K. COMMUNITY FOUNDATIONS

by
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1. Introduction

There are over 400 community foundations in the United States. Many cities have one or more. In 1991, the assets these institutions held amounted to over $8 billion and they distributed a total of $525 million in grants to local charities.

The Cleveland Trust Company created the first one in 1914 out of administrative necessity. The trust company held several small-to-medium-sized charitable trusts that were established to benefit various areas of charitable interest. Many of the trusts did not specify the charities operating within those areas that should receive distributions from them. The trust company's attempts to search out deserving charities proved to be both inefficient and uneconomical. Thus, an independent organization, the Cleveland Foundation, was created to make these grant decisions. The Cleveland Trust Company, however, retained administrative responsibility over the trusts' assets as trustee. This format a distribution committee affiliated with a number of separately trusteed trusts was the prototype for the community foundation movement. Sidney S. Whelan Jr., Community Foundations Take Off, Trusts & Estates, Aug. 1987, at 10, 14.

Following the Cleveland Foundation, early community foundations were also created in trust form and were called community trusts. Community trusts are the express subject of Treas. Regs. 1.170A-9(e)(10)-(14).

Since 1940, a number of community foundations have organized themselves as corporations and unincorporated associations. Whether these types of organizations are subject to the same or similar rules is currently under debate. There are also hybrids combining features of both the corporate and the trust forms. For example, a distribution committee that has incorporated, has funds which it holds in its own name, and is affiliated with several separate trusts would be such a hybrid. See G.C.M. 37818 (Jan. 11, 1979); G.C.M. 38812 (Aug. 31, 1981). This article will treat the trust and corporate forms as separate and distinct although many community foundations combine both features.

2. What are Community Foundations?

A. Organizational Structure

The primary purpose of both trust-form and corporate-form community foundations is to provide charitable support to their local communities. They do this by building endowments with contributions from local residents, and administering them for the benefit of their communities. They also administer non-endowment funds.

An "endowment" is money or property donated to establish a permanent source of charitable funds. Typically, a donor will place his or her contribution in trust in the trust-form or in special fund in the corporate-form. The original donation is used to generate income, and the income is used for charitable purposes. "Non-endowment" funds are depleted annually and then replenished.

Community foundations are akin to holding companies. Both forms are composite organizations that administer an accumulation of various trusts and funds. Typically, these foundations do not themselves hold the trusts and funds; rather, they are held in and managed by banks and trust companies within the community. For example, the New York Community Trust has sixteen banks acting as its trustees, each holding one or more of its trusts and funds.

Usually, community foundations are non-operating charities. They do not operate museums, run homeless shelters, maintain community parks, or perform other services. They do charity by providing grants and gifts to local charities and charitable community projects. Their organized efforts to collect and distribute funds greatly benefit their local communities. Howard A. Sweet and Joanne R. Whiting, Community Foundations: Estate Planning's Best Kept Secret, The Wisconsin Lawyer, June 1991, at 27, 28.

B. Advantages

As charitable vehicles, community foundations are particularly effective in serving the needs of their local communities:

(1) They are knowledgeable. They focus only on their communities' needs. This helps them identify the neediest community institutions.

(2) They are flexible. Their specialized knowledge of the community helps them quickly change beneficiaries when local

needs change.

(3) They are efficient. They provide economies of scale by aggregating modest gifts into endowments for similar purposes. Large endowments can tackle big community problems.

Whelan, <u>supra</u>, at 14.

They offer many attractions to donors. They provide professional investment management of charitable contributions. Donors making contributions to these foundations generally receive the maximum charitable deduction allowed because most community foundations are publicly supported within the meaning of IRC 170(b)(1)(A). Further, community foundations perpetuate the donors' names and personalities. <u>Id.</u>

C. <u>The Single Entity Question</u>

Central to most of the unresolved issues in this area is the question of whether incorporated community foundations or other similar organizations are subject to the rules of Treas. Regs. 1.170A-9(e)(10)-(14). These regulations were written for community foundations as they existed in 1969. As will be discussed later, the regulations create a "fiction" that the typical community foundation of that time, the trust-form foundation composed of more than one otherwise taxable entity would be treated as a single entity for tax purposes. The single entity rules are necessary under IRC 509 if trust-form community foundations are to be treated as a single public charity rather than a group of related private foundations.

There are rules that govern whether individual funds or even gifts will be treated as part of the single taxable entity. There are also rules that govern the tax treatment of those funds and gifts that will not be so treated. What the regulations do not address is how these questions are to be resolved where corporate-form organizations because of their structure do not need the fiction that the regulation creates.

D. <u>Public-Charity Status of Community Foundations</u>

Most community foundations, both trust and corporate forms, qualify as publicly-supported charities under IRC 509(a)(1) and 170(b)(1)(A)(vi). (As noted, above, trust-form foundations need single-entity treatment to do so.) Others qualify under IRC 509(a)(3) as supporting organizations. A few qualify under

509(a)(2) because they are supported primarily by exempt function income.

Community foundations, because of their structure, tend to attract large contributions from a small number of donors. Therefore, they initially find it difficult meeting public support requirements. Treas. Reg. 1.170A-9(e)(10) expressly recognizes this. It states that they do not have to "engage in periodic, community-wide, fundraising campaigns in a manner similar to campaigns conducted by a community chest or united fund." Rather, they can satisfy the "attraction of public support" requirement of the facts and circumstances test of Treas. Reg. 1.170A-9(e)(3)(ii) "if they seek gifts and bequests from a wide range of potential donors in the community . . . [in] ways which call attention to the community trust as a potential recipient of gifts and bequests made for the benefit of the community," Treas. Reg. 1.170A-9(e)(10).

3. <u>Community Foundations and Donor Control</u>

A. <u>Forms of Donor Control Permissible Under Treas. Regs. 1.170A-9(e)(10)-(14)</u>

Many potential donors are hesitant to release total control of their gifts to charities. Community foundations deal with this reluctance by offering donors a choice of funds, several of which allow them some ability to affect the disposition of their beneficence. This gives donors great flexibility in tailoring their gifts to meet their charitable objectives. Sweet & Whiting, <u>supra</u>. Donors to foundations that meet the requirements of the regulations are somewhat limited as discussed below. The following illustrates the variety of the funds that they can offer:

(1) <u>Unrestricted Funds</u>. Fund in which the community foundation has unfettered use of the gift's income and principal. The donor places no restrictions or conditions on the management or distribution of these funds. The foundation, not the donor, identifies community needs and distributes these funds according to those needs.

(2) <u>Memorial Funds</u>. Fund that memorializes its creator or the creator's family; for example, the George Johnson Fund. Such funds may be named after private foundations.

(3) <u>Field of Interest Funds</u>. Fund where the donor chooses the charitable field of interest or area of concern that the fund will

support. For example, the donor may wish his or her donation to be used to advance the arts, education, health, religion, or social services. These fields may either be broad and general or narrow and specific. Although the donor chooses the field, the community foundation selects the most appropriate organization or program within the field based on the needs of the community.

(4) Advised Funds. Fund where the donor or his/her designate retains the privilege to suggest the charity or community project to receive the fund's income. The suggestions are not binding on the community foundation, which retains final authority to determine the use of such income.

(5) Designated Funds. The donor designates at the time the fund is created a particular purpose or public charity that the fund will support. This may be done in the instrument of transfer.

(6) Agency Endowments. A designated fund that supports a particular charity. Generally, a local public charity enters into a relationship with the community foundation. A fund is established in the name of the charity and donors can donate to this fund knowing that the income will go to the charity. The charity then solicits for donations to the fund.

(7) Pooled Income Funds. A split interest fund described in IRC 642(c)(5) where contributions from several donors are pooled together. The donors receive for life annual distributions of the fund's income from their proportionate share of its assets. Upon his or her death, the donor's proportionate share of the fund's assets is distributed to the community foundation.

B. Donor-Directed Funds Impermissible Donor Control

Many donors have an interest in exercising continuing control over the use of their contributions. Usually donors express this interest by donating to funds where the donor has a continuing right to designate the charitable recipient of the fund's income and/or principal. The donor reserves this right expressly (as in the instrument of transfer) or by implied agreement. The donor exercises this right of designation after the fund's creation, usually when the fund's income is distributed.

Under Treas. Regs. 1.170A-9(e)(10)-(14), gifts to donor-directed funds are not treated as gifts to and support for a trust-form community foundation. When it considered the matter in 1969, Congress made special provision for this type of fund in IRC 170(b)(1)(E)(iii). Under 170(b)(1)(E)(iii), such gifts are provided 50% deductibility, but they are treated as gifts to private foundations. The Service is currently considering whether gifts to donor- directed funds held by corporate-form organizations will be treated as gifts to and support for the parent organization. See G.C.M. 39875 (June 26, 1992).

4. Regulations that Govern Community Trusts

As indicated above, the regulations governing trust-form community foundations create a legal fiction that allows individual trusts and funds to aggregate and become one. Without this structure, each trust and fund would be treated as a separate legal entity and would have to apply on its own for tax-exempt and public-charity status. Failing this, each would be taxable on, and have to report, its own income.

The community trust's structure coupled with its promotion of funds giving donors a degree of control make it a tempting target for those seeking to avoid the private foundation restrictions. Therefore, Treas. Reg. 1.170A-9(e)(11) was carefully drafted to strike a balance between competing concerns. The Service wanted to treat favorably those organizations possessing the characteristics of then existing community foundations, and to prevent any attempt to avoid the private foundation restrictions. Thus, the Service specified in detail the characteristics thought to be representative of community trusts to prevent any loosely organized group of funds from claiming the benefits of the regulations.

The regulations lay out two tests applicable only to community trusts: (1) the "single-entity test" of Treas. Reg. 1.170A-9(e)(11)(iii)-(vi), and (2) the "component-part test" of Treas. Reg. 1.170A-9(e)(11)(ii). The first determines whether the community foundation will be treated as a single entity for federal income tax purposes. The second determines whether the individual trusts and funds can be treated as component parts of a single entity. The single-entity test must be applied before the component-part test. G.C.M. 37818 (Jan. 11, 1979).

A. The Single-Entity Test

Community trusts (in their normal format distribution committees and affiliated group of trusts and funds) that meet the single-entity test will be treated as one entity for federal income tax purposes. The single entity includes all component parts to determine its tax-exempt and public-charity status, and other questions. A community trust will be treated as a single entity if: (1) it is commonly known as a community trust, fund, or foundation; (2) all of its trusts and funds are subject to a common governing instrument; (3) it has a common body that governs all of its trusts and funds; (4) this governing body has the power to modify fund restrictions and replace fund trustees; (5) the governing body resolves to exercise its powers of modification and replacement; and (6) the community trust includes all component parts in a common report. Treas. Reg. 1.170A-9(e)(11)(iii)-(vi). All six requirements must be met.

(1) Name. The community trust's name must convey the idea of an endowment fund that supports charitable activities in the community or area it serves. Names such as the Danville Community Trust, the City of Metropolis Fund, or the Gotham City Foundation would satisfy this requirement.

(2) Common instrument. All of its trusts and funds must be subject to a common governing instrument such as a master trust or agency agreement. This common governing instrument may be a single document, or several documents containing common language. It is sufficient that the language used in the instrument of transfer makes the trust or fund subject to the governing instrument.

(3) Common governing body. It must have a common governing body or distribution committee that controls all fund distributions. In the case of a fund designated for specific beneficiaries, the governing body or distribution committee must monitor fund distributions to ensure that they are used exclusively for charitable purposes.

(4) Powers of modification and removal.a. The governing body must have power to modify donor-imposed distribution restrictions if, in its sole judgment and discretion, they become "unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community." The community trust can satisfy this requirement if it adopts in its master trust agreement or similar document language similar to that provided in

Revenue Ruling 77-333, 1977-2 C.B. 75. The phrase "in its sole discretion," joined with "inconsistent with the charitable needs of the community," gives the governing body great latitude to modify any fund restrictions, including the beneficiary of a designated fund.b. The governing body must have the unrestricted power to replace any trustee or fund custodian for breach of fiduciary duty or for failure to produce a reasonable return of income over a reasonable period. The governing body determines what is "reasonable."

(5) Exercise of powers. The governing body must resolve in writing to use its powers of modification and removal. It can satisfy this requirement by adopting a resolution similar to that given in Revenue Ruling 77-334, 1977-2 C.B. 77. It must exercise these powers if it has grounds to do so. It must also commit to obtain information and take other appropriate steps to ensure that each trustee or custodian of its component parts: (a) abides by the terms of the common governing instrument; and, (b) obtains a reasonable return of net income.

(6) Common reports. The community trust must prepare periodic financial reports treating all funds, except noncomponent funds, as its funds.

Whether an organization meets all six requirements of the single-entity test can be established by the organization's master trust agreement, bylaws, or transfer documents. G.C.M. 37818 (Jan. 11, 1979).

B. The Component-Part Test Applying the Brakes to Donor Control

The regulations deal with the issue of donor control in the component-part test. Trusts and funds meeting the component- part test are treated as one with the community foundation and share its tax-exempt and public-charity status. Treas. Reg. 1.170A-9(e)(11). The income from component trusts and funds is considered investment income of the community trust for purposes of testing the community trust's public support under Treas. Reg. 1.170A-9(e).

Any contribution to a publicly-supported community trust or to any of its component parts is treated as a contribution to a publicly- supported charity for the following purposes: (1) allowing the donor the maximum charitable deduction under IRC 170(b)(1)(A); and (2) IRC 507(b)(1)(A), the transferring of net assets by a terminating private foundation. Treas. Reg. 1.170A-9(e)(11)(ii).

Treas. Reg. 1.170A-9(e)(11)(ii) lists the following two requirements of the component-part test:

(1) The trust or fund must be created by a gift, bequest, legacy, devise or other transfer to a community trust that has established itself as a single entity; and

(2) The trust or fund may not be subject to material restrictions or conditions within the meaning of Treas. Reg. 1.507-2(a)(8).

a. The First Requirement of the Component-Part Test

The starting point for control issues begins with part (ii)(A) of Treas. Reg. 1.170A-9(e)(11). To be treated as a component part, a trust or fund must be created by a contribution "to a community trust." Id. (emphasis added). If a trust or fund is treated as a noncomponent part, contributions made in connection with that part's creation are **not** treated as being made "to a community trust." Regs. 1.170A-9(e)(14). Whether a trust or fund is treated as a component part is critical to a determination of its and the community trust's private foundation status.

The word "to" in both sections of the regulations refers to IRC 170(c) which defines a charitable contribution as a contribution or gift "to" or "for the use of" certain charitable organizations. Generally, the IRC 170(c) distinction is between gifts "to" an organization and gifts "in trust" for an organization. See Davis v. United States, 495 U.S. 472 (1990).

There is one situation where the community trust regulations do not parallel IRC 170(c)'s "to" or "for the use of rules. The community trust regulations permit a donor to designate the specific charity to receive the income and/or principal of a fund at the fund's creation. This right to designate would not prevent a trust or fund from being treated as a component of the single entity. IRC 170(c), however, would treat a contribution so limited as a contribution in trust for the designated beneficiary. Because the community trust regulations allow designated funds, the Service in G.C.M. 38812 held that the term "to" as it is used in Treas. Reg. 1.170A-9(e)(11) includes a trust concept. This concept considers designated funds as transfers "for the benefit of" the community trust. See G.C.M. 38812 (Aug. 31, 1981). Clearly, however, these regulations cannot permit transfers in trust that are prohibited elsewhere in the regulation.

When this article discusses earmarking, it will deal with the situation where an exempt organization is treated for tax purposes as the conduit for certain transfers. In these situations, the ultimate beneficiary is treated as the recipient of the contribution   the individual or organization "to" whom the contribution is being made. The requirement that a contribution must be made "to" a community trust is limiting. Donors cannot make certain kinds of transfers to community trusts as holders and have them treated as transfers "to" community trusts.

b. The Second Requirement of the Component-Part Test

Part (ii)(B) of Treas. Reg. 1.170A-9(e)(11) adds a second element to the control rules of Part (ii)(A), and is not, therefore, a totally separate requirement. It refers to Treas. Reg. 1.507-2(a)(8), and the rules thereunder. In this context, Treas. Reg. 1.507-2(a)(8) describes the effect of donor-imposed restrictions and conditions upon a community trust's distribution of assets. IRC 507 otherwise governs the termination of private foundation status.

A donor may not encumber a fund with a restriction that prevents the community trust from "freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes." Treas. Reg. 1.507-2(a)(8)(i). (In this section of this article and in the regulations, the term "fund" is interchangeable with "trust.") If so encumbered, it is considered a material restriction and the fund will not be treated as a component part of the community trust. The community trust must have full control over all fund distributions.

Treas. Reg. 1.507-2(a)(8)(iii) lists four donor-imposed restrictions that are not considered "material" restrictions. They, therefore, are relevant only so far as determining whether a fund is or is not a component part. They are:

(1) Name. A fund may take the name of a private foundation, the fund's creator, or the creator's family.

(2) Purpose. The donor can designate that the income and assets of the fund be used for a certain charitable purpose or for one or more section 509(a)(1), (2), or (3) organizations. Such use must be consistent with the charitable basis for the community trust's exempt status. Where the fund is designated for one or more

charitable organizations, the community trust's governing body or distribution committee must have the power to stop distributions and recover funds that were not used in furtherance of the community trust's exempt purposes.

(3) Administration. The donor may require that his or her donation be placed in a separate or identifiable fund, and that some or all the principal not be distributed for a time. This separate and identifiable fund must otherwise qualify as a component part of the community foundation.

(4) Restrictions on disposition. A donor may require the foundation to retain donated property if, because of the property's peculiar features, its retention is important to the accomplishment of a charitable purpose in the community. For example, a donor donates a woodland preserve and requires it to be retained as a public arboretum for the community.

c. Designated versus Donor-Directed Funds

It is important to distinguish between designated and donor- directed funds. The community trust regulations permit donors to designate before or at the fund's creation the purpose or the specific charity to receive the income and/or principal of the fund (e.g., a designated fund.) However, these regulations do not permit donor- directed funds. That is, donors cannot "reserve" a right to: (1) name the specific charity or charities to which the community trust must distribute in the future, or (2) direct the timing of such distributions.

The reservation of such a right is considered a material restriction and prevents the community trust from freely and effectively employing the transferred assets or their income. Such reservation prevents the fund from being a component part. The regulations list factors that indicate whether such a right has been reserved.

Treas. Reg. 1.507-2(a)(8)(iv)(A)(2) states that the presence of some or all the following factors indicates that the donor did not reserve a right to designate:

(1) The community trust investigates the donor's advice, and its investigation shows that the advice is consistent with specific charitable needs most deserving of support in the community.

(2) The community trust has published guidelines listing the specific charitable needs of the community, and the donor's advice is consistent with those guidelines.

(3) The community trust has begun an educational program advising donors and other persons of its guidelines that list the specific charitable needs most deserving of support. These needs must be consistent with its charitable purposes.

(4) The community trust disburses other funds to the same or similar organizations or charitable needs as those recommended by the donor. "Other" funds are from sources other than, and in excess to, those distributed from the donor's fund.

(5) The community trust's solicitations for funds specifically state that it will not be bound by any advice the donor offers.

Treas. Reg. 1.507-2(a)(8)(iv)(A) states that if one concludes the presence of "a" below, this indicates that the donor has reserved such a continuing right. The presence of two or more of factors "b" through "e" indicates "a" (that the donor has reserved such a right):

a. The only criterion considered by the community trust in making a distribution of income or principal from the donor's fund is the donor's advice.

b. Solicitations of funds by the community trust state or imply that the donor's advice will be followed. Also, a pattern of conduct by the community trust that creates an expectation the donor's advice will be followed.

c. The donor's advice is limited to distributions of amounts from his or her fund and the community trust has not: (1) done an independent investigation to evaluate whether the donor's advice is consistent with the charitable needs most deserving of support in the community; or (2) established guidelines that list the specific charitable needs of the community.

d. The community foundation only solicits advice from the donor regarding distributions from the donor's fund and no procedure is provided for considering advice from others.

e. The community foundation follows the advice of all donors concerning their funds substantially all the time.

Treas. Reg. 1.507-2(a)(8)(iv)(A)(3).

C. Trust-Form v. Corporate-Form Organizations

The regulations governing the trust-form organizations prevent internal trusts or funds from being so encumbered with donor-retained controls that they are, in effect, mini-private foundations. What happens, however, when a contribution that is so encumbered is made to a corporate-form organization? A possible answer may be discerned from the holdings of National Foundation, Inc. v. United States, 13 Cl. Ct. 486 (1987), and G.C.M. 39748 (approved Aug. 3, 1988, withdrawn June 24, 1992).

The organization (hereafter "NFI") involved in National Foundation allows donors to recommend the initiation, funding, and administration of any charitable project of their choice. NFI then evaluates the proposed project and either accepts or rejects it. If the project is rejected, the donor's contribution is refunded or, if the donor requests, donated to a public charity of the donor's choice. NFI's standard agreement form provides, however, that once the donor commits the funds for a project or for general charitable use, NFI gets full control of those funds. It is then free either to use or not use the funds for the donor's desired purpose(s).

In court, the Government argued that these funds were, in reality, donor directed and, therefore, the organization was a mere "conduit" for donors. (The "conduit" concept is discussed later in this article.) However, the Claims Court (now the Court of Federal Claims) made much of the fact that donors appear to relinquish control over the funds to NFI. It stated, "The record is replete with convincing evidence that donors relinquish all ownership and custody of the donated funds or property. . . . The Court is convinced that NFI exercised full control over the donated funds and exercises independent discretion as to the charitable disbursement of the funds." Id. at 493 (emphasis added).

Despite the court's finding, the facts show that if donors become dissatisfied with NFI's administration of the funds, they can request that their funds be distributed to another IRC 501(c)(3) organization of the donor's choice. They also show that NFI will ordinarily honor such a donor request if the request is consistent with the terms of the project, IRC 501(c)(3), and NFI's policies. Further, there was nothing in its agreement with donors or in the way it operates that would indicate that it will exercise an independent judgment about needs most deserving of support by NFI. On the contrary, the solicitations of NFI and its policies create the expectation that the donor's advice will be followed.

This, the Service argued, indicates improper donor direction and control. Were Treas. Reg. 1.507-2(a)(8) applicable, these funds would be treated as donor-directed funds. The Claims Court, however, did not apply, nor even mention Treas. Regs. 1.170A-9(e)(10)-(14) (the single-entity fiction) or 1.507-2(a)(8) (the material-restrictions provision). Instead, it found that "NFI is a unitary organization," i.e., a corporation. National Foundation, 13 Cl. Ct. at 493.

The Service was overruled and NFI was given its exemption. In doing so, the court held that contributions to these funds counted as gifts for purposes of computing its public support under IRC 509. Implicitly, this holding indicates that such donor-controlled contributions are gifts "to" corporate-form organizations.

G.C.M. 39748 (Aug. 3, 1988) (now withdrawn), addressed the question of whether contributions collected by one public charity and earmarked for a second public charity could be counted as good support for the first organization for purposes of determining private foundation status under IRC 509. The G.C.M. involved two corporate-form organizations. It concluded that they could.

The earmarking occurred at the time of the contributions. If the first organizations were community trusts, the G.C.M.'s result would have been consistent with Treas. Reg. 1.170A-9(e)(11)'s expanded definition of what constitutes a gift "to" the single entity. However, donors made the contributions to corporate-form organizations. The G.C.M. suggested that such organizations could not take advantage of Treas. Reg. 1.170A-9(e)(10)-(14). This very issue caused the withdrawal of the G.C.M.

Some practitioners have argued that this G.C.M. signals that the Service will not consider IRC 170(c) in determining public support for corporate-form organizations for purposes of IRC 509(a). Such argument suggests the possibility that other restricted gifts, for example donor-directed funds, could count as good public support. Taken to the ultimate, it suggests that donors could establish mini-private foundations within corporate-form organizations a circumstance that the drafters of the component- part regulations intended to prevent. Counsel contemplated these consequences and in G.C.M. 39875 (June 26, 1992), withdrew G.C.M. 39748 for reconsideration.

D. Noncomponent Trusts and Funds

A single-entity community trust may hold both component and noncomponent funds. Unlike component funds, noncomponents do not share the community trust's tax exempt or public charity status. They are not considered part of the community trust and are treated as separate entities governed by Treas. Reg. 1.170A-9(e)(14). Generally, they are treated as private foundations, supporting organizations, or given some other appropriate tax status.

Treas. Reg. 1.170A-9(e)(14) states that noncomponent trusts are governed by the exempt provisions of IRC 501 or the nonexempt charitable trust provisions of IRC 4947. If the noncomponent is a 501(c)(3) nonprofit corporation or association, it will be treated as a private foundation unless it is described in section 509(a)(1), (2), (3), or (4). If the noncomponent is a nonprofit corporation or association and it is not described in IRC 501(c)(3), it will be treated as a taxable corporation or other taxable entity.

Any transfers to noncomponents will not be considered as transfers made "to" a publicly-supported community trust or its components. Treas. Reg. 1.170A-9(e)(14)(i). Unless the noncomponent itself qualifies as a tax-exempt public charity (or a private foundation described in either IRC 170(b)(1)(E)(ii) or (iii)), contributions to it are not entitled to the maximum charitable deduction under IRC 170. If a private foundation transfers funds to a noncomponent and the noncomponent does not qualify as a tax-exempt public charity, the private foundation must exercise expenditure responsibility regarding the funds to ensure they are properly used by the noncomponent.

If a noncomponent distributes funds to the community trust, the community trust may treat it as a distribution from a separate entity. If the noncomponent is a governmental unit or a public charity, the community trust may treat the distribution as a contribution from the general public and count it as good public support. However, if the noncomponent is not a governmental unit or a public charity, the community trust can only count up to two percent of all distributions as contributions from the general public and as good public support.

5. Fiscal Sponsorship, Conduits, Earmarked Contributions, and Donor Control

A. Legitimate Fiscal Sponsorship Arrangements

Fiscal sponsorship is an area of current concern for the Service. For purposes of this article, fiscal sponsorship occurs when one or more charities choose to financially support another charity or nonexempt project. The following are examples of the proper use of fiscal sponsors:

> C, an individual, desires to start a tutoring program in the inner city but does not have sufficient resources or the sophistication needed to apply for tax exemption. C submits a grant application to X Community Foundation for financial support for the tutoring program. X approves the grant, establishes a fund called the C Fund, and solicits contributions for this fund. X is C's fiscal sponsor.
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> X community foundation approaches S Private Foundation soliciting for C's fund. S makes a grant to X designated for the C Fund. S, in the instrument of transfer, gives X full control over the investment decisions concerning the grant and full discretion in determining how much and when distributions from the fund will be made.
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> X Community Foundation receives a grant request from Z Charity. X reviews and approves the request. X establishes the Z Fund, and solicits contributions for this fund.

In each of these situations, X acts as a fiscal sponsor. Notice that in the second situation, S, a private foundation, is relieved of exercising expenditure responsibility because it gave X full control over the grant's income and corpus.

B. Improper Fiscal Sponsorship Arrangements

There is nothing inherently wrong with fiscal sponsorship; it is what nonoperating public and private charities do. However, it can and has been misused. Take for example a donor who attempts to do indirectly what he or she cannot do directly. Such a situation arises when the donor uses a community foundation as a conduit to accomplish an otherwise prohibited transfer of money or property. For example:

> X, a philanthropist, wants to give to Z, an individual who is poor. X knows that a transfer directly to Z lacks the necessary public benefit

> to be considered charitable. X would not be entitled to a charitable tax deduction. To avoid this result, X donates money to Y Community Foundation with instructions to distribute it to Z. Y has no discretion as to the distribution of the funds. Here, Y is nothing more than a conduit. X is not entitled to a deduction.
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> C, a private foundation, wishes to support a nonexempt charitable project. (A nonexempt project, as used in this context, is a charitable activity of an organization that does not have an IRS determination letter.) C does not want the burden of exercising expenditure responsibility, but wishes to maintain continuing supervision of the project. C gives the money to Y Community Foundation after Y has agreed that C will maintain continuing control and that the money will be used solely for the project.
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> S, a fledgling organization, is struggling to maintain public charity status. T, a wealthy donor, wants to give S a large contribution. If T gives it directly to S, the contribution will be subject to the two percent of total support limitation and S would fail the public support test. To avoid this, T "earmarks" the money for S and runs it through the Y Community Foundation. Y has no discretion but to distribute the money to S.

In the preceding three examples, Y Community Foundation has no control over the donations. Y is acting as a mere conduit in a transfer between the donor and the ultimate recipient. The donor and the recipient are the only beneficiaries in these transactions.

Improper conduit arrangements often arise where grants or contributions are "earmarked" for separate, secondary organizations. Conduit situations always involve three players: a donor, an intermediary grantee through which earmarked contributions pass, and the actual recipient. A community foundation is improperly used as a conduit when it is merely an intermediary grantee acting as a channel through which earmarked gifts are passed.

Earmarking is generally not a problem when there are only two players involved and the gift is not earmarked for an individual or other non-charitable purpose. Donors and grantors are free to earmark contributions to a community foundation for a specific project or program of that community foundation. John A. Edie, Council on Foundations, <u>Use of Fiscal Agents: A Trap for the Unwary</u> 11

(1990). Similarly, donors are free to earmark contributions to programs operated by third-party organizations but supervised by community foundations. Inherent in all of these situations is the control that community foundations exercise over projects and programs. Id.

If the Service suspects a conduit transaction, it will look beyond the fact that the community foundation is a publicly-supported charity. Cf. S.E. Thomason v. Commissioner, 2 T.C. 441 (1943). Rev. Rul. 63-252, 1963-2 C.B. 101, is an example of this substance over form approach. The ruling deals with contributions to a domestic charity which thereafter transmits some or all of its funds to a foreign organization. The Service states that it will look beyond the fact that the intermediary grantee is a charitable domestic organization. It will deny IRC 170 deductions if the domestic organization is only a nominal donee and the real donee is the foreign organization.

C. Why Do Donors Use Conduits?

Private foundations may be motivated to use conduit transactions to avoid exercising expenditure responsibility. They are generally reluctant to exercise such responsibility because they perceive it will add to their administrative costs and fear the potential tax penalties if the required procedures are not properly followed. Edie, supra, at 6. Private foundations can avoid this if they make contributions only to publicly-supported charities.

Individuals use conduit transactions to obtain tax deductions for noncharitable gifts. This may be either intentional or unintentional. They may erroneously believe that they are entitled to a charitable deduction for giving gifts to community foundations that are earmarked for third parties.

The most common situations where improper use of fiscal sponsors can be found are when contributions are intended for:

(1) Individuals. Gifts to individuals lack public benefit and, therefore, do not qualify as charitable gifts. S. E. Thomason v. Commissioner, 2 T.C. 441 (1943); Tilles v. Commissioner, 38 B.T.A. 545 (1938).

(2) Fledgling charities that do not have an IRS determination letter. Often, fledgling charities do not have sufficient sophistication or resources to apply for tax-exempt status. Others may not

apply because they have short life spans and will be dissolved before a determination letter can be issued.

(3) Non-charities. For example, noncharitable entities that are operating charitable projects or programs.

(4) Foreign charities.

(5) Private foundations and the contributions are from private foundations. Private nonoperating foundations may not give grants to other private nonoperating foundations. They can, however, support private operating foundations.

(6) Charities struggling to meet the public support test under IRC 170(b)(1)(A)(vi). In determining their public support, charities can count no more than two percent of all contributions from certain types of donors. Contributions from public charities generally are not subject to the two percent limit. Thus, a struggling charity may try to run large gifts through a publicly-supported community foundation to avoid the two percent limit.

Edie, supra, at 6-8.

6. Common Themes

There are common elements in the questions of donor-imposed restrictions and earmarked funds. Clearly, donors wish to retain certain forms of continuing control over the use of their funds; just as clearly, the Service's policy resists some of these forms. How this line will continue to be drawn remains to be seen.