is distinguishable from ordinary commercial practices. In this ruling, an organization was

formed for the purpose of encouraging basic research in specific types of physical and mental disorders, to improve educational procedures for teaching those afflicted with such disorders, and to disseminate educational information about such disorders, by the publication of a journal containing current technical literature relating to these disorders. The IRS ruled that the organization qualified under Section 501(c)(3) , stating:

> The methods used in preparing and presenting the abstracts conform to methods traditionally accepted as "educational" in character. The organization provides a reference to literature on the research undertaken in the area, and enables the afflicted to receive improved instruction and treatment. The distribution of the abstracts is carried out essentially in a "charitable" manner, in the sense that there is a public benefit derived from the distribution. The charges for the publication recover only a portion of the costs.

The IRS noted that the facts in this ruling were distinguishable from another ruling, Rev. Rul. 60-351 , [20] "involving an organization which is publishing a magazine and selling it to the general public in accordance with ordinary commercial publishing practices." Unlike in Rev. Rul. 67-4 , where the charges for the publication recovered only a portion of the cost, in Rev. Rul. 60-351 , the publication was sold to the general public at "regular subscription rates" which accounted for most of its revenue, with only a limited amount received in the form of charitable contributions.

Interestingly, in finding that the organization in Rev. Rul. 60-351 failed to meet the requirements of Section 501(c)(3) , the IRS particularly noted that the articles of incorporation of the organization, in addition to providing that it was formed to further charitable, scientific, literary, and educational purposes, also stated that it was organized to publish a magazine "to provide a vehicle for the creative activity of writers and scholars," which the IRS determined was not limited to furthering Section 501(c)(3) tax-exempt purposes. Based upon the specific authority in the articles of incorporation of the organization "to publish a magazine, the use or distribution of which is not distinctly required to accomplish any" Section 501(c)(3) purposes, the IRS concluded in Rev. Rul. 60-351 that the corporation "was devoted to publishing a magazine and selling it to the general public in accordance with ordinary commercial practices," thereby causing it not to be considered organized exclusively for Section 501(c)(3) purposes.

Indeed, consistent with Rev. Rul. 60-351 , where the primary activity is undertaken in a way in which the IRS considers it to have a "commercial hue," an organization's tax-exempt status may be at risk.[21] In *Living Faith, Inc.*,[22] for example, in determining whether the organization qualified under Section 501(c)(3) , the court stated that the "particular manner in which an organization's activities are conducted, the commercial hue of those activities, competition with commercial firms, and the existence and amount of annual or accumulated profits, are all relevant evidence in determining whether an organization has a substantial nonexempt purpose." The court then recognized that although an organization was not disqualified from tax-exempt status solely because its primary activities constituted operating a business, when it conducts a business with an apparently commercial character as its primary activity, that fact weighs heavily against exemption. In this case, the organization's primary activity was the operation of restaurants and health food stores that were considered commercial in nature and, therefore, it did not qualify for exemption. In making the determination regarding its commercial nature, the court emphasized that the organization competed with other commercial enterprises, operated in a manner consistent with commercial businesses, engaged in substantial advertising, and did not solicit charitable contributions.

Nonprofit news organizations that have successfully attained Section 501(c)(3) status have focused on the delivery of public interest journalism through print and interactive media, and rely substantially upon charitable contributions for their ongoing operations as opposed to the more traditional subscription and advertising revenue sources of commercial newspapers. They provide coverage of such issues as the environment, housing, homelessness, transportation, education, politics, government, public policy, and breaches of the public trust.

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Examples of news organizations classified as tax-exempt organizations under Section 501(c)(3) include the San Francisco Public Press, ProPublica, Mother Jones, The Texas Tribune, and the Voice of San Diego. Interestingly, the San Francisco Public Press, which applied for tax-exempt status in January 2010, did not receive a favorable IRS determination until more than two and a half years following the submission of its application, and other news organizations seeking such status also faced long waits for IRS approval, [23] while the IRS was apparently wrestling with the issue of whether journalism fell within the educational purpose enumerated under Section 501(c)(3) .

Although the Philadelphia Inquirer and the Tampa Bay Times are owned by charities, as for-profit newspapers, they are not subject to the "educational" and "non-commercial" requirements imposed on Section 501(c)(3) tax-exempt organizations. Because it is seeking tax-exempt status, the Salt Lake Tribune, the first legacy newspaper apparently seeking to do so, would have to meet such requirements, in addition to giving up its for-profit ownership structure and political endorsements. The 148-year-old Salt Lake Tribune provides a wide mix of coverage well beyond investigate journalism, including sports and entertainment, which are not the type of topics generally considered to be "educational" or to further other tax-exempt purposes enumerated under Section 501(c)(3) , perhaps setting the stage for a challenge by the IRS to a successful transition of the newspaper from for-profit to tax-exempt.

Under the "operational test" applicable to a Section 501(c)(3) tax-exempt organization, it is not necessary for an organization to engage "exclusively" in activities accomplishing tax-exempt purposes. Instead, the standard is that the organization must engage "primarily in activities that accomplish one or more of such exempt purposes specified in Section 501(c)(3) ... An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose." [24] In *Better Business Bureau,* [25] where the asserted basis for the exemption under Section 501(c)(3) was "educational," the U.S. Supreme Court stated:

> In this instance, in order to fall within the claimed exemption, an organization must be devoted to educational purposes exclusively. This plainly means that the presence of a single non-educational purpose, if substantial in nature, will destroy the exemption

> regardless of the number or importance of truly educational purposes. It thus becomes unnecessary to determine the correctness of the educational characterization of petitioner's operations, it being apparent beyond dispute that an important if not the primary pursuit of petitioner's organization is to promote not only an ethical but also a profitable business community. The exemption is therefore unavailable to petitioner.

An organization operating a newspaper, including one that is seeking Section 501(c)(3) status, is essentially engaged in a trade or business. Where an organization otherwise meets the requirements of Section 501(c)(3) , the operation of a trade or business by such organization that contributes importantly to the accomplishment of the tax-exempt purposes constituting the basis for its tax-exempt status will not negatively impact its Section 501(c)(3) exempt status. [26] Therefore, even where an organization conducts a trade or business of operating a newspaper as its primary activity, Section 501(c)(3) tax-exempt status is still available where the activities of the newspaper substantially further the organization's educational purposes, [27] such as the provision of public interest and investigative journalism for the benefit of the local community. Indeed, this is the case with the various

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nonprofit news organizations across the country that have obtained a favorable IRS ruling as to their Section 501(c)(3) tax-exempt status where, apparently, the IRS determined that the organizations were being operated in a manner that lacks a commercial character.

As indicated in *Better Business Bureau*, if more than an insubstantial part of an organization's activities is in furtherance of purposes other than those described in Section 501(c)(3) , the Section 501(c)(3) status of the organization will be at risk under the operational test of Section 501(c)(3) . Thus, the coverage by a newspaper of sports, entertainment, and other topics that may be beyond that which is considered "educational" under Section 501(c)(3) and therefore not considered to contribute importantly to the accomplishment of a tax-exempt purpose, if more than as an insubstantial part of the entire coverage provided by the paper, could lead to disqualification under Section 501(c)(3) .

Under a so-called "fragmentation rule" under Reg. 1.513-1(b) , an activity does not lose its identity as a trade or business merely because the activity is carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that may, or may not, be related to the exempt purposes of the organization. The regulations provide, for example, that "activities of soliciting, selling, and publishing commercial advertising do not lose identity as a trade or business even though the advertising is published in an exempt organization periodical which contains editorial matter related to the exempt purposes of the organization." Thus, a legacy newspaper that continues to cover sports and entertainment within the body of one newspaper whose primary purpose is educational may be viewed as operating two separate trades or businesses, one an "unrelated trade or business" and the other a "related trade or business."

Because an organization running a newspaper may be considered to be operating an unrelated trade or business with respect to its "non-educational" coverage, it is instructive to look to the "commensurate in scope" test of Rev. Rul. 64-182 , [28] and the related provisions under Reg. 1.501(c)(3)-1(e)(1) . Under this authority, an organization otherwise qualifying under Section 501(c)(3) will not be disqualified from such status "although it operates [an unrelated] trade or business as a substantial part of its activities" provided, however, that the organization "is not organized and operated for the primary purpose of carrying on an unrelated trade or business" and the Section 501(c)(3) tax-exempt activities "are commensurate in scope" with its financial resources." [29] The IRS has recognized that by its terms, "the 'primary purpose' test recognizes that under certain circumstances, the operational requirement of Code § 501(c)(3) may be met even though an organization operates [an unrelated] trade or business as a substantial part of its activities." [30]

The IRS has emphasized that the "primary purpose test" under Reg. 1.501(c)(3)-1(e)(1) is "essentially a proof requirement, the practical application of which results in a denial of an exempt status only if it affirmatively appears that the particular trade or business activities in question are being so conducted as to substantially serve some non-exempt purpose. The test is satisfied if the facts show that an organization is carrying on a charitable program reasonably commensurate with its financial resources, including income from business activities." [31]

In GCM 34682 (1971) , for example, the IRS stated that so long as the profits of a department store owned by a nonprofit corporation "have been effectively dedicated to some charitable objective ... such organization could engage in an indeterminate amount of business and still be exempt under Section 501(c)(3) so long as it can be said that there is a reasonable operation of the property for the beneficial use of charity. In such case, we would regard it as being operated exclusively for charitable purposes, and not for the primary purpose of carrying on unrelated trade or business within the meaning of regulations section 1.501(c)(3)-1(e)." In determining the existence or nonexistence of such primary purpose, all the circumstances

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must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes. [32]

In the case of a legacy newspaper seeking Section 501(c)(3) exempt status, the continued provision of sports, entertainment, and other coverage beyond that which may be considered "educational" would appear to be essential to the organization's ongoing ability to maintain and attract readers, which is vital to sustaining the very existence of the newspaper and its ability to provide the type of public interest journalism that the IRS has considered to be educational in granting Section 501(c)(3) tax-exempt status to newly created news organizations. That is, the discontinuation of the sports, entertainment, and other non-educational coverage that a legacy paper has historically provided, and which readers have come to expect, could jeopardize the continued viability of the paper and, therefore, its very ability to provide any coverage, including public interest journalism important to the local community that otherwise furthers a Section 501(c)(3) tax-exempt purpose.

Indeed, the sports and entertainment coverage of a legacy newspaper seeking Section 501(c)(3) tax-exempt status may be just as necessary to the fulfillment of a newspaper's educational purposes as in the case of GCM 34682 , where the profits of a department store owned by a charity were essential to the charity's ability to continue its charitable activities. In determining the effect of such non-educational coverage on the Section 501(c)(3) status of a legacy newspaper, it would appear appropriate to apply the commensurate in scope test, given that such non-educational coverage of a newspaper may essentially be considered to be an unrelated trade or business carried on in conjunction with, and as part of, a larger trade or business that directly furthers educational purposes under Section 501(c)(3) by primarily providing investigative and other public interest journalism for the benefit of the local community.

It would appear, therefore, that so long as a legacy newspaper otherwise meets all of the requirements under Section 501(c)(3) and is operated in a manner that is distinguishable from a commercial newspaper, then continuing to provide sports, entertainment, and other coverage that may not be considered to be "educational" should not be fatal to the Section 501(c)(3) tax-exempt status provided, however, that the primary purpose of the paper is not the coverage of sports, entertainment, or other non-educational issues and any revenue produced by the paper is effectively and primarily dedicated to the achievement of the Section 501(c)(3) tax-exempt objectives of the paper, such that the educational activities of the newspaper are commensurate in scope with its financial resources.

As indicated by the IRS and the courts, a determination regarding "commerciality" is a question of fact and all relevant evidence is to be considered. In this regard, factors such as soliciting contributions from the public, contributions constituting a major source of funding, reduced emphasis on advertising and subscription revenue, not engaging in competitive pricing so as to encourage readership rather than to generate profits, the lack of substantial accumulated earnings, the use of volunteer workers, and partnering to further educational purposes with other tax-exempt organizations, such as colleges and universities, among other possible distinguishing features from a for-profit newspaper, are all helpful to establish that a Section 501(c)(3) tax-exempt organization is not engaged in an activity comparable to a for-profit newspaper.

Thus, while a newspaper devoted solely to sports and entertainment would not likely qualify for Section 501(c)(3) tax-exempt status, a legacy newspaper that only incidentally covers these areas in order to continue to attract readers to a newspaper focusing primarily on public interest journalism and other "educational" purposes that can be distinguished from a commercial newspaper presumably should qualify as a tax-exempt entity under Section 501(c)(3) .

Indeed, without the incidental sports and entertainment coverage that induces the continued readership of a legacy newspaper, the educational objectives of the newspaper may never be even accomplished. There is, of course, no certainty that the IRS will agree with this approach and it may simply take the position that mixing sports and entertainment coverage with public interest journalism is fatal to attaining tax-exempt status or that a particular newspaper is operating in a manner indistinguishable from a commercial enterprise.

Funding of for-profit newspaper through philanthropy

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Even where a newspaper retains its for-profit status, it is still possible for it to receive funding directly from private foundations and other charitable foundations for certain public interest journalism beneficial to the community, and this in fact is being done. A grant by a private foundation in this context can be applied against its annual 5% minimum distribution requirement. Although the grantee in this situation is a for-profit entity, the grant must be used to accomplish tax-exempt purposes and, indeed, in Rev. Rul. 74-587, 1974-2 CB 162 , the IRS specifically recognized that for-profit entities may serve as "the instruments by which the charitable purposes are sought to be accomplished." Thus, the focus in this situation is not on the entity receiving the funds, but on the use of the funds for tax-exempt purposes.

Private foundations can indeed make grants to "noncharitable" organizations and treat these grants as qualifying distributions and not taxable expenditures if the foundation exercises expenditure responsibility and complies with the requirements of the applicable regulations, including complying with Reg. 53.4945-6 ("Expenditures for noncharitable purposes"), whereby the grantee must maintain the grant funds in a separate fund dedicated to Section 170(c)(2)(B) tax-exempt purposes. Indeed, many private foundations across the country are funding local journalism at for-profit newspapers. Public charities may similarly make a grant to a for-profit newspaper and in making such grants to noncharitable entities typically follow the rules applicable to private foundations, so as to ensure the grant funds will be used for tax-exempt purposes.

For example, in 2012, the Ford Foundation awarded a $500,000 grant to the Washington Post for government-accountability coverage. That same year, the Ford Foundation awarded a $1 million grant to the Los Angeles Times to hire five journalists, including one in Brazil, to focus on the Vietnamese, Korean, and other immigrant communities, the California prison system, the border region, and Brazil. In 2010, the Gates Foundation awarded a $1.5 million grant to ABC News to expand coverage of global health issues. In each case, although the grant was made to a for-profit newspaper, the grants were made exclusively to further tax-exempt purposes.

Individuals, of course, as well as corporations, may not claim an income tax deduction for a charitable contribution made directly to a for-profit newspaper. The alternative is to make a contribution to a tax-exempt entity that supports public interest journalism coverage of a for-profit newspaper, such as to a charitable foundation that supports local journalism, even where the local journalism is carried out by a for-profit newspaper. In addition, as the Seattle Times situation demonstrates, a for-profit newspaper may establish a fund at a community or other charitable foundation, to seek philanthropic support for investigative journalism from individual donors. Because the donations are made to a tax-exempt organization, which retains control and oversight over the funds, contributions are tax-deductible, although used to support public interest journalism at a for-profit newspaper.

Conclusion

Local newspapers across the country, whether in printed or digital form, are turning to philanthropy to help sustain their operations. As demonstrated recently by the Seattle Times, the Salt Lake Tribune, and the Philadelphia Inquirer, there is no "one size fits all" model, as there are various alternatives available to local newspapers to attract philanthropic dollars from individuals, private foundations, and other donors, whether the newspaper is a for-profit entity or a Section 501(c)(3) tax-exempt organization.

A newspaper, including a legacy for-profit newspaper seeking to convert to nonprofit status, can qualify under Section 501(c)(3) if its primary purpose is educational and it does not operate in a manner comparable to a commercial newspaper, a question of fact in each case. While it would appear that a legacy newspaper that can otherwise qualify under Section 501(c)(3) could continue to engage, to a limited extent, in the coverage of non-educational topics, such as sports and entertainment, there is no certainty that the IRS will accept this position.

[1] Letter from Thomas Jefferson to Edward Carrington (1/16/1787).

[2] Sulzberger, "Accusing the New York Times of 'Treason,' Trump Crosses a Line," Wall Street Journal (6/19/19).

[3] Keane, "The U.S. Newspaper Crisis Is Growing: More Than 1 in 5 Local Papers Have Closed Since 2004," The Salon (10/16/18). See also 6/6/19 Press Release by Congressman Mark DeSaulnier, issued in connection with the introduction of the Saving Local News Act of 2019, stating "Today many local newspapers are dying out-penny pinching until they close or are bought up and sold off piecemeal by hedge funds."

[4] Hagey, Alpert, and Serkez, "In News Industry, a Stark Divide Between Haves and Have-Nots," Wall Street Journal (5/4/19).

[5] Hare, "How the Seattle Times Brought in More Than $4 million to Fund Critical Coverage," Poynter (8/22/18).

[6] For a discussion of available fiscal sponsorship models, see Chiodini and Colvin, "The Use of LLCs in Fiscal Sponsorship-A New Model," Taxation of Exempts (May/June 2011).

[7] "Seattle Times Launches Investigative Journalism Fund," Seattle Times (4/14/19). See: https://company.seattletimes.com/investigativefund/ ("The Seattle Times Investigative Journalism Fund, an initiative with the Seattle Foundation, is collaborating with community funders and personal champions of the free press to ensure the future of local investigative journalism and protect and expand the ambitious, rigorously reported work that has a direct impact on our community.")

[8] In Rev. Rul. 74-587, 1974-2 CB 162 , the IRS specifically recognized that for-profit entities may serve as "the instruments by which the charitable purposes are sought to be accomplished." Indeed, provided the expenditure responsibility requirements under Section 4945 are followed, it is permissible for a private foundation to make an outright grant to a for-profit entity as long as it is to be used exclusively for tax-exempt purposes. See Reg. 53.4945-6(c) ("Grants to 'noncharitable' organizations").

[9] A donor may earmark a contribution to a qualified charity for a particular purpose or use without jeopardizing the charitable deduction, provided that such restrictions do not prevent the charity from freely and effectively employing the transferred assets, or the income therefrom, in furtherance of its exempt purposes. See *Phinney v. Dougherty*, 10 AFTR2d 5531 , 307 F2d 357 (CA-5, 1962); Reg. 1.507-2(a)(8)(i). In *Winn, Jr.*, 44 AFTR2d 79-5076 , 595 F2d 1060 (CA-5, 1979), the court concluded that a contribution is considered "to or for the use of" a charity, as required for deductibility under Section 170(a) , "despite the fact that the donor controlled which of the qualified entity's charitable purposes would receive the exclusive benefit of the gift." For a further discussion of restrictions placed on charitable contributions by donors, see Fox, "Planning for Donor Control and Other Strings Attached to Charitable Contributions," Estate Planning Journal (Sept. 2003).

[10] Rosman, "Can Paul Huntsman Save The Salt Lake Tribune?," New York Times (5/17/19). Note that under Section 337 , a for-profit newspaper converting to Section 501(c)(3) tax-exempt status must recognize any built-in gain upon conversion.

[11] Pending the IRS approval of the transition to Section 501(c)(3) tax-exempt status, the Salt Lake Tribune will retain its current business model, as stated by Paul Huntsman, the Tribune's publisher, to

the readers on 5/8/19, stating:

> We are in the beginning stages of transitioning The Salt Lake Tribune to a 501(c)(3) nonprofit organization. We will be the first legacy newspaper in the United States to take this bold move. To be clear, there are no immediate changes to our current business model or to subscriptions while we await approval from the IRS.I have always seen The Salt Lake Tribune as Utah's institution, much like our libraries, hospitals and the arts and cultural organizations that enrich our lives and reflect our shared civic goals. I will continue to serve as publisher, and Jennifer Napier-Pearce will continue in her role as editor.These are challenging times for our nation, our state, and journalism. Utahns have relied on The Tribune to make sense of the world around us, to create a common conversation that crosses geography and party lines, and to participate effectively in a democratic society. By transitioning to a nonprofit business model we are ensuring that Utahns will continue to have the impactful, empowering journalism they need in perpetuity.

[12] Reg. 1.501(c)(3)-1 (requiring an organization to be "both organized and operated exclusively for one or more" exempt purposes in "order to be exempt as an organization described in Section 501(c)(3) ."

[13] Griggs, "Could It Be Sunny In Philadelphia," The Knight Foundation (6/15/16); Friedlich, "Must Newspapers Die? A Prescription for Revitalizing Local News," Philadelphia Inquirer (3/15/19). For more information on the Lenfest Institute for Journalism, see: www.lenfestinstitute.org/about/.

[14] Stan Wischnowski, Executive Editor and Senior Vice President of the Philadelphia Inquirer, has stated: "Our status as a public benefit corporation owned by the nonprofit Lenfest Institute for Journalism means that we're not beholden to any Wall Street shareholders, hedge funds, or corporate owners looking to profit off our work. We are beholden solely to the citizens of the Philadelphia region, a rare and coveted position given the many pressures facing the news industry." See "Indispensable Journalism,' Philadelphia Inquirer (3/31/19).

[15] For a discussion of the Newman's Own rule, see Fox, "Private Foundations Can Now Own 100% of Business Enterprise," Estate Planning Journal (November 2018).

[16] While a private foundation can make a grant to a for-profit newspaper under Reg. 53.4945-6(c) , it must, among other things, exercise expenditure responsibility in accordance with Section 4945(h) .

[17] Reg. 1.501(c)(3)-1(a)(1) .

[18] The bill is supported by the News Media Alliance, the National Newspaper Association, the American Society of News Editors, the Associated Press Media Editors, the Association of Alternative Newsmedia, the California News Publishers Association, Free Press Action, and the Open Markets Institute.

[19] 1967-1 CB 121.

[20] 1960-2 CB 169.

[21] Moore, "Commercial Activities and Subsidiaries-Issues and Choices in Planning," Taxation of Exempts (January/February 2017).

[22] 69 AFTR2d 92-301 , 950 F.2d 365 (CA-7, 1991), aff'g TCMemo 1990-484 .

[23] See "Nonprofit News Outlets Face Long Waits for IRS Approval," Chronicle of Philanthropy

(10/23/11).

[24] Reg. 1.501(c)(3)-1(c)(1) .

[25] 34 AFTR 5 , 66 S Ct 112 (S Ct, 1945).

[26] Reg. 1.501(c)(3)-1(c)(1) , (e)(1); *Dumaine Farms*, 73 TC 650 (1980); *B.S.W. Group*, 70 T.C. 352 (1978).

[27] *Id.*

[28] 1964-1 CB 186.

[29] The "commensurate in scope" language is contained in Rev. Rul. 64-182 , where notwithstanding an organization deriving its income principally from the rental of space in a large commercial office building which it owned, maintained, and operated, the IRS ruled that the organization would be entitled to tax exemption under Section 501(c)(3) where it is shown to be carrying on a charitable program "commensurate in scope with its financial resources."

[30] GCM 36130 (1975) . See also GCM 34682 (1971) .

[31] *Id.*

[32] Reg. 1.501(c)(3)-1(e)(1) .

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Enclosure 7

Treasury Regulations Clarify Requirements for Type III Supporting Organization Status,

Journal of Taxation, Nov 2016

EXEMPT

Treasury Regulations Clarify Requirements for Type III Supporting Organization Status

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In order to eliminate perceived abuses and to make sure that Type III supporting organizations advance the charitable purposes of their supported organizations, recent regulations have added complexity to the tax rules, while making it clear that these rules must be followed to avoid treatment as private foundations *rather than as public charities.*

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The so-called "Type III supporting organization" (SO), [1] which came into existence as a result of the enactment of Section 509(a)(3) under the Tax Reform Act of 1969, [2] is one of the most complex Section 501(c)(3) tax-exempt organizations. Although it may often bear a striking resemblance to a private foundation, particularly in the case of a charitable trust whose sole purpose is to make payments to one or more publicly supported organizations, [3] a Type III SO is classified as a public charity and is therefore not subject to the strict and burdensome tax regime, chock-full of potential excise tax penalties, applicable to private foundations. [4]

Over the years, both Congress and the IRS have struggled with the treatment of Type III SOs, particularly in light of their perceived abuses, from considering eliminating them altogether to subjecting them to rules more akin to those applicable to private foundations. [5] After years of debate and dialogue, including congressional hearings on the subject, [6] the Pension Protection Act of 2006 (PPA) [7] made a vast array of changes to Type III SOs that were intended to curb perceived abuses, while continuing to bestow public charity status upon these entities. This new statutory framework did not, however, contain a precise set of rules defining the new requirements for Type III SO status, as the PPA opted instead to direct the Treasury and the IRS to issue regulations to provide such guidance. As a result, after the enactment of the PPA, there was substantial uncertainty as to whether existing Type III SOs, including certain charitable trusts, could continue to qualify as Type III SOs and what measures such entities

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should take in order to maintain their status in a post-PPA Type III SO tax regime. Indeed, as a result of such uncertainty, many existing charitable trusts that were historically classified as Type III SOs opted simply to convert, albeit sometimes erroneously, to private foundation status, rather than risk running afoul of the new requirements. [8]

Pending the issuance of the regulations required by the PPA, the Treasury and IRS took steps to provide interim guidance on the new requirements applicable to Type III SOs, first in the form of an Advanced Notice of Proposed Rulemaking in 2007, and then in proposed regulations in 2009. [9] Although these measures were not effective until either final or temporary regulations were promulgated, they provided an indication of the changes to come, gave taxpayers time to prepare for such changes, and allowed for taxpayer comment before temporary or final regulations were issued.

On 12/28/12, more than six years after the enactment of the PPA (and more than three years after the issuance of the proposed regulations in 2009), the Treasury and IRS finalized portions of the 2009 regulations and issued temporary and proposed regulations providing the promised guidance on Type III SOs. [10] The Preamble to the regulations indicated, however, that additional guidance in this area was anticipated. [11] Subsequently, on 12/23/15, final regulations were issued (and the 2012 temporary regulations removed) regarding the distribution requirements applicable to Type III SOs [12] and then, on 2/19/16, proposed regulations were issued to clarify a number of important issues that had not been resolved by the earlier issued regulations. [13] The 2016 proposed regulations are generally effective on the date the Treasury decision adopting these rules as final or temporary regulations is published in the Federal Register. However, until such time, taxpayers may rely on the provisions of the proposed regulations.

The current set of regulations that have been issued since the enactment of the PPA revise and clarify the requirements for Type III SO status that had been lacking under the statutory regime put in place under the PPA. The regulations also make significant changes to the historical requirements for Type III SO status and add

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complexity to an already complicated tax regime, presenting substantial challenges to organizations seeking to achieve or maintain such status.

This article addresses the requirements for an organization to qualify for Type III SO status in a post-PPA tax regime, as implemented by regulations issued by the Treasury and the IRS over the years following the enactment of the PPA in 2006, including the recently proposed regulations published on 2/19/16.

OVERVIEW OF SOs

An SO is one of the most complex, technical, and least understood of all Section 501(c)(3) tax-exempt organizations. [14] It has also been one of the most controversial and scrutinized tax-exempt organizations. An SO is excluded from the definition of a private foundation and is, therefore, classified as a public charity, essentially on a derivative basis by virtue of its support of, and relationship with, the one or more public charities that it supports. An SO can be formed as a nonprofit corporation or as a charitable trust and is a separate and distinct legal entity from the charity or charities it supports. In order to qualify as an SO, the organization must meet each of the following three statutory requirements under Section 509(a)(3) : [15]

(1) 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 publicly supported organizations. [16]

(2) To ensure that a public charity has the ability and motivation to properly oversee its activities, the organization must have one of three possible relationships with one or more publicly supported organizations which, depending on the type of relationship, results in the organization being known as a Type I, Type II, or Type III SO. The three alternative types of relationships are where the SO is (1) "operated, supervised or controlled by" (Type I); (2) "supervised or controlled in connection with" (Type II); or (3) "operated in connection with" one or more publicly supported organizations (Type III). [17]

(3) The organization must not be controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946) other than foundation managers with respect to such organization and other than the one or more publicly supported organizations the organization supports. [18]

TYPE III SOs GENERALLY

The Type III SO, whose relationship with the supported organization is tested under the "operated in connection with" standard, has the least intimate relationship with its supported organizations of any type of SO. It is not subject to the control of the supported organization or its board members, but has its own independent board. As a result, there is a lower threshold of supported organization participation in a Type III SO's operations. Because it has the most attenuated relationship with the supported organizations of any type of SO, the Type III SO has traditionally been subject to the most complexity, and the most IRS scrutiny. [19]

To meet the "operated in connection with" requirement, a Type III SO must meet a "responsiveness test" and an "integral part test." The responsiveness test generally requires that the SO be responsive to the needs or demands of its supported organization. The integral part test is generally met by the Type III SO maintaining a significant involvement in the operations of one or more supported organizations that are dependent on the SO for the type of support which it provides. The PPA added additional requirements that must be met in order to achieve Type III SO status, which are discussed below.

CHANGES TO TYPE III SOs UNDER THE PPA

The PPA made a vast array of statutory changes to the tax regime applicable to Type III SOs, including introducing two newly-created categories of Type III SOs: the "functionally integrated Type III SO" and the "non-functionally integrated Type III SO." The functionally integrated Type III SO meets the integral part test due to the activities of the organization-that is, by performing the functions of, or carrying out the purposes of, its supported organizations. The non-functionally integrated Type III SO meets the integral part test by virtue of distributing funds to its supported organizations so that its activities tend to focus on grant-making, similar to a private foundation. Whether a Type III SO is "functionally integrated" or "non-functionally integrated" is a very important distinction because many of the limitations and restrictions

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imposed on Type III SOs under the PPA apply only if the organization is a non-functionally integrated Type III SO, [20] making the functionally integrated Type III SO more attractive from a tax standpoint. In addition to the creation of the two new categories of Type III SOs, the PPA made the following changes to the requirements for Type III SO classification by:

(1) Removing an alternative test historically available for charitable trusts as a means of meeting the responsiveness test, thereby requiring such trusts to meet the general responsiveness test that otherwise applies to all Type III SOs.
(2) Requiring the IRS to set a new annual payout requirement for non-functionally integrated Type III SOs to ensure that such organizations pay a significant amount to their supported organizations.
(3) Imposing a notification requirement, whereby a Type III SO must annually provide to each of its supported organizations such information as the IRS may require.
(4) Prohibiting a Type III SO from supporting any supported organization not organized in the United States.
(5) Prohibiting a Type III SO from accepting a gift or contribution from a person who, together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type III SO.

MEETING THE REQUIREMENTS OF A TYPE III SO IN A POST-PPA TAX REGIME

Under the PPA, as implemented by regulations issued by the Treasury and the IRS, in order to be classified as a Type III SO, the organization must:

(1) Be organized and operated exclusively for the benefit of one or more specified domestic publicly supported organizations.
(2) Meet both a "responsiveness test" and an "integral part test," with the nature of the integral part test dependent on whether it is functionally integrated or non-functionally integrated.
(3) Not be controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946) other than foundation managers with respect to such organization and other than the one or more publicly supported organizations the organization supports.
(4) Meet annual notification requirements with respect to each of the one or more publicly supported organizations it supports.
(5) Not receive contributions from persons with direct or indirect control of any supported organization.

Organized and Operated Exclusively for the Benefit of One or More Domestic Publicly Supported Organizations

As is the case with all SOs, a Type III SO 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 publicly supported organizations described in Sections 509(a)(1) or (2).[21] There is no limitation on the number of publicly supported organizations a Type III SO may support.[22] An organization may not qualify as a Type III SO if it supports any supported organization organized outside of the United States.[23] Thus, U.S. "friends" organizations that are formed to support a specific foreign charity can no longer qualify as Type III SOs, although such organizations can generally qualify as a public charity under Section 509(a)(1) , assuming that it receives sufficient public support.

Responsiveness Test

Whether a Type III SO is functionally integrated or non-functionally integrated, it must meet a "responsiveness test," so as to ensure that it is responsive to the needs or demands of a supported organization.[24] To do this, (1) the Type III SO must have a specified relationship with a supported organization and (2) by virtue of such relationship, the officers, directors, or

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trustees of the supported organization must be considered to have a "significant voice" in the operations of the Type III SO. The Treasury and the IRS have stated that they anticipate that Type III SOs may be able to demonstrate that they satisfy the responsiveness test in a variety of ways, and that the determination will be based on all the facts and circumstances.[25]

Requisite Relationship. A Type III SO will have the requisite relationship with respect to a supported organization only if: (1) one or more officers, directors, or trustees of the SO are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (2) 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 SO; or (3) the officers, directors, or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization.[26]

Significant Voice Requirement. A Type III SO will meet the significant voice requirement only if the officers, directors, or trustees of the SO have a significant voice in the investment policies of the SO, the timing of grants, the manner of making grants, and the selection of grant recipients by such SO, and in otherwise directing the use of the income or assets of the SO.[27]

Responsiveness Test for Charitable Trusts. Consistent with the elimination of the alternative responsiveness test historically applicable to charitable trusts, the regulations do not adopt a special rule for charitable trusts.[28] Thus, charitable trusts, including those having institutional trustees, must meet the same responsiveness test applicable to all other Type III SOs. The regulations make it clear, however, that, notwithstanding the elimination of the alternative responsiveness test historically available for charitable trusts, a charitable trust may nonetheless still be able to meet the responsiveness test applicable to all other Type III SOs. The Preamble to the 2012 regulations states that as "a general matter, the Treasury Department and the IRS anticipate that charitable trusts will be able to demonstrate that they satisfy the responsiveness test in a variety of ways, and whether a supported organization has a close and continuous relationship with, or a significant voice in directing the use of the income or assets of, a supporting organization will be determined based on all the relevant facts and circumstances." The regulations provide the following specific example that illustrates factors demonstrating how a trust can be responsive to the needs of its supported organization:

> X, an organization described in section 501(c)(3), is a trust created under the last will and testament of Decedent. The trustee of X (Trustee) is a bank. Under the trust instrument, X supports M, a private university described in section 509(a)(1). The trust instrument provides that Trustee has discretion regarding the timing and amount of distributions consistent with the Trustee's fiduciary duties. Representatives of Trustee and an officer of M have quarterly face-to-face or telephonic meetings during which they discuss M's projected needs and ways in which M would like X to use its income and invest its assets. Additionally, Trustee communicates regularly with that officer of M regarding X's investments and plans for distributions from X. Trustee provides the officer of M with quarterly investment statements, the information required under paragraph (i)(2) of this section, and an annual accounting statement. Based on these facts, X meets the responsiveness test ... with respect to M. [29]

This example shows the importance attached to regular communication and interaction between a charitable trust and a supported organization in establishing that the trust meets the responsive test, including such things as the trustee of the SO instituting regular meetings with its supported organizations, whether face-to-face or telephonically; [30] having regular discussions regarding the needs of the supported organizations; and taking into account and, when deemed appropriate, following the recommendations of the supported organizations in connection with the operations of the SOs, including with respect to such things as investment of assets, the timing of payments to the supported organizations, and other matters pertaining to the operations of the SOs.

Although the example in the regulations involves a charitable trust, there is no reason it could not be applied to a nonprofit corporation for purposes of determining whether the responsiveness test is met in that context. Indeed, the Treasury and the IRS have noted that, although the examples in the regulations relating to the responsiveness test may involve a Type III supporting organization that is organized as either a corporation or a trust, the applicable law and relevant regulatory provisions apply to all Type III SOs in the same manner, whether organized as a corporation or a trust. [31]

In the absence of regular communication and interaction between an SO and its supported organizations, the responsiveness test will not be met, as illustrated by the following example in the regulations:

> Y is an organization described in section 501(c)(3) and is a trust under State law. The trustee of Y (Trustee) is a bank. Y supports charities P, Q, and R, each an organization described in section 509(a)(1). Y makes annual cash payments to P, Q, and R. Once a year, Trustee sends to P, Q, and R the cash payment, the information required under paragraph (i)(2) of this section, and an accounting statement. Trustee has no other communication with P, Q, or R. Y does not meet the responsiveness test. [32]

Responsiveness Test Must Be Met for Each Supported Organization.The 2016 proposed regulations clarify that the responsiveness test must be met with respect to each and every supported organization. [33] In imposing this requirement, the Treasury and the IRS note in the Preamble to the proposed regulations that the distinguishing characteristic of Type III SOs, and the basis for their public charity classification, is that they are responsive to and significantly involved in the operations of their publicly supported organizations. [34] The Preamble further indicates that, unless a Type III SO is responsive to each of its supported organizations, the supported organizations cannot exercise the requisite level of oversight of and engagement with the SO, and it stated that limiting the responsiveness requirement to fewer than all of the supported organizations may result in the necessary oversight and accountability being present for less than all of an SO's operations.

To illustrate how concerns about potential administrative burdens may be addressed consistent with the applicability of the responsiveness test to all supported organization, the proposed regulations include a new example. [35] The new example is intended to demonstrate one way in which a Type III supporting organization that supports multiple organizations may satisfy the responsiveness test in a manner that can be cost-effective. The example shows that an SO can, with respect to each of its supported organizations, meet a different subset of the required relationships between the SO and its supported organizations. It also shows how a supporting organization can organize and hold regular meetings, including those held jointly or separately, provide information, and encourage communication to help ensure that all of the supported organizations have a significant voice in the operations of the supporting organization. The following is a summary of the new example, whereby the SO is considered to meet the relationship [36] and significant voices tests with respect to each of its supported organizations and, therefore, to meet the responsiveness test with respect to each of its ten supported organizations.

> Z is described in Section 501(c)(3) and its organizational documents provide that it supports ten different organizations, each of which is a public charity described in Section 509(a)(1) . One of the directors of S, one of the ten supported organizations, is a voting member of Z's board of directors and participates in Z's regular board meetings. Officers of Z hold regular face-to-face or telephonic meetings during the year to which officers of all the supported organizations are invited. Z's meetings with the supported organizations may be held jointly or separately. Prior to the meetings, Z makes available to the supported organizations (including by email) up-to-date information about its activities including its assets and liabilities, receipts and distributions, and investment policies and returns. In the meetings, officers of each of the supported organizations have an opportunity to ask questions and discuss with officers of Z the projected needs of their organizations, as well as Z's investment and grant-making policies and practices. In addition to holding these meetings with the supported organizations, Z provides the contact information of one of its officers to each of the supported organizations and encourages them to contact that officer if they have questions, or if they wish to schedule additional meetings to discuss the projected needs of their organization and how Z should distribute its income and invest its assets.

Integral Part Test

The application of the integral part test depends on whether the Type III SO is functionally integrated or non-functionally integrated. A functionally integrated Type III SO meets the integral part test due to the activities of the organization-that is, by directly performing the functions of, or carrying out the purposes of, its supported organizations. A non-functionally integrated Type III SO meets the integral part test by virtue of distributing funds to a supported organization, not by conducting activities.

Functionally Integrated Type III SOs. A functionally integrated Type III SO is one that engages in activities "substantially all" [37] of which (1) "directly further" the exempt purposes of one or more supported organizations by performing the functions or carrying out the purposes of such supported organization(s) and (2) but for the involvement of the SO, would normally be engaged in by the supported organization. [38]

In this context, the activities must be conducted by the SO itself, rather than by a supported organization. [39] The regulations provide that holding title to or managing tax-exempt-use assets are activities that directly further the exempt purposes of a supported organization. [40] On the other hand, the regulations

clarify that fundraising, making grants (whether to the supported organization or to third-party organizations), and investing and managing non-exempt-use assets (such as investments) are not considered to directly further the exempt purposes of a supported organization. [41] The following are examples in which the integral part test is met by an SO carrying on activities that further the exempt purpose of its supported organization: [42]

> V, an organization described in Section 501(c)(3) , is organized and operated as a supporting organization to L, a church described in Section 509(a)(1) . L transferred to V title to the buildings in which L conducts religious services, Bible study, and community enrichment programs. Substantially all of V's activities consist of holding and maintaining these buildings, which L continues to use, free of charge, to further its exempt purposes. But for the activities of V, L would hold and maintain the buildings. V satisfies the integral part test.

> O is a local nonprofit food pantry described in Section 501(c)(3) . O collects donated food from local growers, grocery stores, and individuals and distributes this food free of charge to poor and needy people in O's community. O is organized and operated as a supporting organization to eight churches of a particular denomination located in O's community, each of which is described in Section 509(a)(1) . All of O's activities directly further the exempt purposes of the eight supported organizations. Additionally, but for the activities of O, the churches would normally operate food pantries themselves. O satisfies the integral part test.

> J, an organization described in Section 501(c)(3) , is organized as a supporting organization to community foundation G, an organization described in section 509(a)(1). In addition to maintaining field-of- interest funds, sponsoring donor advised funds, and

> conducting general grantmaking activities, G also engages in activities to beautify and maintain local parks. Substantially all of J's activities consist of maintaining all of the local parks in the area of community foundation G by performing activities such as establishing and maintaining trails, planting trees, and removing trash. But for the activities of J, G would normally engage in these efforts to beautify and maintain the local parks. Based on these facts, J satisfies the requirements of paragraph (i)(4)(ii) of this section [the integral part test].

The making or awarding of grants, scholarships, or other payments to individual beneficiaries who are members of the charitable class benefited by a supported organization is treated as a direct activity, but only if (1) the recipients are selected on an objective and nondiscriminatory basis consistent with the private foundation rules in Reg. 53.4945-4(b) ; (2) the officers, directors, or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making them, and the selection of recipients; and (3) the making or awarding of such payments is part of an active program of the SO that directly furthers the exempt purposes of the supported organization and in which the SO maintains a significant involvement consistent with that required in the case of a private operating foundation under Reg. 53.4942(b)-1(b)(2)(ii) . [43]

Parent of Supported Organization(s) and Organizations Supporting Governmental Supported Organization as Functionally Integrated Type III SOs. The regulations provide for two special types of functionally integrated Type III SOs. One is the parent of each of its supported organizations. [44] In order for an SO to qualify as the parent of each of its supported organizations, the supporting organization and its supported organizations must be part of an integrated system (such as a hospital system), the supporting organization must engage in activities typical of the parent of an integrated system, and a majority of the officers, directors, or trustees of each supported organization must be appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacities) of the supporting organization. Examples of activities typical of the parent of an integrated system of supported organizations include (but are not limited to) coordinating the activities of the supported organizations and engaging in overall planning, policy development, budgeting, and resource allocation for the supported organizations. [45]

The other type of functionally integrated Type III SO is one that supports a "governmental supported organization." [46] The requirements for this type are revised and clarified in the proposed regulations issued in 2016.

In the 2009 proposed regulations, an exception to the general rules for qualifying as a functionally integrated Type III SO was provided if the SO supported only one governmental entity, which was defined as an entity the assets of which are subject to the appropriations process of a federal, state, local, or Indian tribal government. The 2009 proposed regulations also provided that, in order to be considered functionally integrated, a "substantial part" of the supporting organization's total activities had to directly further the exempt purpose(s) of its supported organization, and that exempt purposes are not directly furthered by fundraising, grantmaking, or investing and managing non-exempt-use assets. The Treasury and IRS received multiple comments regarding this proposal. The 2012 TD stated that the Treasury and the IRS were continuing to consider the public comments on the 2009 proposed regulations regarding this governmental entity exception and reserved Reg. 1.509(a)-4(i)(4)(iv) for future guidance on how a Type III supporting organization can qualify as functionally integrated by supporting a governmental entity.

Prior to the issuance of the 2016 proposed regulations, however, the IRS provided transitional guidance in Notice 2014-4 ,[47] which provides that a Type III supporting organization will be treated as meeting the requirements of Reg. 1.509(a)-4(i)(4) , and thus will be treated as functionally integrated, if it: (1) supports at least one

supported organization that is a governmental entity to which the SO is responsive within the meaning of Reg. 1.509(a)-4(i)(3) ; and (2) engages in activities for or on behalf of the governmental supported organization that perform the functions of, or carry out the purposes of, that governmental supported organization and that, but for the involvement of the supporting organization, would normally be engaged in by the governmental supported organization itself.

The 2016 proposed regulations revise and clarify the requirements for a Type III SO supporting a governmental organization under the functional integration rules. For "simplicity and administratability,"[48] the term "governmental supported organization" is clarified to mean a supported organization that is a governmental unit described in Section 170(c)(1) or an organization described in Sections 170(c)(2) and (b)(1)(A) (other than in clauses (vii) and (viii)) that is an instrumentality of one or more governmental units described in Section 170(c)(1) .[49]

The Treasury and the IRS stated that they agreed with comments they received that it would be appropriate to treat a Type III SO that supports two or more governmental supported organizations as functionally integrated, provided that the governmental supported organizations are themselves connected geographically or operationally, which will help ensure that the supported organizations provide sufficient input to and oversight of the supporting organization. As a result, under the 2016 proposed regulations, a Type III SO will satisfy the functionally integrated requirement if it supports only governmental supported organizations and, if it supports more than one governmental supported organization, all of the governmental supported organizations either: (1) operate within the same geographic region (defined as a city, county, or metropolitan area); or (2) work in close coordination or collaboration with one another to conduct a service, program, or activity that the supporting organization supports.[50] In addition, the 2016 proposed regulations incorporate the 2009 proposed regulations requirement that a "substantial part" of the SO's total activities must directly further the exempt purposes of its governmental supported organization(s). The Treasury and the IRS stated that using a substantial part requirement, instead of the "substantially all" requirement in Reg. 1.509(a)-4(i)(4)(iv)(A), is appropriate when SOs support only governmental supported organizations operating in the same geographic region or working in close collaboration because the input from and oversight by the governmental supported organizations minimize the potential for abuse.

The 2016 proposed regulations do not treat fundraising, grant-making, and managing non-exempt-use assets as activities that directly further the exempt purposes of a governmental supported organization. The Treasury and the IRS excluded these items because they determined that a Type III supporting organization should qualify as functionally integrated only if the supporting organization itself conducts activities that perform the functions, or carry out the purposes, of the supported organization (as distinguished from providing financial support for the activities carried out by the supported organization). The Treasury and the IRS do not believe a different definition of "directly further" should apply to supporting organizations that support governmental supported organizations. However, under the 2016 proposed regulations, these types of organizations would still be considered functionally integrated if a substantial part, as opposed to substantially all, of their total activities directly further the exempt purposes of their governmental supported organization(s). Accordingly, the proposed regulations allow these organizations to conduct more fundraising and other financial activities than is permitted under the "substantially all" test of Reg. 1.509(a)-4(i)(4)(ii) .

The 2016 proposed regulations also provide a special rule for existing Type III SOs provided that they support no more than one additional supported organization that is not a governmental supported organization. A Type III supporting organization in existence on or before 2/19/16 is treated as functionally integrated if: (1) it supports one or more governmental supported organizations and no more than one supported organization that is not a governmental supported organization; (2) it designated each of its supported organizations as provided in Reg. 1.509(a)-4(d)(4) on or before 2/19/16; and (3) a substantial part of its total activities directly furthers the exempt purposes of the governmental supported organization(s).

The 2016 proposed regulations also further extend the transitional relief provided in Notice 2014-4 and extended by the 2015 TD. Under the proposed regulations, a Type III SO in existence on or before 2/19/16 that continues to meet the requirements of Notice 2014-4 is treated as functionally integrated until the earlier of the

first day of the organization's first tax year beginning after the date final regulations under Reg. 1.509(a)-4(i)(4)(iv) are published or the first day of the organization's second tax year beginning after 2/19/16.

Minimum Payout Requirement for Non-Functionally Integrated Type III SOs

If an organization does not qualify as functionally integrated, it must meet a separate integral part test to qualify as a non-functionally integrated Type III SO. This would be the case when the Type III SO's activities consist of making grants to the supported organization, such as when a charitable trust makes distributions to designated charities. A non-functionally integrated Type III SO must meet both (1) a minimum payout requirement and (2) an attentiveness requirement.

Background on payout requirement prior to the PPA. Prior to the PPA, the integral part test for a Type III SO required the organization to: (1) make payments of "substantially all of its income" to or for the use of one or more supported organizations; (2) provide enough support to one or more supported organizations to ensure the attentiveness of such organizations to the operations of the Type III SO; and (3) pay a substantial amount of the total support of the Type III SO to those supported organizations that meet the attentiveness requirement. For purposes of these rules, the phrase "substantially all of its income" means at least 85% of adjusted net income. [51] A number of donors establishing Type III SOs historically contributed non-income-producing assets, so that under the traditional 85% income distribution requirement, a significant amount of money was not being paid to supported organizations. [52]

The PPA directed the IRS to promulgate new regulations on a payout requirement for non-functionally integrated Type III SOs to ensure that these SOs pay a significant amount to their supported organizations. [53] In advance of the issuance of regulations addressing the distribution requirement, the

2007 ANPRM [54] provided that a non-functionally integrated Type III SO would be required to make an annual payout equal to the annual payout required by a private nonoperating foundation-generally, 5% of the fair market value of its investment assets. Many commentators stated that the private foundation 5%-payout requirement contained in the ANPRM was too high and would erode an organization's assets over time. The commentators asserted that a Type III SO provides long-term consistent support to specific organizations, while private foundations may pay out to whomever they choose. Further, the commentators stated that an SO maintains a governance relationship with its supported organizations in a way that a private foundation does not. Commentators argued that because of these differences, the private foundation payout requirement should not be imposed on an SO. Imposing a 5% payout, these commentators contended, would jeopardize the ability of SOs to provide the kind of consistent, reliable, long-term support that supported organizations have come to expect.

Despite the many comments arguing against a 5% distribution requirement, consistent with the 2007 ANPRM, the 2009 proposed regulations set the distribution requirement for non-functionally integrated Type III SOs at 5% of the fair market value of the non-exempt-use assets of the SO, although this requirement never became effective. As discussed below, in response to the many comments received on the topic, the final regulations ultimately rejected a 5% payout requirement, opting instead to impose a lesser 3.5% payout requirement for non-functionally integrated Type III SOs.

Distribution Requirements. Under the 2012 proposed regulations, and the final regulations adopted in 2015, the required annual minimum distribution requirement, known as the "distributable amount," with respect to each tax year of a non-functionally integrated Type III SO is equal to the greater of (1) 85% of its adjusted net income (determined by applying the principles of Section 4942(f)) for the immediately preceding tax year) or (2) its "minimum asset amount," generally equal to 3.5% of the fair market value of its noncharitable use assets for the immediately preceding tax year, [55] determined by applying the principles applicable to private nonoperating foundations under Section 4942 . [56] Distributions in excess of the annual distributable amount may be carried over for five subsequent years with the distributable amount in that later year first reduced by any excess amount carried over, with the oldest excess amount applied first. [57] The amount of a distribution made by a Type III SO to a supported organization includes the amount of cash distributed or the fair market value of property distributed as of the date the distribution is made, determined solely on a cash basis. [58]

Only certain distributions by a Type III SO count toward its distribution requirement. The 2016 proposed regulations revise and clarify what counts toward the distribution requirement and make it an exclusive list. [59]

(1) Any amount paid to the supported organization to accomplish the supported organization's exempt purposes.

(2) Any amount paid to perform a direct activity of the supported organization, but only to the extent that such amount exceeds any income derived from such activity.

(3) Any reasonable and necessary: (a) administrative expenses paid to accomplish the exempt purposes of the supported organization, which do not include expenses incurred in the production of investment income or the conduct of fundraising activities (except as provided in (b)), and (b) expenses incurred to solicit contributions that are received directly by a supported organization, but only to the extent the amount of such expenses does not exceed the amount of contributions actually received by the supported organization as a result of the solicitation, as substantiated in writing by the supported organization.

(4) Any amount to acquire an exempt-use asset.

(5) Any amount set aside for a specific project that accomplishes the exempt purposes of a supported organization, with such set-aside counting toward the distribution requirement for the tax year in which the amount is set aside but not in the year in which it is actually paid, if at the time of the set-aside.

The Preamble to the 2016 proposed regulations clarifies that expenses incurred by a supporting organization that count toward the supporting organization's distribution requirement may include administrative expenses incurred by the supporting organization, including, but not limited to, such items "as salaries, rent, utilities and other overhead expenses," if attributable to exempt activity, but that any such expenses attributable to nonexempt activities, such as investment activities and unrelated business activities, of the supporting organization cannot be counted. In providing this guidance, the Preamble makes reference to TD 9605 issued on 12/28/12, which it refers to as the "2012 TD," stating as follows:

> The 2012 TD clarified that reasonable and necessary administrative expenses paid to accomplish the exempt purposes of supported organizations, and not expenses incurred in the production of investment income, count toward the distribution requirement. For

> example, if a supporting organization conducts exempt activities that are for the benefit of, perform the functions of, or carry out the purposes of its supported organization(s) and also conducts nonexempt activities (such as investment activities or unrelated business activities), then the supporting organization's administrative expenses (such as salaries, rent, utilities and other overhead expenses) must be allocated between the exempt and nonexempt activities on a reasonable and consistently-applied basis. The administrative expenses attributable to the exempt activities are treated as distributions to its supported organization(s) if such expenses are reasonable and necessary. The administrative expenses and operating costs attributable to the nonexempt activities are not treated as distributions to the supported organization(s). The proposed regulations retain this provision, but also provide additional guidance on fundraising expenses.

Therefore, under the 2016 proposed regulations and Preamble thereto, reasonable and necessary administrative expenses incurred by a Type III SO to accomplish its exempt purpose of supporting its supported organizations count toward its distribution requirement and those administrative expenses that do not further its exempt purposes, such as investment activities and unrelated business activities, do not count. When reasonable and necessary administrative expenses attributable to both exempt and nonexempt activities are incurred, such expenses should be allocated to each such activity on a reasonable and consistently applied basis, and the expenses allocated to the exempt activities should be counted toward the minimum distribution requirement and expenses allocated to nonexempt activities should not.

Attentiveness Requirements. In order to meet the attentiveness requirement, a non-functionally integrated Type III SO must distribute one-third or more of its annual distributable amount to one or more supported organizations that are "attentive" to the operations of the Type III SO. [60] For this purpose, a supported organization is

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considered "attentive" to the operations of the Type III SO during a tax year if, in that year: [61]

> (1) The Type III SO distributes to the supported organization 10% 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 tax year ending before the beginning of the Type III SO's tax year;

(2) The amount of support received from the Type III SO is necessary to avoid the interruption of a particular function or activity of the supported organization. The support is considered necessary if the Type III SO or the 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 or activity is at least a substantial one; or

(3) 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 Type III SO, and the purpose to which the funds are put, the amount of support received from the Type III SO 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. [62]

The following is an example from the proposed regulations.

> O is an organization described in Section 501(c)(3) that is organized to support five private universities, V, W, X, Y, and Z, each of which is described in Section 509(a)(1) . O meets the responsiveness test with respect to each of its supported organizations. Each year, O distributes an aggregate amount that equals its distributable amount and distributes an equal amount to each of the five universities. O distributes annually to each of V and W an amount that equals more than 10 percent of each university's total annual support received in its most recently completed taxable year. Based on these facts, O meets the attentiveness requirement because it distributes two-fifths (more than the required one-third) of its distributable amount to supported organizations that are attentive to O. [63]

Type III SOs Cannot Be Controlled by Disqualified Persons

A Type III SO may not be controlled directly or indirectly by one or more disqualified persons, as defined in Section 4946 , including substantial contributors; their family members; and corporations, partnerships, or trusts in which interest of more than 35% is owned by disqualified persons. [64] For this purpose, a disqualified person does not include foundation managers or organizations that are public charities under

Section 509(a)(1) or (2).[65] The regulations provide that an organization will be considered controlled if the disqualified persons (other than those specifically excluded as indicated above), by aggregating their votes or positions of authority, "may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act."[66] This includes, but is not limited to, the right of any substantial contributor or his or her spouse to designate annually the recipients, from among the publicly supported organizations, of the income attributable to his contribution to the SO. The regulations further provide that an SO will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50% or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization.[67]

Type III SOs Cannot Receive Contributions or Gifts from Persons with Direct or Indirect Control Over a Supported Organization

Prior to the PPA, the control exercised over a supported organization by a contributor to a Type III SO was not relevant to the determination of SO status under Section 509(a)(3) . To curb perceived abuses resulting from donors or related parties controlling the supported organization of a Type III SO, under Section 509(f)(2) , if a Type III SO accepts any gift or contribution from a person who directly or indirectly controls, either alone or together with one or more specified related persons,[68] the governing body of a supported organization, the Type III SO will no longer qualify as an SO under Section 509(a)(3) .[69] The 2012 regulations reserved

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Reg. 1.509(a)-4(f)(5)(ii) , "Meaning of Control," with the Preamble to the regulations indicating that the Treasury and the IRS intended to issue proposed regulations that would provide such a definition. Without a clear definition of "control" in this context, and the potential risk to their public charity status (and conversion to private foundation status), Type III SOs were placed in a position of having to decline a contribution from a would-be contributor associated with a supported organization.

Under the 2016 proposed regulations, the meaning of the term "control" is consistent with Reg. 1.509(a)-4(j) , discussed above, which relates to control by disqualified persons for purposes of the disqualified person test. In general, the governing body of a supported organization is considered "controlled" by a person if that person, alone or by aggregating his or her votes or positions of authority with certain related persons, as described in Sections 509(f)(2)(B)(ii) and (iii), may require the governing body of the supported organization to perform any act that significantly affects its operations or may prevent the governing body of the supported organization from performing any such act. [70] The proposed regulations further provide that an SO will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50% or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. [71]

Annual Notification Requirement to Each Supported Organization

For each tax year, referred to as the "Reporting Year" under the 2016 proposed regulations, [72] of a Type III SO, whether functionally or non-functionally integrated, it must provide the following documents to each of its supported organizations:

(1) A written notice addressed to a principal officer of the supported organization describing the type and amount of all of the support (including all of the distributions described in Reg. 1.509(a)-4(i)(6) that count towards the distribution requirements) that the SO provided to the supported organization during the SO's tax year immediately preceding the Reporting Year. [73]

(2) A copy of the SO's most recently filed Form 990 (the name and address of any contributor may be redacted from the return). [74]

(3) A copy of the SO's currently effective governing documents, including its articles of incorporation, unless such documents have been previously provided and not subsequently amended. [75]

The notification documents required for any tax year are to be delivered or electronically transmitted by the last day of the fifth calendar month of Reporting Year. [76] Because the due date for the provision of these notification documents is not tied to the due date of Form 990, only the most recently filed Form 990 is required to be provided. For example, for a Type III SO that is on a calendar tax year, the documentation required to be provided to each supported organization for its 2017 Reporting Year by 5/31/17 need not include the 2016 Form 990, which is generally due by 5/15/17 (but subject to two three-month extensions), if such Form 990 is put on extension and is filed after 5/31/17. In such a case, only the 2015 Form 990 need be submitted by 5/31/17 for the 2017 Reporting Year. The 2016 Form 990 would need to be submitted in the 2018 Reporting Year by 5/31/18.

CONCLUSION

In seeking to curb perceived abuses and ensure that Type III SOs will further the charitable purposes of their supported organizations and be held accountable to such organizations, the post-PPA regulations have made an already complex tax regime even more complicated. Notwithstanding the added complexity, the rules for qualification as a Type III SO in a post-PPA tax regime have been clarified and those organizations seeking to achieve or maintain such status must understand and comply with these rules in order to be treated as public charities, rather than private foundations.

[1] As discussed hereinafter, there are three types of SOs, depending on the relationship of the SO with the one or more publicly supported organizations it supports. The Type III SO has the most attenuated relationship with its supported organizations and, as a result, is subject to significantly more complex rules to ensure that it will further the charitable purposes of, and be held accountable to, its supported organizations.

[2] P.L. 91-172, 12/30/69. Section 509(a)(3) 's legislative history indicates that SOs were created in order for the Milton Hershey School Trust, which supports the Milton Hershey School, to be classified as a public charity, even though it would otherwise be considered a private foundation because it does not receive public support sufficient for it to be classified as a public charity under Section 509(a) . See Congressional Records of 12/6/69, p. S 15982.

[3] For purposes of Section 509(a)(3) and references hereinafter to such term, the term "publicly supported organization" means a public charity described in Section 509(a)(1) or (2).

[4] Chapter 42 of the Code subjects private foundations to a wide array of excise tax provisions under Sections 4941 through 4945 . Note, however, that certain Type III SOs, and organizations making grants to such Type III SOs, are subject to certain private foundation rules. See, e.g., Section 4943(f) (treating certain SOs as private foundations for purposes of the excess business holdings rule); Section 4942(g)(4) (disallowing qualifying distribution treatment for distributions by private foundations to certain

SOs); Section 4945(d)(4) (treating distributions by private foundations to certain SOs as taxable expenditures unless expenditure responsibility is exercised). In addition, contributions to private foundations are subject to less favorable income tax treatment under Section 170 .

[5] The scrutiny of SOs came to the limelight in an 4/25/05 front page article in *TheNew York Times*, entitled "Big Tax Break Often Bypasses Idea of Charity." The article, which presented a highly critical view of SOs, was followed by a joint press release issued by Senator Charles Grassley (R-Iowa), then Chairman of the Senate Finance Committee, and Senate Max Baucus (D-Mont.), then ranking Democratic member, which stated that they planned to propose reforms "to stop the use of supporting organizations for generous tax breaks rather than charitable purposes." In a written statement to the Senate Finance Committee dated 4/5/05 regarding SOs, then IRS Commissioner, Mark W. Everson, stated that "[s]ome promoters in this area have encouraged individuals to establish and operate supporting organizations purportedly described in 509(a)(3) that they can control for their own benefit. There are a variety of methods of abuse, but a common theme is a 'charitable' donation of an amount to the supporting organization, and a return of the donated amount to the donor, often in the form of a purported loan that may never be repaid. For example, we have seen contributed amounts that have ultimately been returned and then used by the donor to purchase residential property." In response to their possible elimination, one large Type III SO placed an advertisement in the 3/31/05 Chronicle of Philanthropy, which stated as follows: "The Senate Finance Committee has targeted Type III supporting organizations for elimination under the proposed revisions to the Internal Revenue Code. Hearings may be as soon as April 5. If you would like to join a coalition of other Type III organizations to develop specific legislation to curb targeted abuses rather than complete elimination, please contact the J.A. Chapman and Leta M. Chapman Charitable Trust ... as soon as possible."

[6] For example, on 6/22/04, the Senate Finance Committee held a highly publicized hearing to focus on governance and best practices of charitable organizations, which also focused on various abuses in the charitable sector, including SOs being used for noncharitable purposes. On 4/5/04, the Senate Finance Committee held a second hearing on nonprofit organizations and charitable giving, focused on ways to strengthen nonprofit governance and reduce various perceived improprieties in charitable giving, which was followed by a hearing by the House Ways and Means Committee on 4/20/05.

[7] P.L. 109-280, 8/17/06.

[8] The IRS actually recognized that following the enactment of the PPA, certain charitable trusts that were historically treated as Type III SOs erroneously converted to private foundation status and, as a result, the IRS provided guidance for such trusts to retroactively convert back to their original Type III SO status. See Fox and King, "Help for Charitable Trusts That Made Erroneous Conversions," 38 Estate Planning 13 (January 2011).

[9] For an article discussing the Advanced Notice of Proposed Rulemaking (REG-155929-06, 8/2/07, 72 Fed. Reg. 42,335) and the proposed regulations (REG-155929-06, 9/24/09, 74 Fed. Reg. 48672), see Fox, "Prop. Regs. Provide New Guidance for Type III Supporting Organizations," 37 Estate Planning 6 (March 2010).

[10] TD 9605 , 12/28/12.

[11] Preamble to TD 9605 , 12/28/12.

[12] TD 9746 , 12/28/15.

[13] Prop. Reg. 1.509(a)-4 , 81 Fed. Reg. 8453 (2016).

[14] The Treasury regulations governing SOs are extremely lengthy, detailed, and complex, to the point where one court characterized them as "fantastically intricate and detailed." *Windsor Found.*, 40 AFTR2d 77-6004 (DC Va., 1977).

[15] As discussed further below, Type III SOs are subject to additional requirements, other than those set forth in Section 509(a)(3) , whereby they must annually provide certain information to each of their supported organizations, may not have any supported organization not organized in the United States, and may not accept donations from donors who control a supported organization.

[16] Section 509(a)(3)(A) .

[17] Section 509(a)(3)(B) . In the Type I SO context, the relationship between the SO and its supported organization is comparable to that of a parent and subsidiary, in which case the SO is under the direction of, and accountable or responsible to, the one or more publicly supported organizations. For a Type II SO, there is common supervision or control by the persons supervising or controlling both the SO and the one or more publicly supported organizations, which is ordinarily met if a majority of the SO's governing board are also on the governing body of the supported organization. The Type III SO "operated in connection with" relationship is discussed below.

[18] Section 509(a)(3)(C) .

[19] See note 5, *supra*.

[20] Such limitations and restrictions include: (1) under Section 4943(f)(3) , a non-functionally integrated Type III SO is subject to the Section 4943 excess business holdings rule; (2) under Section 4942(g)(4)(A)(i) , grants by a private foundation to a non-functionally integrated Type III SO are not considered qualifying distributions; (3) under Section 4945(d)(4)(A)(ii) , grants by a private foundation to a non-functionally integrated Type III SO constitute a taxable expenditure unless expenditure responsibility is exercised with respect to the grant; and (4) under Sections 4966(c)(2) and (c)(4), an excise tax is imposed under Section 4966(a) with respect to distributions from a donor-advised fund to a non-functionally integrated Type III SO. In addition, no charitable deduction is permitted for income, gift, and estate tax purposes for a contribution to a donor-advised fund of a non-functionally integrated Type

III SO. Section 170(f)(18) (income tax); Section 2522(c)(5) (gift tax); and Section 2055(e)(5) (estate tax). For a further discussion of these limitations and restrictions put in place under the PPA, see Fox, "Charitable Limitations and Reforms of the Pension Protection Act," 33 Estate Planning 3 (December 2006).

[21] Section 509(a)(3) ; Reg. 1.509(a)-4(f)(5) . Note that in the case of a Type III SO, the governing document must designate each of the specified supported organizations by name, except when there has been an historic and continuing relationship between the Type III SO and the publicly supported organization and, by reason of such relationship, there has developed a substantiality of interest between such organizations. Regs. 1.509(a)-4(d)(1) and (d)(2)(iv).

[22] An Advanced Notice of Proposed Rulemaking (2007 ANPRM) issued by the IRS on 8/2/07, which described the regulations that the IRS anticipated issuing to implement the PPA changes to Type III SOs, proposed a limitation on the number of supported organizations a non-functionally integrated Type III SO could support, generally limiting the supported organizations to no more than five. In response to comments asking that such limitation not be imposed, the subsequently issued regulations do not contain any such limitation.

[23] Section 509(f)(1)(B)(i) .

[24] Reg. 1.509(a)-4(f)(3)(i) .

[25] Preamble to Prop Regs. 2/19/16. 81 Fed. Reg. 8,446.

[26] In the case of an SO that was supporting or benefiting a supported organization before 11/20/70, additional facts and circumstances, such as a historic and continuing relationship between the organizations, may be also taken into account to establish compliance with the responsiveness test.

Reg. 1.509(a)-4(i)(3)(v) .

[27] Reg. 1.509(a)-4(i)(3)(iii) .

[28] Prior to the PPA, under a special alternative test available only to charitable trusts, the regulations provided that the responsiveness test was also met when (1) the SO is a charitable trust under state law, (2) each specified supported organization is a named beneficiary under the charitable trust's governing instrument, and (3) each supported organization has the power to enforce the trust and compel an accounting under state law. Thus, even when a charitable trust did not meet the general responsiveness test because a supported organization lacked a significant voice over its operations, provided the charitable trust met the alternative responsiveness test, it nonetheless was considered to be responsive to its supported organizations. Former Reg. 1.509(a)-4(i)(2)(iii) .

[29] Reg. 1.509(a)-4(i)(3)(iv), Example 1 .

[30] The example in the final regulations clarify that face-to-face meetings are not a requirement, as opposed to the example in the proposed regulations that made no indication that such meetings could be held telephonically.

[31] Note 25, *supra*.

[32] Regs. 1.509(a)-4(i)(3)(iv), Example 2 .

[33] Prop. Reg. 1.509(a)-4(i)(3)(i) . Reg. 1.509(a)-4(i)(3)(i) provides that an SO meets the responsiveness test if it is "responsive to the needs or demands of a supported organization." The Preamble to the 2012 regulations signaled this clarification, stating "The Treasury Department and the IRS intend to issue

proposed regulations in the near future that amend the responsiveness test by clarifying that Type III supporting organizations must be responsive to all of their supported organizations."

[34] Note 25, *supra*.

[35] Prop. Reg. 1.509(a)-4(i) (3(iv), Example 3.

[36] The example specifically notes that the SO meets the relationship test of Reg. 1.509(a)-4(i)(3)(ii)(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 SO) and Reg. 1.509(a)-4(i)(3)(ii)(C) (the officers, directors, or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organizations).

[37] The regulations do not provide a definition of "substantially all," indicating only that "in determining whether substantially all of a supporting organization's activities directly further the exempt purposes of one or more supported organization(s), all pertinent facts and circumstances will be taken into consideration." Prop. Reg. 1.509(a)-4(i)(4)(ii)(B) .

[38] Regs. 1.509(a)-4(i)(4)(ii)(A) and (B). The only definition of a "functionally integrated Type III SO" in the Code is found at Section 4943(f)(5)(B) , for purposes of subjecting Type III SOs to the excess business holdings rule of Section 4943 other than in the case of a functionally integrated Type III SO. Section 4943(f)(3)(A) .

[39] Reg. 1.509(a)-4(i)(4)(ii)(C) .

[40] *Id*.

[41] *Id.*

[42] Reg. 1.509(a)-4(i)(4)(v), Example s (2), (3), and (5).

[43] Reg. 1.509(a)-4(i)(4)(ii)(D) . In Reg. 1.509(a)-4(i)(4)(v), Example (4) , the making of scholarships by an organization to students of a private secondary school did not meet the integral part test because the organization did not provide the scholarships "as part of an active program in which it maintains a significant involvement," given that its activities were basically limited to investing assets and disbursing funds to the scholarship recipients selected by the school.

[44] Reg. 1.509(a)-4(i) .

[45] Prop. Reg. 1.509(a)-4(iii).

[46] Reg. 1.509(a)-4(i)(C).

[47] 2014-2 IRB 27

[48] Note 25, *supra*.

[49] The Preamble to the proposed regulations notes "that a governmental unit described in section 170(c)(1) includes all of the agencies, departments, and divisions of the governmental unit, and all such agencies, departments, and divisions will be treated as one governmental supported organization."

[50] To satisfy the close cooperation or coordination requirement, a supporting organization must maintain on file a letter from each of the governmental supported organizations (or a joint letter from all of them) describing their collaborative or cooperative efforts with respect to the particular service, program, or activity.

[51] Rev. Rul. 76-208, 1976-1 CB 161 .

[52] The Joint Committee on Taxation stated that with respect to the pre-PPA distribution regime applicable to Type III SOs, there is a "concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations." Staff of the Joint Committee on Taxation, "Technical Explanation of H.R. 4, the Pension Protection Act of 2006," p. 360, note 571.

[53] Section 1241(d)(1) of the PPA required the Treasury to promulgate new regulations to require such non-functionally integrated Type III SOs "to make distributions of a percentage of either income or assets to supported organizations ... in order to ensure that a significant amount is paid to such organizations."

[54] See note 22, supra.

[55] Regs. 1.509(a)-4(i)(5)(ii)(B) and (C). The distributable amount for the first tax year an organization is treated as a non-functionally integrated Type III SO is zero. Reg. 1.509(a)-4(i)(5)(ii)(D) .

[56] Reg. 1.509(a)-4(i)(8) . The "distributable amount" is calculated on Part V, Section C, of Schedule A of

Form 990. Note that there is a "reasonable cause exception" under Reg. 1.509(a)-4(i)(5)(ii)(F) , which, if met, will not result in loss of Type III SO status when the organization fails to meet the minimum distribution requirement in a given tax year.

[57] Reg. 1.509(a)-4(i)(7) .

[58] Reg. 1.509(a)-4(i)(6) .

[59] Reg. 1.509(a)-4(i)(6) , as amended by Prop. Reg. 1.509(a)-4(i)(6) . Note that Reg. 1.509(a)-4(i)(6) , when setting forth its listing of distributions counting toward the distributable amount was prefaced by the statement that the listing "shall include, but not be limited to." In the Preamble to the 2016 proposed regulations, the Treasury and IRS stated that they "believe that the non-exclusive list in the current regulations creates uncertainly for supporting organizations and the IRS about what counts toward the distribution requirement." Distributions applied against the distributable amount are set forth on Part V, Section D, of Schedule A of Form 990.

[60] Prop. Reg. 1.509(a)-4(i)(5)(iii)(A).

[61] Regs. 1.509(a)-4(i)(5)(iii)(B)(1) , (2), and (3). In determining whether a supported organization will be considered attentive to the operations of a Type III SO, any amount received that is held by the supported organization in a donor advised fund is disregarded. Reg. 1.509(a)-4(i)(5)(iii)(C) .

[62] Normally, the attentiveness of a supported organization is influenced by the amounts received from the SO. Thus, the more substantial the amount involved in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the SO is sufficient to ensure the attentiveness of the supported organization to the operations of the SO (including attentiveness to the

nature and yield of the SOs investments), evidence of actual attentiveness by the supported organization is of almost equal importance. A supported organization is not considered to be attentive solely because it has enforceable rights against the Type III SO under state law. Reg. 1.509(a)-4(i)(5)(iii)(B)(3) .

[63] Prop. Reg. 1.509((a)-4(i)(5)(iii)(D), Example 4.

[64] Section 509(a)(3)(C) . As a result of this requirement, unlike in the case of a private foundation, a founder of a Type III SO, and his or her relatives, cannot be in a control position.

[65] *Id.*

[66] Reg. 1.509(a)-4(j)(1) .

[67] *Id.* Notwithstanding the foregoing, an organization is permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it. The regulations give an example in which, notwithstanding the fact that the majority of a religious organization's board of directors are substantial contributors, the organization will not be disqualified under Section 509(a)(3)(C) when a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization. Reg. 1.509(a)-4(j)(2) .

[68] Related persons include those persons described in Sections 509(f)(2)(b)(ii) and (iii), generally consisting of family members (as described in Section 4958(f)(4)) and a 35% controlled entity (as described in Section 4958(f)(3)). Contributions from related persons will also cause the loss of the SO status of a Type III SO. Section 509(f)(2)(b) .

[69] Note that Section 509(f)(2) also applies to a Type I SO, but does not apply to a Type II SO.

[70] Prop. Reg. 1.509(a)-4(f)(5)(ii) .

[71] *Id.* The proposed regulations also provide that "all pertinent facts and circumstances will be taken into consideration in determining whether one or more persons do in fact directly or indirectly control the governing body of a supported organization."

[72] Prop. Reg. 1.509(a)-4(i)(2)(i) .

[73] Prop. Reg. 1.509(a)-4(i) . A principal officer includes, but is not limited to, a person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body of a supported organization; supervising the management, administration, or operation of the supported organization; or managing the finances of the supported organization. Reg. 1.509(a)-4(i)(2)(iv) .

[74] Reg. 1.509(a)-4(i)(2)(i)(B) .

[75] Reg. 1.509(a)-4(i)(2)(i)(C) .

[76] Prop. Reg. 1.509(a)-4(i)(2)(A)(iii). Date of delivery is determined by applying the general principles of Section 7502.

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Enclosure 8

Planning for Charitable Contributions by Estates and Trusts,

Estate Planning Journal, Jan 2017

CHARITABLE CONTRIBUTIONS

Planning for Charitable Contributions by Estates and Trusts

Differences between the rules for deducting charitable contributions by estates and trusts and by individuals create tax opportunities.

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The income tax charitable deduction for an estate or trust [1] is similar to, but somewhat different from, the income tax charitable deduction for individuals. These differences include: (1) no income-based percentage limitation on the charitable donation of an estate or a trust, but the deduction is limited to contributions of gross income; (2) the ability of an estate or trust to deduct a charitable contribution in the immediately preceding tax year in some circumstances; (3) a requirement that the governing instrument of the estate or trust evidence a charitable intent; and (4) no necessity that the charitable recipient of the gift from an estate or trust be a U.S. (domestic) organization.

Because the parameters for an income tax charitable deduction for trusts (and estates) are not the same as for individuals, it is important to recognize the differences when trusts are created that might, should, or perhaps, should not seek an income tax charitable deduction. Moreover, the income tax charitable deduction for an estate or trust may be more advantageous in some instances than contributions that individuals might make, and as a result, there may be important planning opportunities to consider.

This article explores the income tax charitable deduction requirements under Section 642(c) for estates and trusts, the planning that is required to qualify for the deduction, and some special opportunities that may be available.

Charitable contributions by individuals

As a general rule, individuals are entitled to a deduction under Section 170(a) for the value of contributions (donations) of property (including cash) to or for the use of charitable organizations defined in Section 170(c) , but the deduction is limited to qualified domestic (U.S.) charitable entities. In addition, the charitable deduction for individuals is subject to several limitations and special rules. In general, the deduction may never exceed 20%, 30%, or 50% of the

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taxpayer's contribution base. [2] The amount allowable as a deduction also may depend on:

- The type of property contributed (e.g., cash, tangible personal property, intangible property, or real estate).[3]

- The nature of any gain inherent in the asset (e.g., ordinary income, short-term capital gain, or long-term capital gain).[4]
- The use to which the charitable recipient will devote the property (e.g., sell it or use it in furtherance of the recipient's exempt function).[5]
- The type of charitable organization (e.g., private foundation or a public charity).[6]
- Other possible factors.[7]

Additionally, Treasury Regulations appear to distinguish between a contribution made by an individual "to" a charitable organization and one that is "for the use" of the organization, basically limiting the deduction for a contribution for the use of charity to no more than 30% of the taxpayer's contribution base.[8]

Furthermore, if the charitable deduction otherwise allowable to an individual in the tax year exceeds the applicable percentage of his or her contribution base, the excess may be carried forward and deducted in the succeeding five tax years of the taxpayer (again subject to a percentage of contribution base for any such later year).[9]

Individuals taxpayers are subject to the substantiation requirements under Section 170 , including those under Section 170(f)(8) . These rules provide that no charitable deduction is allowed under Section 170 for gifts of $250 or more unless the taxpayer receives a contemporaneous written receipt from the donee charity.[10] For large, charitable gifts, more complex compliance rules apply.

Estate or trust charitable deduction

Several differences exist between a Section 170 charitable deduction for an individual and a Section 642(c) charitable deduction for an estate or trust. A decedent's estate or a trust is entitled to a charitable deduction under Section 642(c) for its gross income paid (or, for a decedent's estate, paid to or set aside[11]), pursuant to the terms of its governing instrument, for a charitable purpose described in Section 170(c) . Unlike an estate or trust, the contribution by an individual need not be paid from gross income.

Flexible timing. While an estate or a trust is entitled to the deduction under Section 642(c) only for a contribution made from its gross income, the deduction may be allowed whether the gross income is from the current year or from a prior year that has not previously been distributed or deducted.[12] Moreover, an estate or trust may elect in the current year to treat a charitable contribution paid from gross income earned in the immediately preceding year as though it had been paid in the prior year, as long as the contribution is made by the time the income tax return for the estate or trust is due to be filed for the immediately preceding year.

The due date of a return may be extended no more than five and one-half months after the normal three and one-half month filing due date following the close of the tax year. [13] For trusts and calendar-year estates, [14] the extended due date to make the election would be September 30 of the year following the year in which the income was included in the gross income of the estate or trust. Thus, the election allows the estate or trust to take the deduction retroactively in the immediate prior year in which the gross income was earned but not paid, or, if the fiduciary does not elect, to take the deduction in the year the gross income is paid.

Individuals cannot take a deduction in a prior year for a contribution made in any later year. On the

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other hand, an estate or trust cannot carryover any excess charitable deduction to a subsequent year and take a deduction for a contribution made in an earlier year.

No percentage limitations. Furthermore, an estate or trust may reduce its taxable income to zero through contributions for charitable purposes except to the extent the payment to charity consists of unrelated business income (UBI), as discussed below. In other words, the deduction under Section 642(c) is not limited to a maximum 50% of the contribution base [15] of the estate or trust, as is the case with an individual, except to the extent of its UBI.

In addition, the charitable deduction for estates and trusts is not dependent on the type of charitable organization that receives the contribution, as it is for individuals. Section 642(c) does not distinguish between contributions to public charities (including "publicly supported charities") and private foundations. Furthermore, an estate or trust is entitled to the deduction for a charitable purpose even if it is not made to or for a domestic (U.S.) charitable organization, as is required for individuals.

Simpler substantiation. Finally, it seems relatively certain that estates and trusts are generally not subject to the charitable deduction substantiation rules of Section 170 for individuals, including the contemporaneous written acknowledgment requirement of Section 170(f)(8) . [16] The charitable deduction for estates and trusts is authorized by Section 642(c) and is in lieu of a deduction under Section 170 .

There is one exception, however. To the extent that a trust (but not an estate) has UBI, no deduction is allowed under Section 642(c) .[17] Instead, Section 681 -which disallows a charitable deduction for UBI-references Section 512 , which permits a more limited charitable deduction under Section 170 . As a result, the substantiation rules likely apply in that situation, given that the charitable deduction is then permitted only pursuant to Section 170 . The UBI limitation is discussed in greater detail later in this article.

Pursuant to governing instrument

To be deducted under Section 642(c) , the payment of gross income for a charitable purpose must be made pursuant to the terms of the governing instrument-likely the will or the trust agreement under which the trust was created.[18] The payment need not be mandated by the governing instrument, but courts have held that "the instrument must be shown to possess some positive charitable intent or purpose of the settlor-not merely that the settlor did not exclude charity from all the possible beneficiaries of his bounty."[19] Therefore, a discretionary payment to charity will support the deduction if authorized in the governing instrument.[20]

Payments to charity, however, will not be treated as made pursuant to the terms of the governing instrument where found not to be made to in accordance with the terms of the will or trust agreement. For example, in *Rebecca K. CrownIncome Charitable Fund*,[21] commutation payments (or prepayments) to the charitable beneficiary of a charitable lead trust[22] that mandated annual payments to charity were not deductible under Section 642(c) where the court found the prepayment of the annuity payments was not authorized under the terms of the instrument that created the trust.

In *John Allan Love Charitable Foundation*,[23] a trustee made distributions to a charitable foundation on the basis that distributions "were agreeable or conformable to the expressed intent of the Trust instrument." The court held that a charitable income tax deduction was not available under Section 642(c) because it was "clear that the trustee was without authority to make these distributions." Thus, where a will or trust makes no provision for a payment to a charitable organization, a charitable income tax deduction will not be allowed to an estate or trust, even though all of the beneficiaries may agree to the contribution. Where the terms of a trust authorize charitable payments only on termination of a trust, payments made prior to termination do not qualify for a

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charitable income tax deduction under Section 642(c) .[24]

In *Riggs National Bank*, [25] a testamentary trust was established under the decedent's will that provided the corpus would be shared by four charities upon the termination of the trust. A charitable income tax deduction was disallowed for income accumulated by the trust because the "will did not direct that the surplus trust income be set aside for, or paid to, the charities," and under local law, such income passed to the decedent's heirs under the laws of intestacy. The court rejected the argument that the trust income was deductible because it was used to repay a loan that was secured by trust property that was to be distributed to charities upon the termination of the trust.

Troubling case. A payment of gross income to charity pursuant to the exercise of a power of appointment granted to a beneficiary may qualify for the deduction under Section 642(c) . [26] In *Brownstone*, [27] however, the court held that no deduction would be allowed to a testamentary trust for gross income paid to the estate of the grantor's surviving spouse although the grantor's surviving spouse exercised her general power of appointment over the trust in favor of her estate and her will devised the entire residue to charity.

The court determined that the surviving spouse's will contained the requisite "positive charitable intent or purpose," but the terms of the testamentary trust created by the husband did not express that intent or purpose: His will was the governing instrument and payments had to be made without regard to his wife's exercise of the power of appointment. In other words, the exercise of general power in favor of the spouse's estate, which passed to charity, was insufficient-the governing instrument was the one that created the power and not the document that exercises it. [28]

The result in *Brownstone* may be questioned on several grounds. First, it seems that the result might have been different if the widow had appointed the property directly to charity rather than to her estate, which passed to charity. [29] Arguably, that is a distinction without any meaningful difference as her will essentially mandated that the income be paid to charity.

Second, it seems that the distribution from the trust to the widow's estate would have been deemed to consist of the trust's distributable net income (DNI), [30] which would have been deductible by the trust (except to the extent consisting of tax-exempt income) under Section 651(a) or 661(a) . The amount deducted by the trust would have been included in the gross income of the estate under Sections 652(a) or 662(a) and then would have been set aside for charity pursuant to the terms of the widow's will. This would seem to support a deduction for her estate under Section 642(c) . [31]

Third, the court stated that it reached its decision, at least in part, because it viewed deductions, quite apparently including charitable deductions, as a matter of legislative grace. Thus, in cases of doubt, the controlling statute should be construed in favor of the government (to collect tax). This conclusion should be contrasted with the many statements of courts that there should be a liberal construction of the law in favor of charitable deductions. For example, in *Green*, [32] in discussing the deduction allowed under Section 642(c) , the court emphasized that charitable deductions are not a matter of legislative grace, but rather

expressions of public policy that should be liberally construed. [33]

Use of decanting. A question of deductibility under Section 642(c) may arise when a trust that does not have the requisite "positive charitable intent or purpose of the settlor" is decanted or otherwise reformed by transferring trust assets to a new trust that has the requisite intent or purpose. [34] For example, a father creates a trust exclusively for the benefit of his descendants and does not grant any of them a power of appointment. Independently, the mother creates a separate trust for them and grants the oldest child a power to appoint all or a portion of the trust's gross income to charity. It appears relatively certain that a deduction will be allowed under Section 642(c) , to the extent the child exercises the power over the mother's trust. Thereafter, the trustee of the trust created by the father decants (contributes) the trust assets to the trust created by the mother.

The Section 642(c) question is whether a deduction is allowed to the extent the eldest child directs that the gross income earned by the assets formerly contained in the trust created by the father be paid to charity. The identity of the grantor of a trust for income tax purposes does not change when assets of one trust are contributed to another; [35] it is as though the income earned on the assets in the trust the father created has effectively been distributed to the trust the mother created, which contains the requisite positive charitable intent or purpose of its settlor.

Thus, the ultimate question is whether decanting can add the requisite charitable intent for income attributable to the assets previously held in the father's trust or whether the father's lack of a stated charitable purpose carries over to the trust created by the mother. If the latter, the income produced by the assets from the trust the father created are not being distributed pursuant to the terms of the governing instrument. The alternative analysis of *Brownstone* above suggests that the charitable intent of the mother's trust should be sufficient if the income attributable to the father's trust "moves" to the mother's trust and then is being distributed pursuant to her express charitable intent.

The uncertainty of decanting suggests that trustees seek a more viable alternative. One potential way to work around the prerequisite of positive charitable intent or purpose of the settlor is to have the trust invest in a partnership that may make contributions to charity from gross income of the partnership. Under Section 702(a)(4) , charitable contributions made by a partnership pass through to the partners. A trust that is a partner must take into account its distributive share of the partnership's income, gain, loss, and deductions (including charitable contributions).

In Rev. Rul. 2004-5 , [36] the Service ruled that a trust was allowed a deduction under Section 642(c) for the trust's distributive share of a charitable contribution made by the partnership from the partnership's gross income, even though the governing instrument of the trust neither authorized nor directed the trustee to make distributions to charity. Note that when a partnership makes a charitable contribution from gross income, that income is never available to the trust. In the ruling, it seemed important that the partnership made the charitable contribution from its own gross income.

Paid from gross income: tracing the income

Unlike the deduction for distributions to beneficiaries, which are deemed to consist of DNI, even if the distributions consist of corpus (with certain exceptions [37]), some type of tracing of the charitable contribution to gross income received by the trust or estate is required to support a deduction under Section 642(c) . [38] Tracing is required because the statute specifically requires that the source of the contribution be gross income. [39]

For example, in *Sid W. Richardson Foundation*, [40] the decedent left his estate to charity. The estate included stock in an S corporation, and as a result the income from the S corporation was attributed to the estate under Section 1366 , although there were no distributions from the S corporation. The decedent's estate took a set aside deduction under Section 642(c) for the S corporation income, as all of the S stock apparently was distributed eventually to the charitable

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residuary beneficiary, even if the income was kept in the corporation. However, the court held that no set aside deduction would be allowed because the income, although imputed to the estate, was never actually received by it and, therefore, could not have been set aside for charity.

Distributions in kind. In *W.K. Frank Trust of 1931*, [41] a distribution of appreciated stock was not deductible because the shares were corpus rather than items of gross income, even if under the instrument the distribution was chargeable to trust-accounting income. However, in CCA 201042023 (not precedent), the IRS ruled that property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income, although the charitable deduction was limited to the trust's adjusted basis in the property.

Nevertheless, the federal district court in *Green*, discussed above, in a case of apparent first impression, disagreed on the limitation of the deduction to basis. The district court held that a trust that was authorized to distribute any amount of its gross income to charity was entitled to an income tax deduction under Section 642(c) for the full fair market value of property that was purchased with gross income the trust had received in prior years and was not limited to the trust's adjusted basis in the property. In *Green*, property purchased by the trust and subsequently contributed to charity was specifically traceable to gross income the trust received in an earlier year.

Estates and trusts that seek to make in-kind contributions of property may follow the *Green* pattern; that is, acquire property with gross income, and when it has appreciated, contribute it to charity. An alternative plan for an estate or trust that already owns property (not traceable to gross income) it would like to contribute to charity might be structured with a two-trust arrangement: property is transferred from the old trust (which permits gifts to charity) to a second trust (which permits gifts to charity) in a manner that the distribution from the first trust to the second trust is deemed to be gross income under the DNI rules of Sections 662 .[42] Therefore, when received by the second trust, it will be deemed to consist of gross income to the extent of DNI. Moreover, the property could be (or at least might be) fiduciary accounting income under UPIA section 402, if the trustee of Trust 1 so designates the distribution.[43]

As a result, the property represents both gross income in a tax sense and accounting income when contributed to charity by the second trust. Therefore, the only real issue is the amount of the charitable deduction because Section 643(e) will limit the amount of gross income received by the second trust to the basis of the property distributed, unless the transferor trust elects to recognize gain. Note at that point, *Green* held that a fair market deduction is appropriate.

Example. Alice created and funded Trust 1 for the benefit of her issue. The trustee has discretion to distribute trust income and principal to or for the benefit of Alice's issue and charity. Trust 1 has assets valued at $10 million and, for the current year, has $200,000 of gross income. Assume that Trust 1's DNI is $200,000 and its fiduciary accounting income is $200,000. Among its assets is Stock X with a fair market value of $100,000 and an income tax basis of $40,000. The trustee would like to distribute Stock X to charity. Because Stock X is fiduciary accounting principal, a transfer of the stock to charity likely would not entitle Trust 1 to an income tax charitable deduction.

However, if Alice creates a second discretionary trust (Trust 2) for her issue and charity, it is possible that the trustee of Trust 1 could distribute Stock X to Trust 2. Under the rules of Section 643(e) , the distribution will limit the DNI attributable to the distribution to $40,000, and Trust 2 will have gross income of $40,000 under Section 662 . Trust 1 will receive a distribution deduction of $40,000 under Section 661 .

Assuming that the trustee of Trust 1 charges the entire distribution of Stock X to its fiduciary accounting income, the receipt of Stock X by Trust 2 will be both gross income, at least to the extent of $40,000, and fiduciary accounting income. Therefore, in the hands of the trustee of Trust 2, Stock X is both gross income and fiduciary accounting income and therefore should support a Section 642(c) deduction for Trust 2. The only question is the amount of the deduction. Is it limited to the trust's basis of $40,000 or is it $100,000? *Green* would support the higher amount.

Imputed income. The apparent tracing requirement may present a problem for trusts and estates that own entities, such as partnerships and S corporations, where the entity's income is imputed to the partners without an equivalent amount of cash necessarily being distributed to and received by them. A

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significant number of investments available in the market are, or use, pass-through vehicles (typically, partnerships or limited liability companies treated as partnerships for federal income tax purposes), including hedge funds, private equity investments, and others. Virtually none of these pass-through entities distributes the income imputed to its partners or owners during the year in which the income is earned and imputed.

Although it would seem the trust or estate could make the election, as discussed above, to treat income paid to charity in the year following the year the gross income is attributed by the investment to the estate or trust, many of these investments do not distribute much cash even in the year following the year in which the income was earned and imputed to the investors. Indeed, when the cash earned in a pass-through entity is distributed, it is not treated as a distribution of the entity's gross income for income tax purposes, but essentially is treated as a redemption of the investment because the income has already been imputed to the partners or S corporation shareholders.

Notwithstanding the lack of cash distributed by the investment vehicle to the estate or trust, there seems to be a workaround, although it is somewhat complicated. The estate or trust creates and owns virtually all, but not all, of the equity in a partnership that is not a disregarded entity. [44] That partnership would make investments in pass-through entities (such as other partnerships) that the estate or trust might otherwise make. The income from the pass-through investments will be imputed to the partnership that the estate or trust "owns," and it is *that* partnership's income, not the income of the pass-through investments, that will be imputed to the estate or trust that is the partner. The partnership that is "owned" directly by the trust may distribute to the trust an amount of cash equal to the amount of its gross income, which of course, would include the gross income attributed to it from the pass-through investments. Thereafter, the trust may contribute to charity the cash it received from the partnership. As a consequence, the amount contributed to charity (or the amount set aside, in the case of an estate) should qualify for the Section 642(c) deduction.

As a practical matter, the determination of the gross income imputed from the partnership to the estate or trust and, therefore, the amount of cash to be distributed as gross income, will not be determined until the year after the income is imputed to the estate or trust. Hence, the estate or trust would need to make the distribution by the time its income tax return for the year the income is imputed is due, and make the election discussed above, to treat the distribution as having been made in the year in which the income was so imputed. [45]

Example. Trust A owns a 25% interest in an investment partnership (Partnership 1) valued at $5 million, together with cash equal to the anticipated earnings that will be imputed from the 25% interest over the next several years. Trust A contributes its interest in Partnership 1 and the cash to a new Partnership 2 in exchange for a 99% limited partnership interest in Partnership 2. As a result, Partnership 2 is a 25% partner of Partnership 1 and Trust A is the 99% partner of Partnership 2. In Year 1, Partnership 1 earns $200,000, of which the Partnership 2's share is $50,000. As a 99% partner in Partnership 2, Trust A has $49,500 of that income, but Partnership 1 makes no distribution of the earnings to its partners, including Partnership 2.

Trust A would like to distribute all of the income from Partnership 2 (totaling $49,500) to charity and receive a deduction under Section 642(c) . For Trust A to receive that deduction, Partnership 2 distributes $49,500 in cash to Trust A and then Trust A contributes $49,500 to Charity C. Partnership 2 advises Trust A that the $49,500 distribution is of Partnership 2's income for Year 1. Even if Trust A does not receive the cash until Year 2, it can distribute it to charity by the time it must file its income tax return for Year 1 (not later than

October 15 of Year 2), if it receives the cash from Partnership 2 by then, and can elect to treat the distribution as though made in Year 1.

Limit where UBI is distributed by a trust

Although an estate or a non-grantor trust is entitled to a charitable deduction without limitation, no Section 642(c) charitable deduction is allowed for payments from a non-grantor trust for a charitable purpose to the extent the income so paid is allocable to the trust's UBI within the meaning of Section 681 . [46] To the extent the

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trust has UBI that is paid to charity, the deduction limitations are the same as those for an individual. [47] Section 681 does not apply to an estate; by its terms, the rule applies only to trusts.

Use of a partnership arrangement. As noted above, an estate or trust that is a partner in a partnership is entitled to a deduction under Section 642(c) for charitable contributions made by the partnership, even if the governing instrument of the estate or trust does not provide the requisite charitable intent that would be required to support the deduction if made directly by the estate or trust. Rev. Rul. 2004-5 states explicitly that the charitable contribution by a partnership is from its gross income, although the conclusion (that the trust, as a partner, is entitled to take a deduction under Section 642(c) for its share of the partnership's charitable donation) is not expressly limited to a case where the donation is made from the partnership's gross income. Nonetheless, it appears to be the position of the IRS that for a charitable contribution by a partnership to be deductible by a trust that is a partner, the charitable contribution must have been made by the partnership from its gross income. [48]

Also, it seems that if the partnership's gross income is used to acquire another asset, the contribution to charity of the asset so acquired with the trust's gross income should be treated as a contribution of gross income for purposes of Section 642(c) . [49] In other words, if gross income is used to acquire an asset, that asset itself should continue to be treated as gross income, at least as long as the asset can be traced to gross income. [50]

UBI ramifications. Rev. Rul. 2004-5 indicates that Section 681 would apply if the partnership makes the charitable contribution from gross income that would have been UBI if received directly by the trust. [51]

Although the concept of UBI does not apply to a partnership, the nature of a partnership's income presumably passes through to a trust for UBI purposes. [52]

Nonetheless, when an estate or trust distributes its gross income to charity pursuant to Section 642(c) or otherwise, the gross income should not be treated as UBI in the hands of the charity, even if it would have been UBI if received directly by the charity. This conclusion is based on:

(1) The absence of a provision that would cause the distribution to be treated as UBI in the hands of the charitable recipient.

(2) The several provisions that otherwise cause a recipient of a distribution from an estate or trust to treat it as having the same income tax character as it had in the hands of the estate or trust.

(3) The fact that there is an explicit provision requiring a charity that is a partner to treat any partnership income (without applying the rule to distributions from an estate or trust) attributed to it as UBTI if it would have been UBTI if earned directly by the charity.

For example, in the case of a partnership, UBI carries out to any partner that is a charity, as provided in Section 512(c) and as UBTI to a trust partner which, to that extent, would be subject the trust's charitable distributions of the UBTI to the Section 170 limitations to individuals. However, payments to charity from an estate or trust, even if consisting of UBTI, should not

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be treated as UBTI in the hands of the charitable recipient. Such transfers from an estate or trust to charity do not qualify for a distribution deduction under Section 651(a) or 661(a) and do not consist of the distributable net income (DNI) of the estate or trust under Section 652(a) or 662(a) , whose tax character is also passed out to the noncharitable recipient of the DNI. [53]

This seems consistent with the private foundation rules, where the net investment income of a trust or estate does not retain its character in the hands of a private foundation for purposes of Section 4940 . [54] But, as previously mentioned, Section 681(a) provides that in computing the deduction allowable under Section 642(c) to a trust (but not an estate), no amount otherwise allowable as a deduction under Section 642(c) shall be allowed as a deduction with respect to income of the tax year that is allocable to "unrelated business income." [55]

Nevertheless, with the uncertainty, the safer course to allow a non-grantor trust partner to be entitled to the charitable deduction without the limitation on contributions made by the partnership, is to have the contribution made from the partnership's gross income other than what would be UBI. [56]

Tracing contribution's source. Although not addressed, Rev. Rul. 2004-5 suggests that tracing of the source of the contribution by the partnership may be permitted-that is, because the partnership can make the charitable contribution from its gross income as opposed to any other asset it holds, it seems to follow that it can make it from gross income that would not be UBI (at least to the extent it has gross income that would not be UBI). However, a 2012 amendment to the Section 642(c) regulations provides that, for purposes of determining the type of income deemed distributed from an estate or trust to charity for purposes of "shifting" income to charity, any such distribution will be treated as consisting proportionately of all classes of gross income unless the governing instrument of the estate or trust provides otherwise and such provision has independent economic effect. [57]

This recent amendment does not, by its terms, apply to income distributed to charity by a partnership where a trust is a partner. Because a trust and an estate under the prior regulation could specify the character of the income being distributed to charity, and because the amended regulation does not by its terms apply to distributions of income by a partnership of which the trust is a partner, it may be that the partnership may specify the type of income being paid, which would be respected for purposes of Section 681 .

In any event, under Rev. Rul. 2004-5 , if a trust is a partner in a partnership, the trust will be entitled to a deduction for charitable contributions made by the partnership (at least if made from the partnership's gross income and potentially subject to Section 681 if paid or deemed paid from what would be UBI if received directly by the trust) and, usually, without the normal limitations (related to "contribution base") applicable to an individual taxpayer.

Trust as S corporation shareholder. There is developed law on whether a non-grantor trust that is a shareholder of an S corporation can take a deduction for charitable

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contributions made by the S corporation. [58] The Treasury Regulations dealing with Electing Small Business Trusts (ESBTs), defined in Section 1361(e)(1) , provide that an ESBT is entitled to a charitable deduction attributable to contributions made by the S corporation from its gross income, although "[t]he limitations of section 681 , regarding unrelated business income, apply in determining whether the contribution is deductible in computing the taxable income of the S portion." [59]

If the shareholder of an S corporation is a grantor trust for income tax purposes, [60] the charitable deduction would pass through to the individual who is the income tax owner of the trust.

In circumstances where the decedent's estate is the shareholder, or treated as the shareholder of the S corporation, the principles of Rev. Rul. 2004-5 should apply. Thus, the estate will obtain a Section 642(c) deduction for contributions by the S corporation (and not be limited by Section 681 , as that section does not apply to a decedent's estate).

Trust with UBI. The limit on a charitable deduction for UBI of a trust does offer one possible advantage. [61] Section 681 disallows the charitable deduction under Section 642(c) . However, the Regulations under Section 681 permit a partial deduction by applying Section 512(b)(11) , which imposes the percentage limitations applicable to individuals. [62] The Regulations provide in part: "While the charitable contributions deduction under section 642(c) is entirely disallowed by section 681(a) for amounts allocable to 'unrelated business income,' a partial deduction is nevertheless allowed for such amounts by the operation of section 512(b)(11) ." [63] Then Section 511(b)(11) provides:

> In the case of any trust described in section 511(b) , the deduction allowed by section 170 (relating to charitable etc. contributions and gifts) shall be allowed (whether or not directly connected with the carrying on of the trade or business), and for such purpose a distribution made by the trust to a beneficiary described in section 170 shall be considered as a gift or contribution. The deduction allowed by this paragraph shall be allowed with the limitations prescribed in section 170(b)(1)(A) and (B) determined with reference to the unrelated business taxable income computed without the benefit of this paragraph (in lieu of with reference to adjusted gross income).

Therefore, a trust with UBI is potentially entitled to a charitable deduction under Section 170 . As a result, the special rules of Section 642(c) are not applicable, particularly the requirement that the contribution come from gross income and, possibly, traceable to gross income. In addition, the requirement that the contribution be authorized by the terms of the governing instrument may not be applicable, although, for their own fiduciary protection, trustees should otherwise ensure the permissibility of distributions to charity. Without the Section 642(c) limits applying, it may be possible for a trust to make charitable gifts in kind and deduct the fair market value of the donated property, subject to the limits applicable to individuals and the amount of UBI for the tax year. Moreover, the charitable deduction carryover may in fact be applicable. However, the

substantiation requirements of Section 170 , including those under Section 170(f)(8) , will apply as the charitable deduction is now authorized by Section 170 instead of Section 642(c) .

Contributions of partial interests

As a general rule, an individual is not entitled to a charitable deduction for a gift of a partial interest in property unless it is the only interest the taxpayer owns [64] or is the remainder in a charitable remainder trust described in Section 664 . [65] It seems that these partial interest rules do not apply to contributions by an estate or trust that qualify for deduction under Section 642(c) as the partial interest rules are contained in Section 170(f)(1) *et seq.*, which states that "[n]o deduction shall be allowed *under this section*...." [66] The word "section," obviously, means Section 170 . [67] But there is no comparable condition in Section 642(c) . [68] Thus, it seems that an estate or trust could create a charitable remainder trust with its gross income, if permitted under the terms of the governing instrument, without complying with the statutory rules under Section 664 .

Alternatively, a trust might contribute gross income to a charitable lead trust, but again, not necessarily in the form described in Section 170(f)(2)(B) . This might be advantageous where it is desirable to pay the noncharitable recipient the fiduciary accounting income or some other payment not consisting of an annuity or unitrust amount, as required by Sections 664 and 170(f)(2)(B) .

Charitable purpose

For an individual, a charitable contribution must be to, or for, an organization described in Section 170(c) . For an estate or trust, the deduction is allowed under Section 642(c) if made for a charitable purpose, and in particular, it is not limited to domestic (U.S.) charities. The scope of "charitable purpose" is uncertain. Neither the Code nor any Regulation seems to provide a definition. Perhaps, it would permit the estate or trust to directly apply its gross income for a charitable purpose, such as "to foster national ... sports competition" or provide education, but not paid to an educational organization within the meaning of Section 170(c)(2) . [69] Alternatively, the trust might provide a direct benefit, such as providing food directly to the hungry or making gifts to families of police officers or soldiers killed in the line of duty. It is possible this difference might permit a charitable deduction when applied to the facts in the U.S. Supreme Court's decision in *Davis*, [70] in which a charitable deduction was denied for members of the Church of Jesus Christ of Latter-day Saints who provided direct support to their adult children who were serving as missionaries for the Church. While an interesting thought, likely it may be more prudent to find an organization described in Section 170(b) or (c) to carry out the program or make the benevolent transfers.

State income tax limitations on charitable deductions

Some states (or their political subdivisions) limit an individual's charitable deduction for state (or local) income tax deductions to an even greater extent than the Internal Revenue Code. For example, certain deductions allowed for federal income tax purposes are not allowed for New York income tax purposes, [71] and all itemized deductions for New York income tax purposes, including charitable contributions made by an individual, are reduced in many situations, especially for "high" income

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taxpayers. [72] One potential way to avoid these state limitations is for the individual taxpayer to create a trust that is not treated as a grantor trust and, perhaps, transfers to the trust are not complete for federal gift tax purposes. [73] Because the trust is not a grantor trust, it would be entitled to a charitable deduction for its gross income paid pursuant to its terms for a charitable purpose without the limitation under Section 642(c), except to the extent that gross income consists of UBI. [74] As a result, this arrangement may avoid the state limitations on the charitable deduction.

Structuring non-grantor trusts in light of Section 642(c)

It is at least arguable that all trusts should permit distributions of gross income to charity, other than ones where a tax benefit might be lost, such as a trust that qualifies for the federal estate tax marital deduction. [75] This discretionary power could be held by the trustee or a beneficiary.

Perhaps, it would be appropriate to require the trustee to obtain the consent of one or more of the beneficiaries of the trust to avoid the appearance that the trustee is trying to garner favor with one or more charities at the "expense" of the beneficiaries. Alternatively, one or more beneficiaries could be given the power to make charitable gifts to charities conditioned on obtaining the consent of another beneficiary and/or the trustees, which avoids any concern that the charity has unfairly influenced the beneficiary or that a beneficiary is trying to "punish" another beneficiary by giving away trust income to a particular charity.

It might be contended that a beneficiary who exercises the power to distribute gross income to charity has made a gift [76] by diverting gross income from himself or herself to charity, but the amount so distributed should qualify for the gift tax charitable deduction. [77] On the other hand, it might be preferable in some cases for the beneficiary to make the donation to charity. When a better choice, the trust could allow discretionary distributions to the beneficiary so he or she could make the charitable contributions with the distributions from the trust.

If gifts of income to charity are anticipated when a trust is created, it may be preferable to merely authorize general distributions to the noncharitable beneficiaries, rather than mandate them. This may be advantageous because "DNI" is defined as the trust's taxable income (with the adjustments provided under Section 643(a)), but the charitable deduction under Section 642(c) is not allowed when computing the amount of DNI for mandatory distributions of accounting income. [78] However, DNI computed for discretionary deductions is calculated after the charitable deduction is allowed. This difference in how DNI is computed and how a beneficiary's reportable income is determined is part of the unique tier system that is a cornerstone of Subchapter J of Chapter 1 of Subtitle A of the Code.

Under what are known as the "tier" rules, all amounts treated as distributed or distributable income fall into one of two categories:

(1) The amount of income, for trust-accounting purposes, required to be distributed currently, including the amount of an annuity (or other item payable out of income or corpus) that is actually paid out of such income for the year (and known as "tier 1 or first-tier distributions").

(2) All other amounts of income or corpus either required to be distributed or properly paid or credited (and known as "tier 2 or second-tier distributions"). [79]

The total amount taxable to the beneficiaries is limited to distributable net income, however, and then only to the taxable portion of DNI. [80]

Amounts in the first category, or first-tier, are included in gross income in full, to the extent DNI is not exceeded, before amounts in the second tier are included in gross income at all. If the first-tier amounts exceed DNI, each recipient of first-tier distributions includes in gross income a proportionate part of the DNI. [81]

If first-tier distributions alone do not exceed DNI, the second-tier distributions are included in the gross income of the recipient-beneficiaries to the extent of the balance of DNI. When the total of first-tier and second-tier distributions exceed DNI, each recipient of second-tier distributions includes in income a proportionate part of the amount that remains after DNI is reduced by the first-tier distributions. [82] For purposes of the DNI limit on taxing first-tier distributions to beneficiaries, the trust's income tax charitable deduction is not allowed when computing distributable net income. [83]

Example. A trust has $65,000 of taxable dividend income. Annually, the trust is required to distribute the first $10,000 of income to a qualified charity, *C*, and the balance of its accounting income to an individual, Alan. In addition, the trustee is authorized to invade principal for the benefit of a second individual, Barbara, and distributes $10,000 to her. The trust pays $10,000 in trustee fees that are chargeable one-half to income and one-half to principal. The accounting income for the trust is $60,000 ($65,000 less $5,000, one-half of the trustee's fee). Thus, the amount distributable to Alan is $50,000 ($60,000 less $10,000 due the charity). The trust's taxable income, before any deduction for the distribution of DNI, is $45,000 ($65,000 less $10,000 trustee fee and less $10,000 charitable deduction). The DNI for the trust is $45,000. Because distributions to Alan and Barbara exceed DNI, the trust's distribution deduction is limited to $45,000.

When the amount of income Alan must report is computed, DNI is recomputed without a charitable deduction. Thus, DNI is $55,000 for this purpose, and Alan has $50,000 of taxable income under Section 662 . The income he must report is less than the recomputed DNI by $5,000, because Alan has received only $50,000.

Nevertheless, Barbara has no income on the distribution of principal as the DNI for purposes of the tier 2 distribution is the original $45,000, and that amount is not in excess of the tier 1 distribution to Alan.

Therefore, a discretionary distribution, as well as a mandatory one, shifts the trust's DNI from the trust to a beneficiary but there is potentially less gross income for a discretionary noncharitable beneficiary for the same amount of a distribution. Consequently, for trusts that will make distributions to charities and individuals, only discretionary beneficiaries will indirectly receive the benefit of the charitable deduction. By providing for discretionary distributions rather than mandatory ones, a decedent can plan for that potential benefit.

Income tax advantages of a trust's charitable deduction

Another potential advantage of using a trust to make charitable gifts, rather than gifts by an individual, is that neither a trust nor an estate is subject to the 3% "cutback" rule of Section 68 .[84]

Also, the net investment income (NII) rules of Section 1411 apply differently to estates and trusts than to individuals and, as a result, there may be less NII tax payable if charitable gifts are made by an estate or trust. Under the Regulations, income distributed for charitable purposes that entitles the estate or trust to a deduction under Section 642(c) is not subject to NIIT in the hands of the trust or estate or, presumably, not in the hands of any tax-exempt recipient.[85]

The fact that an estate or trust can shift its NII to a charity may provide it with an advantage when compared to an individual taxpayer. An individual pays the NIIT on the lesser of NII or adjusted gross income (over the threshold). Charitable contributions do not reduce NII of an individual because the charitable deduction is an itemized deduction for an individual. However, the charitable contributions do reduce NII for an estate or trust.[86]

Conclusion

One of the most important differences in computing the taxable income of an individual on the one hand, and an estate or trust on the other, relates to the deduction for charitable contributions, except where the contribution by an estate or trust consists of UBI. This difference may result in preferable outcomes for taxpayers by arranging for contributions to be made by an estate or trust rather than by its beneficiaries. Building in the opportunity for the trust or estate to make discretionary distributions to charity, where doing that will not cause adverse effects, may be beneficial.

[1] For purposes of this article, all trusts are assumed not to be grantor trusts, under Sections 671 through 679 .

[2] Contribution base is the taxpayer's "adjusted gross income (computed without regard to any net operating loss carryback to the taxable year under section 172)." Section 170(b)(1)(G) .

[3] See Section 170(e)(1)(B)(i) .

[4] See Section 170(e)(1)(A) .

[5] See Section 170(e)(1)(B)(i)(I) .

[6] See Section 170(e)(1)(B)(ii) .

[7] See, e.g., Section 170(b)(1)(E) .

[8] Reg. 1.170A-8(a)(2) .

[9] Section 170(b)(1)(B) .

[10] For a more expansive discussion of the substantiation rules of Section 170(f)(8) , see the instructions for IRS Forms 1040, 1065, or 1120 and IRS Publication 526.

[11] A set-aside deduction is also allowed for certain pre-1970 trusts. See Section 642(c)(2)(A) .

[12] Section 642(c)(1) .

[13] For tax years before 2016, an estate or a trust may receive a *five-month* automatic extension of time to file its income tax return by timely filing the appropriate form (IRS Form 7004). Section 6081 . Both the Code and Reg. 1.642(c)-1(b)(1) provide that the payment must be made by the end of the year following the year in which the gross income was earned. Reg. 1.642(c)-1(b)(2) states that the "election ... shall be made not later than the time, including extensions thereof, prescribed by law for filing the income tax return for the succeeding taxable year." The Regulation goes on to provide that the election may be revoked within the time prescribed for making it.

[14] While a trust is required to use a calendar tax year (see Section 644), an estate has the option of choosing a calendar or non-calendar year.

[15] The term "contribution base" has no meaning for an estate or trust but the equivalent for an individual is adjusted gross income, as specially computed. See *supra* note 4.

[16] Reg. 1.170A-13(f)(13) .

[17] Section 681(a) .

[18] See discussion in Brownstone, 465 F.3d 525 98 AFTR2d 2006-6889 (CA-2, 2006).

[19] Weir Foundation, 362 F. Supp. 928 32 AFTR2d 73-5649 (DC N.Y., 1973), *aff'd*508 F.2d 894 35 AFTR2d 75-538 (CA-2, 1974); see also Old Colony Trust Co., 301 U.S. 379 19 AFTR 489 (1937).

[20] See, e.g., Green, 144 F. Supp. 3d 1254 116 AFTR2d 2015-6668 (DC Okla., 2015).

[21] 8 F.3d 571 72 AFTR2d 93-6524 (1973).

[22] The term "charitable lead trust" refers to a trust described in Section 170(f)(2)(B) .

[23] 710 F.2d 1316 52 AFTR2d 83-5487 (CA-8, 1983).

[24] Rev. Rul. 55-92, 1955-1 CB 390 ; W.K. Frank Trust of 1931, 145 F.2d 411 32 AFTR 1478 (CA-3, 1944).

[25] 352 F.2d 812 16 AFTR2d 5881 (Ct. Cl., 1965).

[26] See, e.g., Green, *supra* note 20.

[27] Note 18, *supra.*

[28] In Williams, 158 F. Supp. 227 52 AFTR 1162 (DC Calif., 1957), *aff'd*251 F.2d 847 1 AFTR2d 815 (CA-9, 1958), the United States District Court for the Northern District of California reached an analogous result.

[29] GCM 34277 (1970) (not precedent).

[30] "DNI" is defined in Section 643(a) as taxable income as specially modified.

[31] This conclusion seems supported by GCM 34277 (1970) (not precedent).

[32] Note 20, *supra*.

[33] The court, referring to other case law, stated: "However, and of particular importance here, *Weingarden* went further to distinguish statutes regarding charitable deductions, stating they are not matters of legislative grace, but rather 'expression[s] of public policy.'" Weingarden [825 F.2d 1027 60 AFTR2d 87-5448] (CA-6, 1987) (citing Helvering v. Bliss, 293 U.S. 144 14 AFTR 668 (1934) (further citations omitted, internal quotations omitted)). As such, "[p]rovisions regarding charitable deductions should ... be liberally construed in favor of the taxpayer." *Id.* (citing Hartwick College, 801 F.2d 608 58 AFTR2d 86-5846 (CA-2, 1986)). Thus, even if the language of the statute were unclear, a liberal construction in favor of the taxpayer" would be appropriate." *Id.* (internal citations reformatted).

[34] "Decanting" is the act of "pouring" assets of one trust to another, where permitted under the terms of the governing instrument or state law. See generally Zeydel and Blattmachr, "Tax Effects of Decanting-Obtaining and Preserving the Benefits," 111 J. Tax'n 288 (November 2009) (cited in Morse v. Kraft, 992 N.E.2d 1021 (Mass. 2013)).

[35] Reg. 1.671-2(e)(5) .

[36] 1 CB 295. See also CCA 200928029 (not precedent).

[37] See, e.g., Section 663(a)(1) .

[38] Compare the following cases with each other: Old Colony Trust Co., *supra* note 19; Benedict, 592 U.S. 692 38 AFTR 1208 (1950); Crestar Bank, 47 F. Supp. 2d 670 83 AFTR2d 99-2555 (1999); Van Buren, 89 TC 1101 (1987); Riggs National Bank, *supra* note 25; W.K. Frank Trust of 1931, *supra* note 24; Freund's Estate, 303 F.2d 30 9 AFTR2d 1479 (CA-2, 1962); Sid W. Richardson Foundation, 430 F.2d 710 26 AFTR2d 70-5144 (CA-5, 1970); and Esposito, 40 TC 459 (1963), *acq*. 1964-1 CB (pt. 1) 4.

[39] Riggs Nat'l Bank, *supra* note 25. The tracing in the context of Section 642(c) forms the basis for the limited exception to the general removal of the tracing requirement accomplished by Subchapter J. Van Buren, *supra* note 38. This concept was specifically recognized in Mott, 462 F.2d 512 30 AFTR2d 72-5193 (Ct. Cl., 1972) (en banc), where the court stated that "tracing of charitable distributions is still required under Section 642(c) and to the extent that a charitable deduction is not paid out of gross income in accordance with the requirements of Section 642(c) , then we think that Congress intended that no deduction is allowable."

[40] Note 38, *supra*.

[41] Note 24, *supra*.

[42] A distribution from a simple trust will likely generate income if the property is appreciated as under Kenan, 114 F.2d 217 25 AFTR 607 (CA-2, 1940), and the amount required to be distributed is being satisfied with appreciated property.

[43] Unif. Principal & Income Act §402 (1997), 7B U.L.A. 163 (2000).

[44] Under Reg. 301.7701-3 , certain entities are disregarded for federal tax purposes. If the trust or estate "owns" such an entity, income imputed from pass-through entities (such as a hedge fund) to that disregarded entity might be treated as received by the trust or estate.

[45] *Cf*. Ltr. Rul. 201246003 (not precedent).

[46] UBI, for purposes of a non-grantor trust, consists of the trust's income from certain business activities and from certain property acquired with borrowed funds reduced by the modifications listed in Section 512(b) . These modifications include a deduction for charitable contributions allowed by Section 170 , subject to the percentage limitations applicable to individuals. UBI, within the meaning of Section 681 for trust purposes, is essentially the same as unrelated business taxable income (UBTI) defined in Section 512 and includes income attributable to acquisition indebtedness. Acquisition indebtedness is defined in Section 514(c)(7) . Capital gain recognized on the sale of an asset is not normally UBTI if there is no debt against the property. Section 512(b)(5) .

[47] See Reg. 1.681(a)-2(a) (second to last sentence); Section 512(b)(11) .

[48] See FSA 200140080 (not precedent).

[49] See, e.g., Green, *supra* note 20. See also Old Colony Trust Co., *supra* note 19 (dealing with the predecessor to current Section 642(c) , in which the Court deferred to the fiduciary's accounting treatment to answer the question whether a certain payment was made from gross income or principal); CCA 201042023 (ruling that a property bought with accumulated income of a trust was deductible under Section 642(c) when distributed to charity because it was out of gross income, however, the charitable deduction was limited to the trust's adjusted basis in the property) (not precedent). *Cf.* Crestar Bank, *supra* note 38; Freund's Estate, *supra* note 38; Sid W. Richardson Foundation, *supra* note 38; W.K. Frank Trust of 1931, *supra* note 24; Esposito, *supra* note 33.

[50] See sources cited *supra* note 49.

[51] The ruling states, in part, "[b]ecause none of [the partnership]'s income for the taxable year would be considered 'unrelated business income' for purposes of §681(a), the amount of the charitable deduction is not limited under §681." Also, note that Box 20 of Schedule K-1 of a partnership income tax return specifically requires that the share of the partner's UBI of the partnership be disclosed. In FSA 200140080 (not precedent), which dealt with a trust's distributive share of a partnership's charitable contributions, the IRS stated that although the courts in Estate of Lowenstein, 12 TC 694 (1949), *aff'd*183 F.2d 172 39 AFTR 643 (sub nom First National Bank of Mobile v. Commissioner) (CA-5, 1950)) and Estate of Bluestein, 15 TC 770 (1950), did not analyze the governing instrument requirement, "the basis for the court's allowance of the deductions appears to be the fact that the contributions were made at the partnership level and that the estate would never receive the benefit of these amounts." The IRS further stated, "Based on the *Bluestein* and *Lowenstein* cases, we believe that a trust should be allowed a deduction for its distributive share of charitable contributions made by a partnership even though the trust's governing instrument does not authorize the trustee to make charitable contributions. However, all of the other requirements of [IRC] §642(c)(1) must be met, and the limitations of [IRC] §681(a) must be taken into account."

[52] Section 513(b) .

[53] See Section 663(a)(2) (denying this treatment for amounts paid to charity that are deducted under Section 642(c) (and determined without regard to Section 681) by an estate or trust).

[54] See Notice 2004-35, 2004-19 IRB 889 . So, UBI should not be treated as "carried out" from an estate or trust to a charity and treated as UBTI in its hands.

[55] See also Section 642(c)(4) (providing that, in the case of a trust (but not an estate), the deduction allowed by Section 642(c) is subject to Section 681 (related to UBI)). *Cf*. also discussion in Blattmachr, "Something Pretty Scary: Application of Certain Private Foundation and UBTI Rules in Estate Planning and Administration," 26th Annual Heckerling Institute on Estate Planning (1992).

[56] Note that Section 68(a) , which provides an overall limitation on itemized deductions, does not apply to a non-grantor trust or a decedent's estate. Section 68(e) . The 2% "floor" rule of Section 67(a) does not apply to Section 642(c) deductions. Section 67(b)(4) .

[57] See Reg. 1.642(c)-3(b)(2) .

[58] Although Section 1366(a)(1) provides that an S corporation shareholder may deduct on the shareholder's own income tax return a pro rata portion of the corporation's charitable contributions, Section 1366(d)(1) limits the deduction to the sum of the shareholder's basis in his or her stock and any basis in any debt the corporation owes to the shareholder. For years 2006 through 2013, a somewhat different rule on the limitation for such deductions applied. This limitation does not apply to a partner on charitable contributions made by the partnership.

[59] Reg. 1.641(c)-1(d)(2) . The "S portion" of the ESBT's income is the income from the S corporation that is attributed to the trust. See generally Blattmachr and Boyle, *Blattmahr on the Income Taxation of Estates and Trusts* (PLI, 2015).

[60] Note that the beneficiary of a qualified Subchapter S trust makes an election pursuant to Section 1361(d)(2) for the trust to qualify by the beneficiary being treated as the income tax owner of the S stock pursuant to Section 678 . See Blattmachr and Boyle, *supra* note 59.

[61] Section 681(a) .

[62] Reg. 1.681(a)-2 .

[63] *Id.*

[64] Note that both the gift tax and income tax charitable contribution provisions contain similar partial interest rules. Both, in general, disallow any deduction for a contribution of a partial interest in property, although both permit a deduction if the only interest the taxpayer holds is the partial interest. Sections 170(f)(3) and 2522(c) . However, for income tax purposes, the rule disallowing a deduction for the partial interest applies even if that is the only interest the taxpayer held in the property if it was divided to avoid the partial interest disallowance rule even if the division occurs by a sale for full and adequate consideration. Reg. 1.170A-7(a)(2)(i) (third sentence). Nonetheless, for gift tax purposes, the disallowance applies regardless of the reason for the division if the interest not contributed to charity is retained by the donor or has been transferred to anyone for less than an adequate and full consideration in money or money's worth.

[65] Section 170(f)(2)(A) .

[66] Emphasis added.

[67] Similarly, other parts of Section 170(f) will not apply to contributions by an estate or trust that qualify under Section 642(c) , such as the substantiation requirement under Section 170(f)(8) , which begins "No deduction shall be allowed under subsection (a)...." There is no substantiation requirement in Section 642(c) .

[68] Note that somewhat different partial interest rules are contained in Sections 2055 and 2522 for estate and gift tax purposes, but there is none under Section 642(c) and the deduction under that section is "in lieu of the deduction allowed by section 170(a) ." To begin, under Section 641(b) , the taxable income of a decedent's estate and a non-grantor trust is determined in the same manner as that of an individual with certain differences provided in the Code. Perhaps, the most important difference in computing the taxable income of an estate or trust compared to that of an individual is the allowance of a deduction

under Section 651(a) or 661(a) for its DNI distributed or required to be distributed to one or more of its beneficiaries. The DNI deducted by the estate or trust is included under Section 652(a) or 662(a) in the gross income of the beneficiary or beneficiaries who are treated as receiving it.

[69] Under Section 170(b)(1) , charitable contributions include those to certain charitable educational organizations that "normally maintain[] a regular faculty and curriculum and normally ha[ve] a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on."

[70] 495 U.S. 472 65 AFTR2d 90-1051 (1990).

[71] N.Y. Tax Law §615(c).

[72] *Id.* §615(g).

[73] See generally Blattmachr and Lipkind, "Fundamentals of DING Type Trusts: No Gift Not a Grantor Trust," 26 Probate Practice Reporter (April 2014).

[74] Note that New York has enacted legislation that causes such a trust created by an individual that is not a grantor trust for federal income tax purposes and transfers to which are not complete for gift tax purposes to be treated as a grantor trust for New York income tax purposes. N.Y. Tax Law §612(b)(41).

[75] Only the surviving spouse may be the beneficiary during his or her lifetime of a trust that is intended to qualify for the gift or estate tax marital deduction. See Sections 2523 and 2056 . Although certain marital deduction trusts, see, e.g., Section 2056(b)(5) , may permit the spouse who is the beneficiary to exercise a general power of appointment, any exercise in favor of charity likely would be treated as

being made by the spouse and not the trust.

[76] See Regester, 83 TC 1 (1984).

[77] The meaning of "charitable" varies slightly for income and gift tax purposes. To avoid any issue, transfers, at least above the gift tax annual exclusion under Section 2503 , should be made only to charitable organizations that qualify for the gift tax deduction under Section 2522(a) .

[78] The last sentence of Section 662(b) , which determines the character of amounts distributed from a trust (or estate) to a beneficiary, provides that with respect to amounts of fiduciary accounting income required to be distributed currently: "[D]istributable net income shall be computed without regard to any portion of the deduction under section 642(c) which is not attributable to income of the taxable year." It may be noted that no Section 642(c) deduction is allowable with respect to trust distributions that are governed by Sections 651 and 652 . See, e.g., TAM 8738007 (not precedent).

[79] Section 662(a) .

[80] Distributable net income (DNI) is described in detail in section 3:3.2 of Blattmachr and Boyle, *supra* note 59. However, in the very limited circumstances when the "throwback rules" apply, distributions of accumulated (prior years') income may also become taxable to the beneficiary.

[81] An exception exists if certain classes of income are distributable to only certain beneficiaries. Reg. 1.662(b)-1 .

[82] Section 662(a)(2) .

[83] Section 662(a)(1) .

[84] See Section 68(e) .

[85] The deduction under Section 642(c) is permitted when the distribution is for a charitable purpose, which might not include an income tax exempt charity. See section 3:2.1[J] of Blattmachr and Boyle, *supra* note 59, for a detailed discussion. In any case, it seems that no part of a distribution of NII could be considered unrelated business taxable income within the meaning of Section 512(a) . See generally Blattmachr, *supra* note 55.

[86] However, it may not reduce the NII allocated to a noncharitable beneficiary of an estate or trust to the extent the beneficiary is entitled to a current distribution of fiduciary accounting income. See *supra* note 78 on how to challenge and defeat or avoid will contests and accompanying text.

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