



COUNCIL *on* FOUNDATIONS



INDEPENDENT SECTOR

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MEMORANDUM

TO: Lois Lerner, Director, Exempt Organizations, Internal Revenue Service

FROM: Pat Read, Senior Vice President, Public Policy and Government Affairs  
Janne Gallagher, Vice President and General Counsel, Council on Foundations

DATE: October 18, 2006

RE: Provisions of the Pension Protection Act that Require Immediate Guidance and Effective Date Relief

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This memorandum follows the October 10<sup>th</sup> meeting that Commissioner Everson, Steve Miller and you held with Diana Aviv and Steve Gunderson, to discuss the need for immediate guidance and transition or effective date relief with respect to provisions of the Pension Protection Act of 2006 ("PPA") affecting charitable organizations. At your request, we have provided some supplementary information with specific examples of just a few of the many cases where ambiguities in the PPA are having an immediate and unintended adverse affect on the ability of charitable organizations to carry out important programs and activities. We appreciate the attention you and your staff are giving to these issues and look forward to discussing them with you on Friday, October 27.

**Issue 1. There needs to be an appropriate transition period for enforcement of provisions that went into effect on, before, or shortly after enactment of the PPA.**

The provisions in the PPA have varying effective dates. Some provisions were effective prior to enactment; some became effective on the date of enactment; some are effective the first tax year after enactment (meaning they are currently applicable to organizations with fiscal years beginning September 1 or October 1 and will affect more and more organizations each month as new tax years begin). Many of these provisions are ambiguous and cannot be applied absent regulatory or other IRS interpretation. In some cases, charitable organizations will need to make changes in their organizational structures and possibly apply for re-classification by the IRS. In other cases, charitable organizations will not have immediate access to legal counsel and will need time to find affordable assistance to help them interpret the new legal requirements and make appropriate changes. We believe it is imperative that the IRS, Treasury and/or Congress find a way to delay implementation of these provisions until guidance is issued, and provide an appropriate transition period to allow organizations to make the necessary adjustments to fully comply with the law. Provisions in this category include the following:

**(a) Limitation on grants by private foundations and donor advised funds to Type III supporting organizations other than those that are “functionally integrated.”**

Problem: The PPA requires private nonoperating foundations and sponsoring organizations of donor advised funds to exercise expenditure responsibility with respect to grants to Type III supporting organizations that are not “functionally integrated” with their supported organizations. In our previous communications, we noted that there is currently no way for funders to know with certainty whether many proposed grantees are Type III supporting organizations, much less whether they are “functionally integrated.” The predictable effect is that funders affected by these rules are delaying or suspending grants. This problem currently affects all private foundations and some sponsoring organizations; it will grow more severe with each passing month as additional sponsoring organizations reach the beginning of their next fiscal year and fall within the effective date.

Examples:

- A large private foundation reported that it has cross-checked 24 grantees and grant applicants that were identified in the IRS EO Master File as supporting organizations against the Forms 990 filed by the organizations. Of this sample, half of the organizations listed on the Master File as supporting organizations had not identified themselves as such on IRS Form 990 (by checking box 13 on Schedule A), reporting instead that they were public charities on some other basis (such as under Section 509(a)(1) or (2)). The private foundation has no way to verify whether the IRS had incorrectly listed the organizations as supporting organizations or whether the organizations (or their tax preparers) did not know the correct status of the organization.
- The staff of another major foundation has been working with its grantees to ascertain whether they are supporting organizations and, more specifically, whether they should be treated as Type III supporting organizations. They have discovered a number of charities who were operating under incorrect assumptions about their exempt status.

For several years, Charity A, which has operated as an affiliate organization of Charity B that operates programs internationally, has reported itself as a 509(a)(1) public charity on its Form 990. Because Charity A has relied on restricted funding for specific project activities, it did not have sufficient funds for its administrative operations and only recently hired an experienced financial officer who discovered that the charity’s original exemption letter indicates that it was classified as a Section 509(a)(3) supporting organization. Although Charity A has clearly had a close working relationship with Charity B, it does not provide financial support to Charity B and it appoints its own Board of Directors. The foundation believes that Charity A may be a Type III supporting organization, but they have no means of verifying this status with the IRS. They also believe it may be necessary for Charity A to amend its organizing documents and seek re-classification based on its operations.

Charity C, which was established several decades ago as the charitable arm of a local chamber of commerce, believed it was a supporting organization and has therefore reported itself as such to the IRS. Charity C operates in a geographic area that has been economically depressed for several years and is dependent upon foundation funding to deliver critically needed services. With the help of legal counsel provided by the foundation, Charity C discovered that it is, in fact, exempt under section 509(a)(1).

This level of inquiry is possible for a large foundation with well-trained staff and legal counsel, but this is the exception in the foundation world. Smaller, un-staffed foundations are unlikely to have the resources to assist grantees in resolving such conflicts and are therefore inclined to avoid funding organizations whose status cannot be easily clarified.

- Supporting Organization A was formed more than 30 years ago to raise money for a single federal government entity. The organization’s determination letter states that it is a section 509(a)(3) supporting organization. It appears that the organization is likely a Type III because it is not controlled by the governmental entity. Since its sole function is fundraising, the organization is concerned that it may not be “functionally integrated.” A representative of the organization wrote:

We believe we have arguments to make that indicate that we are functionally integrated, but a review of our mission statement would show that our principal reason for existence is to provide significant financial support (\$600,000 + last year) to a single supported organization, the XYZ. We are not functionally integrated to the degree reflected in the one or two examples in the Code—e.g. we are not an organization that runs a printing press run for the XYZ, that it would run but for our participation. By design, our Foundation has always tried to avoid any functional integration, leaving as much discretion as possible in the hands of the XYZ to determine the appropriate use of on our support. In light of the foregoing, we are concerned that despite our 31 years of dedicated and transparent support of a single institution, our private foundation donors may be reluctant to consider grants to us this year, at least until such time as further regulations are issued to clarify the PPA.

Clear guidance with respect to the definition of what is a functionally integrated Type III supporting organization would help this organization avoid the time and expense of determining whether it can meet the public support test and then seeking reclassification as a section 509(a)(1) public charity.

- A Type III supporting organization reported that it is "functionally integrated," because, as described in the PPA and the Joint Committee on Taxation’s Technical Explanation, it carries out the purposes of its supported organization. The organization was promised a grant from a large private foundation. It has been advised not to expect the grant because the foundation has discontinued grants to all Type III supporting organizations until there is guidance on what due diligence is necessary to verify the supporting organization’s status as “functionally integrated.”
- A corporate foundation that makes thousands of relatively small matching grants each year reported that it intends to suspend its public charity matching gift program until there is guidance as to what it can rely on in determining whether a proposed grantee is a “functionally integrated” Type III supporting organization. The foundation does not have the resources to undertake an independent investigation as to the specific public charity status of thousands of prospective grantees for small matching gifts.
- A public charity was created by a group of public charities to support education reform in a small state. Because the majority of the organization’s initial funding came from a single private foundation, it decided to establish itself as a Type III supporting organization to the group of charities. Over the years, it has expanded its public support and could likely qualify

as an independent public charity today. When Congress raised awareness of its concerns with Type III supporting organizations, the charity obtained legal counsel and made the necessary changes to its bylaws to reflect its current operation as a Type I supporting organization. The charity believes that its legal counsel's interpretation of the new law is correct, but it has no way of verifying to itself or prospective funders that this interpretation will conform with Treasury Department regulations implementing the bill.

**(b) Limitation on grants by private foundations to a supporting organization if it or its supported organizations are controlled directly or indirectly by a disqualified person of the private foundation, and the similar limitation on grants by donor advised funds if the donor or advisor directly or indirectly controls a supported organization.**

Problem: The PPA requires private nonoperating foundations and sponsoring organizations of donor advised funds to exercise expenditure responsibility with respect to grants to supported organizations where there is "direct or indirect" control by a disqualified person. As noted above, there is no way for a funder to know with certainty whether a prospective grantee is a supporting organization. Moreover, the PPA does not provide a clear definition of what constitutes direct or indirect control, or how this definition applies in the context of Type I supporting organizations that support a class of charities. Like (a) above, this problem gets more severe with each passing month as more organizations fall within the effective date.

Examples:

- Community Foundation X has created Community Foundation Y, a Type I supporting organization, to provide community foundation services in an adjoining community. Y's bylaws provide that its board will be named by X. Community Foundation X supports Y by providing a range of services to Y, including accounting, payroll, and assistance with soliciting and accepting large and complex gifts. Y supports Community Foundation X by providing information and education to donors in Y area, by soliciting gifts from Y area donors, and by making grants to the class of charities that X supports. If Y is successful in attracting substantial charitable gifts, it may opt to become independent of X in the future. To help it toward this goal, private foundation Z, a large private foundation with a diverse independent board, would like to make a grant to Y's unrestricted endowment, the fund Y uses to make discretionary grants in Y community. No private foundation Z disqualified person has any connection with either X or Y; however, two Z disqualified persons hold positions of authority with charitable organizations that are members of the broad class to which Y may make grants. Since Z controls neither X nor Y, it cannot compel Y to make grants to any particular member of the class of charities. Consequently, there is no reason why it should be required to exercise expenditure responsibility for its grant to Y or be required to exclude the grant from its qualifying distributions.
- See the examples in (a) above. Private foundations and sponsoring organizations of donor advised funds typically rely, as part of their due diligence, on IRS Publication 78 to verify the public charity status of proposed grantees. Pub. 78 contains no information as to supporting organization status. Without concrete guidance, private foundations and sponsors of donor advised funds have no way of determining with certainty whether a particular organization is a supporting organization – which is a critical threshold requirement for compliance with this new provision.

- Sponsoring organizations of donor advised funds make hundreds of thousands of grants to public charities every year, many of which are under \$500. It is essential that they have guidance as to (i) the definition of direct and indirect control and, of equal or greater importance, (ii) what due diligence they must conduct to establish whether such control relationship exists. In the absence of such guidance, many sponsoring organizations have expressed concern about the possible need to discontinue grants to supporting organizations. They are also concerned that they may lack the resources to conduct extensive independent due diligence as to the issue of control, particularly for relatively small grants.
- Some private foundations have expressed concern that, in the absence of a clear definition of control for purposes of these provisions, it might be necessary for a director of the foundation to resign as the board member or officer of an organization that is supported by a supporting organization that has applied to receive a grant from the foundation. In a recent meeting of nonprofit technical assistance providers, some participants believed that family members of foundation board members and executives might need to resign their board positions on local public charities that are classified as supporting organizations if those organizations were to be eligible to receive grant support from the foundations in the future. While current statutory and regulatory language does not support this definition of control, many organizations do not have access to legal counsel who are familiar with this aspect of tax law and others are uncertain as to whether current definitions will apply to the new law.

**(c) Prohibition of payments by supporting organizations to the substantial contributor and related parties.**

Problem: Effective for "transactions" after July 25, 2006, the entire amount of any "grant, loan, compensation, or other similar payment" provided by a supporting organization to a substantial contributor or person related to the substantial contributor is an automatic excess benefit. The PPA does not define the term "transactions."

Examples:

- Community Foundation A has a Type I supporting organization that holds a tract of land valued at approximately \$2 million and about \$5 million in cash. Both land and cash were contributed to the supporting organization by a generous donor. The donor's purpose in giving the land to the supporting organization was to create a public recreational resource. To that end, construction is underway on a network of hiking and ski trails. The supporting organization contracts with the donor's LLC to manage the property, including both the development of it as a public recreational resource and the management of four rental properties, which, together with an agricultural license, provide income to supplement the supporting organization's cash endowment. The fees paid to the LLC by the supporting organization are significantly less than what would be charged by other real estate management firms, a fact that was documented by comparables obtained by the supporting organization and verified by the community foundation. In order to keep this beneficial arrangement, the land is being transferred to a public charity that is not a supporting organization. The parties expect that the public charity will continue the management contract with the donor's LLC because of the significant cost savings. The community foundation is uncertain whether it can compensate the donor's LLC for services to the supporting organization during the period from July 25, 2006 until the restructuring is complete.

- An employee of a supporting organization who was hired prior to July 25, 2006, has a parent who was a substantial contributor to the organization in recent years. The organization wants to know whether this pre-existing employment relationship is a violation of PPA such that it must now terminate the employee.

**Issue 2. The definition of donor advised fund should be clarified to exclude funds created by a public charity or governmental entity and employer disaster relief funds.**

Many of the PPA provisions affecting donor advised funds are now in effect. In order to comply with these provisions, it is essential for sponsoring organizations to be able to identify whether particular special purpose charitable funds fall within the definition of "donor advised funds." This is also critical for donors who wish to make gifts from their IRA accounts, since the PPA's special rules for charitable IRA rollovers do not apply to gifts to donor advised funds. The definition of "donor advised fund" in the PPA is ambiguous in certain respects. In addition, the PPA grants the IRS discretionary authority to exclude certain special purpose funds from the definition. The IRS and Treasury should issue immediate guidance as to the types of special purpose charitable funds that are *not* donor advised funds. These include the following:

**(a) Funds established and advised by a public charity or governmental entity that support more than one identified organization or governmental entity.**

Problem: The PPA specifically excludes from the definition of donor advised fund a charitable fund or account that makes distributions only to a single identified organization or governmental entity. This definition does not explicitly exempt a fund established by a public charity or governmental entity that may make distributions to other organizations. It also does not except funds established by a group of public charities or governmental entities. The PPA gives the IRS authority to exclude a fund that "benefits a single identified charitable purpose," but this provision requires affirmative IRS action. Without such action or other guidance, the treatment of funds established by public charities and governmental entities to make distributions to other entities in furtherance of their purposes remains open to question.

Examples:

- A public charity establishes a disaster relief fund at a community foundation to raise and grant funds for disaster relief. All of the advisors for the fund are appointed by the public charity. The advisory committee for the fund recommends grants to several local disaster relief organizations.
- A state governmental entity establishes a fund at a community foundation to raise and grant funds for economic revitalization projects for economically depressed neighborhoods in the area. All of the advisors for the fund are appointed by the governmental entity. The advisory committee for the fund recommends grants to several local organizations.
- Public Charity A works intensively with disadvantaged local high school students throughout their high school careers to prepare them for college and help with admissions, scholarship, and financial aid applications, etc., with the promise of a scholarship if the student graduates and has completed all the program requirements. The charity has created a fund at Community Foundation B from which the awards are made. Community Foundation B pools the fund's assets with its other funds for investment purposes, issues checks to the universities the students are attending, and generally conducts the due diligence required for scholarships. The charity is the sole donor to the fund, although the amounts contributed

represent gifts to the charity from many different sources. Each year, the charity's staff provides the community foundation with a list of those students who qualify to receive awards. Technically, these take the form of recommendations to the community foundation because the fund is legally the property of the community foundation, and, since the recommendations are made by the fund's "donor" the fund may be donor-advised as that term is defined in the Pension Protection Act. Although the process used to determine which students receive awards is unusual, it meets the general requirements of section 4945(g), but the fund may not qualify for the scholarship exclusion from the definition of donor-advised fund because the "advice" is provided by a group that consists solely of the donor's employees. In order for the fund to qualify for the scholarship exclusion, only a minority of its advisory group could consist of the charity's employees.

- A public charity with the mission to enhance opportunities for women in school establishes a fund at Community Foundation J to award scholarships to high school graduates who meet certain established criteria. The public charity has transferred some money to the fund and the fund directly receives contributions from other individual members of the public charity. A committee selected by the board of the public charity serves as the selection committee of the scholarship recipients each year. While the public charity could administer the scholarship fund itself in this manner, it prefers to work with J because of J's expertise in administering scholarship programs. However, because the committee is selected by the board of the public charity the fund apparently cannot meet the requirements of the exception for scholarships unless the public charity does not appoint a majority of the committee.
- Three public charities have created a fund at Community Foundation B to carry on a jointly funded activity. The fund is "advised" by the chief executive officers of the three public charities. The fund makes grants to various organizations, including to the three donors, in order to carry out the fund's purposes. Because the fund makes distributions to more than one charity, it is not automatically exempted from the definition of a donor-advised fund and is, therefore, apparently subject to the automatic excess benefits provision which bars the making of grants to a fund's donors.

**(b) Funds established by employers that benefit employees in the aftermath of disasters or other hardship circumstances.**

Problem: Employers establish funds at community foundations and other public charities to provide disaster relief and hardship assistance grants to employees. In some cases, the fund receives contributions only from the employer, but more commonly from employees as well. The PPA prohibits donor advised funds from making grants to individuals, making it impossible for such funds to operate if they are classified as donor advised funds.

Example:

- Company A established a fund at a community foundation to provide assistance to employees who are victims of disasters or in other emergency situations. The fund has received contributions from the company and from employees. Consistent with applicable IRS rules governing disaster assistance organizations, individual grants have been awarded by a committee appointed by the community foundation and comprised of company employees, a majority of whom are not in positions of management for the employer. Based

on the prohibition against individual grants in the PPA, the community foundation informed the company that it would no longer approve grants from the fund to employees as of the first day of its new fiscal year, October 1, 2006.

### **Issue 3. Transition rule for scholarships awarded by donor advised funds prior to August 17, 2006.**

Problem: As noted above, the PPA prohibits grants to individuals, including scholarships, from donor advised funds. There is an exception for grants to individuals for travel, study or other similar purposes, provided that (1) the donor's or donor advisor's advisory privileges are performed exclusively in such person's capacity as a member of a committee appointed by the sponsoring organization, (2) no combination of a donor or donor advisor or persons related to such persons control such committee, and (3) all grants from such fund are awarded on an objective and nondiscriminatory basis pursuant to a procedure designed in advance and approved by the sponsoring organization's board. While this provision provides an important exception, it is not clear how scholarship grants awarded but not paid prior to the effective date of the PPA should be treated.

#### Examples:

- A community foundation awarded a two-year scholarship in June 2006, but has not paid the first year of the scholarship yet. The scholarship was awarded by a committee from a fund created by a donor. The committee, which included the donor as one member, used fair and objective procedures in arriving at its recommendations; however, the committee's procedures were not approved by the community foundation's board at the time the scholarship was awarded. The community foundation, which has a fiscal year that began October 1, 2006, is not certain whether it can pay the scholarship in October 2006 and October 2007 because the fund did not comply with all of the requirements for the exclusion from the definition of "donor advised fund" stated above at the time the scholarship was awarded.
- Community Foundation D has more than 100 funds that award scholarships. Last year, D gave more than \$800,000 in scholarships from these funds to almost 600 students. D is reviewing the documents establishing each of these funds to determine how many of them might be classified as donor-advised under the definition used in the Pension Protection Act of 2006, but preliminary indications are that as many as half may meet the definition and thus must meet the requirements to be excepted in order to continue making scholarship grants. The PPA's ban on distributions to individuals from donor-advised funds will take effect January 1, 2007 for D, which is a calendar-year taxpayer, but D needs to be able to make distributions after January 1, 2007 to fulfill scholarship commitments made prior to the enactment of the PPA. The process that D used to award these scholarships meets the requirements of section 4945(g) except that D's board had not formally approved the process in advance of the awards because there was no need for the board to do so.

### **Issue 4: Clarify that the term "distribution" in section 4966 does not include the purchase of goods and services in exchange for fair market value.**

Problem: The PPA establishes penalties for sponsoring organizations and managers of donor advised funds if a sponsoring organization makes a "distribution" from assets held in a fund to a natural person, to certain organizations without the exercise of expenditure responsibility, and for

a noncharitable purpose. The legislation does not define what constitutes a “distribution,” creating uncertainty with respect to whether all payments of any type from assets held in a donor advised fund are subject to the rules set out above, or whether the term “distribution” simply refers to gratuitous transfers and not to the purchase of goods or services at fair market value. It is also unclear whether the provision prohibiting distributions to natural persons should be interpreted as prohibiting the purchase of goods or services from sole proprietorships.

Examples:

- Seven municipalities have created a fund at Community Foundation E for the purpose of improving the quality of a river that runs through all seven. Each municipality designated an employee to form a committee to advise with regard to distributions from the fund, which makes payments to vendors, including some individuals, for consulting/planning services, river clean-up and improvement activities. Without an exemption from the definition of donor-advised fund, or clarification that the term “distribution” does not include payments for fair market value to vendors, the fund will apparently be barred from contracting with consultants who are individuals and required to somehow exercise expenditure responsibility for all other payments.
- Community Foundation F has a donor-advised fund that, among other things, benefits a local elementary school by providing supplies and equipment for use in classrooms. Prior to August 17, 2006, the fund’s donor would periodically receive a teacher wish list from the school principal. The donor would then purchase items on the list, using her own resources, and submit receipts to the community foundation for reimbursement. After verifying that the items purchased matched the list and had been received by the school, F would issue a check to the donor. To comply with the restriction in the Pension Protection Act of 2006 barring sponsoring organizations from reimbursing donor expenses, F proposes to itself purchase the requested items directly from vendors. Grants of cash to the school are not an effective alternative because school district rules require that such grants be deposited in the school system’s general fund with the result that teachers do not receive the supplies they need. It is unclear how, if at all F could exercise expenditure responsibility when purchasing items from commercial vendors, as it would be required to do if the purchase constitutes a “distribution,” because merchants cannot be expected to segregate the “grant” on their books or provide a written report documenting the use of the “grant” funds.
- A couple whose child died from a rare form of cancer established a memorial fund at Community Foundation G. The fund makes grants to support research on the prevention and treatment of the child’s cancer. Each year, the couple organizes a golf tournament to raise money for the fund. Prior to August 17, 2006, the couple paid the tournament expenses from their own resources and sought reimbursement from the fund. The PPA clearly prohibits the fund from reimbursing the couple for any expenses incurred for the event, so vendors who provide goods and services for the event must now be paid directly from the donor advised fund. G believes that the expenses incurred are reasonable in light of the amount of money raised by the event and would like to continue the tournament. As in the preceding example, G is uncertain whether such payments will constitute taxable distributions if it fails to exercise expenditure responsibility. In the absence of guidance on this issue, the community foundation has informed donors that it will not make payments from donor advised funds for fundraising events.

## **Conclusion**

We hope these examples will assist you and your staff in considering whether and how the Service can provide a Notice and Guidelines to assist foundations and public charities that are currently making tremendous efforts to comply with the new laws. These organizations need both transition time and clear guidance so that they do not waste limited charitable resources and time implementing inappropriate solutions.

cc: Steven T. Miller, Commissioner, Tax Exempt and Governmental Entities  
Division, Internal Revenue Service  
Susan Brown, Deputy Tax Legislative Counsel – Regulatory Affairs, Department of the  
Treasury  
Dean Zerbe, Tax Counsel, Senate Finance Committee  
Roger Colinvaux, Legislation Counsel, Joint Committee on Taxation