



COUNCIL *on* FOUNDATIONS

# LEGAL COMPENDIUM FOR COMMUNITY FOUNDATIONS

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## **CHAPTER 3, Component Funds: The Absence of Material Restrictions**

This is an excerpt from the *Legal Compendium for Community Foundations* (Council on Foundations, 1996).

Note that while much of the information in the following excerpt is still accurate and relevant, some changes in the law and regulations may affect portions of this material. For this reason, this material should be read in conjunction with other, more recent resources, or should be used in consultation with local counsel who can advise on any changes.

## CHAPTER THREE: COMPONENT FUNDS: THE ABSENCE OF MATERIAL RESTRICTIONS

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## Chapter Three

### Component Funds: The Absence of Material Restrictions

#### A. Component Funds

##### 1. ADVANTAGES OF A COMPONENT FUND

One of the most important tax advantages offered by a community foundation is that a separate trust or corporation<sup>179</sup> can be considered part of a community foundation if it qualifies as a "component fund." No other type of charity has this advantage. Normally a trust or corporation is considered a separate entity that must file its own tax return and must meet the tax law requirements, such as qualifying as a public charity, on its own merits. Although any type of public charity may be named as the beneficiary of multiple trusts established by a few donors, the only way that it can have these trusts qualify as public charities is to go through the laborious process of having the IRS classify each trust as a "supporting organization" and then filing annual tax returns for each trust. By comparison, trusts and corporations that qualify as component funds of a community foundation do not have to file any tax return and do not have to apply to the IRS for tax-exempt charitable status. A contribution to a component fund is automatically treated as a gift to a public charity.<sup>180</sup> Thus, such a trust or corporation is considered a component part of the community foundation for tax purposes even though it is treated as a separate legal entity under state law.

This feature can provide numerous advantages to donors and to the charities and the communities that a community foundation serves. For example, a donor can establish an irrevocable charitable trust at a bank to benefit a charity in the community or for a specific charitable purpose. Provided that the trust instrument submits itself to the governing document of the community foundation (the community foundation's trust instrument or articles of incorporation and bylaws) and the community foundation accepts the bank as an eligible trustee, the trust can qualify as a component fund.<sup>181</sup> This is the case even if the sole function of the trust is to endow another charity.<sup>182</sup> Thus the community foundation can assist the charity, the donor and the bank by avoiding the administrative costs of a separate supporting organization.

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<sup>179</sup> The overwhelming majority of component funds are trusts that are component parts of a community trust. For an example of a corporation that qualifies as a component fund, see Private Letter Ruling 8621112 (Feb. 28, 1986).

<sup>180</sup> Treas. Reg. Section 1.170A-9 (e) (11) (ii) (second to last sentence).

<sup>181</sup> Although the trust is irrevocable, the community foundation must be able to replace the trustee if the trustee has either (1) breached its fiduciary duty under state law or (2) failed to produce a reasonable return of net income over an extended period of time. Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (2) and (3). The power to replace the trustee under these circumstances occurs when the trust agrees to be subject to the governing instrument of the community foundation.

<sup>182</sup> Treas. Reg. Section 1.170A-9 (e) (11) (v), Example (3); Treas. Reg. Sections 1.507-2 (a) (8) (iii) (B) and 2(a) (8) (iv) (A) (1).

These regulations also provide opportunities for banks to relieve themselves of the tax and administrative burdens of administering private foundations while they retain the assets in their trust departments. For example, a private foundation can terminate into a component fund even though the assets remain at the trust department of the bank.<sup>183</sup>

## 2. REQUIREMENTS FOR A COMPONENT FUND

There are five requirements for a fund to be treated as a component fund of a community foundation rather than a separate trust, not-for-profit corporation or association:

1. The donor must have made a completed gift.<sup>184</sup>
2. The gift must be for a charitable purpose.<sup>185</sup>
3. If the fund is a separate legal entity (such as a trust or a corporation), then the organizational legal documents of the community foundation must meet the single entity requirements contained in the tax regulations for community trusts.<sup>186</sup>
4. If the fund is a separate legal entity, it must subject itself to the common governing instrument of the community foundation.<sup>187</sup>
5. The fund may not be directly or indirectly subjected by the donor to any "material restriction" or condition (as that term is defined in the private foundation tax regulations) with respect to the transferred assets.<sup>188</sup>

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<sup>183</sup> See, generally, Sections SEVEN.C and SEVEN.D for the rules for private foundation terminations. The footnotes in Section SEVEN.C.2 list court decisions that permitted trusts to terminate into incorporated community foundations.

<sup>184</sup> This is a requirement for every charitable contribution. If the donor retains too much control over the property, or fails to deliver the property, then the donor has made an incomplete gift and is not entitled to a charitable tax deduction until the control has been relinquished. In addition, the charity must accept the gift in order for it to qualify as a completed gift. See, generally, Section SIX.C.1 for the requirements to have a completed gift. As is explained in Section THREE.C.8, an incomplete gift may also be a material restriction.

<sup>185</sup> This is also a requirement for every charitable contribution. For example, even if a donor has made a completed gift to a charity, the donor is not entitled to a charitable tax deduction if the gift is earmarked for an individual or a foreign charity. The charitable deduction is also reduced to the extent that the donor received a financial benefit from the gift. See Section SIX.C.1 for the definition of a charitable purpose and Section SIX.D.1 for the rules governing "quid pro quo" contributions. As is explained in Section THREE.C.8, a gift that is not completely for a charitable purpose, or a gift that could have subjected a private foundation to an excise tax (such as an earmarked gift to an individual without expenditure responsibility), could be subject to a "material restriction."

<sup>186</sup> Treas. Reg. Section 1.170A-9 (e) (11) (ii) (A). The organizational documents of a community foundation are the trust instrument (if it is a trust) or the articles of incorporation and bylaws (if it is a corporation). The single-entity requirements are described in Section ONE.D.

<sup>187</sup> Treas. Reg. Section 1.170A-9 (e) (iv). Although this is not technically required by Treas. Reg. Section 1.170A-9 (e) (11) (ii) it is a practical necessity that the fund's instrument of transfer, trust instrument or articles of incorporation subject it to the control of the community foundation by reference to the common instrument. The IRS suggested on the last page of GCM 38812 (Aug. 31, 1981) that the common instrument provisions should be considered a requirement for component fund status.

<sup>188</sup> Treas. Reg. Section 1.170A-9 (e) (11) (ii) (B). Material restrictions, which are defined in Treas. Reg. Section 1.507-2(a) (8), are described in this Chapter THREE. Essentially they determine whether a private foundation, as opposed to a human being, has made a completed gift.

Thus, in addition to the usual rules that limit donor control over gifts to any charitable organization, the tax regulations provide that contributions to community trusts are subject to the added requirement that a donor may not impose a "material restriction." If a donor imposes a material restriction, then the non-component fund is treated as a separate legal entity (a trust, corporation or association) rather than as a component part of the community trust. There is, however, a controversy as to whether or not these rules apply to philanthropic funds that are held directly by a community foundation rather than in a separate trust, corporation or association.<sup>189</sup>

### 3. DEFINITION OF A MATERIAL RESTRICTION

A material restriction is a restriction or condition that prevents a community foundation from "freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes."<sup>190</sup>

The definition is from the regulations that govern private foundation terminations. It is designed to determine whether a private foundation has transferred "all of its right, title, and interest in and to all of its net assets" to a public charity.<sup>191</sup>

In other words, it is the legal standard to determine whether a private foundation has made a completed charitable gift or not. These standards are generally tougher than the standards normally imposed on charitable gifts made by individuals<sup>192</sup> since the IRS wants to be certain that private foundations do not avoid any excise taxes through restricted gifts to public charities.<sup>193</sup>

Many people who read the material restriction regulations for the first time are confused since they only mention transfers by private foundations. To make sense of them, one must read these regulations in conjunction with the single entity regulations. In oversimplified terms, they provide that the material restriction regulations apply to contributions to component funds of community foundations and that the word "donor" should be substituted for the words "private foundation."<sup>194</sup>

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<sup>189</sup> See Section THREE.A.5.

<sup>190</sup> Treas. Reg. Sections 1.170A-9 (e) (11) (ii) (B) and 1.507-2 (a) (8).

<sup>191</sup> Treas. Reg. Section 1.507-2 (a) (7).

<sup>192</sup> See, generally, Section SIX.C.1 for the requirements to have a completed gift.

<sup>193</sup> See, for example, Treas. Reg. Section 53.4943-2(iv) which provides that even if a gift is a completed gift under other tax laws a transfer will not be a completed gift for purposes of Section 4943 (concerning the private foundation excess business holding excise tax) if there is a material restriction imposed on the transfer. The regulation states:

*(iv) Effect of disposition subject to material restrictions.* If a private foundation disposes of an interest in a business enterprise but imposes any material restrictions or conditions that prevent the transferee from freely and effectively using or disposing of the transferred interest, *then the transferor foundation will be treated as owning such interest until all such restrictions or conditions are eliminated (regardless of whether the transferee is treated for other purposes of the Code as owning such interest from the date of the transfer)....*

<sup>194</sup> Treas. Reg. Section 1.170A-9 (e) (11) (ii) (third to last sentence) states:

For purposes of paragraph (e) (11) (ii) (B) of this section, if the transferor is not a private foundation, the provisions of Section 1.507-2 (a) (8) shall be applied to the trust or fund as if the transferor were a private

#### 4. DEALING WITH PERMISSIBLE AND MATERIAL RESTRICTIONS

A donor's restrictions, if any, usually appear in the instrument of transfer that accompanies the gift to the community foundation and governs the terms of the gift. Most contributions to community foundations are restricted in one way or another; unrestricted gifts are a distinct minority of contributions. This is a national phenomenon. Universities receive a significant number of contributions that are restricted to a specific purpose (e.g., scholarships or athletic department); the United Way receives a significant number of contributions that are earmarked for a specific charity.

Before it accepts a gift, a community foundation must determine whether it is willing to accept the restrictions that the donor seeks to impose. Although a community foundation can exercise the variance power to change a restriction, that power is generally available only if circumstances have changed over time to make the restriction unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community.<sup>195</sup> As a general rule, a community foundation must comply with the restrictions that it has accepted at the time of the gift.

Most restricted contributions do not pose any problems. If a material restriction is not imposed, then a fund can qualify as a component fund of the community foundation. A donor who makes a contribution to a component fund can claim a tax deduction for a contribution to a public charity and the community foundation can use the contribution to satisfy the public support test.<sup>196</sup> A component fund is not required to file a separate tax return even if it is a trust or corporation under state law. Instead, its financial transactions are included on the tax return of the community foundation.<sup>197</sup>

By comparison, whereas other public charities do not experience any negative consequences if a donor makes an incomplete gift or makes a gift subject to significant restrictions,<sup>198</sup> a community trust could experience problems if a donor imposes a "material restriction" on a contribution. If a material restriction is imposed, then the contribution is to a "non-component fund": a separate trust, not-for-profit corporation or association that is generally treated as a separate organization.<sup>199</sup> In that case, the

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foundation established and funded by the person establishing the trust or fund and such foundation transferred all its assets to the trust or fund.

<sup>195</sup> Treas. Reg. Section 1.170A-9(e) (11) (v) (B) (1).

<sup>196</sup> See Treas. Reg. Section 1.170A-9 (e) (11) (ii) (the second to last sentence), Private Letter Ruling 8752031 (Sept. 28, 1987) and the last pages of GCM's 38812 (Aug. 31, 1981) and 38880 (July 21, 1982).

<sup>197</sup> Private Letter Ruling 8621112 (Feb. 28, 1986). See also the last sentence of Treas. Reg. Section 1.170A-9 (e) (14) (i) which states that financial information of component funds are to be included on the community foundation's Form 990.

<sup>198</sup> Except for the possible enactment of "intermediate sanctions" for excessive compensation to executives, the only sanction the IRS can impose on a public charity is revocation of its 501 (c) (3) tax-exempt charitable status. By comparison, private foundations can be subject to numerous penalties under Sections 4941 through 4945.

<sup>199</sup> Treas. Reg. Section 1.170A-9 (e) (14) (i). See Chapter FOUR for the treatment of non-component funds.

donor and the fund could be subject to negative consequences, particularly if the fund is classified as a private foundation.

Often a donor and a community foundation will intend to have a separate organization, such as a supporting organization, a charitable remainder trust or a pooled income fund. The donor will, of course, impose restrictions that prevent the community foundation from having free and effective use of the transferred assets. What is to be avoided is a situation where the parties intend to have a component fund but they are unaware that the transaction might involve a material restriction, such as a contribution of a life insurance policy that is subject to an outstanding loan.<sup>200</sup>

The tax regulations give several clear examples of permissible restrictions and material restrictions, but they leave considerable uncertainty as to whether other restrictions are material or not. These other restrictions will be analyzed by the IRS on a case-by-case basis, and there is considerable room for the donor, the community foundation, and the IRS to have varying interpretations.

Consequently, it is advisable for community foundations to insist that there be provisions in the instrument of transfer that state that both parties intend the contribution to be made to a component fund and that the terms of the instrument of transfer are to be construed to that effect. There could also be a provision that gives the community foundation the power to retroactively amend the instrument of transfer to reach that result. This gives a community foundation greater legal authority to amend the agreement than the variance power does. If certainty is required by a donor, she or he could condition a gift on obtaining a favorable ruling from the IRS.<sup>201</sup>

##### 5. DO THE MATERIAL RESTRICTION REGULATIONS APPLY TO FUNDS THAT ARE HELD DIRECTLY BY A COMMUNITY FOUNDATION?

There is an unresolved controversy as to whether or not the material restriction provisions apply to philanthropic funds that are held directly by a community foundation. These funds are essentially accounting entries on the books of a community foundation rather than separate trusts or corporations.

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<sup>200</sup> Treas. Reg. Section 1.307-2 (a) (8) (iv) (C). Whereas most other public charities can accept such a gift, it poses problems for a community trust. A private foundation is also prohibited from accepting such a gift. See Rev. Ruls. 80-132, 1980-1 C.B. 253 and 80133, 1980-1 C.B. 238. See generally Section SIX.C.3.d concerning gifts of life insurance policies.

<sup>201</sup> Private Letter Ruling 8220038 (Feb. 18, 1982). This would, of course, make the gift a conditional gift so that the donor would not be able to obtain a tax deduction until the ruling had been issued and any other conditions had been satisfied. See generally Treas. Reg. Section 1.170A-1(e) for rules concerning conditional gifts. See also Private Letter Ruling 8713050 (Jan. 14, 1987) in which a grant was conditioned on the community foundation not losing its public charity status.

The Legal Advisory Subcommittee of the Council on Foundations will, at no cost, review drafts of ruling requests that members would like to submit to the IRS.

The ambiguity stems from language in the community trust single-entity regulations that apply the component fund rules to "a trust or fund."<sup>202</sup> The regulations therefore differentiate between trusts and funds and on their surface appear to apply to all funds of a community foundation, including funds that are held directly by a community foundation.

However, there is evidence in the tax regulations that philanthropic funds that are held directly by a community foundation are not subject to the single-entity tax regulations or to the material restriction regulations.<sup>203</sup> If this is the case, a philanthropic fund that is directly-held by a community foundation would not be classified as a separate organization solely because there was a material restriction (as that term is defined in the private foundation tax regulations) imposed on the fund.<sup>204</sup> That sanction would only apply to a separate trust, corporation or association that was seeking component fund status.<sup>205</sup> Instead, community foundations and their directly-held funds would only be subject to the same consequences that exist if a material restriction is imposed on a gift to any other type of public charity.<sup>206</sup>

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<sup>202</sup> The regulation states that "in order to be treated as a component part of a community trust ... (rather than as a separate trust or not for-profit corporation or association) a trust or fund . . . may not be directly or indirectly subjected by the transferor to any material restriction or condition (within the meaning of section 1.507-2(a) (8)) with respect to the transferred assets." (Treas. Reg. Section 1.170A-9 (e) (11) (ii) - emphasis added).

<sup>203</sup> The tax regulations make a distinction between directly-held funds and component funds. This suggests that the component fund rules only apply to funds that are capable of being separate legal entities, such as trusts and corporations. See single-entity regulation 1.170A-9 (e) (11) (vi) ("financial reports [must treat] all of the funds which are held by the community trust, either directly or in component parts, as funds of the organization") and material restriction regulation 1.507-2 (a) (8) ("In the case of a community trust, the transferred assets must be administered in or as a component part of the community trust") [emphasis added by author].

In addition, the tax regulations that govern non-component funds only apply to a trust, corporation or an association. They do not mention a directly-held fund or account. Treas. Reg. Section 1.170A-9 (e) (14) (i) states that "any trust or not-for-profit corporation or association which is alleged to be a component part of a community trust, but which fails to meet the requirements ... shall not be treated as a component part of a community trust ... If such organization is a not-for-profit corporation or association, it will be treated as a separate entity...."

<sup>204</sup> One reason is that a directly-held fund does not meet the tax law or state law definition of an association (continuity of life, centralized management, etc.). See Reg. 301.7701-2 (a). It also does not meet the basic requirements to qualify for Section 501 (c) (3) status. A charity must at a minimum have a separate governing instrument, a separate governing body with regularly chosen officers, and separate books and accounts. If a donor were to send a copy of the agreement that establishes such a fund to the IRS and apply for separate Section 501 (c) (3) status, the application would surely be rejected because the arrangement would not qualify as a separate legal entity.

<sup>205</sup> Treas. Reg. Section 1.170A-9 (e) (14) (i). See Chapter FOUR for the rules governing non-component funds.

<sup>206</sup> Except for their appearance in the community trust regulations, there is only one other reference to the private foundation material restriction rules in the tax regulations concerning gifts to public charities from donors other than private foundations. The reference is in the regulations that concern the "unusual grant" exception for the public support test. Those regulations state that the Service should examine nine factors to determine whether a large gift qualifies as an unusual grant. The last factor is "whether material restrictions or conditions (within the meaning of section 1.507-2 (a) (8)) have been imposed by the transferor upon the transferee in connection with such transfer." Treas. Reg. Section 1.509 (a)-3 (c) (4) (ix). The regulations make it clear that even if a donor imposed one or more section 507 private foundation material restrictions on a gift, the Service has discretion to approve the gift as an unusual



This can be important for those transactions where a donor may have made a completed charitable gift under conventional standards but where a material restriction may have been imposed under the private foundation standards.<sup>207</sup> For example, a private foundation cannot make a grant unless it is 100% charitable, but an individual can.<sup>208</sup> Whereas these types of transactions clearly pose problems for a trust or a corporation that seeks component fund status, they should not be a problem if they are done in connection with a philanthropic fund that is entirely administered by a community foundation. Such transactions include:

- Issuing a charitable gift annuity;<sup>209</sup>
- Accepting a gift of real estate or a life insurance policy that is subject to a mortgage or debt; and<sup>210</sup>
- Accepting a contribution of stock that is subject to a right-of-first refusal<sup>211</sup>

In its 1993 training manual, the IRS made a distinction between community foundations in trust form and those in corporate form.<sup>212</sup> Although a community foundation with multiple trusts is unquestionably subject to the single-entity and material restriction rules, the IRS acknowledged that the law was not clear concerning incorporated community foundations.<sup>213</sup> However, in a chapter of its 1995 training manual concerning

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grant Treas. Reg. Section 1.509 (a)-3 (c) (4) states that of the nine factors listed, "no single factor will necessarily be determinative" of whether a grant is an unusual grant or not.

With any other type of public charity, the only sanction that exists if a donor retains too much control over a particular gift is that the donor cannot claim a charitable tax deduction since there has been an incomplete gift. There is no penalty imposed on a public charity for holding property that a donor could not claim a tax deduction for. The IRS stated in a private letter ruling that the material restriction regulations did not apply to charitable organizations other than community trusts. Private Letter Ruling 8604102 (Nov. 4, 1985).

<sup>207</sup> See the text of supra n. 193.

<sup>208</sup> For example, an individual can claim a charitable income tax deduction for the charitable portion of a gift to a charitable remainder trust or a "quid pro quo" contribution. A private foundation would incur an excise tax for a comparable gift that benefitted a non-charitable beneficiary.

<sup>209</sup> See Section NINE.H for the rules governing charitable gift annuities. The material restriction would consist of the portion of the gift that had a non-charitable purpose. See Treas. Reg. Section 1.170A-9 (e) (14) (ii) for analogous treatment of a charitable remainder trust.

<sup>210</sup> Although this can be a material restriction under Treas. Reg. Section 1.507-2 (a) (8) (iv) (C), other public charities can accept such gifts. See Section SIX.C.2.c. Private foundations, however, are prohibited from accepting gifts of life insurance subject to loans because of the self-dealing and jeopardy investment taxes. Rev. Ruls. 80-132, 1980-1 C.B. 255 and 80-133, 1980-1 C.B. 258.

<sup>211</sup> See Section THREE.C.4.b.

<sup>212</sup> *The 1993 IRS Exempt Organizations CPE Technical Instruction Program Textbook*, Chapter K ("Community Foundations") states on page 135: "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 [as community trusts] is currently under debate.... This article will treat the trust and corporate forms as separate and distinct although many community foundations combine both features."

<sup>213</sup> *The 1993 IRS Exempt Organizations CPE Technical Instruction Program Textbook*, Chapter K ("Community Foundations") states on pages 137 and 138:

commercial donor-advised and donor-directed funds, the authors cited the material restriction regulations and did not make a distinction between the trust and corporate form.<sup>214</sup> The ambiguity concerning these regulations increased six months later. The IRS failed to make any reference to the material restriction regulations in a court case that involved a national donor-advised fund even though it probably would have been appropriate based on its analysis in the 1995 training manual.<sup>215</sup>

What are the positions of the courts and the IRS regarding the application of the private foundation material restriction regulations to directly-held philanthropic funds of community foundations? The courts have never cited the material restriction regulations in any published opinion. Their position is, therefore, uncertain.<sup>216</sup> The regulations are only mentioned in a single official IRS pronouncement.<sup>217</sup> Consequently, there is very little formal guidance to interpret the regulations.

Until the laws are clarified, the following course of action may be appropriate with respect to directly-held philanthropic funds:

1. Every community foundation should structure its operations and its philanthropic funds along the lines of the traditional arrangement described in the material restriction regulations (unrestricted, field of interest, designated and advised funds). These varied funds constitute the backbone of community foundations and distinguish them from the commercial advised funds that are emerging. Community foundations can be assured that there will not be any negative consequences if their directly-held funds are administered in compliance with the private foundation material restriction regulations that apply to multiple-trust community trusts.
2. Community foundations can probably engage in transactions that are clearly permitted for other public charities, such as issuing charitable gift annuities and accepting gifts of life insurance policies subject to loans, even though these

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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. 1.170-9 (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 Sec. 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.

<sup>214</sup> 1995 (for FY 1996) *IRS Exempt Organizations (CPE Technical Instruction Program Textbook Part II, Chapter E: "Conduit Organizations - Charitable Deductibility and Exemption Issues."*

<sup>215</sup> *Fund for Anonymous Gifts v. U.S.*, U.S. District Court (Wash. D.C.); Mr. No. 95-CV-1629 (IRS resists application for charitable tax status by a trust that will do nothing but administer advised funds; the case was still pending at the time of publication).

<sup>216</sup> A 1996 LEXIS search of all published court decisions shows that the material restriction regulations have never been cited; they have never been a judicial standard for measuring donor control.

<sup>217</sup> They are mentioned in passing in a revenue procedure that describes how a large contribution could be an "unusual grant." Rev. Proc. 81-7, 1981-1 C.B. 621. Other references to the regulations are only in internal IRS documents, such as private letter rulings and general counsel memoranda.

transactions might be classified as material restrictions and could cause problems if done by a private foundation. However, such transactions should not be done by a separate trust or corporation that seeks component fund status since the material restriction could cause the trust or corporation to lose its component fund status.

3. If a community foundation is considering a relatively novel transaction that may include a material restriction, the community foundation might consider requesting guidance from the IRS. The Legal Advisory Subcommittee of the Council on Foundations will, at no cost, review drafts of ruling requests that members would like to submit to the IRS.

## B. Restrictions That Are Not Material Restrictions

The regulations list several donor-imposed restrictions that are not material restrictions. They include:

### 1. DESIGNATED FUNDS

The instrument of transfer may designate that the income or assets are to be used for one or more particular public charities described in Sections 509 (a) (1),(2) or (3).<sup>218</sup> These sections describe virtually every public charity and charitable service provider, including hospitals and supporting organizations.<sup>219</sup> However, Section 509 (a) (4) organizations (testing for public safety) are apparently ineligible. In addition, although contributions to private operating foundations . generally qualify for the same tax benefits as contributions to public charities, the tax regulations do not list them as eligible beneficiaries of designated funds.<sup>220</sup> Although most community foundations establish a separate designated fund for every organization to be benefited, the tax regulations appear to classify a designated fund as any fund that benefits five or fewer readily ascertainable organizations.<sup>221</sup>

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<sup>218</sup> Treas. Reg. Sections 1.307-2(a) (8) (iii) (B) and 2(a) (8) (iv) (A) (1); Treas. Reg. Section 1.170A-9(e) (11) (v), Example (3).

<sup>219</sup> Section 509(a) (1) describes organizations that are classified as public charities:

- because they passed the public support test of 170(b) (1) (a) (vi) (Community Foundations, Boys Club, Red Cross, etc.) (see Sections TWO.B and TWOD for the public support test), or
- because of their charitable function (without regard to the public support test): churches, educational organizations, medical research facilities, state-supported organizations and governmental units {see Sections 170 (b) (1) (A) (i) through (v)1.

Section 509 (a) (2) describes organizations that are classified as public charities because they receive fees for exempt services, such as symphonies and certain health care organizations.

Section 509 (a) (3) describes "supporting organizations" that are classified as public charities (even if they could not pass the public support test) because they support a publicly-supported Section 309 (a) (1) or 509 (a) (2) charity, such as a community foundation. See Chapter EIGHT for supporting organizations.

<sup>220</sup> Sections 170(b) (1) (A) (vii) and (b) (1) (E) provide that contributions to private operating foundations qualify for the same tax benefits as contributions to public charities, but a private operating foundation does not meet the definition of a public charity under Sections 309 (a) (1), (2) or (3).

<sup>221</sup> Treas. Reg. Section 1.170A-9 (e) (11) (v) (F) and 9 (e) (13) (x).

Public charities often establish endowed designated funds at community foundations for their own benefit. They are usually called "agency endowment funds." There are a variety of reasons why they establish such funds, including a community foundation's greater sophistication for administering long-term investments and greater assurance that principal will not be spent by the agency.<sup>222</sup> One of the more sensitive issues that can arise is when an organization establishes an agency endowment fund with a prohibition on the distribution of principal, but years later a new governing body requests a distribution of principal. There should be fewer disputes if the instrument of transfer is drafted to anticipate such a situation and if it contains instructions on how the request should be resolved.

A controversy in the mid-1990s concerned how designated funds should be reported on the audited financial statements of a community foundation.<sup>223</sup> Although the debate was not settled at the time of publication, the Financial Accounting Standards Board (FASB) conceded in 1995 that if the donor explicitly stated (in the instrument of transfer that established the designated fund) that the community foundation had the unilateral right to redirect the use of the assets, then the assets were indeed the property of the community foundation.<sup>224</sup> Consequently, it may be advisable for community foundations to put such a provision into the instruments of transfer that establish designated funds.

The single entity regulations require the community foundation to exercise a monitoring function over the benefitted organization. The community foundation should redirect the resources in the fund to other charitable purposes if the governing body determines that the donor's restriction is unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served.<sup>225</sup> The most common situation when this occurs is when the designated charity ceases to exist. The tax regulations also require that the financial investment performance of designated funds be measured on

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<sup>222</sup> For an interesting case where a city attempted (and failed) to obtain money from an agency endowment fund that a community foundation held for a local arts organization, see *Baltimore Arts Festival, Inc. v. Mayor & City Council of Baltimore*, 326 Md. 633 (1992).

<sup>223</sup> The FASB modified generally accepted accounting principles relating to contributions received and awarded by charitable organizations in its pronouncement: Statement of Financial Accounting Standards No. 116, "Accounting for Contributions Received and Contributions Made." Among other things, SFAS 116 analyzed whether an organization that held an endowment fund for another organization was merely acting as an agent for the organization or whether it held the assets in its own right. Although the tax regulations make it clear that a contribution to a designated fund is treated as a contribution "to" the community foundation for tax purposes (see Treas. Reg. Section 1.170A-9 (e) (11) (ii)), some people contended that the assets should be reported on the books of the other charity for financial reporting purposes.

On a related matter, the IRS announced that charities that changed their accounting methods to conform to SFAS 116 on their tax returns (Form 990) did not have to apply to the IRS for permission to change their accounting methods, as would normally be the case. IRS Notice 96-30, 1996-20 IRB 1.

<sup>224</sup> The rule that the FASB proposed was as follows:

"If an organization receives assets and the resource provider specifies the beneficiary, the recipient is presumed to be acting as an agent or trustee. *It would be acting as a donee only if the resource provider explicitly provided the organization the power to redirect the use of those assets away from the specified beneficiary.*" "FASB To Issue Interpretation on Community Foundations." 13 *Exempt Org. Tax Rev.* 27, at 27 (Jan. 1996).

<sup>225</sup> Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (1). See Section ONE.D.2.d of this publication.

a fund-by-fund basis rather than on an aggregate basis, as all other component funds are measured.<sup>226</sup>

## 2. FIELD-OF-INTEREST FUNDS

The instrument of transfer may instruct the community foundation to limit the use of a fund's: income and assets to a specific charitable purpose.<sup>227</sup> Examples include broad purposes such as supporting higher education<sup>228</sup> and more narrow purposes such as researching causes of cancer,<sup>229</sup> caring for needy children,<sup>230</sup> or providing housing to the working poor.<sup>231</sup>

The range of charitable purposes is extremely broad.<sup>232</sup> There are many court cases and IRS rulings that approve specific grants as charitable.<sup>233</sup> They can also be the basis for a grant from a field of interest fund. Clearly, if a private foundation can make a certain type of grant then a community foundation can also make the same grant under the same circumstances. Based on this principle, several community foundations have established funds to facilitate the charitable activities of large, local corporations. They are administered under the same standards that apply to company private foundations, including scholarship grants for company employees and dependents<sup>234</sup> and disaster

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<sup>226</sup> Treas. Reg. Section 1.170A-9 (e) (11) (v) (F) and 9(e) (13) (x). See Section ONE.D.2.e of this publication.

<sup>227</sup> Treas. Reg. 1.507-2(a) (8) (iii) (B). See Section THREE.B.5.b.ii for a list of charitable purposes that have been approved by the IRS.

<sup>228</sup> Treas. Reg. 1.170A-9(c) (13) (x).

<sup>229</sup> Treas. Reg. 1.507-2 (a) (8) (v), Example (1).

<sup>230</sup> Private Letter Ruling 8836033 (June 14, 1988).

<sup>231</sup> Private Letter Ruling 8923071 (Mar. 16, 1989).

<sup>232</sup> Sections 170(c) (2) (income tax deductions) and 501 (c) (3) (charitable organizations) specifically define charitable activities to include religious, scientific, literary, and educational activities. Treas. Reg. Section 1.501 (c) (3)-1 expands the definition to include: relief of the poor and distressed or of the underprivileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of Government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency.

Numerous court cases and IRS rulings describe additional activities as charitable. See Section THREE.B.5.b. An organization will usually qualify as a charity if it can demonstrate that its activities will benefit the community (the "community benefit" standard).

<sup>233</sup> The rulings that specifically approve charitable grants that are free from material restrictions are listed in Section THREE.B.5.b.

<sup>234</sup> In order to avoid having a scholarship from a private foundation treated as compensation income to an employee, and in order to avoid incurring a private foundation tax for making a "taxable expenditure," private foundations usually apply to the IRS in advance for approval of their scholarship program. They usually have to show impartial, objective standards for selecting eligible recipients. The IRS set the standards in Rev. Proc. 7647, 1976-2 C.B. 670 and all company private foundation scholarship programs must meet the requirements of that Revenue Procedure.

The IRS has extended these requirements to public charities that receive grants from a private foundation (as opposed to from the corporation itself) to administer their employee scholarship programs. Thus, if a private foundation makes a grant to a public charity (such as a community foundation or a university) and limits the eligible beneficiaries to company employees, the IRS concludes that the public

and emergency relief grants for company employees.<sup>235</sup> A corporation can also establish an advised fund and allow selected directors to make grant recommendations.<sup>236</sup> Funds can be established for the charitable purposes of cemeteries, although generally the fund cannot simply endow a cemetery association.<sup>237</sup>

As is the case with designated funds, the single entity regulations require the community foundation to exercise a monitoring function over the fund and to redirect the resources in the fund to other charitable purposes if the governing body determines that the donor's restriction is unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served.<sup>238</sup>

### 3. ADVISED FUNDS

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charity must meet Rev. Proc. 76-47. See Rev. Rul. 81-217, 1981-2 C.B. 217. For an example of such an arrangement, see Private Letter Ruling 8816077 (Jan. 29, 1988).

<sup>235</sup> The IRS regularly approves programs at company private foundations to provide disaster-relief for the company's employees. The requirements are (1) a fair selection process and (2) a sufficient number of employees that they constitute a public "class" (as opposed to, for example, members of one person's family). If a private foundation can make such grants, then a community foundation should be able to do it under the same terms. Examples can be found in Private Letter Rulings 9316051 (Jan. 29, 1993) (fund setup by hospital for its 2,900 employees and 6,000 others); 9314058 (Jan. 14, 1993) (hardship grant and loan program to assist current employees); and 9228045 (Apr. 20, 1992). See also IRS Notice 92-45, 1992-2 C.B. 375 (relief to victims of Hurricanes Andrew and Iniki) and IRS Notice 93-41, 1993-2 C.B. 332 (relief to victims of the midwest floods). For an analysis of the IRS' view of emergency relief funds, see 1994 (for FY 1995) *IRS Exempt Organizations CPF Technical Instruction Program Textbook* Chapter O: "Private Foundations in the Mid-1990s with an Emphasis on IRC 4941 and IRC 4945." (Section H - "Emergency Funds Provided to Company Employees by Company-Foundation").

<sup>236</sup> The rulings involved advised funds within a private foundation. Private Letter Rulings 9350009 (Sept. 14, 1993) and 9336041. The IRS concluded that there was no income to the directors from this benefit and no reduction in the corporation's charitable income tax deduction. Grants were generally limited to universities.

<sup>237</sup> By way of background, most cemetery companies are not charities under Section 501 (c) (3) but are tax-exempt under a different section: Section 501 (c) (13). Although a special statute makes a gift to a cemetery company eligible for an income tax charitable deduction, such a gift is not eligible for an estate tax deduction (see Rev. Rul. 77-385, 1977-2 C.B. 331 and *Child v. U.S.*, 540 F.2d 579 (2d Cir. 1976) ). Similarly, the IRS has taken a firm position that a private foundation cannot make a grant to a cemetery company without exercising "expenditure responsibility." Rev. Rul. 80-97, 1980-1 C.B. 257. The same result will occur if an earmarked grant is made indirectly through another charity, such as a community foundation. Treas. Reg. Sections 53.4942(5.)-3 (a) (3) and 53.49455 (a) (6).

Because it is not a Section 501 (c) (3) public charity, a Section 501 (c) (13) cemetery company cannot be the beneficiary of a designated fund at a community foundation. See Treas. Reg. Sections 1.507-2(5.) (8) (iii) (B) and 2(5.) (8) (iv) (A) (1). However, a cemetery performs some charitable functions such as beautifying a city and educating the public about its history. The Saint Paul Foundation received IRS approval in 1982 to establish a field of interest fund that supports the charitable activities (but not the non-charitable activities) of cemeteries in the Saint Paul area. Grants are made for particular charitable projects, such as replacing deteriorating headstones and improving public areas of the cemetery. The fund cannot provide an endowment for the general administrative expenses of a cemetery company since it is not a public charity.

Of course, donors must understand that contributions to such a fund are for general charitable purposes. Donors cannot claim tax deductions for amounts paid to maintain a specific for or crypt, since such expenditures would not be for a public purpose. Rev. Rul. 69-256, 1969-1 C.B. 151 and Rev. Rul. 58-190, 1958-1 C.B. 15.

<sup>238</sup> Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (1). See Section ONE.D.2.d of this publication.

## a. Overview

There is no definition in the Internal Revenue Code or the tax regulations of an advised fund, per se. The commonly accepted definition is that it is a fund where the donor, or a committee designated by the donor, may recommend eligible charitable recipients of grants from the fund. The recommendations are advisory and the governing body must be free to accept or reject them.

By comparison, if a community foundation could be legally compelled to follow the donor's designation, the fund would be subject to a material restriction (with one exception).<sup>239</sup> A material restriction exists if a donor has, directly or indirectly, reserved the right to later name the charitable beneficiaries of the fund.<sup>240</sup>

Thus, for example, a "power of appointment"<sup>241</sup> is a material restriction.<sup>242</sup> Also, a donor directed fund that is administered in a separate trust or corporation is not eligible to be treated as a component part of a community trust because of the donor's right to designate the charitable beneficiaries.<sup>243</sup> A community foundation should, therefore, structure its advised fund program to avoid giving the donor any direct or indirect control over the selection of the charitable beneficiaries.<sup>244</sup>

The material restriction regulations list a series of favorable and unfavorable factors to determine whether a donor has, directly or indirectly, imposed a material restriction on a gift. These factors provide a legal standard to determine whether an advised fund qualifies as a component part of a community trust or not.<sup>245</sup> By comparison, the IRS has

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<sup>239</sup> An exception exists if the designated organization is named in the instrument of transfer, in which case the fund would be a designated fund rather than an advised fund. Treas. Reg. Sections 1.307-2 (a) (8) (iii) (B) and 2(a) (8) (iv) (A) (1).

<sup>240</sup> Treas. Reg. 1.570-2 (a) (8) (iv) (A) (1).

<sup>241</sup> A power of appointment often exists where a bank administers the investments in a trust but an individual has the right to designate who will receive the income or principal from the trust. Usually retaining a power of appointment will cause a gift to be an "incomplete gift." However, the tax laws have some inconsistencies on this subject. Although a gift where a donor retains a power of appointment will prevent a completed gift for gift tax purposes (Treas. Reg. Section 25.2511-2 (c) ), there are a few situations where it will qualify as a completed gift for income tax purposes. See Rev. Rul. 69-276, 1969-1 C.B. 64 (a donor can make a contribution to one public charity and reserve the right for up to 18 months to have cash transferred to another public charity); Rev. Rul. 76-371, 1973 C.B. 303; Rev. Rul. 78-101, 1978-1 C.B. 301 (a gift to a charitable remainder unitrust, where the donor or trustee reserves the right to change the identity of the charitable beneficiary, qualifies for immediate tax deductions); Section 170(b) (1) (E) (iii) (donor-directed funds) and Section 170(b) (1) (E) (ii) (pass-through private foundations) allow for donor designations after a gift is made. For the general rules concerning a completed gift, see Section SIX.C.1.

<sup>242</sup> Treas. Reg. 1.570-2 (a) (8) (iv) (A) (1) specifically states that a power of appointment is a material restriction.

<sup>243</sup> Sections 170 (b) (1) (E) (iii) and 170 (b) (1) (A) (vii); Treas. Reg. Section 1.170A-9 (e) (14) (iii); Rev. Rul. 80-303, 1980-2 C.B. 71; Private Letter Ruling 8134046 (May 26, 1981). See Section FOUR.C for analysis of donor-directed funds.

<sup>244</sup> See also the Council on Foundations publication "Establishing an Advised Fund Program."

<sup>245</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (1), in conjunction with Treas. Reg. Section 1.170A- 9 (e) (11) (ii).

on several occasions approved the administration of advised funds by charities other than community foundations (including some private foundations) and has not mentioned the material restriction regulations with regard to those funds.<sup>246</sup> Two court cases involved organizations that did nothing but administer advised funds.<sup>247</sup> This suggests that advised funds can be administered by organizations other than community foundations and that the material restriction regulations might not be the sole criteria for the administration of such funds.

#### b. Direct Control

The legal documents (instrument of transfer, articles of incorporation or trust instrument, and the bylaws) are of paramount importance in determining whether the donor has reserved any control over the fund. The instrument of transfer should specifically state that the community foundation exercises control over the fund, preferably with specific references to appropriate provisions in the bylaws or organizational documents.<sup>248</sup> It should also contain statements to the effect that all parties intend that the fund shall be a component fund and that the document should be interpreted to that effect. The U.S. Court of Claims found such language in the documents to be persuasive evidence of

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<sup>246</sup> The IRS permitted donors to establish advised funds with:

\* publicly supported charities (Private Letter Rulings 9250041 (Sept. 17, 1992) ("Advise and Consult Funds"), 8936002 (May 24, 1989) and 7825028 (Mar. 22, 1978)),

\* universities (Private Letter Rulings 8021079 (Feb. 28, 1980), 7827015 (Mar. 31, 1978), and 7821096 (Feb. 27, 1978)), and \* private foundations (Private Letter Rulings 9350009 (Sept. 14, 1993) and 9412039 (Dec. 23, 1993)).

None of the rulings mention the material restriction regulations. Most of the rulings mention that the charity will have ultimate control over the assets and that the gift is the property of the charity. The most detailed arrangement is in Private Letter Ruling 9230041 (Sept. 17, 1992).

In some of the rulings the IRS permitted actions that violate the material restriction regulations. For example, the IRS permitted binding arbitration for disputes between a donor and a charity. See Private Letter Ruling 9412039 (Dec. 23, 1993) (an advised fund of a private foundation). It also permitted a donor and a charity to each have a veto power over every grant. Private Letter Ruling 896002 (May 24, 1989) (an advised fund where no grant could be made without full concurrence of the donor and the executive director of the public charity).

The IRS has also issued favorable determination letters to several organizations (some of which are affiliated with commercial financial service firms) that do nothing but administer advised funds. See, for example, "The Scudder Charitable Foundation Qualifies for (c) (3) Exemption," 94 *Tax Notes Today* 219-63 (Nov. 8, 1994). In none of these rulings or determination letters were the material restriction regulations mentioned. However, the IRS did raise the possibility of applying the material restriction regulations to commercial-related advised fund organizations in its training manual. See 1995 *IRS Exempt Organizations CPE Technical Instruction Program Textbook Part II*, Chapter E: "Conduit Organizations - Charitable Deductibility and Exemption Issues."

<sup>247</sup> *National Foundation, Inc. v. U.S.*, 13 Cl. CL 486; 1987 U.S. Cl. CL LEXIS 202; 87-2 U.S.T.C. (CCH) Par. 9602 at p. 89,831; 60 A.F.T.R. 2d (P-H) 5926 at 5930 (1987) (The case is described in Section THREE.B-3.c.2). See also *Fund for Anonymous Gifts v. U.S.*, U.S. District Court (Wash. D.C.); Dkt. No. 95-CV-1629 (IRS resists application for charitable tax status by a trust that will do nothing but administer advised funds; the case was still pending at the time of publication).

<sup>248</sup> This may be required under other regulations anyway. Treas. Reg. Section 1.170A-9 (e) (11) (iv) provides that a fund will meet the common governing instrument requirement by having language in the instrument of transfer that makes the fund subject to the community foundation's governing instrument.



the lack of a donor's control despite IRS arguments of donor control.<sup>249</sup> A federal court case in 1996 involved very similar issues.<sup>250</sup>

### c. Indirect Control: Favorable and Adverse Factors

Although the donor may relinquish direct control over the assets in the fund, the regulations instruct the IRS to carefully examine whether the seeking of advice by a community trust from, or the giving of advice by, any donor constitutes an indirect reservation of a right to direct distributions. If the only criterion considered by the community trust in making a distribution from a fund is advice from the donor, then the fund is subject to a material restriction.<sup>251</sup> Consequently, a community trust should have other procedures for making distributions.<sup>252</sup>

In those situations where it is not clear whether the right to direct the selection of the recipients has been retained, the IRS will examine how the facts and circumstances of the community trust's administration of the advised funds compares with several favorable and adverse factors listed in the regulations. The community trust's strategy is, therefore, to structure its affairs so as to stress the favorable factors and to avoid the adverse factors. Again, this is only a "facts and circumstances" analysis and it does not provide legal certainty; people can reasonably disagree about the legal outcome of the same set of facts. In addition, the list is not exhaustive; the Treasury regulations anticipate that there could be other favorable and adverse factors.<sup>253</sup>

#### 1. Favorable Factors

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<sup>249</sup> Although the material restriction regulations were never mentioned in the decision, the court analyzed the terms governing an organization's "advised funds" and concluded the donors did not control them. The court stated:

NFI does not act as a "conduit" for its donors. A conduit function assumes that the donor maintains control over the donation. The record is replete with convincing evidence that donors relinquish all ownership and custody of the donated funds or property. NFI executes with its donors a standard form of agreement which provides that NFI has control of all donations. NFI is free to accept or reject any suggestion or request made by a donor. However, in accepting a donor's recommendation, NFI is bound by its articles of incorporation which prohibit NFI from applying any funds toward a non-exempt purpose. In addition, once NFI accepts a donation, the donor has no legal recourse against NFI for the return of the contribution should NFI refuse to honor the donor's request. The Court is convinced that NFI exercises full control over the donated funds and exercises independent discretion as to the charitable disbursement of the funds. *National Foundation Inc. v. U.S.*, 13 Cl. Ct. 486; 1987 U.S. Cl. Ct. LEXIS 202, at 17-18; 87-2 U.S.T.C.(CCH) Par. 9602, at p. 89,831; 60 A.F.T.R.2d (P-H) 5926, at 5930 (1987).

<sup>250</sup> *Fund for Anonymous Gifts v. U.S.*, U.S. District Court (Wash. D.C.); ME. No. 95-CV-1629 (IRS resists application for charitable tax status by a trust that will do nothing but administer advised funds; the case was still pending at the time of publication).

<sup>251</sup> Treas. Reg. 1.570-2(a) (8) (iv) (A) (1). The IRS raised this argument concerning commercial donor-advised funds in its 1995 training manual 1995 (for FY 1996) *IRS Exempt Organizations CPE Technical Instruction Program Textbook Part II*, Chapter E: "Conduit Organizations-Charitable Deductibility and Exemption Issues" and in its legal briefs in the case of *Fund for Anonymous Gifts v. U.S.*, U.S. District Court (Wash. D.C.); Dkt No. 95-CV-1629 (the case was still pending at the time of publication).

<sup>252</sup> An example is the educational programs most community foundations carry on through newsletters and personal contacts with donors and members of the community to identify worthwhile grants in the community.

<sup>253</sup> Treas. Reg. 1.570-2 (a) (8) (iv) (A) (1) (last sentence).

The tax regulations state that the presence of some or all of the following factors will help to demonstrate that donor control does not exist.

- a. Independent Investigation. There has been an independent investigation by the community trust evaluating whether the donor's advice is consistent with specific charitable needs most deserving of the community trust's support.<sup>254</sup>

Comment: Written documentation of investigations can be helpful. The tax regulations do not specify how lengthy or brief the investigation must be. In a 1996 court case, the IRS contended that simply looking to see if a charity was listed in IRS Publication 78 (the list of IRS-approved charitable organizations) was not a sufficient investigation. It also contended that if this was the only investigation done by an organization, it would justify disqualification of the organization's charitable tax status.<sup>255</sup>

Many community foundations emulate some of the expenditure responsibility requirements imposed on private foundations under Section 4945. Some establish a file on each public charity for the first grant that includes a copy of its determination letter and Form 990, and then periodically re-evaluate the organization after several years.

- b. Guidelines of Specific Charitable Needs. The community trust has promulgated guidelines enumerating specific charitable needs that are consistent with its charitable purposes and the donor's advice is consistent with such guidelines.<sup>256</sup>

Comment: All community foundations should establish written guidelines, grant-making procedures in addition to guidelines concerning the establishment and administration of funds. The guidelines should address issues such as the range of charitable activities the community foundation is willing to support (e.g., may grants be made to religious institutions), and the procedures for selecting and evaluating grants.

- c. Educational Program. The community trust has instituted an educational program publicizing to donors and other persons the guidelines that enumerate the specific charitable needs.<sup>257</sup>

Comment: The educational program appears to be a very effective way to demonstrate the community foundation's control over the fund. By being in regular communication with the donor (circulating the guidelines, sending correspondence or newsletters and suggesting possible grant recipients to the

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<sup>254</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (2) (i).

<sup>255</sup> *Fund for Anonymous Gifts v. U.S.*, U.S. District Court (Wash. D.C.); Dkt No. 95-CV1629 (the case was still pending at the time of publication).

<sup>256</sup> Treas. Reg. Section 1.507-2(a) (8) (iv) (A) (2) (ii).

<sup>257</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (a) (2) (iii).

donor) a community foundation can demonstrate that it does not simply wait to receive advice from the donor but, rather, is actively involved in a cooperative philanthropic venture with the donor.

d. **Foundation Makes Similar Grants from Other Funds.** The community trust distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor.<sup>258</sup>

e. **Solicitations State There Is No Donor Control.** The community trust's written and oral solicitations for funds specifically state that it will not be bound by advice offered by the donor.<sup>259</sup> Comment: At the very least, community foundations should include an affirmative statement to this effect in all publicly distributed material.

## 2. Adverse Factors

The tax regulations state that the presence of some or all of the following factors may indicate that donor control exists.

a. **Solicitations Imply Foundation Will Follow Donor's Advice.** The solicitations (written or oral) of the community trust state or imply (or a pattern of conduct on the part of the community trust creates an expectation) that the donor's advice will be followed.<sup>260</sup>

Comment: The statement that the community foundation will not be bound by the donor's advice should mitigate this factor. Community foundation publications and correspondence should be carefully screened to avoid the implication that a donor can control the resources in a fund. In conversations and in written correspondence one should consider avoiding possessive terms such as "your fund" and using instead more neutral terms such as "the fund you established."

b. **Advice of the Donor is Limited to the Fund the Donor Established.** The advice of a donor is limited to distributions of amounts from the fund the donor established, and the independent investigation and guidelines for specific charitable needs (described above in Section I (a) and (b)) are not present.<sup>261</sup>

Comment: Arguably the word "and" means that this factor becomes unimportant if the guidelines have been adopted and investigations take place.

c. **Only the Advice of the Donor is Considered with Respect to That Fund.** The community trust only solicits advice of the donor as to distributions from the fund that

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<sup>258</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (2) (iv).

<sup>259</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (a) (2) (v).

<sup>260</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (3) (i).

<sup>261</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (3) (ii).

she or he established and no procedure is provided for considering advice from persons other than the donor with respect to such fund.<sup>262</sup>

Comment: The most likely source of other advice is the community foundation staff. This factor stresses the importance of an educational program. Some community foundations go a step further to demonstrate their control by maintaining a mandatory distribution policy similar to that which applies to private foundations. For example, if a donor only recommends a few grants, the community foundation will make additional distributions so that 5% of the net investment assets of the fund is distributed during the year.

- d. Follows the Donor's Advice Substantially All of the Time. For the taxable year and all prior taxable years the community trust follows the advice of all donors with respect to their funds substantially all of the time.<sup>263</sup>

Comment: There is no court case or ruling that specifically interprets this regulation. However, in one court case that involved a national donor-advised fund, the U.S. Court of Claims concluded that it is acceptable to generally follow a donor's advice.<sup>264</sup> The court found the written statements that the charity controlled the contributed property that were contained in the organization's articles of incorporation and the instruments of transfer to be of greater significance than IRS arguments of indirect control. A charity raised the same argument in a similar 1996 court case.<sup>265</sup>

The IRS has also issued several private letter rulings that approve procedures for advised funds, at organizations other than community trusts, that permit the charity to generally follow a donor's advice.<sup>266</sup> Although none of the rulings or court opinions make any reference to the private foundation material restriction regulations, a community trust may be able to demonstrate that it is an acceptable practice to generally follow a donor's advice. Certainly the fact that a charity may generally follow a

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<sup>262</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (3) (iii).

<sup>263</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (A) (3) (iv).

<sup>264</sup> *National Foundation, Inc. v. U.S.*, 13 Cl. CL 486; 1987 U.S. Cl. Ct. LEXIS 202; 87-2 U.S.T.C.(CCH) Par. 9602 at p. 89,831; 60 A.F.T.R.2d (P-H) 5926 at 5930 (1987).

<sup>265</sup> *Fund for Anonymous Gifts v. US.*, U.S. District Court (Wash. D.C.); Dkt. No. 95-CV-1629 (IRS resists application for charitable tax status by a trust that will do nothing but administer advised funds; the case was still pending at the time of publication).

<sup>266</sup> In a private letter ruling that involved advised funds held by a public charity other than a community foundation, the IRS approved a procedure whereby grants were based on criteria mutually agreed upon between the donor and the charity. No grant could be made without full concurrence of both the donor and the executive director of the charity. Private Letter Ruling 8936002 (May 24, 1989). The IRS also allowed advised funds to be established at private foundations where the private foundation relinquished control over distributions. In one ruling a private foundation established a separate fund and gave the widow of the donor the legal right to designate the charitable beneficiaries. Private Letter Ruling 9513006 (Dec. 23, 1994). In another, disputes between a donor and the charity were to be resolved by binding arbitration. Private Letter Ruling 9412039 (Dec. 23, 1993). Although these rulings appear to conflict with the private foundation material restriction regulations, the IRS did not require the funds to be treated as a separate organizations.

donor's advice should not be the sole criteria for determining whether there is a material restriction imposed on a fund.

### 3. OTHER SAFE RESTRICTIONS FROM REGULATIONS

#### a. Name

The name of any type of fund in a community foundation can be selected by the donor and can include the name of the donor or the donor's family.<sup>267</sup> The tax regulations are very liberal about giving donors credit for their contributions without having this be construed as a material restriction or a personal benefit.<sup>268</sup> The IRS even approved a donor's demand that a public charity change its name to include that of the donor as a condition of receiving the donor's grant.<sup>269</sup> These rulings suggest that grants may be made from advised funds for projects which bear the donor's name.

#### b. Administrative Provisions

Assets can be administered in a separate fund if the community foundation (or its participating trustee, custodian or agent) is the legal and equitable owner of the fund and the governing body has ultimate control and direct authority over the fund. Thus, assets are not required to be pooled.<sup>270</sup> At any rate, the assets must be administered in, or as a component part of, the community foundation.<sup>271</sup>

### 4. OTHER SAFE RESTRICTIONS: FACTS AND CIRCUMSTANCES TEST

The tax regulations anticipate that a donor may impose other restrictions on a contribution that are not material restrictions. For those restrictions that are not specifically exempted by the regulations described above, the IRS will examine the restrictions using a facts and circumstances test. If there is concern about a large contribution, it may be appropriate to apply to the IRS for a ruling.

#### a. In General

To repeat, a material restriction is a restriction or condition that prevents a community foundation from "freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes."<sup>272</sup> It is basically a test to

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<sup>267</sup> Treas. Reg. Section 1.507-2(a) (8) (iii) (A) and 2(a) (8) (v), Example 2; see also Private Letter Rulings 8705049 (Nov. 4, 1986), 9008007 (Nov. 16, 1989), 9250041 (Sept. 17, 1992) and 9511022 (Dec. 16, 1994) (fund to retain name of terminated foundation).

<sup>268</sup> For example, see Treas. Reg. 53.4941 (d)-2(f) (2) and (4), Example (4).

<sup>269</sup> Rev. Rul. 73-407, 1973-2 C.B. 383 and Private Letter Rulings 8705049 (Nov. 4, 1986) and 9336041 (June 1993).

<sup>270</sup> Treas. Reg. Section 1.507-2 (a) (8) (iii) (C) and Treas. Reg. Section 1.507-2 (a) (8) (v), Example (1). Private Letter Rulings 9008007 (Nov. 16, 1989) and 9511022 (Dec. 16, 1994). See also Private Letter Ruling 8606040 (Nov. 12, 1985) in which the donor compelled investments to be made in a separate fund for a period of years before they could be commingled.

<sup>271</sup> *Id.*

<sup>272</sup> Treas. Reg. Sections 1.170A-9 (e) (11) (ii) (B) and 1.507-2(a) (8).

determine whether there has been a completed charitable gift. Consequently, several significant factors that the tax regulations instruct the IRS to consider are:<sup>273</sup>

1. Whether the community foundation (or participating trustee, custodian or agent) is the owner in fee of the contributed assets;
2. Whether the assets are to be held and administered consistent with the community foundation's charitable purposes,
3. Whether the governing body of the community foundation has the ultimate authority and control over the assets and the income derived therefrom; and
4. The extent to which the governing body of the community foundation is organized and operated independently from the donor.<sup>274</sup>

Is a community foundation required to have an independent governing body and are the terms of directors limited to five years?<sup>275</sup> A charity argued in a 1996 court case that the composition and term of the governing body is irrelevant if the charity is able to pass the 33-1/3% public support test, described in Section TWO.D.1 of this publication.<sup>276</sup>

#### b. Provisions Approved in IRS Private Letter Rulings

Private Letter Rulings and General Counsel Memoranda are documents which became available to the public under the Freedom of Information Act. The IRS takes the position that these documents are not legal precedent and, in the case of private letter rulings, may only be used by the taxpayers who received them.<sup>277</sup> In practice, however, these

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<sup>273</sup> Treas. Reg. Section 1.507-2 (a) (8) (i) (A) through (D).

<sup>274</sup> Whether the governing body is independent or not is also determined under a fuzzy facts and circumstances standard. Some of the more significant factors that Treas. Reg. 1.507-2 (a) (8) (ii) states should be considered are:

(A) Whether, and to what extent, members of the governing body are comprised of persons selected by the donor or "disqualified persons" with respect to the donor or are themselves such disqualified persons; (B) whether, and to what extent, members of the governing body are selected by public officials acting in their capacities as such; and (C) How long a period of time each member of the governing body may serve. A safe harbor for a community foundation to meet this last standard is if the members can serve no more than ten consecutive years and upon completion of a period of service the departing member is ineligible to serve for either the number of years he or she had just served or five years, whichever is less. Treas. Reg. Sections 1.507-2 (a) (8) (ii) (C) and Treas. Reg. Section 1.170A-9 (e) (13) (iv) (A) and (B). With respect to this "governing body" standard, a community foundation may be free to use different selection criteria and terms of office particularly if it meets the 33-1/3% public support test (described above in Section TWO.D.1), since all of these provisions are simply factors to be considered under the facts and circumstances standard rather than binding legal requirements. See the text of the next footnote.

See also Private Letter Ruling 8635044 (June 3, 1986) in which the IRS approved extended terms of ten years for some directors and Private Letter Ruling 8202088 (Oct. 15, 1981) in which it concluded that bank trustees could also serve as directors of a community foundation without having a conflict of interest. In Private Letter Ruling 8225165 (Mar. 29, 1982) the brother of the founder of a private foundation was one of seven directors of a community foundation. The IRS also authorized a change in the size and manner of selection of the governing body as a result of the merger of two community foundations. Private Letter Ruling 9203038 (Oct. 22, 1991).

<sup>275</sup> See the text of the preceding footnote.

<sup>276</sup> *Fund for Anonymous Gifts v. U.S.*, U.S. District Court (Wash. D.C.); Dkt. No. 95-CV-1629 (the case was still pending at the time of publication).

<sup>277</sup> Section 6110 (j) (3); *Texasgulf, Inc. v. U.S.*, 17 Cl. CL 275 (U.S. Claims Court 1989).

documents tend to indicate the Service's view of the tax law. They are particularly important for tax issues which have little legal precedent, such as issues involving community trusts. The U.S. Supreme Court has analyzed private letter rulings to interpret the IRS position on an issue.<sup>278</sup> Therefore, private letter rulings can be important during tax audit negotiations even though IRS agents are instructed not to treat them as precedent.

i. Restrictions Concerning Contributions and Investments of Property (See Section THREE.C.2 through 8 for the restrictions on property that are material restrictions).

- 1) Legal Title May Be Held by a Trustee Rather Than the Community Foundation.<sup>279</sup> Despite the fact that the regulations state that legal ownership of assets is a very important factor to determine whether a fund is a component fund or not, the IRS concluded that the most important issue is whether the governing body of the community foundation has ultimate authority and control over the use of funds rather than legal ownership. In addition, a trustee's fiduciary and administrative responsibilities are not material restrictions, either.
- 2) Donor May Contribute Non-Voting Stock of a Closely Held Corporation.<sup>280</sup> The Tax Court concluded that donors could claim a charitable deduction for a contribution of nonvoting stock to a charitable organization even though they retained control of the voting stock. The court rejected the IRS argument of donor control over the property through retention of the voting stock. Although this case did not involve a community foundation or the material restriction regulations, the conclusion is analogous to the rulings cited above concerning contributions of something less than a fee simple interest. The IRS subsequently issued a favorable ruling on the subject to a different taxpayer.<sup>281</sup>
- 3) Donor May Limit Distributions to Income and Prohibit Distributions from Principal.<sup>282</sup> No time limit was specified as to when the community foundation could ever distribute principal.
- 4) Donor May Require That Consent of an Independent Third Party Be Obtained Before Distributions May Be Made from Principal.<sup>283</sup>
- 5) A Trustee Bank Can Have the Discretion To Distribute Principal to the Community Foundation.<sup>284</sup>
- 6) Donor May Compel a Community Foundation To Replace a Trustee and/or To Hire an Investment Counselor,<sup>285</sup> although the donor cannot specify who the trustee or investment counselor will be. Under the facts in the ruling, the community foundation was left to choose among five other approved trustees. Donors might be able to

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<sup>278</sup> *Rowan Companies, Inc. v. Commissioner*, 452 U.S. 247, 101 S.Ct. 2288, at footnote 17 (1981).

<sup>279</sup> GCMs 37818 (Jan. 11, 1979), 38812 (Aug. 31, 1981) and 38880 (Jul. 21, 1982).

<sup>280</sup> *IL Pullman v. Commissioner*, T.C. Memo 1964-218 (1964).

<sup>281</sup> Private Letter Ruling 9432019 (May 12, 1994).

<sup>282</sup> Private Letter Rulings 8705049 through 8705051 (Nov. 4, 1986). See also GCM 38812 (Aug. 31, 1981) and footnote 1 of GCM 38880 (July 21, 1982).

<sup>283</sup> Private Letter Ruling 9014004 (Dec. 19, 1989).

<sup>284</sup> GCM 38812 (Aug. 31, 1981).

<sup>285</sup> Private Letter Ruling 8225165 (Mar. 29, 1982).

suggest particular trustees or mutual fund investments for component funds, provided that their suggestions to the community foundation are advisory and not directory.

- 7) Donor May Compel Investment in a Separate Fund over a Specified Number of Years; Then Commingle Assets.<sup>286</sup>
- 8) Donor Can Require a Community Foundation To Retain Property That Has Charitable Characteristics.<sup>287</sup>
- 9) With a Field of Interest Fund for Low-Income Housing, Donor May Make a Program Related Loan to the Community Foundation and Require the Community Foundation to Collect Amounts as Housing Units Are Sold or Refinanced.<sup>288</sup> This ruling was issued to a private foundation that made a program-related investment (PRI) with a community foundation. Although it did not specifically hold that the fund was free from material restrictions, the IRS concluded that the private foundation could treat the loan as a PRI to a public charity, thereby implying that the fund was a component fund.
- 10) A Field of Interest Fund Can Purchase 22 % of the Stock of a Bank Holding Company That Owns a Minority-Owned Bank.<sup>289</sup> This private letter ruling was issued to a private foundation to approve a loan it was making to a minority-owned bank (i.e., a program-related investment) in conjunction with the purchase of the stock by the field of interest fund of the community foundation. Thus, the IRS did not expressly rule on the community foundation's purchase but it probably tacitly approved of it.
- 11) Qualified Conservation Easements Are Not Subject to Material Restrictions, Even Though Donors Retain Some Rights, Including the Right To Approve Any Future Transfer of Property by the Charity.<sup>290</sup> Although the tax laws generally disallow deductions for contributions of partial interests in property,<sup>291</sup> there is an exception for a "qualified conservation contribution," such as a scenic easement.<sup>292</sup> The IRS ruled that a grant of an easement on a ranch was such a contribution.

In addition, the material restriction regulations place importance on whether a community foundation is the owner "in fee" (i.e., 100% owner) of its assets,<sup>293</sup> but the Service ruled that a contribution of a conservation easement was not subject to a material restriction. The IRS also ruled that the donor could retain many rights without imposing a material restriction, including the right to prohibit the charity from transferring

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<sup>286</sup> Private Letter Ruling 8606040 (Nov. 12, 1985). See also Treas. Reg. Sections 1.507-2(a) (8) (iii) (C) and 1.507-2 (a) (8) (v), Example (1) which permit a donor to require a community foundation to keep the assets in a separate fund. See also Private Letter Ruling 9008007 (Nov. 16, 1989).

<sup>287</sup> Private Letter Rulings 9547035 through 9547053 (May 1, 1995) (The Kansas City Royals). The IRS concluded that having a charity own the team lessened the burdens of local government by, among other things, filling an otherwise empty stadium owned by the government. See *infra* n. 309 and the accompanying text.

<sup>288</sup> Private Letter Ruling 8923071 (Mar. 16, 1989).

<sup>289</sup> Private Letter Ruling 9134033 (May 31, 1991).

<sup>290</sup> Private Letter Ruling 8247024 (Aug. 18, 1982) and Private Letter Ruling 8301064 (Oct. 5, 1982).

<sup>291</sup> Section 170 (f) (3) (A); see also Section NINE.A.3 of this publication concerning the general prohibition of tax deductions for gifts of partial interests.

<sup>292</sup> Sections 170 (f) (3) (B) (iii) and 170(h).

<sup>293</sup> Treas. Reg. Section 1.507-2 (a) (8) (i) (A).



the property without the donor's consent,<sup>294</sup> the right of the donor to stay on the property, build on the property and retain mineral rights. These restrictions are broader than the provision in the tax regulations that permits a donor to require a community foundation to retain contributed property that has unique charitable characteristics.<sup>295</sup>

This ruling was not issued to a community foundation but the drafter examined the same material restriction regulations that apply to community foundations. The conclusions could have significance for community foundations.<sup>296</sup>

ii. Restrictions Concerning Grants (See Section THREE.C.1 for the restrictions on grants that are material restrictions).

1. Donor May Restrict the Charitable Purposes That a Fund May Be Used for, Even If the Fund Is an Advised Fund.

Some of the charitable purposes that have been approved by the IRS are:

- Assisting sick, needy, dependent, neglected and disadvantaged children;<sup>297</sup>
- Low income housing;<sup>298</sup>
- Reducing chronic high unemployment; revitalizing and beautifying the community;<sup>299</sup>
- Scholarships;<sup>300</sup>
- Limiting grants to universities and colleges;<sup>301</sup>
- Assisting children with speaking disabilities;<sup>302</sup>

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<sup>294</sup> The reason that the IRS permitted this restriction was to provide further assurance that the property would only be used for charitable purposes.

<sup>295</sup> Treas. Reg. Section 1.507-2 (a) (8) (iii) (D). See Section THREE.C.4.a of this publication.

<sup>296</sup> For example, it may be possible for a community foundation to receive a contribution of less than a fee interest in property, especially when there is a statute that permits such deductions. For example, a community foundation could probably receive a one-half tenancy in common interest since that is normally deductible under Section 170 (f) (3) (B) (ii). In addition, it may be possible for a community foundation to receive a contribution of a conservation easement, particularly if the property is contributed to a separate corporation that would be classified as a component fund under the single entity regulations.

<sup>297</sup> Private Letter Ruling 8836003 (June 14, 1988).

<sup>298</sup> Private Letter Ruling 8923071 (Mar. 16, 1989).

<sup>299</sup> Private Letter Ruling 8831006 (Apr. 12, 1988).

<sup>300</sup> Private Letter Ruling 8243204 (July 29, 1982). It is possible to have scholarships that are required to be given to individuals with a specific surname. Private Letter Ruling 9527026 (Apr. 7, 1995) (involving a trust administered for the benefit of a specific university not a community foundation with a requirement that once every 15 years a beneficiary have the same surname as one of four friends of the donor).

<sup>301</sup> The rulings involved advised finds within a private foundation. Private Letter Rulings 9350009 (Sept. 14, 1993) and 9336041 (June 15, 1993).

<sup>302</sup> Private Letter Ruling 8705049 (Nov. 4, 1986).

- Removing unsightly, blighted buildings around an industrial perimeter and establishing a greenbelt of lawns, gardens and parks;<sup>303</sup>
- Maintaining an endowment fund to conserve, develop and expand a nature sanctuary that the donor had given to another public charity;<sup>304</sup>
- Planning an annual meeting for a conference of charitable organizations;<sup>305</sup>
- To construct an aquarium and hotel to serve educational purposes;<sup>306</sup>
- To construct a fountain in a transit plaza;<sup>307</sup>
- To acquire and operate an art museum;<sup>308</sup>
- To keep a major league baseball team in a community; contributions earmarked to purchase stock in the corporation were "qualifying distributions" for private foundations;<sup>309</sup>
- To lend money to a developer for the construction of a low income housing project;<sup>310</sup>
- To construct a multi-million dollar public mall; and<sup>311</sup>
- To combat poverty and promote human rights.<sup>312</sup>

<sup>303</sup> Private Letter Ruling 8309117 (Dec. 1, 1982).

<sup>304</sup> *Rheinstrom v. Commissioner*, T.C. Memo 1982-101. The charitable purpose of the fund was not an issue in this case, but the fact that the IRS did not contest the community foundation's fund suggests implicit approval of its purpose.

<sup>305</sup> Private Letter Ruling 9325038 (Mar. 26, 1993).

<sup>306</sup> Private Letter Rulings 9551037 and 9551038 (Sept. 28, 1995).

<sup>307</sup> Private Letter Ruling 9604031 (Nov. 3, 1995) involving a grant from a private foundation to an advised fund of a community foundation to construct a fountain in a public transit area. The foundation had been a charitable lead trust before the death of the original founder.

<sup>308</sup> Private Letter Ruling 9547035 (Aug. 29, 1995).

<sup>309</sup> Private Letter Rulings 9547035 through 9547053 (May 1, 1995) (The Kansas City Royals). This is a very complicated series of rulings, many of which are 26 pages long. In oversimplified terms, upon the death of the owner, the major league baseball team (a Subchapter S corporation) was contributed to a fund at the community foundation. The IRS concluded that having a charity own the team lessened the burdens of local government by, among other things, filling an otherwise empty stadium owned by the government. To cover projected operating deficits, a new class of stock was issued that donors and private foundations could purchase by making contributions to advised funds at the community foundation. The IRS ruled that such grants were qualifying distributions and that the team served a charitable purpose for the community. Private Letter Rulings 9530024 and 9530025 (May 1, 1995). The community foundation was expected to own the team for eight years until the team became profitable and attractive for sale. At that time, the stock would be sold and the advised funds would make traditional grants in the community. Despite the charity's ownership and the additional classes of stock, the corporation was able to keep its Subchapter S status. Private Letter Ruling 9530026 (May 1, 1995).

<sup>310</sup> Private Letter Ruling 9016078 (Jan. 20, 1990), involving a community trust.

<sup>311</sup> Private Letter Ruling 9439014 (June 30, 1994). The IRS concluded that there was no material restriction even though there was an obligation to work with a particular developer. The ruling did not involve a community trust but the IRS examined the material restriction regulations.

2. An Advised Fund Is Not a Material Restriction; A Contribution to It Is Treated as a Contribution "to" a Public Charity.<sup>313</sup>
3. Donor May Require That All Grants Be Made Within a State.<sup>314</sup> Smaller geographic boundaries are also possible. Perhaps the most famous illustration is the Buck Trust (now the Marin Community Foundation) which limited grants to Marin County, California.<sup>315</sup>
4. A Private Foundation That Establishes a Fund May Limit Eligible Grant Recipients to Those Who Would Be Eligible to Receive "Qualifying Distributions "from the Private Foundation.<sup>316</sup>
5. A Private Foundation That Establishes a Fund May Provide That the Community Foundation Must Follow the Terms of the Will That Established the Private Foundation, to the Extent That It Is Not Inconsistent with the Exempt Purposes of the Community Foundation.<sup>317</sup>
6. Donor May Require Community Foundation To Obtain Advisory Committee Consent Before Changing the Charitable Purpose of a Fund,<sup>318</sup> although the provision may have been moot since the governing body of the community foundation may have had the authority to override any act of the advisory committee.
7. A Corporation Can Establish Fund Restricted to Universities and Allow Selected Directors To Make Grant Recommendations.<sup>319</sup>
8. A Private Foundation That Establishes a Scholarship Fund Can Have One of Its Representatives Serve on the Selection Committee.<sup>320</sup> The IRS concluded that it was not a material restrictions for one of the three members of a scholarship selection committee to be a representative of the private foundation that established the scholarship fund. That ruling applied to a scholarship fund established at a junior college rather than a community foundation, but the IRS examined the same material restriction regulation that applies to community foundations: Treas. Reg. Section 1.507-2 (a) (8).

### iii. Restrictions with Contingencies and Forfeitures

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<sup>312</sup> Private Letter Ruling 9511022 (Dec. 16, 1994).

<sup>313</sup> Private Letter Rulings 8920009 (Feb. 3, 1989) and 8752031 (Sept. 28, 1987).

<sup>314</sup> Private Letter Ruling 8705049 (Nov. 4, 1986).

<sup>315</sup> *San Francisco Foundation v. County of Marin*, 37 Cal. 3d 285, 690 P.2d 1, 208 Cal. Rptr 31 (1984). For a summary of cases relating to geographical restrictions, see *Annotation*, "Extension of Charitable Trust Benefits to Persons Residing Outside Geographical Area Prescribed by Trust Instrument, Under Doctrines of Cy Pres or Equitable Deviation," 68 A.L.R. 3d 1069 and Sisson, "Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres," 74 Va. L. Rev. 635 (Apr. 1988).

<sup>316</sup> Private Letter Ruling 8715051 (Jan. 14, 1987).

<sup>317</sup> Private Letter Rulings 9008007 (Nov. 16, 1989) and 9511022 (Dec. 16, 1994).

<sup>318</sup> Private Letter Ruling 8225165 (Mar. 29, 1985).

<sup>319</sup> The rulings involved advised funds within a private foundation. Private Letter Rulings 9350009 (Sept. 14, 1993) and 9336041. The IRS concluded that there was no income to the directors from this benefit and no reduction in the corporation's charitable income tax deduction.

<sup>320</sup> Private Letter Ruling 8707073 (Nov. 19, 1986). As an illustration, see "A Guide to the Making of Grants to Individuals by Private Foundations," (Council on Foundations, 1987) to understand the process that private foundations must go through to establish a scholarship program.

The IRS concluded in two private letter rulings that no material restriction existed even though events could cause the charitable recipient to forfeit the contributed assets. In both rulings the events that could cause such forfeiture were beyond the control of either the donor or the trustee of the fund. By comparison, if a donor or trustee has any discretion to take assets or endowment income away from a community trust then a material restriction probably exists.<sup>321</sup>

1. A Donor May Compel Investment in a Separate Fund over a Specified Number of Years (Then Commingle Assets) but Compel the Charity To Lose the Fund if It Distributes Principal, Changes Its Name, Merges, Liquidates or Dissolves.<sup>322</sup> One might wonder how a charitable organization could have "free and effective use of the assets" if it could lose them upon a variety of contingencies. On the other hand, such a provision could simply be an enforcement mechanism for legal rights that exist under state law. If, for example, a donor (or a community foundation) makes a grant to a charitable organization which agrees to undertake a specific project but later declines to do it, then the donor has the legal right to compel the project to be undertaken or to have the money returned to the donor or redirected to another organization.<sup>323</sup> These rights follow from the basic premise of carrying out a donor's intent (similar to cy pres).<sup>324</sup> If, however, the chance that the property could revert to the donor is not "so remote as to be negligible," then there might not have been a completed gift for income tax purposes.<sup>325</sup>

This ruling was issued to a medical research organization rather than a community foundation, but the IRS analyzed the same material restriction regulations that apply to community trusts: Treas. Reg. Section 1.507-2 (a) (8).

2. Donor Can Make a Contingent Grant (e.g., a Challenge Grant) to an Escrow and Reserve the Right to Later Name an Alternate Public Charity To Receive the Money if the Contingency Is Not Met.<sup>326</sup> The IRS concluded that a contribution deposited into an

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<sup>321</sup> See, for example, the case of *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274 (7th Cir. 1979). In that case a donor established a trust with a bank to benefit three charitable organizations (including a Community foundation that was to receive 49% of the trust's net income). The bank trustee (rather than the community foundation) was given the power to redirect the income away from the designated organizations if, in the trustee's judgment, their charitable uses became "unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public." The Tax Court and the Seventh Circuit Court of Appeals concluded that the fund could not be a supporting organization of the designated charities because of the trustee's power and was, instead, a private foundation. Clearly, if it could not be a supporting organization it could not be a component fund, either.

<sup>322</sup> Private Letter Ruling 8606040 (Nov. 12, 1985).

<sup>323</sup> In one case the National Audobon Society agreed that it would divest itself of a nature sanctuary (it would convey the property to a community foundation) if it ever tried to sell the property or failed to properly maintain it. The Tax Court did not mention that such a contingency could be a problem that would endanger a charitable deduction to a public charity. *Rheinstrom v. Commissioner*, T.C. Memo 1982-101.

<sup>324</sup> Even private foundations are permitted to have a say in how public charities use their grants. Treas. Reg. Sections 53.4943-2 (a) (5) and 53.4945-4 (a) (4) 00.

<sup>325</sup> Treas. Reg. Section 1.170A-1 (e) denies a deduction for a conditional gift if the possibility that the gift will not be completed is "not so remote as to be negligible." See also some of the cases mentioned in Section THREE.C.5 of this publication.

<sup>326</sup> Private Letter Ruling 9014004 (Dec. 19, 1989).

escrow to endow a future museum was a "qualifying distribution" by a private foundation even though the museum would not be entitled to the funds if additional funding could not be obtained from other sources or if the building was not completed by a certain date. The IRS viewed the contribution to the escrow as similar to a contribution to a trust and found it very important that the museum treated the assets and investment income as its own for income tax purposes. It was also important that there was no chance that the assets would revert to the private foundation. Although the reservation of the right to name the charitable beneficiaries of a fund of a community trust is normally considered a material restriction, the IRS focused on the absence of material restrictions (as defined in Treas. Reg. Section 1.507-2 (a) (8) (i)) after the final distribution from the escrow would be made. This ruling was issued to a private foundation for a grant to a museum and a community foundation was only indirectly involved; still the IRS analyzed the same material restriction regulations that apply to community trusts: Treas. Reg. Section 1.507-2 (a) (8).

### C. Restrictions That Are Material Restrictions

The regulations contain a list of restrictions that are per se material restrictions. Other restrictions a donor may impose will be analyzed under the facts and circumstances test described above to determine whether they are material or not.

The following restrictions are material restrictions:

#### 1. RESTRICTIONS CONCERNING DISTRIBUTIONS

##### a. Control Selection of Charitable Beneficiaries

A donor (or a person or committee designated by the donor) may not, directly or indirectly, reserve the right to name the charitable beneficiaries of the fund.<sup>327</sup> These rules are described at length in Section THREE.B.3 concerning advised funds.

##### b. Control Timing of Distributions

A donor (or a person or committee designated by the donor) may not reserve the right, directly or indirectly, to direct the timing of distributions from the fund.<sup>328</sup> Presumably the same advisory role that donors may play with respect to identifying charitable recipients also applies to recommending the timing of distributions.<sup>329</sup>

Although a donor cannot direct the timing of grants after a fund has been established, there is some latitude for donors to direct the timing of distributions in the instrument of transfer. Two regulations permit a donor to specify in the instrument of transfer that some or all of the principal, as opposed to income or specific assets, may not be

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<sup>327</sup> Treas. Reg. Sections 1.570-2 (a) (8) (iv) (A) (1) and 1.507-2 (a) (8) (v), Example (4).

<sup>328</sup> Treas. Reg. Section 1.570-2 (a) (8) (iv) (A) (1).

<sup>329</sup> Recommendations as to timing of grants were mentioned in Private Letter Rulings 9250041 (Sept. 1T, 1992) ("Advise and Consult Funds" of a public charity similar to a community foundation).

distributed for a specified period of time.<sup>330</sup> Another regulation (as well as several private letter rulings and general counsel memoranda) allows a donor to limit distributions to income without specifying any date when principal can be distributed.<sup>331</sup>

Another regulation permits a donor to instruct the foundation to make annual distributions, so that it might also be permissible to specify more frequent distributions (e.g., monthly).<sup>332</sup> May a donor require income to be accumulated for a period of years before distributions commence? A community foundation can accumulate income,<sup>333</sup> but whether a donor can require income to be accumulated will be analyzed under the "facts and circumstances" standard since the regulations do not specifically address this issue. Although the IRS has permitted donors to impose such a restriction upon at least one public charity, it has not ruled as to whether this would be a material restriction for a community foundation.<sup>334</sup>

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<sup>330</sup> Treas. Reg. Sections 1.570-2(a) (8) (iv) (A) (1) and 1.570-2(a) (8) (iii) (C). There is one situation when a donor may require the community foundation to retain contributed property. If it has unique features and its retention accomplishes a charitable purpose (e.g., a woodland reserve to be used as an arboretum), a donor may require retention of the property without violating the prohibition against directing the timing of distributions. Treas. Reg. Section 1.507-2 (a) (8) (iii) (D). See also Private Letter Rulings 9547035 through 9547053 (May 1, 1995) (Kansas City Royals baseball team to be held by a community foundation).

The IRS also appears willing to allow donors to establish endowment funds which restrict distributions to income and do not specify any date when the community foundation may distribute principal. Private Letter Rulings 8705049 (Nov. 4, 1986) and 8606040 (Nov. 12, 1985). It has also permitted a donor to require a charity to obtain the consent of an independent third party before large grants could be made from principal. Private Letter Ruling 9014004 (Dec. 19, 1989).

<sup>331</sup> Treas. Reg. Section 1.507-2 (a) (8) (v), Example (3); Private Letter Ruling 8705049 (Nov. 4, 1986); GCM 38812 (Aug. 31, 1981) and footnote 1 of GCM 38880 (July 21, 1982).

<sup>332</sup> Treas. Reg. Section 1.570-2 (a) (8) (v), Example (3).

<sup>333</sup> See Private Letter Ruling 8132051 (May 13, 1981) in which the IRS approved the decision of a community foundation's distribution committee to accumulate some of the income of the component funds.

<sup>334</sup> A public charity that was not a community foundation offered donors the right to specify that the income attributable to a donor's contribution could be accumulated over any number of years (maximum 63) selected by the donor, and that the cumulative amount would then serve as an endowment. The drafter of the ruling wrote: "[The charity] is not a community trust, and therefore the material restrictions provisions of section 1.507-2 (a) (8) of the Foundation Excise Tax Regulations are not applicable to it." Private Letter Ruling 8604102 (Nov. 4, 1985) [a virtually identical ruling is Private Letter Ruling 8604064 (OCL 30, 1985)].

In that same ruling, the IRS summarized its philosophy as to whether it was reasonable for a public charity to accumulate income. The drafter of the ruling wrote:

Although private foundations may not accumulate income under Code section 4942, there is no such requirement for a public charity described in Code section 170(b) (1) (A) (vi). The only type of public charity for which accumulations are prohibited are medical research organizations.

In general, the validity of an accumulation is determined by a flexible rule of reasonableness which imposes no specific limitation on the duration or amount of charitable accumulations. The test of reasonableness is said to be whether the accumulation is contrary to public policy, or phrased differently, whether it would be injurious to the public good or welfare. In making such a determination of reasonableness - a number of factors are considered in determining whether the accumulation of the assets in question are serving a charitable purpose. The basic requirement that funds dedicated to charity must be used or disbursed for charitable purposes is balanced by such factors as the need for allowing inadequate sums to grow until sufficient to carry out the charitable wishes of the donor, the need for

## 2. NON-COMPLIANCE WITH SINGLE ENTITY REGULATIONS

Although not mentioned in the material restriction regulations, a failure to comply with the, single entity regulations would cause a fund to be a non-component fund. If, for example, a trust or corporation has a separate governing body that makes grants, or if a community trust cannot unilaterally exercise the variance power over the fund or cannot replace a trustee for a breach of fiduciary duty, then the trust or corporation is probably not a component part of the community trust.<sup>335</sup> The failure to comply with the single entity regulations would prevent the community trust from having free and effective use of any contributed assets. For example, a supporting organization is not a component fund because it has a separate governing body and it does not subject itself to the common governing instrument of a community trust. This is the case even if the contributions that the supporting organization receives from donors have no material restrictions as defined in the Section 507 private foundation material restriction regulations.

## 3. PAYMENTS TO INDIVIDUALS AND FOR NON-CHARITABLE PURPOSES

The material restriction rules come from the private foundation tax regulations and private foundations are prohibited from making non-charitable grants.<sup>336</sup> Consequently, a grant that is not fully charitable, or any grant that could trigger a private foundation excise tax, is probably subject to a material restriction.<sup>337</sup> By comparison, individuals are able to claim charitable income tax deductions for gifts that are partially charitable and partially personal. Examples include deferred charitable gifts.<sup>338</sup> and "quid pro quo" contributions.<sup>339</sup>

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accumulation of a specific sum needed for the implementation of a specific project, and the need for encouragement of charitable giving by giving the donor some manner of control over the disposition of the charitable gift- at least with regard to the disbursement or duration of accumulation of sums donated. See E. Fisch, D. Freed, and E. Schachter, *Charities and Charitable Foundations* (1974), Para. 117, and precedent cited therein.

Charitable trust provisions for the accumulation of income generally have been subject to a rule that such accumulations cannot be unreasonable, unnecessary or injurious to the public. It is only in a few states that there exist statutes regulating accumulation of income of charitable trusts. See *Validity of Accumulation of Trust Income*, 6 ALR 4th 903 (1981) Sections 2, 9, and 10.

While the gift giving program that will provide funds for the P Fund will involve accumulations of up to 63 years, the facts and circumstances do not indicate that this conflicts with M's exempt status under section 501 (c) (3). The law of charities recognizes that charitable accumulations may be valid if they are not contrary to sound public policy. In this case, there are no state statutes prohibiting such accumulations. M has a current program of substantial disbursements for charitable objectives, and the proposed giving program is intended to stimulate additional giving by donors over and above their current donation level."

<sup>335</sup> Treas. Reg. Section 1.170A-9(e) (11) (iii) through (vi). See Chapter ONE.D for a list of the requirements.

<sup>336</sup> Sections 4945 ("taxable expenditures").

<sup>337</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (B). See, generally, Section THREE.C.7 of this publication.

<sup>338</sup> See Chapter NINE for the rules concerning gifts to deferred giving arrangements.

<sup>339</sup> Section 170 (f) (8).

Thus, some gifts that individuals can make to other public charities will be treated as being made to a non-component fund of a community trust if there is a non-charitable component to the gift. For example, the single entity regulations make it clear that a charitable remainder trust, a charitable lead trust and a pooled income fund cannot be component funds of a community foundation because the non-charitable portion of the gift constitutes a material restriction that prevents the community foundation from having unfettered use of the trust's assets for its charitable purposes.<sup>340</sup> Consequently, the trust must prepare a separate tax return under the rules applicable to split-interest charitable trusts and pooled income funds.<sup>341</sup> Whether a charitable gift annuity will also be considered a separate entity because of a material restriction is open to debate.<sup>342</sup>

On one occasion the IRS attempted to use the complexity of this regulation to deny a charitable bequest from a "living trust" to a community foundation. It abandoned the approach. after the estate filed a petition in Tax Court.<sup>343</sup>

#### 4. RESTRICTIONS CONCERNING CONTRIBUTED PROPERTY

A donor might request the community foundation to take certain action with respect to contributed property or to refrain from selling the property. Such action could be a material restriction that would make the fund (or at least that portion of the fund attributable to the property) a non-component fund. The tax regulations specify that the following events can be material restrictions:<sup>344</sup>

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<sup>340</sup> Treas. Reg. Section 1.170A-9 (e) (14) (ii). See also Section FOUR.B of this publication for more information. A charitable lead trust can never be a component fund since the charitable interest will expire before the non-charitable interest. GCM 38880 (July 21, 1982).

<sup>341</sup> *Id.* Charitable remainder trusts file Form 5227 and pooled income funds file Forms 5227 and 1041. Most deferred giving trusts pay income to the donor or some other specified individual over a period of time (usually their lifetimes) and, upon their death, the principal is severed from the trust and distributed to the community foundation. The amount can be used at that time to establish a component fund (unrestricted, field-of-interest, designated or advised). Private Letter Ruling 8924040 (Mar. 20, 1989). As an alternative to distributing assets to a community foundation, a charitable remainder trust can retain the corpus and can itself become a component fund after all non-charitable interests expire, but only if the terms of its governing instrument satisfy the single entity requirements (in particular, the common instrument requirement). Treas. Reg. Section 1.170A-9 (e) (14) (ii). The IRS concluded in two private letter rulings that income distributions from a charitable lead trust can be made to an advised fund at a community foundation. Private Letter Ruling 8146072 (Undated) and 9604031 (Nov. 3, 1995).

<sup>342</sup> See Section THREEA5.

<sup>343</sup> A donor's living trust provided that upon his death and after the payment of a few specific bequests (e.g., \$20,000 to a relative) the residue of his estate of approximately 5700,000 would be paid to the California Community Foundation. The IRS contended that the trust was an ineligible charitable remainder trust and that it failed to qualify as a component fund of a community trust so that no charitable deduction would be allowed to the estate, even though the amounts were in fact paid to the community foundation. "Estate Seeks Deduction for Charitable Gift," 94 Tax Notes Today 73-107 (Apr. 15, 1994). The IRS later abandoned this argument.

<sup>344</sup> The footnote references that define material restrictions are to Treas. Reg. Section 1.507-2 (a) (8) (iv). The reader is reminded that although the regulation refers to terminating transfers of private foundations, the single entity regulations provide that the word "donor" should be substituted for the words "private foundation." See Treas. Reg. Section 1.170A-9(e) (11) (ii) (third to last sentence) and footnote 101 of this publication.



## a. Required Retention of Investment Assets

The community trust is required by any restriction or agreement (other than a restriction or agreement imposed or required by law or regulatory authority), express or implied, to retain any securities or other investment assets transferred to it by the donor.<sup>345</sup> In a case where such transferred assets consistently produce a low annual return of income, the tax regulations instruct the Internal Revenue Service to carefully examine whether the community trust is required by any such restriction or agreement to retain such assets.<sup>346</sup>

An exception exists if the retention of contributed property is important to the achievement of charitable or other similar purposes in the community because of the peculiar features of the property. For example, a donor may contribute a woodland preserve to a community foundation and require it to own and maintain the property as an arboretum for the benefit of the community. Such a restriction is not deemed to be a restriction on the disposition of an investment asset or the distribution of income.<sup>347</sup>

## b. Right-of-First- Refusal<sup>348</sup>

A material restriction exists if an agreement is entered into "in connection with the transfer" of securities or other property which grants directly or indirectly to the donor<sup>349</sup> a right-of-first refusal with respect to the transferred securities or other property when and if disposed of by the community foundation.<sup>350</sup> Thus, although other public charities can receive stock subject to a conventional right-of-first-refusal without any difficulty,<sup>351</sup>

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<sup>345</sup> Treas. Reg. Sections 1.507-2 (a) (8) (iv) (D) and 1.507-2(a) (8) (v), Ex. (4).

<sup>346</sup> *Id.*

<sup>347</sup> Treas. Reg. Section 1.507-2 (a) (8) (iii) (D). The IRS concluded in a private letter ruling that it was not a material restriction for a donor to prohibit a charity from transferring contributed property with charitable characteristics without the donor's consent. Private Letter Ruling 8247024 (Aug. 18, 1982) and Private Letter Ruling 8301064 (Oct. 5, 1982). The reason that the IRS permitted this restriction was to provide further assurance that the property would only be used for charitable purposes. The IRS also permitted the donors to retain other rights with respect to the property (e.g., continued use of the property and mineral rights). See Section THREE.B.5.b.i of this publication for additional analysis of this ruling. See also Private Letter Rulings 9547035 through 9547053 (May 1, 1995) (The Kansas City Royals). The community foundation that received the team was restricted in its ability to sell the team to a purchaser who would remove the team from the city. The IRS concluded that the community foundation's ownership of a major league baseball team lessened the burdens of local government by, among other things, filling the governments otherwise empty stadium.

<sup>348</sup> Most stock of closely-held corporations is subject to some sort of resale restriction. Probably the most common resale restriction is a "right-of-first-refusal." This gives the corporation, the shareholders, or both, an option to purchase the stock of an existing shareholder before it can be sold to any other person. The purchase price is usually stated in the shareholders agreement. It may be a formula price (e.g., book value) or it may simply be the same price that is being offered by a potential buyer.

<sup>349</sup> The term "donor" includes any person who would be a "disqualified person" with respect to the donor if the donor had been a private foundation. In the case of many closely-held businesses, the corporation will itself be a disqualified person.

<sup>350</sup> Treas. Reg. Section 1.507-2(a) (8) (iv) (E). The regulation exempts securities or other property that was acquired by the donor subject to such right of first refusal prior to October 9, 1969.

<sup>351</sup> *Grove v. Commissioner*, 490 F.2d 241 (2d Cir. 1973).

the situation is more complicated for community trusts and private foundations because of the material restriction provisions.

Despite the prohibition, there are a series of favorable IRS rulings involving community foundations and private foundations that suggest that some forms of a right of first refusal may be permissible. First, if the property has unique charitable characteristics, it may be permissible for a charity to grant a right of first refusal in connection with the transfer if it furthers charitable objectives.<sup>352</sup> Second, the terms of the right of first refusal can be drafted in such a way that it might not be a material restriction.<sup>353</sup> Third, the phrase "in connection with the transfer" might mean that a community trust should not itself sign a right of first refusal, but that it may be able to accept stock of a closely-held corporation that is already subject to such a restriction. There are a few IRS rulings that permit stock that is already subject to a pre-existing right-of-first-refusal to be contributed to a private foundation and to a charitable remainder trust.<sup>354</sup>

## 5. ASSUMPTION OF LEASES, CONTRACTS AND PLEDGES

A material restriction exists if a community trust assumes leases, contractual obligations, or liabilities of the donor, or takes the assets subject to such liabilities (including obligations under commitments or pledges to donees of the donor), for purposes inconsistent with the purposes or best interests of the community trust.<sup>355</sup> Despite this prohibition, there is room for controversy, especially concerning pledges.<sup>356</sup> In addition, some binding contracts may be permissible. For

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<sup>352</sup> Private Letter Ruling 9530026 (May 1, 1995) (Kansas City Royals major league baseball team is given to a community foundation; the team lessens the burdens of government by filling an otherwise empty stadium); Private Letter Ruling 8641017 (donor has right of first refusal if charity attempts to sell contributed land within 20 years to anyone other than a charity).

<sup>353</sup> See, for example, Private Letter Ruling 8416033 (Jan. 17, 1984). In that ruling, a private foundation gave stock to a public charity and, in connection with the transfer, the for-profit corporation required the charity to agree to a right of first refusal. The terms that the IRS approved were that the corporation had the right to purchase the stock at an appraised price that was no less than the offer that the charity received from a potential buyer. The IRS concluded that this was not a material restriction because it did not prevent the charity from "freely and effectively using or disposing of the interest." The charity would receive the same price, or more, for the stock no matter who the purchaser was.

<sup>354</sup> Private Letter Ruling 9611047 (Dec. 15, 1995) (stock of a "statutory close corporation" given to a "pass-through" private foundation); Private Letter Ruling 9452020 (Sept. 28, 1994) (gift to a charitable remainder trust, which is subject to some of the private foundation excise taxes). "Transfer of Stock to Trust, Followed by Redemption by Corporation, Will Not Be Recharacterized," *11 Exempt Org. Tax Review* 471.

<sup>355</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (C). Not all contracts are prohibited. For example, see Private Letter Ruling 8639019 (June 25, 1986) for an approved contribution to a private foundation of real estate subject to leases.

<sup>356</sup> Many community foundations have adopted policies to prohibit a grant from a component fund to satisfy the pledge of a donor. There are several reasons for this. First, the tax regulations specifically mention that the payment of a donor's pledges could be a material restriction. The counter argument to this is that if the grant is consistent with the community foundation's charitable purposes it should not matter that a pledge was involved.

The second reason is that if a private foundation makes a grant or other payment which satisfies the legal obligation of a donor (a pledge can be such a legal obligation), then the private foundation has committed an act of self-dealing and it could be subject to an excise tax. Treas. Reg. Section 53.4941 (d)-

example, the IRS approved of a multi-million dollar contribution that was earmarked to construct a public mall even though the grant "may lock [the charity] into a continuing relationship with the mall developer concerning the operation of the facility."<sup>357</sup>

Another exception applies if the donor is a private foundation, in which case the community foundation can assume the private foundation excise taxes that were incurred prior to the transfer to the community foundation.<sup>358</sup> One community foundation was even able to avoid paying an excise tax on a scholarship fund that it had received from a terminated private foundation by obtaining retroactive IRS approval of the private foundation's administration of the program.<sup>359</sup>

## 6. RELATIONSHIPS WITH INVESTMENT ADVISORS

A material restriction exists if an agreement is entered into between the donor and the community foundation which establishes irrevocable relationships with respect to the maintenance or management of contributed assets. Such a situation could arise whenever a contract or agreement would prevent a community foundation from changing a fund's trustee, bank, brokerage firm, or other investment counselor. However, a revocable relationship with a trustee, custodian, or agent of a community foundation acting in such a capacity is not considered a material restriction. For example, an irrevocable trust can qualify as a component fund provided that the community foundation has the power to replace the trustee under two circumstances.<sup>360</sup>

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2. Although community foundations are not subject to such taxes, another regulation provides that "other actions" can be material restrictions if they could subject a private foundation to an excise tax. Treas. Reg. Section 1.507-2(a) (8) (iv) (B). Consequently, caution might be advisable.

Finally, there is the argument that the donor might have taxable income because a legal liability was discharged by a third party (the community foundation), thereby making donor richer. However, Section 108(e) (2) provides that a taxpayer does not have taxable income if there is a discharge of indebtedness and the payment would have been deductible. Since the payment of a pledge provides a charitable deduction, a donor should not have taxable income if a third party satisfies it. See also Rev. Rul. 64240,19642 C.B. 172, which specifically provides that a donor will not be treated as the owner of a trust if the trust discharges one of the donor's charitable pledges.

For a general analysis of how the IRS views pledge, see GCM 38505 (Sept. 19, 1980.)

Despite the prohibition on assuming a donor's pledge, the IRS issued private letter rulings that concluded that it was not a material restriction for a public charity that received a contribution to satisfy a private foundation's pledge. Private Letter Ruling 9551033 (Sept. 27, 1995). The transaction involved a contribution from a private foundation to a community foundation to permit the private foundation to avoid the Section 4943 excess business holdings tax. Part of the terms of the gift were to satisfy a pledge of the private foundation.

<sup>357</sup> Private Letter Ruling 9499014 (June 30, 1994). The IRS concluded that the relationship did not conflict with the material restriction regulations since the developer would not charge more than its costs and would cover any shortfalls. See also Private Letter Ruling 9604031 (Nov. 3, 1995) for a grant from a private foundation to an advised fund to construct a fountain in a public area.

<sup>358</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (C) and Private Letter Ruling 8920009 (Feb. 3, 1989). The maximum liability of the community foundation is the value of the assets that were transferred by the private foundation.

<sup>359</sup> Private Letter Ruling 8243204 (July 29, 1982).

<sup>360</sup> In order for a trust or corporation to qualify as a component fund, the single-entity tax regulations provide that community trust must have the power to replace any participating trustee, custodian, or agent for (1) breach of fiduciary duty under state law or (2) for failure to produce a reasonable return of net income over a reasonable period of time. Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (2) and (3).

There is also relief from these requirements for certain agreements established prior to November 11, 1977.<sup>361</sup>

## 7. ACTIONS THAT WOULD TRIGGER A PRIVATE FOUNDATION EXCISE TAX

A material restriction exists if a community foundation agrees to take or withhold action with respect to the contributed assets which does not further the charitable purposes of the community foundation and which, if performed by a private foundation, would subject it to a private foundation tax.<sup>362</sup> There are no cases or rulings that specify how this standard will be applied. In general, a private foundation cannot make a gift that is not fully charitable (by comparison, an individual can make such a gift, such as a contribution to a charitable remainder trust). Consequently, any grant that would be treated as a "taxable expenditure" under Section 4945 might constitute a material restriction.

An example might be an earmarked grant to an individual to conduct research. If done directly by a private foundation, the grant could have exposed it to the taxable expenditure tax of Section 4945 if the private foundation had not exercised expenditure responsibility. A different sanction applies to a donor who makes a gift to a public charity that is earmarked for an individual: rather than pay a penalty tax, he or she simply cannot claim an income tax deduction.<sup>363</sup> Another example may be a bifurcated gift, where a donor pays the noncharitable portion and the private foundation pays the charitable portion.<sup>364</sup>

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<sup>361</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (F). The transfer of property to a community foundation subject to contractual obligations that were established prior to Nov. 11, 1977 between the donor and any person (other than a person who would be a "disqualified person" if the donor had been a private foundation) with respect to such donor will not be treated as prohibited, but only if such contractual obligations were not entered into pursuant to a plan to terminate the private foundation status of the transferor under section 507(b) (1) (A) and if the continuation of such contractual obligations is in the best interests of the community foundation.

<sup>362</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (B). The prohibition does not apply to a violation of the minimum investment return requirement imposed on private foundations under Section 4942(e).

<sup>363</sup> *Tripp v. Commissioner*, 337 F. 2d 432 (7th Cir. 1964) (individual made gift to a college with the understanding that it would be applied to pay the tuition of an unrelated individual; the gift was not made to a scholarship fund with indefinite beneficiaries); *Faussner v. Commissioner*, 55 T.C. 620 (1971) (tuition to parochial school was really disguised tuition). See also *Harold Davis v. Commissioner*, 110 S. Ct 2014 (1990) in which the U.S. Supreme Court concluded that payments made directly to Mormon missionaries could not be treated as charitable contributions to the Mormon church. See also Tech. Advice Memo 9405003 where the IRS disallowed charitable contributions that were made to a theological seminary by parents who "requested" that the amounts be applied toward the religious ministry expenses of their children.

The IRS and the courts denied tax deductions for contributions to, and took away the tax exempt status of, an alleged charitable foundation whose sole activity was to pay tuition costs of the donors' children in exchange for a 15% fee. *Crave v. Commissioner*, T.C. Memo 1994-616. For an analysis of some of these issues, see Raby, William, "1994 in Review: Charitable Contributions or Something Else?," 11 *Exempt Org. Tax Rev.* 228 (Feb. 1995).

<sup>364</sup> For example, if there is a charitable fundraising dinner where the ticket costs \$100 but the value of the meal is \$30, it is a prohibited self-dealing transaction for a private foundation to write a check for the charitable portion (\$70) and for the donor to pay for the meal (\$30). Private Letter Ruling 9021066 (Mar. 1, 1990).

Applying these principles to a community trust, a donor who makes such an earmarked gift to a fund might trigger three consequences: (1) a lost deduction for an earmarked grant to an individual, (2) a reclassification of a component fund to a non-component fund that will be classified as a private foundation, and (3) the imposition of private foundation taxable expenditure taxes on the fund.

Perhaps a defense is that some transactions that would trigger private foundation excise taxes could further the charitable purposes of a community foundation. Thus, transactions that are prohibited for a private foundation, such as issuing a charitable gift annuity<sup>365</sup> or accepting a gift of a life insurance policy that is subject to a loan,<sup>366</sup> might not be subject to this material restriction provision if the transaction can be shown to be in furtherance of the community foundation's charitable purposes. On the other hand, there are other regulations that could classify the transactions as material restrictions.<sup>367</sup>

## 8. OTHER MATERIAL RESTRICTIONS: FACTS AND CIRCUMSTANCES

A material restriction exists if "any other condition is imposed on action by the [community trust] which prevents it from exercising ultimate control over the assets received from the [donor] for purposes consistent with its exempt purposes."<sup>368</sup> The IRS will presumably look at the general facts and circumstances factors described above (Section THREE.B.5.a) to determine whether these other factors are material or not. To date there is only one private letter ruling in which the IRS stated that it would reclassify a fund (an advised fund) as a non-component fund.<sup>369</sup> A few of the restrictions that might cause a fund to be classified as a non-component fund are listed below.

### a. Grant to a Donor-Directed Fund or a Private Non-Operating Foundation

The IRS concluded in Private Letter Ruling 8134046 (May 26, 1981) that a grant from an advised fund to a donor-directed fund (a private foundation under Section 170 (b) (1) (E) (iii) ) would cause the advised fund to be retroactively treated as a non-component fund (i.e., a private foundation from its inception).<sup>370</sup> The IRS would probably reach the

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<sup>365</sup> The material restriction would consist of the portion of the gift that had a non-charitable purpose. See Treas. Reg. Section 1.170A9 (e) (14) (ii) for analogous treatment of a charitable remainder trust.

<sup>366</sup> Although this can be a material restriction under Treas. Reg. Section 1.507-2 (a) (8) (iv) (C), other public charities can accept such gifts. See Section SIX.C.2.c. Private foundations, however, are prohibited from accepting gifts of life insurance subject to loans because of the self-dealing and jeopardy investment taxes. Rev. Ruls. 80-132, 1980-1 C.B. 255 and Rev. Rul. 80-133, 1980-1 C.B. 258.

<sup>367</sup> See the previous two footnotes.

<sup>368</sup> Treas. Reg. Section 1.507-2 (a) (8) (iv) (G).

<sup>369</sup> Private Letter Ruling 8134046 (May 26, 1981), which is described in the next footnote.

<sup>370</sup> The author of the ruling came to this conclusion based on the following line of reasoning:

You now propose to transfer to [the donor-directed fund] the assets of the B and C Advised Funds, with all rights of designation over income and principal accorded donors under the governing instrument of [the donor-directed fund], being allowed thereafter to B and C and their spouses.

Based on the information submitted, we have determined that if the proposed transactions are consummated in the manner stated, the B and C Advised Funds will not be treated as component parts of your organization from their inception because of a material restriction under the provisions of section 1.507-2(a) (8) of the regulations. The restriction referred to arises from the fact that B and C now seek to establish Advised [sic] Funds under section 170(b) (1) (E) (iii) of the Code with funds they originally

same conclusion if a grant were made from a fund of a community foundation to a private non-operating foundation.

#### b. Trustee Has Legal Power To Remove Fund from Community Foundation

The Seventh Circuit Court of Appeals addressed a situation where a donor established a trust with a bank to benefit three charitable organizations (including a community foundation that was to receive 49% of the trust's net income). The bank trustee (rather than the community foundation) was given the power to redirect the income away from the designated organizations if, in the trustee's judgment, their charitable uses became "unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public."<sup>371</sup> This is almost the same standard that the single entity regulations require community foundations to use for the exercise of the variance power.<sup>372</sup>

The trustee argued that it was essentially subject to the judicial standard of *cy pres* so that it did not have any real discretion to change the fund's charitable purposes. The Tax Court and the Seventh Circuit Court of Appeals disagreed and concluded that the fund could not be a supporting organization of the designated charities but was instead

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transferred to you. Therefore, under the provisions of section 1.170a-9 (e) (14) (i), the B and C Advised Funds will be treated as held in trust separate and apart from the community trust from inception. In this regard, then, the tax under section 4940 of the Code [the 2% excise tax on a private foundation's gross investment income] would be due from inception.

[T]here will be no adverse affect in your status [as a publicly supported charity] or the status of [the donor-directed fund]. In addition, neither you nor [the donor-directed fund] or any manager or trustee, thereunder, will be subject to any excise taxes under Chapter 42 [the private foundation excise taxes].

While the transfers do not in and of themselves violate sections 4941 through 4943 of the Code [the private foundation excise taxes], we are expressing no opinion as to whether the B and C Advised Funds have been administered so as to comply totally with the provisions of those sections. While there are no evident violations, no ruling was requested as to this end and, the file does not contain the necessary information to analyze this.

In addition, for the purpose of determining whether B and C are disqualified persons with respect to [the donor-directed fund] and whether [the donor-directed fund] would be liable for Chapter 42 taxes resulting from acts or failure to act occurring with respect to the B and C Advised Funds prior to any transfer, it makes no difference whether the B and C Advised Funds would constitute separate organizations by reason of the transfer. Because all of the assets of the B and C Advised Funds are to be transferred to [the donor-directed fund], section 507(b) (2) of the Code and section 1.507-3 of the regulations would treat [the donor directed find] as if is were the Band C Advised Funds for these and other purposes. [Text highlighted and explained by author].

<sup>371</sup> The court phrased the issue as follows:

The crucial terms of the Designation provide that: In the event that at some future date, any of the aforesaid charitable uses in the judgment of the Northern Trust Company [Note: does not say "in the judgement of the Community Foundation"] shall have become unnecessary, undesirable, impracticable, impossible or no longer adapted to the needs of the public, the income otherwise to be devoted to such use shall be distributed to such charitable, scientific, educational or religious corporations, trusts, funds or foundations as the Northern Trust Company may select to be used for their general purposes. According to the Tax Court this provision requires that The Fund be treated as a private foundation, and not as a supporting organization. [Text highlighted and added by author] *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274, at 1276 (7th Cir. 1979).

<sup>372</sup> Treas. Reg. Section 1.170.39 (e) (11) (v) (B) (1). See Section ONE-D. Le of this publication.

a private foundation.<sup>373</sup> Clearly, if it could not be a supporting organization it could not be a component fund, either.

By comparison, the IRS ruled on two occasions that if funds could be diverted from a charitable beneficiary because of objective standards (i.e., a donor or trustee had no discretion to cause a diversion), there would not be a material restriction.<sup>374</sup>

#### c. Contribution of a Short Term Property Interest

In a situation that did not involve a community foundation, the IRS concluded that a private foundation's proposed contribution of a five-year interest in stock to several public charities would be subject to a material restriction. The reversion of the property to the private foundation after five years meant that the public charities would not be the owners in fee of the assets and the private foundation, therefore, would not have transferred all of its right, title and interest in the assets.<sup>375</sup> This conclusion is consistent with the regulation that provides that split interest gifts (e.g., remainder interests of charitable remainder trusts) are non-component funds.<sup>376</sup>

By comparison, a gift of a portion of an interest in property (such as a one-half tenancy in common interest in real estate) is not split interest<sup>377</sup> and such a gift is probably not subject to a material restriction. See Sections THREE.B.5.b.i, FOUR.B and NINE.A.3 of this publication for the rules governing split interest and partial-interest gifts to community foundations.

#### d. Other

The regulations do not give any examples of "other" material restrictions and the material restriction regulations have never been cited in any published court decision. There are, however, numerous court cases that examine whether a donor has made a completed gift to a public charity or has exercised so much control that a tax deduction was denied or that the gift did not have a charitable purpose.

Since the material restriction regulations essentially determine whether a private foundation has made a completed charitable gift, presumably the court cases that held that individuals did not make a completed charitable gift would also constitute material restrictions. These cases usually involve situations where the donor had not completed delivery,<sup>378</sup> there was a possibility that the property could revert back to the donor,<sup>379</sup>

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<sup>373</sup> *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274 (7th Cir. 1979).

<sup>374</sup> Private Letter Rulings 8606040 (Nov. 12, 1985) and 9014004 (Dec. 19, 1989). See Section THREE.B.5.b.iii of this publication for a summary of these rulings.

<sup>375</sup> G4CM 38397 (June 4, 1980).

<sup>376</sup> Treas. Reg. Section 1.170A-9(e) (14) (ii).

<sup>377</sup> Section 170(f) (3) (B) (ii).

<sup>378</sup> *Dyer v. Commissioner*, T.C. Memo. 1990-51 (town exercised an option to acquire property for \$1 in 1983 and occupied the property without paying rent, but donor could not claim tax deduction until she delivered legal title in 1986); *Dorian M. Benneit v. Commissioner*, T.C. Memo. 1991-604 (gift of piano by Louisiana taxpayer to a Virginia college failed because Louisiana law requires an inter vivos gift

the contribution was earmarked to assist a designated individuals<sup>380</sup> (such as a fund to pay a specific individual's medical expenses)<sup>381</sup> or there was a personal benefit to the donor.<sup>382</sup>

In addition, transactions that could trigger a private foundation excise tax could constitute material restrictions.<sup>383</sup>

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of movable property to be represented by a written deed of gift that is executed before a notary public and two witnesses (piano temporarily remained in Louisiana)), *Weil v. Commissioner*, 31 B.T.A. 899 (1934), aff'd. 82 F.2d 561 (5th Cir. 1936), cert. denied 299 U.S. 512 (1936). *Brotzler v. Commissioner*, 44 T.C.Memo 1982-615; *Glynn v. Commssioner*, 76 T.C. 116 (1981). See, generally, Section SIX.C.1 for the requirements for a completed gift.

<sup>379</sup> Treas. Reg. Section 1.170A-1 (e) denies a deduction for a conditional gift if the possibility that the gift will not be completed is "not so remote As to be negligible." See *885 Investment Co. v. Commissioner*, 95 T.C. No. 12 (1990) in which A deduction was denied under this standard. See Also Rev. Rul. 79-249, 1979-2 C.B. 104; *Briggs v. Commissioner*, 72 T.C. 646 (1979), Aff'd without published opinion 665 F.2d 1051 (9th Cir. 1981) and Tech Adv. Memo 9443001 (Apt. 14, 1993). By comparison, the chance that a school would lose its accreditation was considered a negligible contingency so that a donor could claim a deduction for A completed gift. Tech Adv. Memo 9443004 (Jan. 7, 1993).

<sup>380</sup> See Section THREE.C.7.

<sup>381</sup> Every community foundation should establish A policy as to whether it will accept contributions to a fund to pay a single person's medical bills. This is different from an emergency relief fund that benefits A large class of individuals. The typical situation is that a person was injured in a car accident or has a serious illness with no insurance.

Although the establishment of such a fund will not jeopardize the Section 501 (c) (3) tax-exempt charitable status of a community foundation, it poses a series of significant legal And policy issues. A community foundation should carefully balance the costs and benefits of establishing such a fund. In many cases the best policy may be for a community foundation to have a list of local banks and organizations that have established such funds in the past and to refer the person to them rather than to establish a fund in the community foundation.

The potential costs are more significant. First, donors who contribute amounts to charities that are earmarked for specific individuals generally cannot claim a charitable tax deduction. See, for example, *Tripp v. Commissioner*, 337 F. 2d 432 (7th Cir. 1964); see also *Wendy I Parker Foundation v. Commissioner*, T.C. Memo 1986-348 wherein the Tax Court denied tax-exempt status to a private foundation for coma victims which planned to spend 30% of the organization's income to help the donor's daughter.

Second, the IRS requires charities to inform potential donors anytime that a contribution will not be deductible. Section 170(f) (8) (if there is a personal benefit to the donor); Rev. Rul. 67-246, 1967-2 C.B. 104. This can lead to public relations problems. Community foundations continually publicize the comparative tax advantages that they have over private foundations, but with a fund for an individual's medical expenses the public would be getting a message that contributions to the community foundation would not be deductible.

Third, there could be disputes over how the money should be spent. If doctors (or the family) disagree over whether there should be surgery or radiation treatment, should the community foundation get involved when it could later be blamed for making the wrong choice? Fourth, several charities have been stied over these funds. This has happened when a patient died and various parties competed for the assets in the fund. The family felt that it belonged to them; unpaid creditors felt that it should be used to pay bills; the charity felt it should go for charitable purposes. Although community foundations can point to the "variance power" that they have, it does not mean that they are immune to lawsuits or to the legal defense costs that may ensue.

<sup>382</sup> *Dejong v. Commissioner*, 309 F. 2d 373 (9th Cir. 1962) (charitable contribution was really disguised tuition); *Stubbs v. U.S.*, 428 F.2d 885 (9th Cir. 1970) (contribution of land that was really intended to help get a zoning change was not charitable); *Hernandez v. Commissioner*, 109 S. Ct. 2136 (1989) (contribution to Scientology Church was really in exchange for training sessions); *U.S. v. American Bar Endowment*, 407 U.S. 105, 106 S. CL 2426 (1986) (life insurance for members).



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<sup>383</sup> See, generally, Treas. Reg. Section 1.507-2 (a) (8) (iv) (B) and Section THREE.C.7.