G. CONTROL AND POWER :
ISSUES INVOLVING SUPPORTING ORGANIZATIONS, DONOR ADVISED FUNDS, AND DISQUALIFIED PERSON FINANCIAL INSTITUTIONS

by
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"It is not what you own;
It's what you control"
Attributed to John D. Rockefeller

"The desire of power in excess caused the angels to fall"
Francis Bacon from "Of Goodmen"

1. Introduction

The 1997 CPE Text, Topic I, and the 2000 CPE Text, Topic P, addressed some of the more common issues and problems of organizations asserting supporting organization status under IRC 509(a)(3). The 1997 CPE Text concentrated primarily on the "operated in connection with" relationship test under Regs. 1.509(a)-4(i), although other important issues were discussed. The 2000 CPE Text focused on the IRC 509(a)(3) control test. This topic will elaborate on the control test; discuss the IRC 501(c)(3) "threshold" requirements; and comment on other IRC 509(a)(3) issues under Regs. 1.509(a)-4(b), (c), (d), and (e) relating to the organizational and operational tests. Part 7 includes a supporting organization check sheet, "SOCHECK", to guide EO specialists through a IRC 509(a)(3) determination.

In addition, this article will provide an update of control and power issues, discussed in prior CPE Texts, relating to donor advised funds ("DAFs") under IRC 501(c)(3) and IRC 4941 self-dealing with respect to disqualified person financial institutions and their financial products and services. The topic will also update the 2000 CPE Text, Topic P, p. 225, discussion on the treatment of IRC 4947(a)(2) distributions to private foundations under IRC 4940. Finally, the topic will touch on the Charitable Family Limited Partnership, another recent tax plan with EO connections and tax abuse potential.

2. IRC 509(a)(3) Supporting Organizations

Note: Hereafter we will identify the terms "supporting organization" and "supporting organizations" as "SO" and "SOs" respectively; an "operated, supervised or controlled by" SO as a "SO1", a "supervised, or controlled in connection with" SO as a "SO2", and an "operated in connection with" SO as a SO3"; IRC 509(a)(1) and 509(a)(2) supported organization(s) will be identified as "SD" and "SDs"; and disqualified persons will be referred to as DPs.

A. Threshold Requirement- IRC 501(c)(3) status

Before considering IRC 509(a)(3) classification, it is necessary to determine if the organization is exempt under IRC 501(c)(3), or, in the case of a non exempt trust under IRC 4947(a)(1), whether all unexpired interests are devoted to solely charitable purposes.

In explaining IRC 509(a)(3) in conjunction with certain grandfather exceptions for existing organizations, the General Explanation of the Tax Reform Act of 1969, H.R. 13270, 91st Congress, Public Law 91-171, p. 59, footnote 29, (Blue Book) states:

> However, this does not change the basic requirement for exemption in section 501(c)(3) that the organizations have been organized and operated exclusively for tax exempt purposes listed in that provision.

EO Determination Specialists, Examination Agents, and Tax Law Specialists should initially review the IRC 501(c)(3) charitable credentials of a IRC 509(a)(3) applicant as vigorously as they would initially review the IRC 501(c)(3) charitable credentials of an applicant claming public charity status under IRC 509(a)(1) or 509(a)(2).

One recent concern is the appearance of a line of cases wherein the 1023 applicant is performing services for unrelated specified charities as a primary activity. Organizations that provide noncharitable services to such a class of organizations do not qualify for exemption themselves unless they are covered by statute, i.e., IRC 501(e) or IRC 501(f), or they provide services at substantially below cost. See Rev. Rul. 71-529, 1971-2 C.B. 234, and Rev. Rul. 72-369, 1972-2 C.B. 245, and the 1986 CPE Text, Topic H.

Recent T:EO examples of unrelated services proposed to be performed by 1023 applicants for unrelated IRC 501(c)(3) organizations include facilitating bond issuances for community trusts or environmental charities, prepaid tuition programs for a number of private colleges, and job placement services for a group of colleges and their alumni. See also Topic E of this Text on College Housing.

B. Organizational and Operational Requirements

(1) Overview

Applicants must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more SDs.

Pursuant to Reg. 509(a) – 4 (c) and (d), an SO's articles must:

(a) Limit purposes to IRC 509(a)(3)(A) purposes;

(b) Not expressly empower SO to engage in activities not in furtherance of purposes in (a);
(c) State the specified SDs on whose behalf such SO is to be operated; and
(d) Not expressly empower the SO to operate to support or benefit any SD other than those referred to in (c).

Further, Reg. 1.509(a)-4(e) provides that an SO will be regarded as "operated exclusively" to support one or more specified SDs only if it engages soley in activities which support or benefit the specified SDs.

In Trust under will of Bella Mabury v. Commissioner, 80 T.C. 733 (1983), the terms of a decedent's trust described in IRC 4947(a)(1) provided that the trust would terminate upon the earlier of (1) the publication of a book by a specified IRC 509(a)(1) church or (2) the expiration of 21 years from the date of the survivor of the persons named in the decedent's will. If (1) occurred, the trust estate would be distributed to the church. If (2) occurred, the trust estate would be distributed to two other organizations designated in decedent's will not stipulated in the facts as IRC 509(a)(1) or 509(a)(2) entities.

The Tax Court held that the trust failed the organization test within the meaning of IRC 509(a)(3) and Regs. 1.509(a)-4(c) because the Trust's articles "expressly empower" the trust to benefit organizations other than specified organizations described in IRC 509(a)(1) or (2).

(2) Specificity In General and SO1 and SO2 Requirements

Reg. 1.509(a)-4(d) provides that the articles of the SOs must specify the IRC 509(a)(1) and 509(a)(2) SDs by name. However, more latitude is granted to SO1s (Reg. 1.509(a)-4(g)) and SO2s (see Reg. 1.509(a)-4(h)). In such cases, the articles of organization need not specify the SDs by name but may, instead benefit one or more beneficiary organizations designated by class or purpose. Example (1) of Reg. 1.509(a)-4(d)(2)(iii) describes organization, **X**, which operates for the benefit of institutions of higher learning in State **Y**. **X** is controlled by these institutions. If **X**'s articles require it to operate for the benefit of such institutions, **X** will meet the organizational test. In Example (2), **M** is an organization described in IRC 501(c)(3), which was organized and operated by representatives of **N** church to run a home for the aged. **M** is controlled by **N**. The care of the sick and the aged are long standing temporal functions and purposes of organized religion such as **N**. By operating a home for the aged, **M** is operating to support or benefit **N** church in carrying out its temporal functions. Thus **M** operates to support one of **N**'s purposes without designating **N** by name.

Under the regulations and the examples cited, articles that merely provide the SO would benefit all IRC 501(c)(3) public charities in a particular geographical area do not meet the specificity requirements.

Reg. 1.509(a)-4(d)(2)(iv) provides another special rule for SO1s and SO2s. A SO will meet the organizational test even though its articles do not designate each "specified" organization if there has been an "historic and continuing" relationship between the SO1 or SO2 and the SDs, and, by reason of the relationship, there has developed a "substantial identity" of interests between the organizations. In Windsor Foundation v. U.S., 1977-2 USTC 9709, the Tax Court held that the SO failed the organization test because of the failure to establish a "substantial identity" of interests between the SO and the SD.

Finally, Reg. 1.509(a)-4(d)(3) provides more special rules for SO1s and SO2s. A SO will not fail the test of being organized for the benefit of "specified" organizations solely because its articles:

(i) Permit the substitution of one SD within a designated class for another SD, either in the same or a different class designated in the articles;
(ii) Permit the SO to operate for the benefit of new or additional SDs of the same or a different class designated in the articles; or
(iii) Permit the SO to vary the amount of its support among different SDs within the class or classes of organizations designated by the articles.

The key to achieving the latitude granted in the regulations is to provide for it in the organizing document. Thus, a change of SDs in the organizing instrument of the SO1 or SO2 that was not covered by articles permitted under Reg. 1.509(a) – 4(d)(3), may cause the SO to fail the organization test, the operational test (when distributions are made by the SO to substituted SDs), and the SO1 or SO2 relationship test. See, for example, PLR 9052055, October 4, 1990. See also PLR 97309040, October 6, 1997, involving substitutions made pursuant to a governing instrument reformation approved by a court.

(3) Requirements for SO3s

SO3s, the "razor edge" organizations described in Reg. 1.509(a)-4(i), must have governing instruments that designate a specified SD. However, there is some flexibility permitted by the Regulations. Reg. 1.509(a)-4(d)(i)(a) provides that an SO will not be disqualified merely because its articles permit an SD designated by class or purpose, rather than by name, to be substituted for the SDs designated by name in the articles, but only if the substitution is conditioned on an event "beyond the control" of the SO, such as loss of exemption. Also, Reg. 1.509(a)-4(d)(4)(i)(a) provides that the articles may permit

the SO3 to vary the amounts of its support between different SDs, so long as the amounts meet the requirements of the integral part test of Reg. 1.509(a)-4(i)(3) with respect to at least one beneficiary. A third exception in Reg. 1.509(a)-4(d)(4)(i)(b) is likely to be of limited application. It permits the SO3 to have governing instrument language allowing it to operate for the benefit of a beneficiary organization that is not publicly supported, but only if the SO3 currently operates for the benefit of an IRC 509(a)(1) or (a)(2) SD and the possibility of operating for the benefit of the other SD is a remote contingency. Reg. 1.509(a)-4(d)(4)(c)(ii) and (iii) make clear, however, that once the SO3 is no longer supporting the SD and the SO3 is supporting the non IRC 509(a)(1) or (2) organization, because the remote contingency has occurred, the SO3 would then fail to continue to qualify as SO. As with SO1s and SO2s, the flexibility permitted in the Regulations for SO3s is conditioned on appropriate language in the governing instrument.

(4) Specificity Examples

A number of authorities illustrate the rules. In Rev. Rul. 79-197, 1979-1 C.B. 204, a SO1's articles of organization required it to pay its future income to specific SDs named in the articles, until a specific sum was paid. After that, it would pay all its assets to public charities selected by the substantial contributor to the SO1. Rev. Rul. 79-197 explains that the organization failed as a SO under IRC 509(a)(3) because, in the end, it was not supporting a SO designated by name, class, or purpose. Although the organization was described as a SO1 and thus was entitled to the more liberal designation requirements of Reg. 1.509(a)-4(d)(2), it failed to qualify as an IRC 509(a)(3) SO because its articles did not specifically designate the SD by class or purpose.

In Quarrie Charitable Fund v United States, 603 F.2d 1274 (7th Cir.,1979), the trust document allowed the trustee to transfer the income to a SD other than the designated charity when, in the trustee's discretion, the charitable uses would become unnecessary, undesirable, impractical, or no longer adapted to the needs of the public. The court found that the language failed the organizational requirement of Reg. 1.509(a)-4(d)(4)(i)(a). The court explained that the problem was not that the charitable use may become impractical or undesirable, but that in the trustee's discretion, such use may become impractical or undesirable etc. In contrast, the Regulations establish objective standards of when the charitable recipient may be changed.

Other cases on the organizational and designation requirements of the regulations were discussed in the 1997 CPE Text, Topic I, page 123-125. In the Goodspeed, Callahan, and Cockerline scholarship cases, the respective courts found that the SOs, by virtue of the language in the trust documents, were supporting specific organizations, i.e., specific high schools or colleges, even though they may not have been directly named in the trust documents.

The organization and operation test discussion herein fits within the major theme of this Topic regarding control and power of DPs or others. As evident in Rev. Rul. 79-179 and the Quarrie case, if discretion (i.e., control or power) is given or retained to select the SD outside the parameters is permitted in the regulations, the SO will fail to qualify under IRC 509(a)(3). For example, retained power in SO3 **X**'s trust instrument to allow descendent DPs to substitute Community Trust **A** with Community Trust **B** when such DPs move to the **B** geographic area would cause **X** to fail the organization test. It is again important to note that the regulations do allow some flexibility in terms of substituting or adding SDs, provided appropriate language is included in the articles of organization.

C. IRC 509(a)(3)(C) – Prohibition of DP Control of SOs

(1) Overview

IRC 509(a)(3) is an area of aggressive tax planning by some taxpayers and their advisors, particularly entities claiming status as SO3s. Applicant SO3s often, and inappropriately, attempt to avoid private foundation status and IRC Chapter 42 regulation while their DPs retain control of assets. This was discussed in Inappropriate Use of a Supporting Organization at page 222 of the 2000 CPE Text, Topic P.

This year's topic leads off with a quote attributed to oil industry titan, John D. Rockefeller, the essence of which is that control may be a more important factor than ownership itself. Control may be the most critical or meaningful factor in the plethora of requirements that must be met for an organization to be classified as an IRC 509(a)(3) SO. SO1 and SO2 applicants generally display facts and circumstances tending to indicate that SDs are in control. On the other hand, SO3 applicants have a greater proclivity to display facts and circumstances tending to show that DPs directly or indirectly control the SOs.

Excess benefits transactions under IRC 4958 may also occur in SOs with Boards consisting of DPs without adequate conflict of interest procedures. The "rebuttable presumption" rules under proposed Regs. 53.4958-6 provides a standard.

(2) Control – Regulatory Authority

IRC 509(a)(3)(C) provides that an organization will fail to qualify as a SO if it is directly or indirectly controlled by one or more DPs as defined under IRC 4946, other than foundation managers.

Reg. 1.509(a)-4(j)(1) provides that if a person who is otherwise a DP with respect to a SO, for example, a substantial contributor, is appointed or designated as a foundation

manager of the SO by a SD to serve as the representative of the SD, such person will still be regarded as a DP, rather than as a representative of the SD.

Reg. 1.509(a)-4(j)(1) also provides:

> Under the provisions of IRC 509(a)(3) a SO may not be controlled directly or indirectly by one or more DPs. An organization will be considered "controlled" for purposes of IRC 509(a)(3), if the DPs, by aggregating their votes or positions of authority, may require such organizations to perform any act which significantly affects it operations or may prevent such organization from performing such act. . . . a 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 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting right with respect to stocks in which members of the governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization."

(3) The Essence of Control – Four Examples

(a) Example 1 - Rev. Rul. 80-207

Rev. Rul. 80-207, 1980-2 C.B. 113, provides an example of indirect control. In Rev. Rul. 80-207, two of the four SO directors were also employees of a corporation in which the substantial contributor to the organization owned more than 35 percent of the voting power of the corporation. This individual was also a director of the SO. Because of the employment relationship of the two employee board members, Rev. Rul. 80-207 concluded that the SO was controlled indirectly by the DP.

Rev. Rul. 80-207 provides the following analysis:

> Because only one of the organization's directors is a disqualified person and neither the disqualified person nor any other director has a veto power over the organization's actions, the organization is not directly controlled by a disqualified person under section 1.509(a)-4(j) of the regulations. However, in determining whether an organization is indirectly controlled by one or more disqualified persons, one circumstance to be considered is

> whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons. Thus, employees of a disqualified person will be considered in determining whether one or more disqualified persons controls 50 percent or more of the voting power of an organization's governing body.

Rev. Rul 80-207 clarifies that all pertinent facts and circumstances will be considered in determining whether a DP does in fact indirectly control an SO such as through a position of influence.

(b) Example 2 – Control of Board of Directors

Consider the following example: "**T**" seeks status as a SO1. **T** has a five member board of directors. Two directors, substantial contributors, "**M**" and his wife, are DPs under IRC 4946. The other three directors are officers or directors of the SD. One of the three SD directors, "**O**", is a partner in a law firm that represents the substantial contributors, **T**, and the SD. **O** and his firm represent **M** and his wife on their personal tax affairs. Further, the SO's directors elect M as the initial operating CEO of the SO. Two of T's three remaining officers are also DPs. Reg. 1.509(a)-4(j)(i) provides that if a SD designates a person who is otherwise a DP, aside from being a foundation manager to the SO, that person is still regarded as a DP. Under the circumstances, **T** appears indirectly controlled by DPs as in Rev. Rul 80-207. It would be difficult to see how **O** could remain independent or be objective in his T board of director dealings with **M** and his wife. Other cumulative evidence of DP control of T is the fact that three of the four officers are DPs.

(c) Example 3 – Complex Trustee Structure

The control issue should be thoroughly analyzed if organizational documents or other facts indicate that: 1) DPs select the "non DPs" or "independents" or "community members" on the Board; or 2) committees controlled by DPs nominate Board members. Other control indicia might include bylaws that provide that DP members of the Board of Directors cannot be removed, even for cause. This is strong evidence of prohibited control. See, for example, D below.

Consider this hypothetical: X is a charitable trust that claims IRC 509(a)(3) status as an SO3 following Rev. Proc. 72-50, 1972-2 C.B. 830. X will provide support to specified SDs as provided in the trust document.

X will receive contributions, make investments, and make grants to SDs in the board's discretion, except that grants totaling over $100,000 to single recipients within a

12-month period must be approved either by (1) the vote of at least 2/3rds of the X Board of Trustees, or (2) two majority votes of the Board, one preceding and one following the annual reconstitution of the Board.

X's Board consists of two "Class A" trustees and three "Class B" trustees. The Class A trustees will be A, the grantor/creator, and a family member of A, or an employee of an entity that A owns. Class B trustees cannot include any DPs.

X's Board will be reconstituted every year. The Class A trustees select the successor Class A trustees. Class B trustees are selected by majority action of the Trustee Electors from among nominations approved by the Class B Nominating Committee. The Trustee Electors, who elect their successors, will be officers or directors of an SD, but cannot include DPs. X's Nominating Committee consists of two individuals selected by the Class A trustees and one selected by the Trustee Electors, and may include trustees. A majority of the Nominating Committee approves the slate of candidates, which includes at least two candidates for each position to be filled. The Trustee Electors then vote on the slate. If the Trustee Electors do not elect a Class B trustee position, then the Nominating Committee proposes a different slate of candidates for each unfilled position. If the Trustee Electors do not fill the Class B trustee position after two slates, then the Class A trustees shall elect the Class B trustee to fill the unfilled position. Trustees of either class may be removed, but only for cause and only by the affirmative vote of 2/3rds of the Trustee Electors. A trustee may delegate in writing his or her rights to any other trustee.

A's approval is expressly required to amend X's trust instrument. Given A's power over the trustee selection process discussed above, A can effectively prohibit grants exceeding $100,000 to a single recipient within a 12-month period. Moreover, a trustee may delegate his or her voting rights on substantive matters to A in making distributions upon dissolution.

If individual A is legally competent, X trust instrument may be amended only with his written approval. If he is dead or incompetent, X's board may amend with an 80% vote. The trust instrument provides that A's charitable preferences will be used as a guide.

In this hypothetical, X fails to meet the control test as a SO because X is indirectly controlled by a DP. A directly controls his own position on the board and indirectly controls the other Class A trustee positions through family or employment relationships. Further, the facts and circumstances show that A exercises indirect control over the three Class B trustee positions through his control over the slate of nominees for those positions. Although A cannot ensure that a particular individual will be on X's Board (because two candidates must be offered for each open position), A can ensure that

particular individuals will not be on the X Board. A has in effect veto power over the return of any or all of the incumbent Class B trustees to the board, such as trustees who may not agree with his ideas on the direction of X. As the Board is reelected every year, A can depend on an X Board that will endorse A's views and proposals. By controlling the nomination process, A also maintains the ability to steer grants to the charities of A's choice. A's control is also manifested by the trust instrument's expressed intent that X not survive A's death or incompetence for very long, and that the Board use A's charitable preferences as a guide in making distributions upon dissolution.

(d) Example 4 – SO Assets Controlled by DPs

Consider this hypothetical:

Business owner **G** loans cash to his wholly-owned corporation, **H**, in an exchange for a promissory note (NOTE) issued by **H**. NOTE is secured by real estate owned by **H** and used in its business. Further, **H** has purchased key man insurance to pay off the debt in the case of **G**'s death. **G** transfers NOTE to newly organized SO3, "**J**". **G** and his wife serve as two of the five directors of **J** and one director is appointed by SD, "**Q**". **G** is DP by virtue of being a substantial contributor in addition to being a foundation manager.

J's asset is H's NOTE. Because **G** controls **H**, **G** controls NOTE transferred to **J**. If he wished, **G** could consume all of **H**'s income and liquid assets through salary and dividends leaving nothing to be paid on NOTE. **G** could also operate **H** in an imprudent manner, such as an untimely expansion of **H**'s product or service without adequate capital support, which could work to the detriment of **J**.

J asserts that **J** holds NOTE secured by **H** real estate and by the corporate life insurance policy on **G**. The life insurance can be cancelled or cashed in by **H**. **G**'s control of **H** allows him control over the real estate. Any number of actions taken by **G** could impair the security. For example, **G**, in operating **H**, could incur debt (or have incurred debt) secured by the real estate with a priority equal to or greater than the priority of the security held by **J**. Further, **G** could impair the going concern value of the **H** business in a manner that impairs the market value of **H**'s underlying real estate asset.

Whether a DP indirectly controls the supporting organization is based on "all pertinent facts and circumstances." Regs. 1.509(a)-4(j)(I), extracted in (2) above, mention that the time length of the retention of SO assets, as well as the manner of exercising voting rights in stock in which members of the SO's governing body also have interests, are factors to suggest that a DP's continuing relationship with certain SO assets have a bearing on the control issue. In this hypothetical, NOTE held by **J** and **G**'s connection to NOTE are relevant facts.

Since **G** exercises, in large part, control over **J**'s asset, it would be difficult not to conclude that **G** is exercising indirect control over **J**. Inurement issues may also arise where DPs, such as **G,** may use assets of IRC 501(c)(3)s for their use. See, for example, Rev. Rul. 67-5, 1967-1 C.B. 123.

Other SO control examples are discussed in the 1997 CPE Text, page 116, et. seq.

D. SOs and Donor Advised Funds ("DAFs")

T:EO is considering situations in which a DAF associated with an IRC 501(c)(3) SD is claiming SO status. As we will discuss through the example below, a DAF may not be compatible with an SD in terms of being classified as an IRC 509(a)(3). In Part 3 of this Topic, we will update past CPE topics on DAFs with a claimed public charity status other than IRC 509(a)(3).

Consider the following example of proposed DAF SO3 X associated with an SD:

X is a charitable trust described in IRC 4947(a)(1). Pursuant to Rev. Proc. 72-50, 1972-2 C.B. 830, X applies for status as a SO3 under IRC 509(a)(3). X's trust instrument provides that the assets are devoted to benefit Christian activities, and that X's primary mission is to support Christian educational activities, such as Christian youth organizations worldwide, with an emphasis on education and scholarship grants. X will receive gifts from its donor founders, invest them, and use the principal and income to support various programs of Christian organizations worldwide.

X's substantial contributor founders are A and B. They are also X's trustees, along with a third trustee. A and B cannot be removed as trustees except upon resignation, death, or incapacitation. Future trustees shall be selected from the direct descendants of A and B. If there are insufficient descendants to constitute a majority, X will be dissolved. X will also be dissolved after the death or permanent incapacitation of the last grandchild of the donors.

The SD named in the trust instrument is Z. Z claims IRC 501(c)(3) and 170(b)(1)(A)(vi) status. Z has the power to enforce the trust agreement and compel an accounting. X may make its grants either through Z or directly, with Z's prior approval, in amounts a majority of X's Trustees determine. Most Board decisions, including trustee selections and grant approvals, must be reviewed by Z. Z cannot unilaterally withhold approval but must provide a valid reason to X for any disapproval. Z has no review approval over X's investment policies.

Z is a relatively large organization with prior year total revenues and expenses in the millions of dollars. Z provides the following public information about its operations:

> Here's how we operate: You approach us with a particular project, either educational, scientific, religious, or charitable. Our board reviews it, and if we believe it falls within our purposes, we accept it as a 'foundation account' or a Z foundation.
>
> The control of a "foundation at Z" is in the hands of the Donor/Applicant, or his designee, under the final authority of the Z. For there to be a "completed gift", the final authority has to be given to the charity – just like it would be if you set up your own "three person Board" in a private foundation. But we make our living by helping you accomplish your bona fide charitable purposes, and we would be swiftly out of business if we crossed up any bona fide charitable suggestions you or your designee might make . . . your foundation can support any qualified charity, except those where your gift will encourage (1) violence (2) promote atheism, or (3) compromise the freedoms guaranteed in our Constitution. We also permit your foundation within this framework to also conduct independent charitable activities.

The facts here make it difficult for X to establish its SO3 status under IRC 509(a)(3). A majority of X's board consists of DPs, who cannot be removed except upon resignation, death, or incapacitation, and, in the future, descendants of DPs. X's board approval is required for X to take most actions. Although Z maintains an approval power over certain decisions, this power does not extend to investment decisions and cannot in any case be exercised unilaterally. Moreover, Z has publicly acknowledged that it will not disapprove any proposal that is charitable in nature and fits within its extremely broad guidelines. In form and in substance, X is controlled by DPs.

Further, X has failed to establish that it meets the operational test of IRC 509(a)(3)(A) and Reg. 1.509(a)-4(e)(1), because in addition to making payments to Z and making grants and providing services to the individual members of the charitable class benefited by Z, X will also make grants to other organizations besides Z. Although Z may approve these grants to other organizations, its authority to disapprove them is significantly restricted, as discussed above. Moreover, Z can make no grants of X's assets without the approval of a majority of X's board. Thus, the grants to other organizations are made by X rather than by Z.

X can carry on independent activities that may not promote Z's purposes and activities. This may conflict with the Reg. 1.509(a)-4(i)(3)(ii) SO3 integral part test (See FY 1997 EO CPE Text, page 108) and/or the organizational and operational tests that are discussed earlier in 2.B of this topic. Also, the power of X to make grants to other organizations without Z's authority and Z's lack of a voice in investment policies make it difficult to meet the Reg. 1.509(a)-4(i)(2)(ii) responsiveness test.

As a collateral matter, Z's status under IRC 509(a)(1) and IRC 170(b)(1)(A)(vi) appears questionable if Z's activities are primarily to service entities such as X.

E. IRC 6104(d) Disclosure Requirements and IRC 509(a)(3) Organizations

Final Regulations under IRC 6104(d), effective March 13, 2000, and published as T.D. 8861 in 2000-5 I.R.B. 441, January 31, 2000, make it clear that IRC 509(a)(3) organizations are subject to the disclosure requirements in the same manner as all other tax-exempt organizations. They include IRC 4947(a)(1) charitable trusts classified as IRC 509(a)(3) organizations through application of the procedures under Rev. Proc. 72-50, 1972-2 C.B. 830. See Reg. 301.6104(d)-1(b)(2); 2000-5 I.R.B. 445.

F. SOCHECK On IRC 509(a)(3) – A Checksheet Guide To Status Determinations

The SOCHECK checksheet may be found in Part 7.

3. Donor Advised Funds – Power and Control Issues

A. General Update

Donor advised funds (hereafter "DAFs") are a thriving industry. According to the Chronicle on Philanthropy, November 4, 1999, the donor advised Fidelity Charitable Gift Fund was number 3 on the Philanthropy 400 for 1998. Only the Salvation Army and the YMCA garnered more receipts.

DAFs have been discussed in a number of recent CPE texts, most recently in Topic C, page 222 of the 2000 CPE Text. Over the last year, T:EO has seen an increasing number of exemption applications or ruling requests involving DAFs. The Service continues to closely scrutinize these cases, especially their public charity status under IRC 509(a)(1) and 170(b)(1)(A)(vi).

T:EO continues to review exemption applications or ruling requests with a DAF feature using the principles similar to the material restriction or condition requirements of Reg. 1.507-2(a)(8). Based on this approach, the Service will look closely at applications that include contractual or promotional material that indicates the DAF would follow donor advice as to charitable distributions all the time, provided that the distribution was made to a public charity. Authority for treating this as a negative factor is found in Reg. 1.507-2(a)(8)(iv)(A)(1) and Example (4) of Reg. 1.507-2(a)(8)(v). The facts of Example (4) involve a transfer of funds to a community trust, which is a public charity described in IRC 170(b)(1)(A)(vi). Under the terms of the transfer, a creator of the transferor foundation retains the right to determine what charities are to receive distributions from the funds and the community trust has no right during the lifetime of the creator to vary

his direction as to distribution of funds to the ultimate charity. Example (4) concludes, that, under such facts, there is a restriction on the transferred funds. In the example, the community trust/transferee is precluded from determining the charitable distributee different than that designated by the creator of the transferor and, thus, precludes the transfer as being treated as part or a component fund of the community trust. The Example treats the funds as a separate trust. Compare this with PLR 200028038, April 14, 2000, which describes a donor advised component in a community trust that follows the requirements of Reg. 1.507-2(a)(8) and represents that it will adopt an annual 5 percent distribution.

Many, if not most, DAFs have implicit or explicit contractual relationships with their donor advisors that require that distributions from the DAFs may only be made with the recommendation of the donors. Put another way, distributions from donors may only be triggered by donor recommendations.

T:EO presently is considering whether this triggering mechanism should be a negative factor. The regulations provide that a retained power to direct the timing of distributions may constitute an adverse factor. Specifically, Reg. 1.507-2(a)(8)(iv)(A)(1) provides that an adverse factor includes, with respect to distributions, the reservation of a right by a disqualified person to direct the timing of distributions to public charities described in IRC 509(a)(1) or (2). The purpose of this material restriction or condition requirement of the Regulation is to ensure that the transfer has relinquished dominion and control ("ownership") of the transferred property. It would be logical to assert that if a DAF is unable to initiate a charitable distribution to a public charity, it lacks dominion and control or "ownership" over the property.

Some DAFs promote, with respect to their donor advisors, specific programs of giving. Depending on the vigor with which such programs are carried out, and the nature of the timing of the promotional communications, such promotions may be viewed as tantamount to requests or demands for distribution.

Further, some DAFs may place more stringent requirements on donor advisors than others. Some DAFs impose an annual 5 percent distribution of net fair market value of assets on each separate donor advised account comparable to the IRC 4942 distribution requirement for private foundations. A failure to recommend such distribution by a donor advisor would result in transfer of funds from the non-compliant donor advisor's account to the DAF's unrestricted account. Such a default provision may be viewed as a method by which the DAF initiates a distribution.

B. Legislative Proposal

In February, 2000, the Department of the Treasury issued the General Explanation of the Administration's Fiscal Year 2001 Revenue Proposals. The Revenue Proposals included tax provisions addressing DAFs. At page 106, this document states, in part, as follows:

> In recent years, the use of so-called "donor advised funds" maintained by charitable organizations has grown dramatically. These funds generally permit a donor to claim a current charitable contribution deduction for amounts contributed to the charity and to provide ongoing advice regarding the investment or distribution of such amounts, which are maintained by the charity in a separate fund or account. Several financial institutions have formed charitable corporations for the purpose of offering such donor advised funds, and other existing charities have begun operating donor advised funds. Although these donor advised funds resemble the separate funds maintained by community trusts, the rules governing their operation are unclear.
>
> Some, but not all, charities that maintain donor advised funds have voluntarily adopted minimum annual payout requirements. As a result, there is concern that amounts maintained in donor advised funds are not being distributed currently for charitable purposes. The lack of uniform guidelines governing the operation of donor advised funds also raises concerns that such funds may be used to provide donors with the benefits normally associated with private foundations (such as control over grantmaking), without the regulatory safeguards that apply to private foundations. Accordingly, legislation is needed to encourage the continued growth of donor advised funds by providing clear rules that are easy to administer, while minimizing the potential for misuse of donor advised funds to benefit donors and advisors.
>
> The proposal would provide that a charitable organization which has, as its primary activity[14], the operation of one or more donor advised funds may qualify as a public charity only if: (1) there is no material restriction or condition that prevents the organization from freely and effectively employing the assets in such donor advised funds, or the income therefrom, in furtherance of its exempt purpose; (2) distributions are made from such donor advised funds only as contributions to public charities (or private operating foundations) or governmental entities: and (3) annual

[14] Any charity that maintains more than 50% of its assets in donor advised funds would be deemed to meet this primary activity test.

> distributions from donor advised funds equal at least five percent of the net fair market value of the organization's aggregate assets held in donor advised funds (with a carry forward of excess distributions for up to five years). It is intended that the definition of "material restriction" generally will be based on current-law regulations under section 507, but the existence of a material restriction will not be presumed from fact that a charity regularly follows donor advice. Failure to comply with any of these requirements with respect to any donor advised fund would result in the organization's being classified as a private foundation, and, therefore, being subject to the current-law private foundation rules and excise taxes. In addition, the proposal would require any other charitable organization that operates one or more donor advised funds, but not as its primary activity, to comply with the above three requirements. If such an organization (e.g., a school that operates donor advised funds) fails to satisfy these requirements with respect to its donor advised funds, the organization's public charity status would not be affected, but all assets maintained by the organization in donor advised funds would be subject to the current-law private foundation rules and excise taxes.

Various groups have submitted comments on the administration's proposal to Congress and to the Treasury Department. See, proposed legislative recommendations from some of the most important DAFs and the Council of Foundations in the Exempt Organization Tax Review, July 2000, vol. 29 No. 1. Page 208 et. seq. As of August 1, 2000, no DAF bill has been introduced in Congress.

4. Update On IRC 4941 – Foundation Manager Bank's Use Of Private Foundation Funds To Further Bank's Commercial Endeavors

A. Overview

T:EO has been considering the IRC 4941 implications of foundation manager banks that invest the funds of their private foundation customers. This investment activity may serve the needs of the private foundation for investment income and simultaneously benefit the bank (or other financial institution) by furthering a specific business opportunity. As in the quote from Francis Bacon, extracted on the title page of this topic, power in excess caused the angels to fall. Non-bank trust function activity can be a self-dealing act. This issue was discussed at some length in the 1999 EO CPE Text, Topic P, pages 324-326, and the 2000 EO CPE Text, Topic P, pages 234 to 237. In the 2000 EO CPE Text, we discussed two examples. The respective offices of T:EO and CC:TEGE:EOEG have reached a tentative consensus on these two examples which we will identify as A and B.

B. Example A

(1) Facts (Extracted from the 2000 EO CPE Text, page 234)

The foundation manager, **X**, is a national banking institution, which serves as trustee of a number of private foundations. Corporate entities related to the parent corporation of **X** have created two business trusts (**BTs)** under state law to invest in large commercial investments not otherwise available to the public at large. Under the placement agreement between the parties, **X** is obligated to use its reasonable efforts to procure subscriptions for the purchase of beneficial interests in the (**BTs**) by eligible investors in accordance with the provisions of the agreement. For such services, **X** is contractually entitled to receive a percentage fee of the amounts procured for subscriptions to the **BTs**. Thus, the ability of the **X** to procure subscriptions not only will entitle it to a fee for its efforts, but also establishes its business credibility with the customer and enable it to live up to its contract terms with the **BTs**.

X has invested a significant portion of the assets of one private foundation for which it is a foundation manager in one of the **BTs**.

X-Sub, as a wholly-owned subsidiary of **X**, is a disqualified person under IRC 4946(a)(1)(E), since **X** is conceded to be a foundation manager within the meaning of IRC 4946(a)(1)(B). **X-Sub** also has a business relationship with the **BTs** and also provides sub-advisory services to the **BTs** for a fee. Pursuant to the agreement with the parties, **X-Sub**, the sub-adviser, has full authority to manage the assets of the **BTs**, allocate and reallocate the **BTs**' assets among the Investment Funds and monitor the performance in each Investment Fund. It also provides administrative and accounting services to the **BTs**, including bookkeeping and distribution of quarterly reports, and the preparation of financial statements and tax information reports for investors. In return for these services, the **BTs** pay **X-Sub** a fee equal to a percentage of the **BTs** net assets per annum.

It may be argued that the benefit to **X** of providing subscriptions to the **BTs** is magnified. Not only does **X** receive a fee directly for the subscriptions secured and not only do such subscriptions build its business credibility and goodwill with the customers (the trusts), but subscriptions also further the business interests of its subsidiary **X-Sub**, a disqualified person, by providing it fees for its services.

> The **BTs** are not an investment vehicle merely to serve **X**'s charitable or trust department fiduciary clients with a needed investment opportunity. Rather, it is a complete investment business endeavor serving existing general bank customers and non-bank customers alike. Admission as an investor to the **BTs** is open to all individual and institutional investors that meet the qualifications for investment under the terms of the private placement agreement. Thus, the **BTs** are conducting an investment business endeavor in which **X** and its subsidiary have a substantial economic interest by virtue of the contractual relationships with the **BTs**. Procuring subscriptions to these **BTs** furthers the establishment of these endeavors, lends credibility to them, and generates fees for the disqualified persons.

(2) Analysis and Conclusion

X's actions in Example A constitute acts of self-dealing within the meaning of IRC 4941(d)(1)(E) as use by a disqualified person of the income or assets of **X**'s private foundation customers for **X**'s own financial and/or business benefit. In both GCM 39107 and 39632, self dealing was held to exist merely on the basis that the use of the private foundation assets by the foundation manager to make a loan to a business customer (at the going interest rate) was self-dealing simply because the use of the assets enhanced the goodwill of the foundation manager with his customer.

X, as trustee of the Foundation, has authority and a duty to invest the assets of the Foundation in income producing assets. By directing a substantial sum of money belonging to the Foundation for investment in the **BTs**, **X** is benefiting a significant business partner, one that is a source of revenue for **X**. Thus, the subscription not only fulfills its contractual obligation to the **BTs** and develops goodwill with this business partner, **X** directly profits by generating a fee for its subscription services to the **BTs**. The use of the Foundation's assets in this regard constitutes the use of trust assets for **X**'s business gain within the meaning of IRC 4941(d)(1)(E). **X** is also indirectly benefited in that **X-Sub**'s business interests are also furthered by such action.

Is benefit to **X** by virtue of the subscription transaction merely an incidental or tenuous benefit within the meaning of Reg. 53.4941(d)-2(f)(2)? Even assuming that **X**'s only benefit is the goodwill generated with the **BTs**, we have concluded that such benefit may not be viewed as incidental or tenuous. The promotion of financial products is at the very core of the business by which **X** generates a profit. Further, by virtue of the various relationships with the **BTs**, **X** is generating fees for services both directly and indirectly.

Does the IRC 4941(d)(2)(E) personal service exception delineated under Reg. 53.4941(d)-2(c)(4) and Reg. 53.4941(d)-3(c)(2) [see e.g. examples 2 and 3] excuse **X**

from self-dealing? In example A, we do not have a bank arranging a common trust fund to provide a better investment opportunity for all or many of its trust accounts. This is an individual and selective investment transaction for this one private foundation, which is also open to all non-fiduciary customers and non-customers of bank **X** who meet certain investment qualifications. What separates this from being within the normal investment trust functions of bank **X** is that the transaction in question is not just serving the investment needs of the foundation, but it is also serving the financial needs of **X**'s business partner, and, thus, furthers **X**'s own core business activity beyond that as merely serving as a fiduciary in providing a trust function. Compare with Example B involving a bank that meets the trust personal service exception.

C. Example B – A Trust Function Personal Service Scenario

Example (B) was first described in the 2000 EO CPE Text, page 236. It is also the subject of PLR 200023051, dated March 10, 2000.

Facts

M and **N** are national banking associations. Each is a direct, wholly-owned subsidiary of **O**. **M** is a national bank offering a full range of banking, trust, and investment services. **M** maintains certain funds exclusively for the collective investment of monies contributed thereto by **M** in its capacity as a trustee, executor, administrator, guardian, or custodian. Some of these common trust funds have been established primarily for the investment of assets of private foundations (PFs) to carry out investment responsibilities of **M**. It has been represented that these funds are common trust funds described in IRC 584(a). **M** wants to convert the two common trust funds maintained primarily for the investment of PF assets into **P**'s mutual funds (**P**'s **Funds**) described in IRC 851 and terminate the common trust funds.

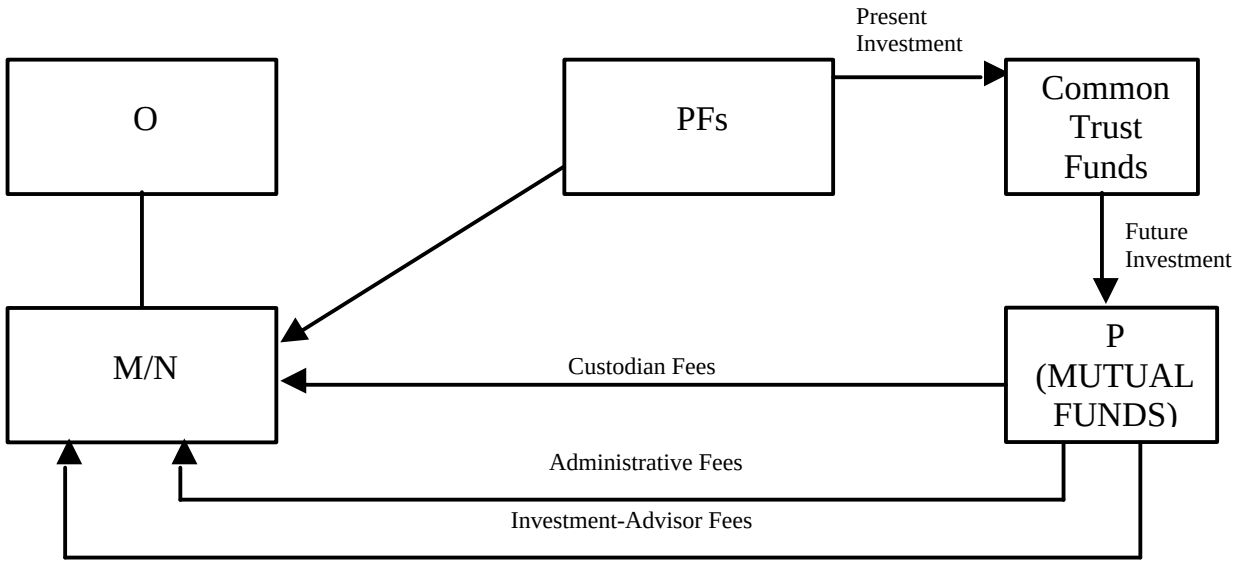
M is the investment advisor to **P**, a family of open-end management investment companies. **P**'s **Funds** are a series of bank advised funds legally separate in corporate form. Each corporate entity consists of a series of distinct portfolios of assets having different investment policies and objectives.

Subject to the approval of the members of the Boards of Directors of **P**, **M** will be substituted for **N** as custodian of **P**'s **Funds**.

It has been represented that none of the Funds own any stock of **O**. **M** does not own any shares of any of the **P**'s **Funds**, except on behalf of other parties.

M has determined, in its capacity as fiduciary of the PFs participating in the common trust funds, that investments be made directly to **P** for investment in **P**'s **Funds**.

To effect this conversion, substantially all of the assets of each common trust fund will be transferred to a **P Fund** in exchange for shares equal in value to the transferred assets. Each common trust fund will then terminate. A Diagram follows:



O & P are unrelated entities
M is fiduciary, agent, custodian of PFs & Trusts
M/N is investment advisor to P

It is represented that:

(a) All of the fees charged by **M** to the PFs for its services as trustee are reasonable and necessary for the services rendered, in accordance with industry practice, and consistent with local laws governing fiduciaries.

(b) All of the fees charged **P**'s **Funds** by **M** or **N** for representative services as investment advisor, sub-administrator and custodian of **P**'s **Funds**, are reasonable and in accordance with industry practice.

Law and Analysis

To fall within the exception provided by IRC 4941(d)(2)(E), three requirements must be met:

(a) The services must consist of trust functions and/or general banking services. The latter term includes only checking accounts, saving accounts, and safekeeping activities;

(b) The services must be reasonable and necessary to carrying out the exempt purposes of the PFs; and
(c) The compensation paid by the PFs to DP banks must not be excessive.

M and **N** will be compensated for their services in managing the assets of the PFs. **P**'s **Funds** are not controlled by **M** or **N** or any of their affiliates and none of **M** or **N**'s assets or any assets of their affiliates will be invested in **P**'s **Funds**. The services provided by **M** and **N** fall within "trust functions" under Reg. 53.4941(d)-2(c)(4) and in Example 2 of Reg. 53.4941(d)-3(c) which describes investment management. It is represented that the services provided are reasonable and necessary to obtain funds to carry out the exempt purposes of the PFs. It has been represented that the amount of compensation to be paid **M** and **N** will be reasonable.

D. Comparison of Example A and Example B

In example A, in contrast to example B, there was more than a fiduciary relationship involving the payment of fees for trust functions such as investment advisory services. In B, the investment vehicle (mutual funds) was not controlled by DP bank. In A, the DP bank was inextricably intertwined with a commercial business activity that does not fall within the self-dealing personal service banking exceptions for trust functions.

T:EO continues to review the IRC 4941 financial products and personal service issue areas including variations of the scenarios described in A and B.

5. Update on IRC 4940 Treatment of Distributions from Charitable Lead Trusts

Topic P of the 2000 CPE Text, page 225, discussed the definition of net investment income under IRC 4940(c)(1) in the context of income distributions from a charitable lead trust to a private foundation (PF). The specific concern is whether the ordinary income component of distributions received by a PF from a IRC 4947(a)(2) trust should be included in the calculation of net investment income for purposes of IRC 4940. Reg. 53.4940-1(d)(2) requires that the PF include the ordinary income component of a distribution from section 4947(a)(2) trusts in the calculation of its net investment income as if the income were its own.

We believe that courts would likely hold that the Reg. 53.4840-1(d)(2) goes beyond the statutory authority. Accordingly, distinctions should not be made for purposes of IRC 4940 between distributions from taxable entities and private foundations, including trusts described in IRC 4947(a)(1) or 4947(a)(2). Similar treatment should be afforded IRC 4942 minimum investment return treatment of IRC 4947(a)(2) trust distributions following Ann Jackson Family Foundation v. Commissioner, 97 T.C. 534 (1991), aff'd 15 F.3d 917 (9th Cir. 1999).

Exempt Organizations personnel should contact the appropriate EO Area Managers regarding development of cases involving private foundations that receive distributions from IRC 4947(a)(2) Trusts.

6. Charitable Family Limited Partnerships

This planned giving scheme known in the trade as the "CHAR-FLIP" displays the control and power elements that have been discussed in this article. As noted in the Wall Street Journal on July 13, 1999, the CHAR-FLIP is "a complicated tax avoidance method that uses charities as partners in business ventures." It may be this years favorite charity scam superseding the charitable split-dollar transaction discussed in the 2000 EO CPE Text, Topic R, and presumably put to rest in recent legislation noted in the Current Developments section of this EO CPE Text.

The charitable family limited partnership technique is touted as avoiding the capital gain tax on the sale of the donor's appreciated assets, allowing the donor to continue to control the assets until some subsequent sale date, often many years in the future, and still provide the donor with a current charitable deduction on his or her income tax return. Another "benefit" is reducing estate taxes. The technique is promoted by one or more commercial firms.

A typical charitable family limited partnership works as follows: Donor "**D**", having substantially appreciated assets, which are often not readily marketable, such as real estate or proprietary interest in a closely held business, sets up a donor family limited partnership ("**DFLP**"). **D** transfers highly appreciated assets to **DFLP** in exchange for both a general and limited partnership interest with the general partnership interest comprising a very modest 1 or 2 percent of the total partnership interests. The **DFLP** agreement usually provides for a term of 40 to 50 years.

D contributes a large percentage of the **DFLP** interest to charity "**Z**", usually as much as 95 to 98 percent, in the form of a limited partnership interest. **D** will usually retain the general partnership interest. **D** may also retain a modest limited partnership interest or transfer such an interest to **D**'s children. **D** obtains an independent appraisal of the value of the partnership interests in order to establish the fair market value of the IRC 170(c) charitable contribution deduction. **Z** receives whatever assets are held by **DFLP** at the end of the partnership term, assuming the partnership interest was not sold prior to the expiration of the partnership term.

D claims an IRC 170(c) tax deduction based on the value of the gift of the partnership interest to **Z**. The value likely has been discounted to take into account the lack of **Z** control and management of partnership operations as well as the lack of marketability of the limited partnership interest in the context of a closely held business.

The key point is control. Control remains with **D** as the general partner. **Z** holds a limited partnership interest with no voice in the day to day management or operations of the partnership.

If appreciated property held by **DFLP** is sold by **DFLP**, most of the gain escapes taxation by virtue of the IRC 501(c)(3) exempt status of **Z**. Only the modest limited or general partnership interests held by **D** and his family are subject to capital gain taxation.

D generally receives a management fee as compensation for operating and managing the partnership.

Z holds a **DFLP** interest that may produce current income (although many charitable family limited partnerships produce little or no income) as well as an interest in a (hopefully) appreciating asset which will be sold or exchanged no later that the expiration of the partnership term, usually 40 years or even 50 years.

One of the aspects of the "CHAR-FLIP" is a feature which gives a **DFLP** the right to sell the property to **D** or his family at a price specified in the partnership agreement. This right is essentially a put option. While such option may serve to benefit **Z**, the option is often viewed by critics of this technique as working more for the benefit of **D** or his family than for **Z**.

The CHAR-FLIP technique raises a number of potential tax issues. Depending on the facts of each particular partnership agreement, the operation of the partnership may cross over into the area of clear tax abuse. An examination of an organization holding an interest in a CHAR-FLIP should include close scrutiny of the partnership agreement as well as the manner of operation, valuation, management compensation and other matters relating to the legal relationships.

In a nutshell, EO examination may uncover IRC 170, IRC 501(c)(3) inurement and private benefit, IRC 511, and IRC 4958 issues. If the charity is a private foundation, there may be issues under IRC 4941 and 4943.

The FY 2000 EP and EO/GE Work plans, dated August 18, 1999, provide the following EO Examinations instruction on page 6:

> Referrals should be made to the Examinations Division if an EO agent identifies an entity holding an interest in a charitable family limited partnership.

7. <u>SOCheck On IRC 509(a)(3) – A Checksheet Guide To Status Determinations</u>

SOCHECK

(Checksheet Questionnaire for IRC 509(a)(3) Supporting Organizations Determinations)

Selected Regs.; Readings; and Notes

Legend

SO = Supporting Organization
SO1 = "operated, supervised or controlled by" SO
SO2 = "supervised or controlled in connection with" SO
SO3 = "operated in connection with" SO
SD = Supported Organization described in IRC 509(a)(1) or (2)
DP = Disqualified Person
("s" for plural form; e.g., "SOs, "SDs")

[Caveat; SOCHECK may not include and/or sketch all possible facts and circumstances tests. Please refer to the Regulations.]

Note: SOCHECK contains 5 parts. All SO applicants must satisfy all parts.

1. THRESHOLD REQUIREMENT

A. Is the SO claiming IRC 501(c)(3) status organized and operated exclusively for charitable purposes?

2001 CPE Topic G. Note: No exemption for organizations primarily operated to carry on UTB for unrelated SDs.

(1) [ ] Yes – go to Part 2
(2) [ ] No – Organization is not eligible for SO status.

B. Is trust entity SO, not claiming IRC 501(c)(3) status, described in IRC 4947(a)(1)?

Rev. Proc. 72-50

(1) [ ] Yes – go to Part 2
(2) [ ] No – Organization is not eligible for SO status.

2. RELATIONSHIP TESTS – [Including relationships with IRC 501(c)(4), (c)(5), or (c)(6) entities treated like IRC 509(a)(2)s]

A. Is the SO a SO1?

(1) Do the SD(s) officials select a majority of Directors or Trustees of SO?

Reg. 1.509(a)-4(g)

a. [ ] Yes – go to Part 3
b. [ ] No – go to B.

B. Is the SO a SO2?

(1) Is control of management of the SO vested in the same persons who control or manage the SD(s)?

Reg. 1.509(a)-4(h)

a. [ ] Yes – go directly to Part 3
b. [ ] No – go to C.

Reg. 1.509(a)-4(i)

C. Is the SO a SO3 because it meets both the **Responsiveness test** (in either (1) or (2) below) and the **Integral Part test** (in (3) below)?

Reg. 1.509(a)-4(i)(2)(ii)

(1) Responsiveness test – The SO must meet a, b, or c and also must meet item d OR meet Alternative Responsiveness test at (2) below.

a. Do the officers, directors, trustees, or membership of the SDs elect or appoint one or more of the officers, directors or trustees of the SO? Or
b. Are one or more members of the governing bodies of the SDs also officers, directors or trustees or hold other important offices of the SO? Or
c. Do officers, directors or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the SDs?

AND

In Windsor Foundation, 77-2 USTC 9709, Tax Court held that SO failed Responsiveness Test for failure to meet (d). 1982 CPE, p. 28.

d. By reason of the relationship described above, does the SD have a significant voice in the SO's investment policies, timing of grants, manner of making grants, and selection of recipients of grants, etc.?

i. [ ] Yes – go to (3)
ii. [ ] No – go to (2)

(2) Alternative Responsiveness test – If Responsiveness test (1) above is not met, the organization must meet a, b, and c below.

Reg. 1.509(a)-4(I)(2)(iii)
Note: More common for SO to meet (2) than (1).

a. Is the SO a charitable trust under State law (or an entity treated as a trust)? and
b. Is each specified SD(s) a named beneficiary under the SO's governing instrument? and
c. Do the specified SD(s) have the power to enforce the trust and compel an accounting under State law?

1982 CPE, p. 29.

i. [ ] Yes – go to (3).
ii. [ ] No – organization fails to meet SO3 relationship test

(3) Integral Part test – The SO must meet requirement a or b below.

1997 EO CPE, Topic I; IRM 7.8.3 (5.2)

Reg. 1.509(a)-4(i)(3)(ii). Note: "FS Test" rarely satisfied. Grantmaking not considered supportive enough. TAM 9730002. Grant making to other public charities may be supportive if SD is a community trust. G.C.M. 38417. 1997 CPE, p. 108.

a. The "Functional Support" test. Does the SO engage in activities, not including grant making, for or on behalf of SD(s) which perform the functions of or carry out purposes of the SD(s) and which the SD(s) would otherwise normally undertake, but for the involvement of the SO?

i. [ ] Yes – go to Part 3.
ii. [ ] No – go to b.

OR

b. The "Attentiveness" test: Requires satisfaction of tests i; ii(a), (b), or (c); and iii, below.

Reg. 1.509(a)-4(i)(3)(iii). Note: Most SO3s meet this test because they distribute to SDs.

(i). Does the SO make payments of substantially all (85%) of its income (including short term capital gain) to or for the use of the designated SD(s)? and

IRM 7.8.3 (5.2.4.2)

G.C.M. 36379

(ii). (a). Does the SO's support of the SD (within the meaning of IRC 509(d)) constitute at least 10% of the SD's total support? (Or, if SO supports multiple SDs, 10% of the total support of one of the SDs?) or

Note: See Reg. 1.509(a)-4(i)(3)(iii) examples; G.C.M. 36326 looks favorably on significant program with 50% SO support.

(b). Does the SO earmark its support for a significant particular program or activity of the SD and, if so, can the SO demonstrate that if its funding of such program or activity is discontinued, the SDs operation of such program or activity will be interrupted?

Reg. 1.509(a)-4(i)(3)(iii)(d); G.C.M. 36379
Note: New organizations do not have a history. Special 5 year rule with H & C at Reg. 1.509(a)-4(i)(1)(iii); 1982 CPE, p. 32.

(c). Is the SD attentive based on all pertinent facts and circumstances often involving a historic and continuing relationship?

and

G.C.M. 36326

(iii) Does the SO's support which meets (ii) above, consistently constitute 33 1/3% of the SO's total support?

(a) [ ] Yes – go to Part 3.
(b) [ ] No – organization fails SO3 test.

3. ORGANIZATIONAL TEST

Reg. 1.509(a)-4(c)(1). IRM 7.8.3 (5.3)

A. Does the SO's organization instrument limit its purposes to those for the benefit of, to perform the

functions of, or to carry out the purposes of one or more specified SDs, and does not expressly empower the SO to engage in activities which are not in furtherance of such purposes?

(1) Are purposes limited appropriately?

a. [ ] Yes – go to (2).
b. [ ] No – organization fails Organizational Test

(2) Do SO1s, SO2s, and SO3s meet specificity requirements?

a. SO1s and SO2s – Are beneficiary SDs specified or designated by class or purpose in governing instrument?

Reg. 1.509(a)-4(d)(2)(iii); Special community trust rule - Rev. Rul. 81-43

(i) [ ] Yes – go to c.
(ii) [ ] No – Is there an historic and continuing relationship with the SD? If yes, go to c. Otherwise, SO fails the organization test.

Reg. 1.509(a)-4(d)(2)(iv); IRM 7.8.3 (5.4.3)

b. Specificity requirements for SO3s – Are SDs specified by name?

(i) [ ] Yes – go to c.
(ii) [ ] No – SO fails organization test.

c. Governing Instrument Provisions – Are there governing instrument provisions involving substitutions, etc.? If so, are there conflicts with the specificity requirements?

(i) If there are no conflicts, SO meets Organization Test. Go to 4. If there are conflicts, SO does not meet Organization Test.

SO1s & SO2s – Reg. 1.509(a)-4(d)(3); SO3s – Reg. 1.509(a)-4(d)(4). IRM. 7.8.3 (5.3); 2001 CPE, Topic G.

4. OPERATIONAL TEST

A. Is the SO operated exclusively for the benefit of, to perform the functions of, or carry out the purposes of one or more specified SDs?

(1) Does the SO support or benefit only the specified SDs meeting the Organization Test in 3 above?

Reg. 1.509(a)-4(e)(l); IRM 7.8.3 (5.5); 2001 CPE, Topic G.

a. [ ] Yes – go on to (2)
b. [ ] No – organization fails Operational Test.

Special permissible activities include fundraising, alumni activity, etc. Reg. 1.509(a)-4(e)(2); 1982 CPE, p. 36.

(2) Does SO support or benefit SD through disbursements to SD or other permissible activities?

a. [ ] Yes – go on to 5.
b. [ ] No – SO fails Operational Test

5. CONTROL TEST – Often the Most Critical Factor

A. Is the SO controlled directly or indirectly by DPs other than foundation managers and other than one or more SDs?

Reg. 1.509(a)-4(j); 2000 CPE, p. 222; 2001 CPE, Topic G; IRM 7.8.3 (5.6)

(1) SO1s and SO2s

By nature of meeting these relationship tests, SOs are generally controlled by the SDs. There should be an analysis to discover whether SDs select or designate SO board members that may be DPs, for a reason in addition to being foundation managers, or are connected to DPs through family or economic associations. Otherwise go to (3).

(2) SO3s

a. Do DPs control SO?

DP power to annually designate charitable recipients is control. Rev. Rul. 80-305.

(i) Directly through majority presence on the Board, or positions of authority, veto power, etc.?

Rev. Rul. 80-207

(ii) Indirectly, through board nomination process, or manipulation of board structure, or through presence of board members or persons of authority that have family or economic association with DPs?

(iii) Indirectly, through control of SO assets or other facts and circumstances?

[ ] If Yes, SO fails Control Test.
[ ] If No, go to (3).

(3) If SO1 or SO2 or SO3 is not controlled by DPs, Control Test is met and if all SOCHECK parts have been met, SO qualifies as a IRC 509(a)(3).

***COLLATERAL NOTES**:*

SOs may not support IRC 509(a)(3) but see G.C.M. 39508. 2% rule – Reg. 1.170A-9(e)(6)(i). Domestic Government entity is a good SD- IRC 170(b)(1)(A)(v); G.C.M. 36523; foreign nongovernment SD is o.k. Rev. Rul. 74-229; Rev. Proc. 92-94. Lobby election restriction – IRC 501(h)(4)(F); 1997 CPE, p. 126.

1. There should be a representation that SD organization is a valid IRC 501(c)(3) and IRC 509(a)(1) (including a government entity) or 509(a)(2) organization. Note that an IRC 509(a)(3) is not excepted from the 2 percent source limit for IRC 170(b)(1)(A)(vi), thus, SO support may affect the public charity status of its SD.
2. SOs that support an IRC 501(c)(4), (c)(5), or (c)(6) can not make the lobbying election under IRC 501(h).
3. ALL 509(a)(3)s are subject to IRC 6104(d) disclosure rules.