COUNCIL *on* FOUNDATIONS

LEGAL COMPENDIUM FOR COMMUNITY FOUNDATIONS

Christopher R. Hoyt

CHAPTER 1, Definition of a Community Foundation

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.

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Chapter One

Definition of a Community Foundation

A. The Quest for a Definition; Commonly Accepted Understanding

1. HISTORY AND PURPOSE

Community foundations exist in every major metropolitan area of the United States, with some cities having several. In 1994, their assets exceeded $10.07 billion and they distributed over $652.5 million of grants to local charities.[3] They represent one of the fastest growing areas of philanthropy.

The genesis of community foundations traces back to Frederick Goff 's establishment of the Cleveland Foundation in 1914. The Cleveland Trust Company held several small endowed charitable trusts and was having difficulty making grants in an effective manner. Many of these trusts were restricted to a specific charitable purpose, such as education or health, but others were simply established to benefit the residents of greater Cleveland. A separate committee (later a corporation) was established to identify the most worthy grant recipients of the income from the trusts. Other Cleveland banks later joined in the arrangement. The multiple-trust community foundation became a model that was adopted in other cities in the 1920s and 1930s[3]. The New York Community Trust, for example, currently has seventeen banks acting as its trustees, each holding one or more of its trusts and funds. The separation of the investment function from the disbursement function permits the trustee banks to do what they do best (make investments) and the community foundation to do what it does best (make grants). The Department of Treasury recognized this structure and the tax regulations give community foundations the unique advantage of being able to treat multiple trusts and corporations as part of the community foundation ("component funds") rather than as separate organizations.[5]

An important distinguishing feature of a community foundation is the "variance power." It gives a community foundation greater flexibility to adapt to the changing charitable needs of the community. More specifically, the variance power gives a community foundation the unilateral power to change the charitable purpose of a fund if circumstances have sufficiently changed to make the original restriction inappropriate.[6]

Although the newer community foundations have the variance power and structure their grantmaking procedures along the traditional lines that were established by the

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[3] *Foundation Giving*, 1996, p. 50.

[4] Sidney S. Whelan Jr., "Community Foundations Take Off," *Trusts & Estates*, Aug. 1987, at 10,14. See, also, the case of *Re Guggerheimer's* Estate, 168 Misc 1, 5 NYS2d 137 (1938) which authorized a gift to establish the New York Community Trust at a time when there was an issue as to whether it was legally possible.

[5] Treas. Reg. Section 1.170.A-9 (e) (11) (ii). See Section THREE.A.2 for the requirements for a trust or corporation to qualify as a component fund.

[6] See Section ONE.D.2.d of this publication for analysis of the variance power.

Cleveland Foundation and The New York Community Trust (e.g., unrestricted, designated, field of interest and advised funds), they generally do not hold each philanthropic fund in a separate trust. Instead, they tend to be non-profit corporations and many manage their own assets in commingled investment pools. The philanthropic funds of these community foundations are basically accounting entries under non-profit fund accounting principles that represent an allocation of the organization's pooled investments. Some of the trust-form community foundations have also established parallel corporate-form community foundations to take advantage of some of the features offered by corporations.[7]

Many community foundations also go beyond making grants from endowed funds by acting as innovative facilitators of charitable activities in their communities. They demonstrate leadership by identifying charitable needs and galvanizing resources to address the problems. Community foundations are ideal vehicles to carry out philanthropic partnerships where numerous donors contribute to a single philanthropic fund at a community foundation to accomplish a long-term objective, such as an endowment for classical music in the area, or a short-term project, such as the construction of a public playground. Such projects can be initiated by the community foundation or by others in the community who identify a charitable objective and need a charitable organization to assist with the project. A philanthropic fund at a community foundation offers contributors with numerous tax and administrative advantages over establishing a separate organization.[8]

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[7] See Section ONE.B of this publication.

[8] See Section SIX.A of this publication for a list of the advantages. See, also, Howard A. Sweet and Joanne R Whiting, "Community Foundations: Estate Planning's Best Kept Secret," *The Wisconsin Lawyer*, June 1991, at 27 & 28.

The IRS acknowledged the effectiveness of community foundations in its 1993 training manual. It stated: "As charitable vehicles, community foundations are particularly effective in serving the needs of their local communities:

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

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

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

They offer many attractions to donors. They provide professional investment management of charitable contributions. Donors making contributions to these foundations generally receive the maximum charitable deduction allowed because most community foundations are publicly supported within the meaning of IRC 170 (b) (1) (A). Further, community foundations perpetuate the donors' names and personalities." *1993 (for IT 1994) IRS Exempt Organizations CPE Technical Instruction Program Textbook:* Chapter K: "Community Foundations," p. 136.

2. BASIC OPERATING PRINCIPLES

a. In General

A community foundation is a grantmaking publicly supported charity[9] that is basically structured as an amalgamation of grant making endowed funds.[10] Each fund is usually named after the donor who established it (e.g., The Ed and Beth Smith Fund) or for its charitable objectives (e.g., The Mill Creek Park Endowment Fund).[11] Several community foundations administer only endowment funds, but many others permit grants from principal.[12]

A community foundation carries out the diverse instructions that have been given by its governing body and its donors. Although most grants are made to public charities within a defined geographic area, grants to national universities and other national charities are very common.

b. Classification of Funds by Charitable Purposes

Grants are made from each fund in accordance with the instructions that a donor gave to the community foundation when he or she established the fund. A community foundation generally permits a donor to impose a variety of restrictions on the types of charitable grants that may be made from a fund. Although most gifts are restricted one way or another, every community foundation has a long-term objective to increase the assets that are held in unrestricted endowment funds. These funds give a community foundation the greatest freedom to address the charitable needs of the community as they change over time.

Each fund is classified into one of four basic categories based on the restrictions imposed by the community foundation or the donor: [13]

- "unrestricted fund" where the community foundation has complete discretion to make charitable grants;

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[9] A community foundation is classified as a public charity, rather than a private foundation, if it can pass the public support test. Most qualify because many unrelated donors contribute to their grant-making funds. The public support test appears generally in Sections 509(a) (1) and 170(b) (1) (A) (vi) and Treas. Reg. Section 1.170A-9 (e) (1) through (9). Community foundations have a modified "facts and circumstances" test in Treas. Reg. Section 1.170A-9 (e) (10). See Chapter TWO for analysis of the public support test.

[10] Treas. Reg. Section 1.170A-9 (e) (10).

[11] Treas. Reg. Section 1507-2 (a) (8) (iii) (A) and 2 (a) (8) (v), Example 2; see also Private Letter Rulings 9008007 (Nov. 16, 1989) and 8705049 (Nov. 4, 1986). See Section THREE.B.4.a for rules governing names of funds.

[12] Community foundations convey the concept of a capital or endowment fund to support charitable activities in the community or area they serve. Treas. Reg. Sections 1.170A-9 (e) (11) (iii) and 1.170A-9 (e) (10).

[13] See Treas. Reg. Section 1.170A-9 (e) (11) (ii) (B) in conjunction with Treas. Reg. Sections 1.307-2 (a) (8) (iii) (A)-(B) and (iv) (A) (2).

- "designated fund" from which distributions are restricted to a public charity that was named by the donor at the time the contribution was made to the community foundation (for example, an endowment fund for a symphony);[14]

- "field of interest fund" from which distributions are restricted to a charitable purpose specified by the donor (for example, education or health);[15] and

- "advised fund" where the donor (or a person or committee designated by the donor) can advise the community foundation on charitable distributions.[16] The recommendations are only advisory; the governing body of the community foundation has legal control over all distributions.[17]

c. Administration of Assets

The multiple-trust community foundations have each fund administered in a separate trust.[18] Bank trust departments generally administer the investments of the fund and an incorporated community foundation directs the charitable grants. Banks that administer a fund in a custodial or agency account rather than in a separate trust are generally subject to the same rules.[19]

Despite the fact that the community foundation does not have legal title to the assets, a charitable trust will be classified as part of the community foundation for federal tax purposes (a "component fund") if certain conditions are met.[20] A charitable corporation can qualify as a component fund if the same conditions are met.[21] A component fund does not file a tax return. Instead, the community foundation files a "consolidated" income tax return that includes the financial transactions of all of its funds, including those that are held in separate trusts or corporations.[22]

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[14] To be an eligible beneficiary, each organization must qualify as a public charity described in Sections 509 (a) (1),(2) or (3). Treas. Reg. Section 1.507-2 (a) (8) (iii) (B) and (iv) (A) (1) in conjunction with Treas. Reg. Section 1.170A-9 (e) (11) (ii) (B). A public charity can establish a designated fund for its own benefit (usually referred to as an "agency endowment fund"). See, generally, Section THREE.B.1 for the rules governing designated funds.

[15] Treas. Reg. Sections 1.507-2 (a) (8) (iii) (B) in conjunction with Treas. Reg. Section 1.170A-9 70A-9(e) (11) (ii) (B). See, generally, Section THREE.B.2 for the rules governing field of interest funds.

[16] Treas. Reg. Section 1.507-2(a) (8) (iv) (A) in conjunction with Treas. Reg. Section 1.170A-9 (e) (11) (ii) (B). Private Letter Rulings 8920009 (Feb. 3.1989) and 8752031 (Sept. 28, 1987). See, generally, Section THREE.B.3 for the rules governing advised funds.

[17] *Id.*

[18] Treas. Reg. Section 1.170A9 (e) (10).

[19] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) in conjunction with Treas. Reg. Section 1.507-2 (a) (8) (iii) (C) and (iv) (F).

[20] Treas. Reg. Section 1.170A-9 (e) (11) (ii) (B) and GCM 38812 (Aug. 31, 1981). See Section THREE.A.2 of this publication for the requirements.

[21] An example of a corporation that qualified as a component fund is in Private Letter Ruling 8621112 (Feb. 28, 1986).

[22] Treas. Reg. Section 1.170A9(e) (14) (i) (last sentence) and Private Letter Ruling 8621112 (Feb. 28, 1986).

By comparison, most incorporated community foundations administer their funds under fund-accounting rules for non-profit organizations.[23] Thus, each fund represents a proportionate share of the community foundation's commingled investment assets. Many of the multiple trust community foundations also offer donors the opportunity to have funds administered as accounts in the organization or in a related community foundation.[24]

3. STATE LAW DEFINITIONS

There is no clear definition under state law as to what constitutes a "community foundation" or a "community trust." The only state that has squarely addressed the issue is Michigan, which enacted a tax credit for a contribution to a community foundation.[25]

The following states have statutes that define, or at least mention, community foundations or community trusts:

Connecticut[26]
Florida[27]
Hawaii[28]
Indiana[29]

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[23] *1993 IRS Exempt Organizations CPE Technical Instruction Program Textbook*, *Chapter K (Community Foundations)*, p. 135.

[24] For example, the New York Community Trust has a parallel incorporated organization that administers philanthropic funds with a commingled pool of investments: New York Community Funds. Private Letter Ruling 8621112 (Feb. 28. 1986) is another example of such an organization.

[25] Michigan Stat. Ann Section 7.558 (38c) (3) (as amended in 1994) defines a community foundation as follows:

> (3) As used in this section, "community foundation" means an organization that ... [meets) all of the following requirements:
>
> (a) Qualifies for exemption from federal income taxation under Section 501 (c) (3) of the Internal Revenue Code, 26 U.S.C. 501.
>
> (b) Supports a broad range of charitable activities within the specific geographic area of the state that it serves, such as a municipality or county.
>
> (c) Maintains an ongoing program to attract new endowment funds by seeking gifts and bequests from a wide range of potential donors in the community or area served.
>
> (d) Is publicly supported as defined by the regulations of the United States Department of Treasury, 26 C.F.R 1.170A-9 (e) (10).
>
> (e) Is not a supporting organization as defined under Section 509 (a) (3) of the Internal Revenue Code and the regulations of the United States Department of Treasury, 26 C.F.R. 1.509 (a)-4 and 1.509 (a)-5.
>
> (f) Meets the requirements for treatment as a single entity contained in the regulations of the United States Department of Treasury, 26 C.F.R. 1.170A-9 (e) (11)....

[26] Conn. Gen. Star. Sections 45a-516 (gifts to charitable community trusts), 517 (annual accounts), 520 (termination of trusts into community foundations) and 527 (definitions).

[27] The Florida legislature established the "Florida Communities Trust" to assist in the conservation of natural resources Fla. Stat. 380.501 through 503 (1989 Fla. Laws 175).

[28] HRS Sections 312-9 (special legislation for a fund at the Hawaii Community Foundation) and 517D-3 (Uniform Management of Institutional Funds Act).

[29] Burns Ind. Code Ann. Section 36-1-141.

Kansas[30]
Maryland[31]
Michigan[32]
New Jersey[33]
North Carolina[34]
Ohio[35]
Oregon[36]
Washington[37]
West Virginia[38]

Six of the state statutes that mention community foundations refer to the federal tax regulations for community trusts, described below.[39] Three states enacted statutes that refer to a specific community trust that was established to perform a few specified charitable purposes; they do not conform to the general perception of a community foundation.[40]

4. FEDERAL TAX LAW DEFINITION

There is not much further guidance from the federal tax statutes. Although the Internal Revenue Code makes several references to a "community chest, fund or foundation" it never explains what such an organization is.[41] The legislative history, as interpreted by the U.S. Supreme Court, explains their function as follows: "numerous communities had established charitable trusts, charitable foundations, or community chests so that individuals could donate money to a trustee who held, invested, and reinvested the principal, and then turned the principal over to a committee that distributed the funds for charitable purposes."[42]

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[30] KS.A. Section 17-1762 (r) (exemption from registration; community foundation defined).
[31] Md. Ann. Code art. 48A, Section 487 (annuity agreements).
[32] M.SA Section 7.557(1261) (tax credit for contribution to a fund); and M.S.A. Section 7.558(38c) (definitions).
[34] Section 3B:11-22(c) of the New Jersey statutes defines a "community trust" as a non-profit organization that provides services to individuals with chronic disabilities; it is part of the New jersey Community Trust for Persons with Severe Chronic Disabilities Act (NJ. Star. Sections 3B:11-19 through 35). North Carolina has a similar statute.
[34] N.C. Gen. Star. Section 363-1 (Uniform Management of Institutional Funds Act); and N.C. Gen. Star. Section 131F-3 (Solicitation of Contributions - Exemptions: the statute exempts "community trusts" that are defined in the federal tax regulations from certain registration requirements). There is also a statute that pertains to a community trust for chronic disabilities, but that does not conform to the common perception of a community foundation. N.C. Gen. Star. Section 36A-59.10 through 20 (North Carolina Community Trust for Persons with Severe Chronic Disabilities). New Jersey has a similar statute.
[35] Ohio Admin. Code 109:1-1-03(B).
[36] O.R.C. Ann. 2109.30 (Anderson).
[37] Rev. Code Wash. (A.R.C.W.) Section 11. 110.073.
[38] W. Va. Code Section 44-6A-2.
[39] See Hawaii, Michigan, North Carolina, Ohio, Oregon and West Virginia.
[40] See Florida, New Jersey and North Carolina.
[41] Sections 170(c) (2), 501 (c) (3) and 2522 (b) (2).
[42] Davis v. U.S., 495 U.S. 472, 479; 110 S. Ct. 2014; 1990 U.S. LEXIS 2571; 109 L.Ed. 2d 457, 468; 58 U.S.L.W. 4587; 90-1 U.S. Tax Cas. (CCH) P50,270; 65 A.F.T.R.2d (P-H) 1051 (1990). The Supreme Court studied the history of contributions made in trust for charities at length. It noted the fact that the

The present law that governs community foundations is found in the Department of Treasury regulations rather than in the Internal Revenue Code. They refer to community foundations as community trusts. These regulations do not contain a specific definition of what constitutes a community foundation. At best there is a description of how many are structured and operated:

> Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body.[43]

[It conveys] the concept of a capital or endowment fund to support charitable activities in the community or area it serves.[44]

Another definition appears in a committee report that explains how a proposed statute will permit community foundations and private foundations to invest in a tax-exempt

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testimony of community foundation representatives in 1921 helped to structure the legislation that permits charitable tax deductions for contributions to all forms of grant-making foundations, including private foundations. The Court stated at 495 U.S. 479-482:

The original version of section 170, promulgated in the War Revenue Act of 1917, ch. 63, section 1201(2), 40 Stat. 330, did not allow deductions for gifts "for the use of" a qualified donee. Rather, it allowed individuals to deduct only "[c]ontributions or gifts ... to corporations or associations organized and operated exclusively for religious, charitable, scientific, or educational purposes. . . ." In interpreting this provision in the Act (and in the subsequent Revenue Act of 1918, ch. 18, section 214(a) (11), 40 Stat. 1068), the Bureau of Internal Revenue stated that "[c]ontributions to a trust company (a corporation) in trust to invest and disburse them for a charitable purpose are not allowable deductions under [section 170]." O.D. 669, 3 Cum. Bull. 187 (1920).

In hearings before the Senate Committee on Finance on the proposed Revenue Act of 1921, representatives of charitable foundations requested an amendment making gifts to trust companies and similar donees deductible even though a trustee, rather than a charitable organization, held legal title to the funds. Hearings on Proposed Revenue Act of 1921 before the Senate Committee on Finance, 67th Cong., 1st Sess., 521 (1921). Testimony before the Committee indicated that numerous communities had established charitable trusts, charitable foundations, or community chests so that individuals could donate money to a trustee who held, invested, and reinvested the principal, and then turned the principal over to a committee that distributed the funds for charitable purposes. *Id*., at 522-526; see also H.R. Rep. No. 350, 67th Cong., 1st Sess., 12 (1921) (House Comm. on Ways and Means) (amendments "would allow the deduction, under proper restriction, of contributions or gifts to a community chest fund or foundation"); S. Rep. No. 275, 67th Cong., 1st Sess., 18 (1921). Responding to these concerns, Congress overruled the Bureau's interpretation of section 170 [then section 214(a) (11)] by adding the phrase "for the use of ... any corporation, or community chest, fund, or foundation . .." to the charitable deduction provision of the Revenue Act o£ 1921, ch. 136, section 214(a) (11), 42 Stat. 241.

[43] Treas. Reg. Section 1.170A-9 (e) (10).

[44] Treas. Reg. Section 1.170A-9 (e) (11) (iii).

investment pool: the "common fund. "[45] It describes a community foundation as follows:[46]

Community foundations are a form of charitable trust or fund (which generally are established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area) as to which section170 (b) (1) (A) (vi) applies. See Treas. Reg. Sec. 1.170A-9 (e) (10).

5. COUNCIL ON FOUNDATIONS DEFINITION

The Council on Foundations uses the following definition to admit community foundations as members:

> A community foundation is a tax-exempt, not-for-profit, autonomous, public-supported, philanthropic institution organized and operated primarily as a permanent collection of endowed funds for the long-term benefit of a defined geographic area. Each community foundation:
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> 1) Is officially recognized by the Internal Revenue Service as a tax-exempt under Section 501 (c) (3);
> 2) Meets the public support test under Section 170(b) (1) (A) (vi) as modified by Treas. Reg. 1.170A9(e) (10);
> 3) Has a governing body broadly representative of the general public;
> 4) Operates primarily as a grantmaking institution and may also provide direct charitable services;
> 5) Focuses its primary grantmaking and charitable services within a defined geographic area no larger than three states;
> 6) Maintains a broad grants program to multiple grantees that is neither limited by field of interest nor to serving only parts of the population; and
> 7) Is structured primarily as a permanent collection of named funds that carry out the diverse charitable purposes specified by the governing body and donors, and has a long-term goal to increase the assets held as permanent unrestricted endowment.

B. Legal Structure Under State Law; Use of Corporations and Trusts

Community foundations can exist in a variety of legal forms. Much of the variation that exists today is a result of the historical evolution of community foundations from the multiple trust arrangement adopted by the nation's first community foundation: the Cleveland Foundation.[47] Thus, some exist in the trust form with single or multiple banks;

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[45] Although passed several times by Congress, the bill was vetoed each time by President Bush or President Clinton because it was pan of a much larger tax bill that they objected to.

[46] The definition appears in footnote number 41 to The Conference Report Explanation; Revenue Reconciliation Act Title XI, Part VIII - Exempt Organizations and Charitable Provisions, available at 95 *Tax Notes Today* 225-9 (Nov. 17, 1993).

[47] See Section ONE.A.1. For the history and evolution of the community foundation movement, see *Community Foundation Manual of the National Agenda for Community Foundations* (Council on Foundations 1989) Part A.3.

some exist as multiple trusts with an incorporated distribution committee;[48] some exist as a single corporation with no trusts, and some operate as a combination of trusts with a corporation. The tax regulations recognize this diversity and permit a community foundation to operate in the form of a trust, not-for-profit corporation, unincorporated association, or a combination thereof.[49] An important issue concerning the legal structure is whether all of the trusts and funds will be considered as component parts of a single charitable organization.[50]

Most of the newer community foundations have opted for the corporate form, either with or without trustee-bank involvement, because of the greater flexibility the corporate form provides for business operations. Corporations can administer funds that are too small to economically justify a separate trust.[51] A corporation has more flexible investment standards under state law than a trust. There is also a more relaxed standard for a conflict of interest where, for example, a director of the community foundation is also a director of a grant seeking charity.[52] Some community foundations in trust form have established affiliated corporations to administer smaller philanthropic funds and general business operations, such as establishing pension trusts for employees. Some have even converted from trust to corporate form.[53]

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[48] Examples of a community foundation with an incorporated distribution committee that has funds which it holds in its own name, and is also affiliated with several separate trusts can be found in GCM 37818 (ran. 11, 1979) and GCM 38812 (Aug. 31, 1981).

[49] Treas. Reg. Section 1.170A-9 (e) (11) (i). An example of a community foundation in a "hybrid form" (both corporations and trusts) is an incorporated distribution committee that has funds which it holds in its own name, and is also affiliated with several separate trusts See GCM 37818 (Jan. 11, 1979) and GCM 38812 (Aug. 31, 1981).

[50] This issue is discussed in Sections ONE.D and THREE.A.

[51] For an extended analysis of the advantages and disadvantages of choosing one legal structure over another as well as sample legal forms, see *Starting a Community Foundation*, (Council on Foundations 1989).

[52] Many of the prominent individuals who serve on the board of directors of a community foundation are often asked to serve on the boards of other prestigious charities. When these charities apply for a grant from the community foundation the director may have a conflict of interest because of potentially conflicting duties to each organization.

Although the conflict of interest exists whether the community foundation is in trust form or in corporate form, the trust fiduciary standards are generally stricter than those incorporate form. Most states have statutes that permit contracts between two corporations (either for-profit or non-profit) with common directors to be valid, provided (1) there has been full disclosure of the director's relationship with the other organization and (2) the transaction was approved by a majority vote of disinterested directors. Some of the community foundations that have formal policies on conflicts of interest are California, Chicago, Cleveland, Kansas City, Milwaukee, Minneapolis, and New Hampshire.

The IRS has presented prototype conflict of interest policies regarding compensation arrangements for executives and other employees in its 1997 training manual. It can serve as a model for any type of charitable organization. "Draft of IRS's New Conflicts of Interest Policy," 96 Tax Notes Today 130-10 (July 10, 1996).

[53] For illustrations of how a community foundation can make the transition with IRS approval, see Private Letter Rulings 8906008 (Nov. 8, 1988) and 9203038 (Oct. 22,1991). See also Private Letter Rulings 8621112 (Jan. 28, 1986) and 8635044 (June 3, 1986) and GCMs 37818 (Jan.11,1979) and 38812 (Aug. 31, 1981) for illustrations of how both the trust and corporate form can co-exist. Private Letter Ruling 9212030 (Dec. 24, 1991) involved a community trust that was a component fund of a community foundation by, in effect, transferring all of its assets to the community foundation. See also Private Letter

C. Required Status as a Charitable Organization Under Section 501(c)(3) 1.

1. OVERVIEW

In addition to being a valid organization under state law, a community foundation must be organized and operated in such a way that it qualifies as a charity under Section 501 (c) (3) of the Internal Revenue Code. A charity's activities must be primarily "charitable,"[54] a although some unrelated activities are permitted, such as lobbying for changes in the law or providing a few commercial services for a fee.[55]

2. ORGANIZATIONAL TEST

The organizational test requires the organizational documents (articles of incorporation, articles of association or trust instrument) to state that the community foundation will be operated "exclusively" for charitable purposes.[56] The organizational documents must also provide that in the event of dissolution, the assets will be transferred to another public charity.[57] A community foundation in trust form will usually have provisions that satisfy the community trust single entity tax regulations in its trust instrument. A community foundation in corporate form can have these provisions in its articles of incorporation but it may be preferable to put them in the bylaws.[58]

3. OPERATIONAL TEST

The operational test determines whether the organization's actual activities are primarily charitable or not. Although the organizational documents must state that the organization operates "exclusively" for charitable purposes, that term has been interpreted to mean "primarily."[59] Consequently, an insubstantial amount of non-charitable activities, such as lobbying, can take place. An organization will lose its charitable status if it engages in a substantial amount of non-charitable activities.[60] In

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Rulings 9621040 (Feb. 27, 1996), 9530010 (Apt. 21, 1995), 9315033 (Jan. 22, 1993) and 9147054 (Aug. 27, 1991) for illustrations of how even private foundations can convert from a trust to a corporation.

[54] See Section THREE.B.2 (field of interest funds) for analysis of the types of activities that are considered charitable for a community foundation.

[55] Treas. Reg. Section 1.501 (c) (3)-1 (c) (3) (action organizations) and Treas. Reg. Section 1.501 (c) (3)-1 (e) (insubstantial trade or business can be carried on, but there may be unrelated business income tax). See Section FIVE.B.1 of this publication.

[56] Treas. Reg. Section 1.501 (c) (3)-1(b).

[57] Treas. Reg. Section 1.501 (c) (3)-1 (b) (4). See IRS Publication 557 and the Instructions to Form 1023 for the requirements to obtain tax-exempt status. See also Hopkins, *The Law of Tax-Exempt Organizations*, (John Wiley & Sons - 6th Ed. 1992) p. 80-91, 611-660; Treusch and Sugarman, *Tax-Exempt Charitable Organizations*, (American Law Institute - 2d Ed. 1983) 59-86, 419-444; and Edie*, First Steps In Starling A Foundation* (Council on Foundations, 1989).

[58] See infra n. 111 and the accompanying text. Examples of language that will satisfy the single entity requirements appear in Rev. Rul. 77-333, 1977-2 C.B. 75 and Rev. Rul. 77-334, 1977-2 C.B. 77.

[59] Treas. Reg. Section 1.501 (c) (3)-1 (c) (1).

[60] See the analysis of a commercial enterprise in Section ONE.C.5.

addition, unrelated profit making activities and certain debt-financed financial investments can subject an otherwise tax-exempt charity to the unrelated business income tax (UBIT).[61] Although most states and cities exempt charities from their income, sales and property taxes, a few jurisdictions impose taxes on charities.

4. PRIVATE INUREMENT PROHIBITED

A charity is not permitted to have any shareholders or owners who benefit from its net earnings.[62] Instead, all of its profits are held by the organization and are applied toward its charitable purposes in future years.

The IRS contends that private inurement can also occur through indirect ways. Examples include excessive salaries to directors or executives, large unsecured interest free loans and unwarranted reimbursements of personal expenses.[63] There have been numerous legislative proposals to subject individuals who receive excessive compensation, and others who authorize it to penalties ("intermediate sanctions").[64]

The private inurement prohibition can also prevent individuals from having compensation formulas determined by a charity's net profits. For example, an arrangement where 10% of a community foundation's net profits will be distributed to an individual, in a manner similar to a partnership, would be a violation of the private inurement prohibitions.[65]

5. NOT A COMMERCIAL ENTERPRISE

Although not mentioned in the statute, the courts have adopted a policy that an organization does not qualify as a charity if it is essentially a commercial enterprise.[66] For example, a corporation that operates a restaurant with 100% of its profits devoted to

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[61] See Section FIVE.B.1 for an overview of the UBIT.

[62] Treas. Reg Section 1.501 (c) (3)-1 (c) (2).

[63] *Church of Boston v. Commissioner,* 71 T.C. 102 (1978) (cash grants to officers); *Best Lock Corp. v. Commissioner,* 31 T.C. 1217 (1959) (loans to officers).

[64] As this publication went to press, it appeared likely that Congress would enact legislation that would permit the IRS to impose penalties on individuals who received excessive compensation from public charities and on the people who authorized such payments. "A Critique of the Intermediate Sanctions Proposal Contained in the Revenue Reconciliation Bill of 1995," 13 *Exempt Org. Tax. Rev*. 211 (Feb. 1996).

[65] Treas. Reg. Section 1.501 (c) (3)-1 (c) (2). For example, the IRS refused to grant tax-exempt charitable status to a community foundation that operated a community golf course because it shared the facility's profits with the individuals who managed it. When the community foundation agreed to pay a fixed salary instead, the IRS granted charitable tax status. "Service Issues Exemption Rulings," 94 *Tax Notes Today* 248-3 (Dec. 20, 1994).

[66] Living Faith Ins. v. Commissioner; 950 F.2d 365 (7th Cir. 1991) (restaurants and health food stores operated in accordance with practices of the Seventh Day Adventist Church did not qualify as charities because they were essentially commercial operations). See also Tech Adv. Memo 9540002 (May 31, 1995) (tour operation was essentially commercial). Gallagher, Janne, "Peddling Products: The Need to Limit Commercial Behavior by Nonprofit Organizations," 12 *Exempt Org. Tax Rev*. 1007 (Nov. 1995). Wright, Carolyn, "Commerciality Doctrine Poses Substantial Threat to EOs. 13 *Exempt Org. Tax Rev*. 537 (Apr. 1996).

making charitable grants will not qualify as a charity. The commercial aspects of the organization dominate over the charitable use of profits.

The IRS argued in two court cases that a national donor advised fund should not qualify as a charity because it was essentially a commercial enterprise. The court ruled against the IRS in one case;[67] the other case was still pending at the time of this publication.[68]

6. ABSOLUTE PROHIBITION ON PARTICIPATION IN POLITICAL CAMPAIGNS

A charity can lose its charitable tax-exempt status if it ever participates in any political campaign.[69] The prohibition applies to supporting or opposing any candidate who is running for, or who may be appointed to, public office. As an alternative to complete revocation of taxexempt status, the IRS has the authority to impose a penalty instead.[70]

7, LIMITED PROHIBITION ON LOBBYING

Whereas there is an absolute prohibition for a charity to participate in a political campaign, there is only a limited prohibition on lobbying. The tax laws permit a charity to lobby, provided that lobbying does not comprise a substantial part of its activities.[71]

Lobbying occurs if a charity attempts to influence legislation. More specifically, lobbying includes (1) contacting, or urging the public to contact, members of a legislative body for the purpose of proposing, supporting, or opposing legislation; or (2) advocating the adoption or rejection of legislation. The term "legislation" includes action by Congress, state legislatures, local councils or similar bodies, or public vote on a referendum, initiative, constitutional amendment, or similar change of laws.[72]

The legal limit of permissible lobbying is not easy to determine.[73] If an organization devotes more than 50% of its resources to lobbying, it has clearly exceeded the limit. To provide greater mathematical certainty, Congress enacted a statute that allows a charity to elect a mathematical safe-harbor that will permit it to make maximum lobbying

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[67] *National Foundation,* Inc. v. U.S., 13 Cl. Ct. 486 ,87-2 U.S.T.C. Par. 9602, 60 A.F.T.R. 2d 5926 (1987).
[68] Fund for Anonymous Gifts v. U.S., U.S. District Court (Wash. D.C.); Dkt. No. 95-CV-1629 (1996).
[69] Section 501 (c) (3); Treas. Reg. Section 1.501 (c) (3)-1 (c) (3) (ii). Miller, Joel, "Political Activity Excise Taxes and the Religious Section 501 (c) (3) Organization: The Death of the De Minimis Exception? A Critical Look at the Excise Taxes of Section 4955 and Its Regulations," 13 *Exempt Org. Tax Rev*. 631 (Apr. 1996).
[70] Section 4935. There is only one reported instance of this penalty being applied: Tech Adv. Memo. 9609007 (Dec. 6, 1995) (charity that was closely associated with a political party sent fundraising letters that violated the prohibition by encouraging readers to imagine certain political candidates being defeated). See also "IRS to Exempts: Politicking Will CostYou," 13 *Exempt Org Tax Rev*. 724 (May, 1996).
[71] Treas. Reg. Section 1.501 (c) (3)-1 (c) (3) (ii).
[72] *Id.*
[73] See generally Edie, *Foundations and Lobbying. Safe Ways To Affect Public Policy* (Council on Foundations). See also Boisture "What Charities Need To Know To Comply with the Lobbying Disclosure Act of 1995," 13 *Exempt Org Tax Rev*. 35 (Jan. 1996). If the IRS revokes a charity's tax status for excessive lobbying, it is prohibited from converting into a Section 501 (c) (4) social welfare organization. Treas. Reg. Section 1.301 (c) (4)-1 (a) (2) (ii).

expenditures up to a certain percentage of the organization's budget; the exact amount varies with the size of the organization.[74]

D. Requirements To Be a Single Entity for Tax Purposes

1. THE REASON FOR ADDITIONAL REQUIREMENTS

When Congress created a distinction between the tax treatment of private foundations and public charities, controversy arose over the tax treatment of community foundations organized in the form of multiple trusts. [75]The Department of Treasury could have treated such a community foundation as a partnership of trusts, in which case each trust would be treated as a separate private foundation with its own obligation to file tax returns. Instead, after considerable negotiations with representatives of many community foundations, the Department issued regulations that treated a community foundation as a single entity with many component funds.[76]

The significance of these regulations is that a donor can treat a contribution to a separate trust[77] or corporation,[78] which could otherwise have been treated as an independent charity, as a contribution to a component part of a community foundation. Thus, for tax purposes, the fund is considered part of the community foundation and the contribution is treated as a contribution "to" the community foundation for purposes of the public support test.[79] Even though the trust or corporation holds legal title to the

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[74] Section 501(h); Treas. Reg. Section 1.501(h). To date only about 2% of the nation's charities have elected this option despite repeated efforts of the IRS to encourage charities to make the election. Compliance with the election requires a charity to have adequate accounting systems to allocate the resources spent between lobbying and exempt activities, which may discourage some organizations from making the election. "Lobbying and Political Activities of Charities," 8 *Exempt Org Tax. Rev*. 303 (Aug. 1993).

[75] The first distinction appeared in Section 209 (a) of Revenue Act of 1964, P.L. 88-272 which permitted donors to deduct a greater percentage of their adjusted gross income for contributions to publicly supported charities. See Section 170(b)(1) (A) of the Code (circa 1964 to 1969). The old tax regulations specifically included community foundations as public charities. See Treas. Reg. Section 1.170-2 (c) (5), Example (1) (1968). Many more significant changes were made as part of the Tax Reform Act of 1969, P.L. 91-172 which enacted most of the excise taxes imposed on private foundations.

[76] The final regulations are contained in Treas. Reg. Sections 1.170A-9 (e) (10)-(14). The proposed regulations that were substantially amended can be found in the notices of proposed rulemaking contained in the Federal Register: 36 Fed. Treas. Reg. Section 19,598 (Oct 8, 1971), 41 Fed. Treas. Reg. Section 50,649 (Nov. 17, 1976), and 41 Fed. Treas. Reg. Section 50,698 (Nov. 17,1976). Explanations of what the drafters of the regulations intended can be found in the IRS internal documents that transmitted the proposed regulations: T.D. 7242 (Sept 14, 1971 and Oct 30, 1972), T.D. 7440 (Nov. 10, 1976), and T.D. 7465 (Nov. 10, 1976 and Jan. 18,1977). These documents are available through the LEXIS computer service.

[77] Treas. Reg. Section 1.170A-9 (e) (11) (ii) specifically mentions trusts.

[78] An example of a corporation that qualified as a component fund is in Private Letter Ruling 8621112 (Feb. 28, 1986).

[79] See Treas. Reg. Section 1.170A-9 (e) (11) (ii) (the second to last sentence) and Private Letter Ruling 8752031 (Sept. 28, 1987). For a donor to be eligible for this treatment, the community foundation must be a publicly supported organization under Section

assets,[80] it will not be required to file a separate tax return since its financial transactions will be included with those of the community foundation.[81] Similarly the community foundation can treat the same contribution as one that will help it satisfy the public support test.[82]

2. REQUIREMENTS FOR TREATMENT AS A SINGLE ENTITY

In order for multiple trusts, not for profit corporations or unincorporated associations to be treated as a single entity for tax purposes rather than as separate organizations, the community foundation must comply with the six single-entity requirements that are described below.[83] If any trust or other eligible organization meets these requirements, it must be treated as a component part of the community foundation.[84]

If, however, a community foundation is a corporation that merely uses fund accounting (i.e., it does not hold any fund in a separate trust or corporation), it is not required to meet these six requirements in order to be treated as a single entity.[85]

a. Must Be Commonly Known as a "Community Foundation," "Community Trust" or "Community Fund"

The organization must be commonly known as a "community foundation," "community trust" or "community fund" or some other similar name conveying the concept of a capital or endowment fund to support charitable activities in the community or area it serves.[86] The regulations do not specify a minimum or maximum geographic area to be served .[87]

170(b) (1) (A) (vi) at the time the contribution is made. *Id* For the legal significance of the term "to" compared to the phrase "for the use of," see the text of supra. n. 42 and Hoyt, "Pooled Income Funds of Community Foundations; IRS Swiftly Revokes Its Revenue Ruling," 58 *Tax Notes* 1499 (Mar. 13, 1993).

[80] Treas. Reg. Section 1.507-2 (a) (8) (v), Example (3). See also GCM 38812 (Aug. 31, 1981) for an extensive analysis concerning whether the administration of property by a trustee poses any problems for treatment as a component fund.

[81] 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.

[82] See Treas. Reg. Section 1.170A-9 (e) (11) (ii) (the second to last sentence) and GCM 38812 (Aug. 31, 1981).

[83] Treas. Reg. Sections 1.170A-9 (e) (11) (i) and 1.170A-9 (e) (11) (iii) through (vi).

[84] In other words, a community foundation does not have the freedom to pick and choose among the trusts that meet the single entity requirements and exclude those that could pose problems. See, for example, GCM 37818 (Jan. 11, 1979) and GCM 38812 (Aug. 31, 1981) in which a community foundation attempted to argue that a trust was not a component part of the community foundation because its large investment income would cause the entire community foundation to fail the public support test. The IRS rejected the argument because the trust met the requirements of the single entity regulations and, consequently, the community foundation failed the public support test.

[85] See Section ONE.D.3 of this publication for further analysis.

[86] Treas. Reg. Section 1.170A-9 (e) (11) (iii).

[87] Treas. Reg. Section 1.170A-9 (e) (11) (iii) states that a community trust supports charitable activities "in the community or area it serves" but there is no geographic restriction. The Council on Foundations recommends a maximum of three states to be considered a community foundation. The geographic area can be much smaller. For example, the Marin Community Foundation serves only a single county: Marin

b. Common Instrument

All funds of the community foundation must be subject to a common governing instrument or a master trust or agency agreement.[88] If a donor states in the instrument of transfer that the fund will be subject to this document, the common governing instrument requirement will be met even if the fund is a separate entity, such as a trust or corporation.[89]

c. Common Governing Body

The community foundation must have a common governing body which either directs or, in the case of a fund designated for specified beneficiaries,[90] monitors the distribution of all of the funds exclusively for charitable purposes. Typically the board of directors of a community foundation in corporate form, or the trustees of one in trust form, will meet this requirement. If the community foundation consists of multiple trusts whose grants are determined by a distribution committee of the community foundation, then the distribution committee will be considered the governing body rather than the trustees of the various trusts.[91]

Another set of tax regulations describes the composition of the governing body for purposes of passing a "facts and circumstances" test to determine the extent of a community foundation's independence from its donors.[92]

County, California. *San Francisco Foundation v. County of Marin*, 37 Cal. 3d 285, 690 P.2d 1, 208 Cal. Rptr 31 (1984).

By comparison, the U.S. Court of Claims concluded that a national organization that administered "project accounts" (similar to advised funds of a community foundation) qualified as a Section 501 (c) (3) tax-exempt charitable organization. Surprisingly, none of the community foundation regulations were mentioned. *National Foundation, Inc. v. U.S.,* 13 Cl. CL 486, 87-2 U.S.T.C. Par. 9602,60 A.F.T.R. 2d 5926 (1987). Another similar case involving a national donor advised fund was still pending at the time of publication: *Fund for Anonymous Gifts v. U.S*., U.S. District Court (Wash. D.C.); Dkt. No. 95-CV 1629 (1996).

[88] Treas. Reg. Section 1.170A-9 (e) (11) (iv). The governing instrument may be embodied in a single document or several documents containing common language. Even if a community foundation adopts anew governing instrument or creates a corporation for future contributions, the common instrument requirement will generally be considered as having been met The IRS appears willing to take a liberal attitude and has stated that a trust will meet this requirement (and be treated as a component fund) with a simple provision that assets will be disbursed for purposes consistent with the bylaws of the community foundation. See the last page of GCM 38812 (Aug. 31,1981).

[89] *Id.*

[90] Treas. Reg. Section 1.170A-9 (e) (11) (v) (A) provides that a fund is designated for specified beneficiaries only if no person is left with the discretion to direct the distribution of the fund.

[91] *Id.*

[92] Treas. Reg. Section 1.507-2 (a) (8) (ii). The regulation examines whether the governing body is controlled by the charity's donors and whether or not their terms service are limited to a maximum of ten consecutive years. Treas. Reg. Sections 1.507-2 (a) (8) (ii) (C) and Treas. Reg. Sections 1.170A-9 (e) (13) (iv) (A) and (B). See Section THREE.B.5.a for general rules and Private Letter Ruling 8635044 June 3, 1986) in which the IRS approved extended terms of ten years for some directors.

A charity argued in a 1996 court case that the composition of the governing body and its term limitations are irrelevant if the charity is able to pass the 33-1/3% public support test (described in Section TWO.D.1

d. Variance Power

The governing body (described above) must have, and must commit itself toward exercising,[93] the following powers:[94]

1. Variance Power Over Charitable Purpose

The governing body must have the power to modify any restriction or condition on the distribution of funds for any specified charitable purpose or to any specified organization if, in the sole judgment of the governing body, such restriction or condition becomes, in effect, unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community or area served.[95] The governing body must be able to modify the restriction without obtaining the approval of any participating trustee, custodian, or agent of the community foundation. However, a donor might be able to require the community foundation to obtain the donor's consent[96] or the consent of a state authority.[97]

This requirement is commonly referred to as the "variance power" and has historically been the hallmark of community foundations: the ability of the governing body to exercise the function of cy pres without having to first obtain court approval.[98] Under cy pres, a court will change the purpose of a charitable trust to the nearest similar purpose when the trustor's purpose cannot be achieved because it is impossible, impracticable or illegal.[99] The standards which the regulations set forth for when a governing body should exercise the variance power are slightly broader than the standards that a court

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of this publication). 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).

[93] Treas. Reg. Section 1.170A-9 (e) (11) (v) (E).

[94] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B).

[95] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (1). This regulation was cited in *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274, at 1280 (7th Cir. 1979).

[96] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (1). A donor may be able to require the community foundation to obtain the donor's consent to modify such a restriction since a charity (particularly one in trust form) is under a duty to carry out a donor's intent. In Private Letter Ruling 8225165 (Mar. 29, 1985) the IRS approved a donor-imposed restriction that a community foundation had to obtain the consent of the advisory committee before changing the charitable purpose of a fund. This restriction may have been moot since outer provisions of the agreement may have granted the governing body of the community foundation the authority to override any act of the advisory committee.

[97] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B). See infra n. 103.

[98] Normally changes to a trust instrument must be approved by a probate court. Although it is a hallmark of community foundation to be able to make such a change without probate court approval, this variance power is not unique to them. Any well-drafted charitable trust instrument could allow a trustee to do the same thing. However, such a clause can cause a charitable trust that was intended to be classified as a "supporting organization" of another public charity to fail the supporting organization test and be classified as a private foundation instead. This is because the trustee of that trust, rather than a public charity such as a community foundation, had the power to decide whether the variance power should be exercised. *Quarrie Charitable Fund v. Commissioner*, 603 F.2d 1274, at 1280 (7th Cir. 1979).

[99] 15 Am Jur 2d Charities Sections 133, 137 and 142; Restatement of Trusts 2d Section 399. There would also be the possibility that the assets could be distributed to the heirs of the original donor if the court concluded that the charitable instructions had been completed or were impossible to satisfy.

would use when exercising the doctrine of cy pres.[100] An advantage of allowing a community foundation to make the change is that it, unlike a probate judge, is a charitable specialist and it is better able to identify the best charitable use of the funds for the community.

The easiest case for exercising the variance power is when a charity that was the beneficiary of a designated fund goes out of existence.[101] Through its monitoring function, a community foundation can exercise the variance power if it determines that a charity has significantly changed the nature of its operations. It can also exercise the variance power if an activity is no longer a worthy charitable purpose (e.g., a trust to fund research to find a cure for polio or AIDS after a cure is found).

Any exercise of the variance power is probably reviewable by a court and the state attorney general to see whether the community foundation acted reasonably and whether it properly applied the standards.[102] In fact, a donor can probably impose a requirement that the actions of a community foundation be reviewed by a state authority.[103] At the time of this publication a court case was pending that would be the first judicial interpretation of the variance power.[104] As the Buck Trust and New York Community Trust litigation demonstrate, any attempt to alter charitable restrictions can be very controversial and should be exercised only if the governing body feels that it could be upheld under the applicable legal standards.[105]

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[100] *Id.*

[101] For example, there might be an endowed designated fund for a local charitable hospital that was sold and converted into a for-profit hospital. The governing body of the community foundation could in that case convert the fund into a field of interest fund that makes grants to improve health conditions in the community.

[102] See, for example, Annotation, "Duty of Trustees to Charitable Trust to Furnish Information and Records to Attorney General Relating to Trust Administration," 86 A.L.R 2d 1375 and Annotation, "Right of Attorney General To Intervene in Will Contest Case Involving Charitable Trust," 74 A.L.R. 2d 1066.

[103] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) provides that if the exercise of the power to modify the donor's instructions or to change trustees is reviewable by an appropriate State authority, then that will not preclude a community foundation from meeting the single entity requirements.

[104] In 1995, the Community Service Society of New York, which provides social services and financial aid to the poor, sued The New York Community Trust for having exercised the variance power in 1971 with regard to designated funds that were established for it during the 1930s. It is asking for restitution of over $7 million. The New York Community Trust contends that circumstances and the nature of the Society's operations had dramatically changed from the time that the ousts were first established. The Salvation Army also joined the lawsuit "NY. Community Trust Is Sued for Rerouting Earmarked Donations," *Chronicle of Philanthropy*, p. 16 (Nov. 16, 1995); "A Matter of Trust: Two Titans of Charity Battle over Millions," The New York Times, B; P. 1; (Oct 30, 1993); "Charity Sues Community Foundation," *Wall Street Journal*; P. 9 (Oct. 27, 1995).

[105] The New York Community Trust litigation is described in the preceding footnote. The Buck Trust litigation involved the attempt by The San Francisco Foundation to remove a restriction of the Trust established by Beryl Buck to limit charitable grants to Marin County, California. Her estate consisted of stock in Belridge Oil Company which at the time of her death in 1975 was worth $10 million. In 1979, the company was acquired by Shell Oil Company and the value of the trust jumped to $253 million.

In 1984, The San Francisco Foundation's board agreed by a bare majority vote to seek court guidance to delete the geographic restriction to Marin County and to permit grants to the entire San Francisco Bay area. The court action was opposed by numerous parties, including Marin County, the California Attorney General and a Trustee of the Buck Trust who had drafted Mrs. Buck's will. See San Francisco Foundation a. County of Marin, 37 Cal. 3d 285, 690 P.2d 1, 208 Cal. Rptr 31 (1984). On July

2. Power To Replace Trustee for Either (1) Preach of Fiduciary Duty or (2) Inadequate Investment Performance

The tax regulations require a community trust to have the power to replace a trustee, custodian or agent under at least two circumstances. The first circumstance is if a trustee, custodian, or agent has breached a fiduciary duty under state law.[106] The second is if a trustee, custodian, or agent has failed to produce a reasonable return of net income over a reasonable period of time. [107] The governing body may determine what constitutes a reasonable return and a reasonable period of time.[108]

Although these are the only two circumstances that are mentioned in the tax regulations, there shouldn't be any problem if a community foundation insists on the ability to replace a trustee under additional situations. By comparison, an irrevocable relationship with a trustee or an investment advisor would probably constitute a "material restriction" that would prevent the trust from qualifying as a component fund.[109]

The community foundation's power to replace a trustee does not need to be expressly stated in each trust instrument that establishes a component fund. It can become a part of the terms of the trust instrument when the trust agrees to become subject to the common governing instrument of the community foundation.[110]

3. Drafting Variance Power And Other Matters

The variance powers to change a charitable purpose or replace a trustee, and the commitment to exercise them, often appear in a community foundation's governing instrument, although they can also appear in other documents. The regulations state that they must appear in either the governing instrument (articles of incorporation or trust agreement), the instrument of transfer to establish a fund, the resolutions or bylaws of the governing body, a written agreement, or some other document that grants these powers to the governing body.[111] It is advisable to have them in the bylaws since they are easier to amend than the organizational documents and, after a number of years,

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23, 1986 the San Francisco Foundation agreed to a settlement whereby it relinquished control and administration of the Buck Trust to an independent charitable organization: The Marin Community Foundation.

See also Sisson, "Relaxing the Dead Hand's Grip: Charitable Efficiency and the Doctrine of Cy Pres," 74 *Va. L. Rev*. 635 (Apr. 1988). 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, Cinder Doctrines of Cy Pres or Equitable Deviation," 68 A.L.R. 3d 1069. See also Annotation, "Charitable Trusts: Elimination or Modification by Court of Restrictions on Amount of Donation or Expenditure Which Trustee May Make for Purposes of Trust," 50 A.L.R. 3d 1116 and Annotation, "Power of Court To Authorize Modification of Trust Instrument Because of Changes in Tax Law," 57 A.L.R. 3d 1044.

[106] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (2).

[107] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) (3). The definition of a reasonable investment return is contained in Treas. Reg. Section 1.170A-9 (e) (11) (v) (F) and Section ONE.D.2.e of this publication.

[108] *Id.*

[109] Treas. Reg. Section 1.5072 (a) (8) (iv) (F). See Section THREE.C.6 of this publication.

[110] GCM 38812 (Aug. 31, 1981) (the last page).

[111] Treas. Reg. Section 1.170A-9 (e) (11) (v) (B).

they are generally easier to locate than resolutions or agreements. The IRS has issued revenue rulings that contain suggested language for governing instruments and resolutions that will meet these requirements, although a community foundation is free to use other terminology.[112]

A problem could arise if state law does not permit the governing body of a community foundation to use the variance power or to replace a trustee without court approval. The tax regulations provide that a community foundation will meet the variance power requirements if it commits itself to meeting these objectives to the fullest extent possible under the law.[113] A transitional rule also exists that modifies these requirements for instruments of transfer that were executed before July 19, 1977.[114]

e. Reasonable Return on Investments

The governing body must (by resolution or otherwise) commit itself (1) to obtain information and (2) to take other appropriate steps with the view to seeing that each participating trustee, custodian, or agent, administers the trust or fund in accordance with the terms of its governing instrument and accepted standards of fiduciary conduct to produce a reasonable return of net income (or appreciation where not inconsistent with the community foundation's need for current income), with due regard to safety of principal.[115] Although the measurement of performance is on an aggregate basis for most component funds, it is on a fund by-fund basis for designated funds.[116] Assets

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[112] Rev. Rul. 77-333, 1977-2 C.B. 75 and Rev. Rul. 77-334,1977-2 C.B. 77.

[113] For example, Treas. Reg. Sections 1.170A-9 (e) (11) (v) (D) (1) and (2) provide that if the power to modify is inconsistent with state law, but if the power to institute proceedings to modify (if so expressly granted) is consistent with state law, a community foundation will be treated as meeting these requirements to the fullest extent possible if the governing body has the power to institute proceedings to modify a condition or restriction. See also Rev. Rul. 77-334, 1977-2 C.B. 77.

On the other hand, if in such a case the community foundation has only the power to cause proceedings to be instituted by someone else to modify a condition or restriction, it will not be treated as meeting these requirements to the fullest extent possible. However, Treas. Reg. Section 1.170A-9 (e) (11) (v) (D) (3) provides that if the power to modify and the power to institute proceedings to modify a condition or restriction is inconsistent with state law, but the power to cause such proceedings to be instituted would be consistent with state law (if it were expressly granted in the governing instrument and if the approval of the State Attorney General were obtained) then a community foundation will be treated as meeting these requirements to the fullest extent possible if it has the power (in the governing instrument or otherwise) to cause proceedings to be instituted, even if such proceedings can be instituted only with the approval of the State Attorney General.

Treas. Reg. Section 1.170A-9 (e) (11) (v) (B) also provides that if the exercise of the power to modify the donor's instructions or to change trustees is reviewable by an appropriate state authority, then that will not preclude a community foundation from meeting the requirements.

[114] Treas. Reg. Section 1.170A-9 (e) (11) (v) (C).

[115] Treas. Reg. Section 1.170A-9 (e) (11) (v) (F). See Rev. Rul. 77-334,1977-2 C.B. 77 for examples of resolutions approved by the IRS. If there has been a low return of net income or asset appreciation, the IRS will examine whether the governing body has, in fact, committed itself to take the appropriate steps.

[116] Treas. Reg. Sections 1.170A-9 (e) (11) (v) (F) and 1.170A-9 (e) (13) (x). The tax regulations apply the requirement to any fund that has five or fewer readily ascertainable charitable organizations as beneficiaries.

held for the active conduct of the community foundation's exempt activities (e.g., program-related investments) are not subject to this standard.[117]

f. Financial Reports Required

The community foundation must prepare periodic financial reports that treat all of the funds which are held by it, either directly or in component parts, as funds of the organization.[118] A community foundation will still meet the single entity requirements even if it failed to correctly classify some of its component funds.[119]

2. DOES EVERY COMMUNITY FOUNDATION HAVE To MEET THE SINGLE ENTITY REQUIREMENTS?

There is a controversy as to whether a charitable not-for-profit corporation needs to meet the single entity requirements, described above, in order to qualify as a community foundation. It is clear that these requirements must be met if multiple trusts are to be treated as a single entity for tax purposes rather than as separate trusts, but it may be possible for an incorporated community foundation to exist without them. Despite this possibility, most community foundations have included the single entity requirements in their organizational documents and bylaws, including those in corporate form.

The tax regulation that determines whether a community foundation is a single entity states:

> Community trusts; requirements for treatment as a single entity - (i) General rule. For purposes of sections 170, 501, 507, 508, 509, and Chapter 42, any organization that meets the requirements contained in paragraph (e) (11) (iii) through (vi) of this section [i.e., the "single entity requirements"] will be treated as a single entity [Note: does not state "will be treated as a community foundation"], rather than as an aggregation of separate funds, and except as otherwise provided, all funds associated with such organization (whether a trust, not-for-profit corporation, unincorporated association, or a combination thereof) which meet the requirements of paragraph (e) (11) (ii) of this section will be treated as component parts of such organization. [Text highlighted and added by author.]

The IRS has issued several favorable determination letters to incorporated organizations that perform the same functions as community foundations even though their organizational documents did not satisfy the single entity requirements. It thereby agreed in those cases with the argument that this paragraph of the regulations is not a requirement for all community foundations but, rather, exists solely to determine whether multiple legal entities associated with a community foundation can be treated as a single entity for tax purposes.

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[117] For example, an IRS private letter ruling analyzed a group of transactions that included the purchase by a field of interest fund of 22% of the stock of a bank holding company that owned a minority-owned bank. Private Letter Ruling 9134033 (May 31, 1991). Presumably this stock served a charitable purpose and would not be subject to the same requirements concerning a reasonable return on investments.
[118] Treas. Reg. Section 1.170A-9 (e) (11) (vi).
[119] See GCM 37818 (Jan. 11, 1979) at footnote 3.

What, then, is a community foundation? We might simply be left with the vague definitions described in Section ONEA of this publication. If that is the case, then all that is legally required to have a community foundation is to have a Section 501 (c) (3) organization that "conveys the concept of a capital or endowment fund to support charitable activities in the community or area it serves."

The tax regulations give community foundations the unique opportunity to treat separate trusts as component parts of the foundation. Consequently, most community foundations will include the single entity requirements in their organizational documents or bylaws in order to obtain the benefits they offer, even though they might not be obligated as a matter of law to do so and even though the rules might impose some additional burdens.[120]

4. TRANSITIONAL RULES FOR COMMUNITY FOUNDATIONS IN EXISTENCE BEFORE NOVEMBER 11, 1976

The tax regulations contain transitional rules for certain community foundations that were in existence before 1976. These rules qualified them to be treated as publicly supported organizations under special rules until 1982, and to then qualify under the general rules.[121] They illustrate some of the agreements reached between the Department of Treasury and representatives of community foundations and also illustrate some of the perceptions as to what constitutes a community foundation.

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[120] Although omitting the single entity requirements frees a community foundation from having to comply with them, perhaps the primary disadvantage of omitting them is that it will probably prevent a community foundation from being able to treat a separate trust established by a donor outside normal operating procedures as a component fund. Such a oust will probably be classified as a private foundation unless it can meet the organizational and operational requirements of a public charity. See Section FOURA of this publication.

If a community foundation does not meet the single entity requirements, its funds should simply be an accounting technique to allocate a proportionate share of its commingled assets toward carrying out the various charitable purposes of the foundation. These purposes are usually specified either in the instruments of transfer executed by donors or in the resolutions of the governing body which establish the funds.

To avoid multiple entities, an incorporated community foundation that transacts business with banks and other investment companies should consider using arrangements other than trust agreements. Caution is required because in some instances even agency and custodial arrangements can be considered separate entities. The material restriction regulations provide that agency and custodial agreements might be treated for tax purposes as separate funds. Treas. Reg. Sections 1.170A-9 (e) (11) (iv), 1.170A-9 (e) (11) (v) (B) (1), (2) and (3), and 1.807-2(a) (8) (i) (A). Consequently, rather than have a custodian or agent manage financial investments on a fund-by-fund basis, it might be better to transfer money to the custodian or agent and then have the community foundation allocate proportionate shares of the assets and investment income to the funds.

[121] Treas. Reg. Sections 1.170A-9 (e) (12) and 1.170A-9 (e) (13).