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ARTICLES

SUPPORTING THE SUPPORTING ORGANIZATION: THE POTENTIAL AND EXPLOITATION OF 509(A)(3) CHARITIES

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"One of the serious obstacles to the improvement of our race is indiscriminate charity."

Andrew Carnegie[1]

SUMMARY

Supporting organizations, a type of charity defined in section 509(a)(3) of the Internal Revenue Code, have vast potential for philanthropic impact but perhaps equally vast potential for abuse. Donors who establish supporting organizations may retain inappropriate levels of control over the assets they contribute, hoard funds within the organization rather than actually using them to accomplish a charitable benefit, or engage in abusive financial transactions with their supporting organization. This Article discusses the complex tax rules that apply to supporting organizations and explains their unique role in charitable giving. It then explores the allegations of abuse in the supporting organization realm and reviews current proposals for reforming the system. The Article concludes by recommending that the public disclosure rules be amended to require fuller transparency of the activities of supporting organizations and greater availability of this information.

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1. *See* The Quotations Page, Quotations by Author, Andrew Carnegie, http://www.quotationspage.com/quotes/Andrew_Carnegie/ (last visited Feb. 7, 2006).

INTRODUCTION

Charity is perhaps the most regulated of the seven virtues. Although charity is often motivated by the best of intentions, modern charitable giving is riddled with scandals, complex regulations, and the overarching need for reform. One area of charitable giving struggling for legitimacy is the supporting organization,[2] a type of charity that derives its freedom from income tax by reason of its relationship with other charities who enjoy broad public support.[3]

Supporting organizations are growing in popularity, net worth, and importance.[4] According to the National Center for Charitable Statistics, there was a 26.1% increase in the number of existing supporting organizations between 1996 and 2004.[5] In 2001, there were almost 400 large supporting organizations (organizations with assets over $50 million) with total assets of $76.7 billion.[6] In 2004, a total of 45,453 supporting organizations were associated with public charities.[7]

While many wealthy Americans are doing well by doing good, a clever and devious few are using the complicated supporting organization structure for doing well by doing bad. The regulations that apply to supporting organizations are detailed and complex, but loopholes exist and the system is, to some degree, being exploited. Unlike private foundations,[8] supporting organizations have no regime of excise taxes restricting their behavior, and these organizations can be manipulated through self-dealing transactions that are hard to detect.[9]

A tight legal framework is necessary to prevent supporting organizations

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2. *See* I.R.C. § 509(a)(3) (2000). A "supporting organization" maintains certain relationships with other charities. *Id.* Examples of a supporting organization include a university printing press, Friends of the Swampscott Public Library, Friends of Harvard College, or similarly named groups.

3. *See id.* § 509(a)(1)-(2). A "publicly supported organization" is a type of charity that generally is required to obtain a substantial amount of its support from the general public or from gross receipts from its charitable activities. *Id.* Examples of publicly supported organizations include museums, orchestras, universities, and churches.

4. Recent testimony before the Senate Finance Committee given by Jane G. Gravelle, Senior Specialist in Economic Policy for the Congressional Research Service of the Library of Congress, examined the issues surrounding supporting organizations. *See Charities and Charitable Giving: Proposals for Reform: Hearing Before the S. Comm. on Finance*, 109th Cong. (2005) (statement of Jane G. Gravelle, Senior Specialist in Economic Policy Congressional Research Service), *available at* http://www.finance.senate.gov/hearings/testimony/2005test/jgtest040505.pdf [hereinafter Gravelle Statement].

5. *See id.; see also* National Center for Charitable Statistics, Number of Nonprofit Organizations in the United States 1966-2004 (Dec. 2004), *available at* http://nccsdataweb.urban.org/PubApps/profile1.php?state=US.

6. *See* Gravelle Statement, *supra* note 4, at 13.

7. *See id.*

8. *See* I.R.C. §§ 4941- 4945 (2000).

9. *See* Gravelle Statement, *supra* note 4, at 14.

from being abused. The regulations governing supporting organizations are already extremely complex. It is not exactly a compliment for a tax regulation to be called "fantastically intricate and detailed" by a federal district court judge, as supporting organizations have been.[10] But are the supporting organization regulations themselves the problem, and are they the only source of a solution?

Some reformers believe rewriting the supporting organization regulations is necessary—perhaps even to the extent of eliminating a form of supporting organization that the regulations created. Would this approach be necessary or sufficient? Or might the problems with supporting organizations lie not in their structure, but in their oversight? This Article suggests the latter. The abuses plaguing the supporting organization culture may be related to the way in which supporting organizations are required to share their information with the public: the public disclosure rules.

Supporting organizations offer a creative planned giving option and a unique charitable structure. This Article explores the role of these charities, the abuses related to them, and proposals for reforming them. First, Parts I and II discuss the history of supporting organizations and the tax rules that govern them. Next, Part III explores what makes supporting organizations such a unique and useful charitable tool. Part IV then examines modern concerns with supporting organization abuse, and Part V discusses proposals for reform. Finally, Part VI recommends a way to reform supporting organizations through a back-door—by expanding the public disclosure requirements.

I. HISTORY OF SUPPORTING ORGANIZATIONS

Supporting organizations, in their current form, were established by the Tax Reform Act of 1969 ("Tax Reform Act").[11] This legislation, aimed at curbing abuse of tax-exempt charitable foundations, distinguished two categories of exempt organizations: those that were categorized as private foundations and those that were not.[12] Among those exempt organizations not categorized as private foundations were publicly supported charities,[13] gross receipts charities,[14] organizations promoting public safety,[15] and supporting organizations.[16] The legislative history relating to supporting organizations in the Tax Reform Act is

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10. Windsor Found. v. United States, No. 76-0441-R, 1977 U.S. Dist. LEXIS 13643, at *5 (E.D. Va. Oct. 4, 1977). District Judge Warriner explained that "the Internal Revenue Service has drafted fantastically intricate and detailed regulations in an attempt to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes." *Id.*

11. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended at I.R.C. § 509 (2000)).

12. *See* I.R.C. § 509(a)(1) (2000).

13. *See id.* § 509(a)(2)(A)(i).

14. *See id.* § 509(a)(2)(A)(ii).

15. *See id.* § 509(a)(4).

16. *See id.* § 509(a)(3).

relatively sparse. The Senate Report (No. 91-552)[17] and House Report (No. 91-413)[18] mention supporting organizations only briefly. Notwithstanding the brevity of the congressional record, a review of the legislative history demonstrates a consistency in the justification for tax-exempt status of supporting organizations.

The oversight rules created in the Tax Reform Act, applicable to private foundations, were created to combat abusive transactions rampant in the world of charitable foundations. Public charities were not subject to these rules, based on the belief that dependence on public support and accompanying public scrutiny would prevent such abuse from occurring with charitable funds.[19] Supporting organizations were distinguished from organizations subject to the rules applicable to private foundations because, in theory, "[supporting organizations] are subject to the scrutiny of a public charity."[20]

A. House and Senate Reports of the 1969 Tax Reform Act

The House Report of 1969 explains the establishment of section 509, defines "private foundations," and explores why certain types of charities are excluded from this definition and the rules incumbent upon private foundations.[21] After differentiating publicly supported organizations and gross receipts organizations, the House discussed supporting organizations:

> Another category of organizations removed from the definition of private foundations comprises those organizations which are organized and operated exclusively for the benefit of one or more of the 30-percent organizations or broadly based organizations described above, provided that they are operated, supervised, or controlled by one or more such organizations, or in connection with one such organization, and are not controlled directly or indirectly by disqualified persons (other than foundation managers, 30-percent organizations, and broadly based organizations described above). In general, religious organizations other than churches, the Hershey Trust (which is organized and operated for a specific school for orphaned boys and is controlled in connection with that school), university presses, and similar organizations are examples of organizations expected to qualify for this category.[22]

The Senate Report is virtually identical but does not name the Hershey Trust explicitly. Instead, it generally describes "organizations organized and operated for the benefit of a specific school and also controlled by or operated in

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17. *See infra* note 23.
18. *See infra* notes 21-22.
19. Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277-78 (7th Cir. 1979).
20. *Id.* at 1278.
21. H.R. REP. NO. 91-413, pt. 1 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 1645, 1686.
22. *Id.* at 225-27.

connection with that school."[23]

Although the legislative history is sparse, the reasoning behind Congress's creation of supporting organizations is expressed consistently. Supporting organizations do not need the rigorous oversight of the private foundation tax rules because they are theoretically monitored by publicly supported charities and therefore are indirectly overseen by the public. The same justification for their tax exemption has been expressed in case law.

In *Cockerline Memorial Fund v. Commissioner*,[24] the Tax Court discussed Congress's intent when it enacted section 509.[25]

> Public charities are exempt from private foundation treatment and, consequently, the excise taxes, on the theory that public scrutiny arising from a foundation's dependence upon public funds will prevent abusive acts by the foundation. Supporting organizations are similarly excepted on the theory that scrutiny by the publicly supported organizations will prevent abuse by the supporting organization. The belief that scrutiny by a publicly supported organization, under the appropriate circumstances, is sufficient to guard against abuse by the supporting organization is embodied in section 509(a)(3). The provisions of that section are designed to insure that a supported organization has the ability and motivation to properly oversee the activities of the supporting organization.[26]

In *Cockerline*, the court concluded that a "close and continuous relationship" existed between the supported charity and the petitioner involved in the case.[27] The relationship produced "the type of close scrutiny which renders unlikely the congressionally feared abuses," and, in fact, no such abuses occurred in the *Cockerline* organization.[28]

It is clear that Congress acknowledged the special role supporting organizations play and intended to provide a structured context in which supporting organizations would operate scrupulously. This structure relies upon attention by the supported charity to insure that abuses are curtailed.

B. Like Taxes for Chocolate—The Hershey Trust Testimony

The Hershey Trust and its proponents were critical in developing the treatment of the supporting organization as exempt from the private foundation taxes of the 1969 Tax Reform Act. Pennsylvania's senior senator, Hugh D. Scott, Jr., offered several pages of testimony explaining why the enactment of section

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23. S. REP. NO. 91-552 at 460-62 (1969), *as reprinted in* 1969 U.S.C.C.A.N. 2027, 2085-86.
24. 86 T.C. 53 (1986).
25. *Id.* at 64-65.
26. *Id.* at 65 (internal citations omitted).
27. *Id.*
28. *Id.*

509(a)(3) was of particular importance to the Hershey Trust.[29]

The Milton Hershey School is an institution that originally housed poor orphan boys in Hershey, Pennsylvania.[30] Milton Hershey, who founded the Hershey Chocolate Company, established the school in 1909, before federal income taxes. Rather than funding the school directly, he established two entities: the school itself and a trust to hold the school's assets. The school qualified as a publicly supported charity because it was an educational organization, having a regular faculty, curriculum, and student body. The IRS apparently considered the trust to be effectively the same entity as the school, since the governing body of the trust and the school were the same and had similar purposes.[31]

However, the 1969 Tax Reform Act caused some concern that the trust would be treated as a private foundation under the new rules. Senator Scott defended the trust, stating that it would be "most unfortunate" if the private foundation rules applied to the trust, and explaining that the "hardship would have been suffered by the School and its students."[32] Senator Scott's pleas on behalf of the Hershey Trust were well received.[33]

References to the Hershey Trust by name appear in the regulations, and it is clear that this organization was critical in securing the advantages of public charity status to supporting organizations. Were it not for the quirky structure of this chocolate charity, supporting organizations might not exist today.

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29. GERALD B. TREACY, JR., SUPPORTING ORGANIZATIONS, at B-401 to -402 (BNA Tax Management Portfolio No. 871-2d, 2002) (excerpting from Congressional Record of December 6, 1969 (page S15982) (Senate Debate)). The Hershey Trust and the administration of its assets have been under public scrutiny in recent years. *See* Evelyn Brody, *Whose Public? Parochialism and Paternalism in State Charity Law Enforcement*, 79 IND. L.J. 937, 985-99 (2004); Mark Sidel, *The Struggle for Hershey: Community Accountability and the Law in Modern American Philanthropy*, 65 U. PITT. L. REV. 1, 2 (2003).

30. The school was originally founded for orphan boys, but the Milton Hershey School now accepts students of both sexes, and they do not have to be orphans. *See* Milton Hershey School, Admissions Criteria for New Students, http://www.mhs-pa.org/admissions/criteria/ (last visited Feb. 7, 2006).

31. *See* TREACY, *supra* note 29, at B-401 (referencing a 1951 Revenue Ruling issued to the school and the trust).

32. *Id.*

33. *Id.* Senator Wallace F. Bennett of Utah, a member of the Committee on Finance, stated in his testimony that he would like to

> assure the senior Senator from Pennsylvania that the committee . . . was very mindful of the problem that certain organizations would have had in the absence of proposed section 509(a)(3) . . . [and that] the sort of situation involving the Milton Hershey School described by the senior Senator from Pennsylvania is what the Committee on Finance had in mind when it approved this part of the bill.

Id.

II. TAX RULES APPLICABLE TO SUPPORTING ORGANIZATIONS

A. Overview[34]

The Tax Reform Act of 1969 created a scheme of rules that apply to private foundations.[35] These regulations specifically did not apply to charities that were not categorized as private foundations.[36] Supporting organizations were not private foundations, and thus were exempt from the new rules.[37]

Supporting organizations are instead subject to the requirements of section 509(a)(3) of the Internal Revenue Code and that section's treasury regulations. Section 509(a)(3) provides that an organization is *not* a private foundation and is therefore classified as a supporting organization if it:

> (A) is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2),
>
> (B) is operated, supervised, or controlled by or in connection with one or more organizations described in paragraph (1) or (2), and
>
> (C) is not controlled directly or indirectly by one or more disqualified persons . . . other than foundation managers and other than one or more organizations described in paragraph (1) or (2).[38]

As developed more fully in the regulations, 509(a)(3) establishes an Organizational Test and an Operational Test (in part A), a Type of Relationship Test (in part B), and a Control Test (in part C).[39] The Organizational and Operational Tests vary depending upon how the organization is classified under the Type of Relationship Test. The best way to understand the regulations is to begin with a discussion of the three types of relationships supporting organizations have with their supported charities.

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34. See Appendix A for a "map" of supporting organization structures resulting from the applicable tax regulations.

35. *See* Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified as amended at I.R.C. § 509 (2000)).

36. Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277 (7th Cir. 1979). "The definition of a private foundation is intentionally inclusive: all organizations exempted from tax by Section 501(c)(3) are private foundations except for those specified in Section 509(a)(1) through (4). The exceptions are churches, schools, and hospitals, § 509(a)(1), other publicly supported organizations, § 509(a)(2), and supporting organizations of such excepted organizations." *Id.* (citations omitted).

37. *Id.*

38. I.R.C. § 509(a)(3) (2000). For simplicity, this Article uses the term "charity' to refer to "organizations described in paragraph (1) or (2)."

39. For a good practitioner-oriented overview of the supporting organization rules, see GERALD B. TREACY, JR., SUPPORTING ORGANIZATIONS (1996), and the more recent B.N.A. Tax Management Portfolio of the same title.

B. The Type of Relationship Test

Section 509(a)(3)(B) contemplates three types of relationships between charities and their supporting organizations.[40] The relationships are categorized as Type I, Type II, and Type III, and each type bases its justification for exemption on slightly different language in the Code section.[41] Type I organizations must be "operated, supervised, or controlled by" a charity.[42] Type II organizations must be "supervised or controlled in connection with" a charity.[43] Type III organizations must be "operated in connection with" a charity.[44] Once a supporting organization has established that it meets the description of one of these three types of relationships, it must meet the requirements that apply to that relationship type.

1. Type I Organizations.—Type I relationships are perhaps the simplest. A Type I organization must be operated, supervised, or controlled by its supporting charity.[45] Type I relationships are "comparable to that of a parent and subsidiary, where the subsidiary is under the direction of, and accountable or responsible to, the parent organization."[46] Type I relationships are established when the supported charity (through its officers, members, or all or part of its governing body) appoints or elects a majority of the officers, directors, or trustees of the supporting organization.[47] The regulations provide that "the distinguishing feature [of Type I organizations] is the presence of a substantial degree of direction by the publicly supported organizations over the conduct of the supporting organization."[48]

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40. I.R.C. § 509(a)(3)(B) (2000).

41. First, there is a distinction between charities that rely on the word "by" rather than the phrase "in connection with." Charities that rely on the word "by" are classified as Type I Organizations (operated, supervised, or controlled by a charity—"by" relationships). Type I organizations are "*operated, supervised, or controlled by* or *in connection* with" qualifying charities. Second, there is a distinction, among charities that rely on the phrase "in connection with," between charities that rely on the phrase "supervised or controlled," and charities that rely on the word "operated." Charities that rely on the phrase "supervised or controlled" are classified as Type II Organizations (supervised or controlled in connection with a charity—"overseen with" relationships). Type II organizations are "operated, *supervised, or controlled* by or *in connection with*" qualifying charities. Charities that rely on the word "operated" are classified as Type III Organizations (operated in connection with a charity—"operated with" relationships). Type III organizations are "*operated*, supervised, or controlled by or *in connection with*" qualifying charities. *See id.* § 509(a)(3)(B) (emphasis added).

42. *See* 26 C.F.R. § 1.509(a)-4(a)(3) (2005).

43. *Id.*

44. *Id.*

45. *Id.*

46. *See id.* § 1.509(a)-4(g)(1)(i).

47. *Id.*

48. *Id.* § 1.509(a)-4(f)(4). This direction should extend "over the policies, programs, and activities of the supporting organization." *See id.* § 1.509(a)-4(g)(1)(i).

A Type I relationship may exist even though the supporting organization is not governed by representatives of the charity it supports.[49] It is possible for a supporting organization to be "*operated, supervised, or controlled by*" one charity but to be operated "*for the benefit of*" a different charity.[50] These alternative relationship structures for Type I supporting organization are only allowed if it is clear that the purposes of the operating, controlling, or supervising charity are carried out by benefiting the other charity.[51] Although slight variations on the parent-subsidiary relationship are permitted, most Type I supporting organizations are clearly and directly supervised and controlled by their supported charity.

2. Type II Organizations.—Type II relationships can be more complex than the parent-subsidiary style Type I relationships, but they are still easily categorized and defined. Type II organizations must be "supervised or controlled in connection with" their supporting charities.[52] These organizations are more akin to sibling entities with a common parent, as opposed to the parent-subsidiary relationship characterizing Type I relationships. For example, a supporting organization might function as a subsidiary fundraising entity for a hospital, with both the hospital and the supporting organization overseen by a parent management company.

The regulations provide that "the distinguishing feature [of Type II organizations] is the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors."[53] In Type II organizations, there must be "common supervision or control" by the leaders who oversee both the supporting organization and the supported charity.[54] Some people who have the power to manage or control the supported charity must also manage the supporting organization.[55] This common control requirement is "to insure that the supporting organization will be responsive to the needs and requirements" of the charity it supports.[56]

A supporting organization will not qualify as a Type II organization if all it does is give money to a supported charity.[57] Payment of money by a supporting organization to a charity, even when the charity can enforce the payments under state law, does not establish a significant enough connection between the two organizations to satisfy the Type II Relationship Test.[58] Type II organizations, the least common of the three types, are most commonly used by publicly

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49. *Id.* § 1.509(a)-4(g)(1)(ii).
50. *Id.*
51. *Id.*
52. *Id.* § 1.509(a)-4(a)(3).
53. *Id.* § 1.509(a)-4(f)(4).
54. *Id.* § 1.509(a)-4(h)(1).
55. *Id.*
56. *Id.*
57. *Id.* § 1.509(a)-4(h)(2).
58. *Id.*

supported charities who wish to establish a separate fund-raising arm.[59]

3. Type III Organizations.—Type III organizations are complex. The Type III structure provides the loosest connection between the supporting organization and its supported public charity. These organizations need only be "operated in connection with" their supported charity.[60] The regulations provide that "the distinctive feature [of Type III organizations] is that the supporting organization is responsive to, and significantly involved in the operations of, the publicly supported organization."[61] Type III organizations must, therefore, satisfy two tests: the "Responsiveness" Test and the "Integral Part" Test.[62] Complicating matters further, more liberal rules apply to grandfathered Type III supporting organizations—those operating before November 20, 1970.[63]

a. The Responsiveness Test.—All Type III supporting organizations must meet the Responsiveness Test in one of two ways.[64] Both ways are intended to ensure that the supporting organization will be "responsive to the needs or demands" of the charity it supports.[65]

(i) The Significant Voice Test.—The first way in which a supporting organization can meet the Responsiveness Test is by passing the "Significant Voice" Test.[66] Under this test, the supported charity must influence the governing board of the supporting organization using one of three possible approaches: (1) the supported charity's leaders or members ("officers, directors, trustees, or membership") must appoint or elect one or more of the supporting organization's leaders ("officers, directors, or trustees");[67] (2) one or more of the supported charity's leaders must also be a leader of supporting organization;[68] or (3) the supporting organization's leaders must "maintain a close and continuous working relationship" with leaders of the supported charity.[69] Regardless of which approach is used, the result must be that the supported charity's leaders "have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by [the] supporting organization, and in otherwise directing the use

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59. June Klaassen & Constance J. Fontaine, *Family Charitable Gifting: Private Foundations Versus Supporting Organizations*, 53 J. FIN. SERVICE PROF. 64, 69 (1999) (citing Monica Langley, *The SO Trend: How to Succeed in Charity Without Really Giving*, WALL ST. J., May 29, 1998, at A1).

60. 26 C.F.R. § 1.509(a)-4(a)(3).

61. *Id.* § 1.509(a)-4(f)(4).

62. *Id.* § 1.509(a)-4(i)(1)(i).

63. *Id.* § 1.509(a)-4(i)(1)(ii). These grandfathered organizations are permitted additional means of meeting the Responsiveness Test; "additional facts and circumstances, such as a historic and continuing relationship between organizations, may be taken into account." *Id.*

64. *Id.* § 1.509(a)-4(i)(2)(i).

65. *Id.*

66. *Id.* § 1.509(a)-4(i)(2)(ii).

67. *Id.* § 1.509(a)-4(i)(2)(ii)(a).

68. *Id.* § 1.509(a)-4(i)(2)(ii)(b).

69. *Id.* § 1.509(a)-4(i)(2)(ii)(c).

of the income or assets of [the] supporting organization."[70] All charities organized as corporations must meet this first alternative test.[71]

(ii) The Charitable Trust Test.—If the supporting organization is a charitable trust, it has a second way to meet the Responsiveness Test.[72] This test has three requirements: (1) the supporting organization must be a charitable trust under state law;[73] (2) the charitable trust's governing document must name the supported charity as a beneficiary;[74] and (3) the supported charity must have the right to compel an accounting and to enforce the trust under state law.[75]

b. The Integral Part Test.—In addition to meeting either prong of the Responsiveness Test, all Type III supporting organizations must also meet the Integral Part Test.[76] The Integral Part Test is used to determine whether the supporting organization "maintains a significant involvement in the operations" of the supported charity, and that the supported charity is "in turn dependent upon the supporting organization for the type of support which it provides."[77] In order to meet this test, the supporting organization must satisfy one of two alternative prongs: the "But For" Test or the "Substantially All Income" Test.[78]

(i) The But For Test.—A Type III organization can satisfy the first alternative prong of the Integral Part Test by engaging in activities "for or on behalf of" the supported charity.[79] The supporting organization must undertake these activities in order to "perform the functions of, or to carry out the purposes of [the supported charity]."[80] The crux of this test is the requirement that "*but for* the involvement of the supporting organization," the supported charity would normally engage in the activities itself.[81]

(ii) The Substantially All Income Test.[82]—Under the second alternative prong, the supporting organization must pay "substantially all of its income to or for the use of one or more publicly supported [charities]."[83] "Substantially all" means at least eighty-five percent of the supporting organization's net income.[84] The amount of support received by one or more of these charities must be sufficient to insure that the charity is attentive to the supporting organization's

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70. *Id.* § 1.509(a)-4(i)(2)(ii)(d).

71. The second alternative test applies only to charitable trusts. *Id.* § 1.509(a)-4(i)(2)(iii)(a).

72. *Id.* § 1.509(a)-4(i)(2)(i) and (iii).

73. *Id.* § 1.509(a)-4(i)(2)(iii)(a).

74. *Id.* § 1.509(a)-4(i)(2)(iii)(b).

75. *Id.* § 1.509(a)-4(i)(2)(iii)(c).

76. *Id.* § 1.509(a)-4(i)(1)(i).

77. *Id.* § 1.509(a)-4(i)(3)(i).

78. *Id.*

79. *Id.* § 1.509(a)-4(i)(3)(ii).

80. *Id.*

81. *Id.*

82. Some sources call this the Attentiveness Test. *See* Lapham Found. v. Comm'r, 84 T.C.M. (CCH) 586 (2002), *aff'd*, 389 F.3d 606 (6th Cir. 2004).

83. 26 C.F.R. §1.509(a)-4(i)(3)(iii).

84. Rev. Rul. 76-208, 1976-1 C.B. 161; *see also Lapham Found.*, 84 T.C.M. (CCH) 586.

operations.[85] This "attentiveness" requirement contemplates that the charity will oversee the operations of the supporting organization to ensure continued financial contributions.[86]

The regulations require that a "substantial amount" of the supporting organization's total support must be donated to those charities that meet this attentiveness requirement.[87] Further, the contribution that the supported charity receives from the supporting organization must be a significant enough portion of the charity's total support to insure that it will be attentive to the supporting organization's operations.[88] To determine whether the supporting organization's support represents a sufficient part of the supported charity's total support to ensure attentiveness, if the supporting organization "makes payments to . . . a particular department or school of a university, hospital or church, the total support of the department or school [is] substituted for the total support of the beneficiary organization."[89] For example, a supporting organization's payment to a university's law school may be a large enough portion of the law school's budget to attract the attention of the university, which may have a dozen or more such schools.

It is possible for a supporting organization to meet the Substantially All Income Test even where the amount of income the supporting organization gives to the supported charity fails to reflect a sizeable portion of its total support.[90] The Substantially All Income Test is not required if "in order to avoid the interruption of . . . a particular function or activity" made possible by the supporting organization's donations, the supported charity is "sufficiently attentive to the operations of the supporting organization."[91] Earmarking the support for a particular program or activity may have the effect of insuring this attentiveness, "even if such program or activity is not the beneficiary organization's *primary* program or activity so long as [the] program or activity is a substantial one."[92] Imagine that a supporting organization funds a visiting speaker program at a medical school. This funding might be enough to secure the school's attention even if the cost of the program were small in relation to the school's total funding. However, a supporting organization will fail to meet the Substantially All Income Test if no supported charity relies upon the supporting organization for a "sufficient amount" of its total support, even if these charities

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85. 26 C.F.R. § 1.509(a)-4(i)(3)(iii)(a).

86. *Id.*; *see also Lapham Found.*, 389 F.3d at 611. The court agreed with the tax court's finding that future contributions from a revocable trust were not enough to satisfy this part of the Attentiveness Test. *Id.* at 612. "It is difficult to believe that [the supported charity] will give [the supporting organization] the sort of regular oversight contemplated by the test when it will not be receiving substantial support from the organization for another two decades." *Id.*

87. 26 C.F.R. § 1.509(a)-4(i)(3)(iii)(a).

88. *Id.*

89. *Id.*

90. *Id.* § 1.509(a)-4(i)(3)(iii)(b).

91. *Id.*

92. *Id.* (emphasis added).

can enforce their rights against the supporting organization under state law.[93]

In determining whether the amount of support received by the charity is sufficient to insure that the charity is attentive to the supporting organization's operations, the IRS considers "[a]ll pertinent factors, including the number of [supported charities], the length and nature of the relationship between the [supported charity] and supporting organization and the purpose to which the funds are put."[94] Because a supported charity's attention is often motivated by the amount of funds received from the supporting organization, the larger the contribution (in terms of a fraction of the supported charity's total support), the more likely it is that the supported charity will be sufficiently attentive to satisfy the Integral Part Test.[95] Evidence that the supported charity is actually attentive to the supporting organization is almost as important.[96]

The regulations offer an example of sufficient evidence that a charity is actually attentive: terms requiring that the supporting organization provide the supported charity with annual reports.[97] These reports should furnish information to assist the supported charity to determine that the supporting organization's assets are invested productively, and that the supporting organization has not been indulging in activities that would trigger the private foundation excise taxes (if the supporting organization were a private foundation), like self-dealing and risky investing.[98] However, the annual report requirement is only one factor the IRS may consider in determining whether a supporting organization passes the Integral Part Test, and the lack of such a requirement is not fatal.[99]

What if a supporting organization meets the Integral Part Test, but the endowment of the charity it supports grows, such that the supporting organization's contribution is no longer the substantial portion of the charity's income that it once was? The regulations provide an exception for supporting organizations in this situation.[100] Even though a supporting organization "cannot meet the requirements . . . for its *current* taxable year solely because the amount received by [its supported charity] . . . is no longer sufficient" to fulfill the test,[101] the supporting organization will pass the Integral Part Test if it can show that it did meet the Integral Part Test for any five-year period,[102] and "[t]here has been a historic and continuing relationship of support between [the] organizations" since the end of the five-year period.[103]

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93. *Id.* § 1.509(a)-4(i)(3)(iii)(e).
94. *Id.* § 1.509(a)-4(i)(3)(iii)(d).
95. *Id.*
96. *Id.*
97. *Id.* § 1.509(a)-4(i)(3)(iii)(d).
98. *Id.*; *see also* I.R.C. §§ 4941, 4944.
99. 26 C.F.R. § 1.509(a)-4(1)(3)(iii)(d).
100. *Id.* § 1.509(a)-4(i)(1)(iii).
101. *Id.* § 1.509(a)-4(i)(1)(iii)(b) (emphasis added).
102. *Id.* § 1.509(a)-4(i)(1)(iii)(a).
103. *Id.* § 1.509(a)-4(i)(1)(iii)(c).

C. The Organizational Test

After satisfying the Relationship Test, a supporting organization must also satisfy an Organizational Test. All types of supporting organizations must meet this requirement.[104] The regulations explain that a supporting organization will only meet the Organizational Test—the requirement that it be "organized . . . exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified [public charities]"—if its governing documents meet certain requirements.[105] The supporting organization's governing documents must: (1) "limit the purposes" of the supporting organization to charitable purposes described in the Code[106] and (2) "state the specified publicly supported [charities] on whose behalf [the] organization is to be operated."[107] The Organizational Test, therefore, has a Purpose Limitations Test and a Charity Specification Test.

1. The Purpose Limitations Test.—Under the Purpose Limitations Test,[108] the supporting organization's governing documents should state purposes consistent with the Code requirement that it be "organized . . . exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified [public charities]."[109] The supporting organization's purposes should be similar to the purposes set forth in the governing documents of the charity it supports; the purposes may be narrower than those of the charity it supports but cannot be broader.[110] A supporting organization whose articles state that it "is formed for the benefit of [a] specified publicly supported [charity]" would meet this Purpose Limitation Test.[111]

2. The Charity Specification Test.—Under the Charity Specification Test,[112] the supporting organization must specify in its governing documents which charities it will support,[113] and the documents cannot explicitly allow it to operate to support other entities.[114] The method of specifying a supported charity

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104. *Id.* § 1.509(a)-4(b)(1).

105. *Id.* § 1.509(a)-4(a)(2) (quoting I.R.C. § 509(a)(3)(A) (2000)).

106. *Id.* § 1.509(a)-4(c)(1)(i). The documents must also not "expressly empower the organization to engage in activities which are not in furtherance of [those] purposes." *Id.* § 1.509(a)-4(c)(1)(ii). The governing documents may include articles of incorporation, a declaration of trust, or other materials. *See id.* § 1.501(c)(3)-1(b)(2).

107. *Id.* § 1.509(a)-4(c)(1)(iii). The documents must also not "expressly empower the organization to operate to support or benefit" any other organization. *Id.* § 1.509(a)-4(c)(1)(iv).

108. *Id.* § 1.509(a)-4(c)(2).

109. *Id.* § 1.509(a)-4(a)(2) (quoting I.R.C. § 509(a)(3)(A)).

110. *Id.* § 1.509(a)-4(c)(2).

111. *Id.*

112. *Id.* § 1.509(a)-4(c)(3), (d)(1).

113. *Id.* § 1.509(a)-4(d)(1).

114. *Id.* § 1.509(a)-4(c)(3). "The fact that the actual operations of [the supporting] organization have been exclusively for the benefit of the specified [charity] shall not be sufficient to . . . meet the organizational test" if the governing documents expressly permit the support of

in the supporting organization's governing documents varies based on whether the supporting organization qualifies as a Type I, Type II, or Type III under the Type of Relationship Test.[115]

Type III organizations have a stringent standard for specifying their supported charity. The governing documents of Type III organizations must either (1) specify the supported charities by name[116] or (2) demonstrate a "historic and continuing relationship between the supporting organization" and the charity,[117] resulting in the development of a "substantial identity of interests" between the organization and the charity.[118] Type III organizations are also limited in their ability to substitute their specified charities.[119]

Type I and Type II organizations have a more generous standard than Type III organizations for specifying their supported charity. In addition to the options afforded to Type III organizations (specifying expressly by name or by a historic and continuing relationship), Type I and Type II organizations may also designate their supported charities "by class or purpose."[120] The governing documents may therefore provide that the supporting organization will "support or benefit one or more beneficiary organizations which are designated by class or purpose,"[121] including: (1) the charity that the supporting organization

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other organizations. *Id.*

115. *Id.* § 1.509(a)-4(d)(1). Thus, "[t]he manner in which the [supported charities] must be *specified* . . . will depend upon whether the supporting organization is *operated, supervised, or controlled by*[,] or *supervised or controlled in connection with*. . .[, or] *operated in connection with* . . . such [charities]." *Id.*

116. *Id.* § 1.509(a)-4(d)(2)(i).

117. *Id.* § 1.509(a)-4(d)(2)(iv)(a).

118. *Id.* § 1.509(a)-4(d)(2)(iv)(b).

119. *Id.* § 1.509(a)-4(d)(4). Assuming that the supported charity is specified by name, the governing documents of the supporting organization may

> (a) [p]ermit a [supported charity] which is designated by class or purpose, rather than by name, to be substituted for the [supported charity or charities] designated by name in the articles, but only if such substitution is conditioned upon the occurrence of an event which is beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization or organizations designated in the articles; (b) [p]ermit the supporting organization to operate for the benefit of a [supported charity] which is not a publicly supported organization, but only if such supporting organization is currently operating for the benefit of a publicly supported organization and the possibility of its operating for the benefit of other than a publicly supported organization is a remote contingency; or (c) [p]ermit the supporting organization to vary the amount of its support between different designated organizations, so long as it meets the requirements of the integral part test . . . with respect to at least one beneficiary organization.

Id.

120. *Id.* § 1.509(a)-4(d)(2)(i)(b).

121. *Id.* § 1.509(a)-4(d)(2)(i)(b).

supports[122] or (2) charities that are "closely related in purpose or function" to that charity (or charities).[123] In accord with the more generous specification standards afforded Types I and II, these organizations can more easily substitute a specified charity than the Type III structure.[124]

D. The Operational Test

In addition to meeting the various aspects of the Organizational Test, supporting organizations must also meet the Operational Test.[125] The Operational Test—which requires that a supporting organization be "*operated exclusively* to support"[126] its supported charity—requires that the supporting organization have (1) permissible beneficiaries[127] and (2) permissible activities.[128]

1. The Permissible Beneficiaries Test.—The Permissible Beneficiaries Test of the Operational Test is met if the supporting organization engages only in activities that benefit or support the supported charity.[129] These activities could include furnishing facilities or services, or even cash payments, to individual members of the charitable class the supported charity benefits.[130] The activities could also include contributing payments indirectly (through an unaffiliated organization) to a member of the charitable class the supported charity benefits.[131]

2. The Permissible Activities Test.—In order to meet the Permissible Activities Test of the Operational Test, a supporting organization need not distribute money directly to the supported charity.[132] This requirement can be met if the supporting organization merely spends its income to engage in

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122. *Id.* § 1.509(a)-4(d)(2)(i)(b)(1).

123. *Id.* § 1.509(a)-4(d)(2)(i)(b)(2).

124. *Id.* § 1.509(a)-4(d)(3)(i)-(iii). The governing documents of Type I and Type II organizations may

> (i) [p]ermit the substitution of one [supported charity] within a designated class for another [supported charity] either in the same or a different class designated in the articles; (ii) [p]ermit the supporting organization to operate for the benefit of new or additional [supported charities] of the same or a different class designated in the articles; or (iii) [p]ermit the supporting organization to vary the amount of its support among different [supported charities] within the class or classes of organizations designated by the articles.

Id.

125. *Id.* § 1.509(a)-4(b)(2).

126. *Id.* § 1.509(a)-4(e)(1).

127. *Id.*

128. *Id.* § 1.509(a)-4(e)(2).

129. *Id.* § 1.509(a)-4(e)(1).

130. *Id.*

131. *Id.* The payment must "[constitute] a grant to an individual rather than a grant to an organization." *Id.*

132. *Id.* § 1.509(a)-4(e)(2).

independent activities or programs that benefit the supported charity.[133] It is also appropriate for the supporting organization to raise funds for the supported charity or for permissible beneficiaries, such as by hosting fund raising dinners or soliciting contributions.[134]

E. The Control Test

Once a supporting organization has passed the Organizational and Operational Tests, and all of the subtests related to its status as a Type I, Type II, or Type III organization, it still must pass a Control Test.[135] The "supporting organization may not be controlled directly or indirectly by one or more disqualified persons."[136] A "disqualified person" is any one of a list of individuals or organizations that have certain relationships with the organization.[137] Disqualified persons include the donor, certain of the donor's relatives, and businesses controlled by the donor or his relatives.[138] Publicly supported charities and managers of foundations generally are excluded from the definition of disqualified persons in this context.[139]

An organization is considered controlled if the disqualified persons can aggregate their positions of authority or their votes and cause the supporting organization "to perform any act which significantly affects its operation."[140] Generally, a supporting organization is considered controlled by disqualified persons if (1) the disqualified persons' voting power is half or more of the total voting power of the governing body of the supporting organization or (2) a disqualified person can veto the organization's actions.[141] The IRS considers "all

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133. *Id.*

134. *Id.*

135. *See* I.R.C. § 509(a)(3)(C); 26 C.F.R. § 1.509(a)-4(j).

136. 26 C.F.R. § 1.509(a)-4(j).

137. *See* I.R.C. § 4946.

138. *Id.*

139. *See* I.R.C. § 509(a)(3)(C); 26 C.F.R. § 1.509(a)-4(j)(1). But note,

> [i]f a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization.

Id.

140. 26 C.F.R. § 1.509(a)-4(j)(1).

141. *Id.* The regulations provide:

> Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone.

pertinent facts and circumstances" to ascertain if disqualified persons do actually control the supporting organization.[142]

Notwithstanding these general guidelines that determine whether the organization passes the Control Test, an organization may provide proof of independent control.[143] The regulations provide an example: "in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are *substantial contributors*" to the supporting organization does not cause it to fail the Control Test as long as "a representative of the church, such as a bishop . . . has control over the policies and decisions of the organization."[144] Actual, independent control must be proven to the Commissioner's satisfaction.[145]

F. Grandfathered Supporting Organizations

Given the intricacy of the section 509(a)(3) regulations, it is unsurprising that they were not predicted by creators of charities before the 1969 Tax Reform Act. The regulations provide that charities established before 1970 that lack the structural documentation required by current rules still will be treated as supporting organizations if they operate as such.[146] Congress imposed specific requirements on pre-1970 organizations in order to continue their tax-exempt existence as supporting organizations, and specific transitional guidelines for satisfying the Integral Part Test for Type III supporting organizations were outlined in the regulations.[147] This rule creates an entire class of supporting organizations that would be classified as private foundations if they applied for

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Id.

142. *Id.* The facts and circumstances to be considered will include:
the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest. Allowing a "substantial contributor" to "designate annually the recipients . . . of the income attributable to his contribution to the supporting organization" constitutes an impermissible level of control.

Id.

143. *Id.* § 1.509(a)-4(j)(2).

144. *Id.* (emphasis added).

145. *Id.*

146. *Id.* § 1.509(a)-4(b)(2). The regulations provide that
[i]n the case of supporting organizations created prior to January 1, 1970, the organizational and operational tests shall apply as of January 1, 1970. Therefore, even though the original articles of organization did not limit its purposes to those required under section 509(a)(3)(A) and even though it operated before January 1, 1970, for some purpose other than those required under section 509(a)(3)(A), an organization will satisfy the organizational and operational tests if, on January 1, 1970, and at all times thereafter, it is so constituted as to comply with these tests.

147. *Id.* § 1.509(a)-4(i)(4).

recognition of exempt status today.

1. The Integral Part Test—Transitional Rules for Type III Organizations.— Liberal requirements for meeting the Integral Part Test apply for supporting organizations established before November 20, 1970.[148] If a grandfathered supporting organization meets the requirements of the transitional rule, it need not pass all aspects of the Integral Part Test.[149] In each tax year, the trustee of a grandfathered trust must make "written reports to all of the [supported charities] . . . setting forth a description of the assets of the trust, including a detailed list of the assets and the income produced by such assets."[150]

A grandfathered supporting organization must pass five requirements. First, all of the existing interests in the trust must be devoted to one or more charitable purposes, and a deduction must have been allowed regarding these charitable interests.[151] Second, the trust must have been created before November 20, 1970, and not have received any later contributions or transfers.[152] Third, the trust's governing instrument must require the organization to make current distributions of its net income to its designated supported charity.[153] Where the supporting organization's governing instrument designates several supported charities, the supporting organization must currently distribute its entire net income in fixed portions to those supported charities.[154] Fourth, the trustee cannot have any discretion to vary either the identity of the beneficiaries or the amounts the trust pays to them.[155] Finally, no trustee may be considered to be a "disqualified person" in relationship to the trust (if the supporting organization had been

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148. *Id.*

149. *Id.* § 1.509(a)-4(i)(4)(i).

150. *Id.*

151. *Id.* § 1.509(a)-4(i)(4)(ii). A deduction must have been previously allowed under "corresponding provisions of prior law (or would have been allowed . . . if the trust had not been created before 1913)." *Id.*

152. *Id.* § 1.509(a)-4(f)(4)(i)(4)(iii).

153. *Id.* § 1.509(a)-4(i)(4)(iv).

154. *Id.* § 1.509(a)-4(i)(4)(iv). The regulations provide that

> [t]he governing instrument of a charitable trust shall be treated as requiring distribution to a designated beneficiary organization where the trust instrument describes the charitable purpose of the trust so completely that such description can apply to only one existing beneficiary organization and is of sufficient particularity as to vest in such organization rights against the trust enforceable in a court possessing equitable powers.

Id.

155. *Id.* § 1.509(a)-4(i)(4)(v). A trustee does not have

> such discretion where the trustee has discretion to make payments of principal to the single [charity] that is currently entitled to receive all of the trust's income[,] or where the trust instrument provides that the trustee may cease making income payments to a particular charitable beneficiary in the event of certain specific occurrences, such as the loss of exemption . . . or classification . . . by the beneficiary or the failure of the beneficiary to carry out its charitable purpose properly[.]"

Id.

classified as a private foundation).[156] If a supporting organization meets these criteria, it will not be categorized as a private foundation even though it does not meet the current requirements for supporting organizations.

2. Consequences for Grandfathered Organizations.—What are the practical consequences of being a grandfathered supporting organization? On their face, these entities may appear to be private foundations under current tax law. Trustees who are unaware of the grandfathering provision may therefore pay taxes from the charity as if it were a private foundation. Pre-1969 supporting organizations may also be structured as simple income-only trusts (e.g., pay all of the income to Samford University in perpetuity). Income-only trusts pose a variety of investment challenges.[157] When considering the complexity of supporting organizations, it is important to remember the differences of this grandfathered class; if dramatic change is made, will current organizations be grandfathered, creating three classes of organizations?

III. BENEFITS OF SUPPORTING ORGANIZATIONS

Supporting organizations provide advantages both to those who give and those who receive. It is a useful planning tool for wealthy families seeking to meet charitable goals, and for charitable entities seeking to structure ownership of their assets efficiently. This section will discuss the benefits of supporting organizations first to donors, and then to charities.

A. Benefits to Donors

The major benefit of supporting organizations to donors is that they allow charitable dollars to go further by avoiding the morass of private foundation rules and penalty taxes. This has two results: (1) fewer hindrances on administration and (2) avoidance of the excise tax on investment income.

The private foundation rules that do not apply to publicly supported charities—and supporting organizations—include restrictions on self-dealing, excess business holdings, and investments. Private foundations may not engage in transactions with "disqualified persons" (those closely associated with the foundation, such as major donors, family members, or affiliated companies).[158] They must also limit their holdings of any one security to a certain portion of their investment portfolio.[159] Private foundations are also forbidden to make "jeopardizing" investments—holdings with an unreasonable amount of risk.[160] These rules limit the way private foundations can structure their business agreements and invest their assets.

Donors to publicly supported charities also enjoy two personal income tax

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156. *Id.* § 1.509(a)-4(i)(4)(vi).

157. *See generally* Alyssa A. DiRusso & Kathleen M. Sablone, *Statutory Techniques for Balancing the Financial Interests of Trust Beneficiaries*, 39 U.S.F. L. REV. 261 (2005).

158. *See* I.R.C. § 4941 (2000).

159. *See id.* § 4943.

160. *See id.* § 4944.

advantages over donors to private foundations. The charitable deduction for gifts to publicly supported charities is capped at fifty percent of adjusted gross income,[161] as opposed to thirty percent for private foundations.[162] Gifts to public charities are also permitted to be deducted at fair market value, whereas gifts of certain kinds of property to private foundations are limited to basis.[163]

In examining the issues surrounding supporting organizations, the Panel on the Nonprofit Sector[164] has identified ways that Type III supporting organizations are "uniquely suited" to address charitable purposes.[165] The Panel suggests that Type III organizations have proven to be an excellent charitable vehicle for donors.[166] For example, donors who want to be sure that property they give is permanently dedicated to a particular charitable program or purpose of a charity can contribute the property to a Type III supporting organization with management that is independent from the supported charity.[167] Similarly, a donor who wishes to donate antiques or unique items such as collectibles can ensure that the items will remain on display instead of being sold to support the charity's other activities by utilizing a Type III supporting organization.[168] A donor can also use a Type III supporting organization where she wants to benefit several different charities that may have conflicting short- and long-term goals, because the "independent management" structure of a Type III can "effectively balance the charities' competing goals."[169]

Supporting organizations may also offer families a unique view of philanthropy, through partnership with a publicly supported charity. As one pair of advisors put it, "A family relationship with a public charity provides a pleasant and natural forum for discussion on how to use family wealth wisely."[170] Whereas private foundations may allow only minimal contacts between donors and the recipients of funds, the close relationship supporting organizations afford may help donors recognize the impact of their contributions. Supporting organizations may work best for donors in certain circumstances, including where (1) the donors have a particular public charity they want to benefit, rather than general philanthropic goals; (2) the donors are aware of individuals that they would like to serve as directors, who would not violate the control rules (perhaps a group of friends); and (3) the funding is sufficient to make a stand-alone entity

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161. *Id.* § 170(b)(1)(A).

162. *Id.* § 170(b)(1)(B).

163. *Id.* § 170(b)(1)(D).

164. The Panel on the Nonprofit Sector is a collaboration of charitable interests formed to study and report to Congress methods for improving oversight and governance of charitable organizations.

165. *See* PANEL ON THE NONPROFIT SECTOR, INDEP. SECTOR, INTERIM REPORT 42-43 (2005), *available at* http://www.nonprofitpanel.org/interim/PanelReport.pdf.

166. *Id.*

167. *Id.* at 43.

168. *Id.*

169. *Id.*

170. Klaassen & Fontaine, *supra* note 59, at 69.

worthwhile.[171]

B. Benefits to Charities

Supporting organizations are created not only by individual donors, but by the publicly supported charities the organizations benefit. Charities create these entities for several reasons: efficient management of assets, segregation of functions (such as fund-raising), and asset protection. The supporting organization structure allows these benefits without subjecting the charity to the arduous task of complying with the private foundation excise tax rules.[172]

Type III supporting organizations provide unique support to charities. The Panel on the Nonprofit Sector's interim report to Congress found that Type III supporting organizations operated in connection with state universities are able "to hold and manage technology assets independently so that they are not subject to control and potential appropriation by state governments for other, unrelated state programs."[173] The Panel also reported that the Type III supporting organization structure is useful for domestic "friends" organizations of foreign public charities; the independent management structure of a Type III supporting organization is utilized so that the supporting organization can solicit U.S. contributions for the benefit of the foreign charity, without being considered a mere conduit for it.[174]

The Panel also reported how Type III supporting organizations benefit charitable institutions such as hospitals. The Panel found that "[m]any hospitals, educational institutions and other public charities are structured as networks of service providers [and not] single entities."[175] The Type III structure is important to these types of networks because frequently the parent charitable organization, which directs and provides administrative services to its subsidiaries, can only qualify for 501(c)(3) status as a Type III supporting organization.[176] This results from the fact that the parent organization controls the supported charities as opposed to being controlled by them (or under common control with them).[177]

Finally, the Panel reported that governmental entities can use Type III supporting organizations to help them advance their public purposes.[178] The Panel provided an example: when a state attorney general oversees a nonprofit hospital conversion in which the sale proceeds are used to fund a community

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171. *Id.* at 69; *see also* Victoria B. Bjorklund, *Choosing Among the Private Foundation, Supporting Organization and Donor-Advised Fund*, *in* CHARITABLE GIVING TECHNIQUES 73, 86 (Comm. on Continuing Prof'l Educ., A.L.I.-A.B.A. 2001); Gerald B. Treacy, Jr., *Supporting Organizations: A Good Alternative to Private Foundations*, 24 EST. PLAN. 17, 21 (1997).

172. PANEL ON THE NONPROFIT SECTOR, *supra* note 165, at 44.

173. *See id.* at 42-43.

174. *Id.* at 43.

175. *Id.*

176. *Id.*

177. *Id.*

178. *Id.* at 45.

foundation's supporting organization, the attorney general may recommend using a Type III supporting organization.[179] This assures that the new entity holding the assets has an independent identity from the community foundation[180] The Panel found that, in other cases, state or federal law may prohibit government-controlled entities from engaging in activities that an independent support organization could do for the benefit of the governmental entity.[181]

Clearly, supporting organizations have some benefits that other types of charities do not have. Eliminating them may cause grave loss to the philanthropic community, who will be unable to replicate the roles these charities played with other types of nonprofit entities.

C. Promoting Supporting Organizations Too Hard

The unbridled enthusiasm for supporting organizations shown by some advisors is enough to give one pause. Although supporting organizations clearly have some advantages over private foundations and are a unique planning tool, they remain vehicles for charitable giving—in that the donor parts with ownership and control of the assets, which should be used to benefit charitable causes. In an attempt to sell clients on the idea of supporting organizations, some advisors have overstepped their bounds and insinuated that this type of charitable vehicle offers its donors unfettered control of donated assets.

For example, in the *CPA Journal* (published by the New York State Society of Certified Public Accountants), one CPA writes,

> Supporting organizations can be used by anyone in the high-income tax bracket who wishes to retain control of assets within the family. They can receive a 50% adjusted gross income (AGI) deduction for removing the asset ownership from their estate, yet maintain virtually the same control they had as fee-simple owners. Control can be passed down to successive generations if desired.[182]

With such promotions in the mainstream, it is no wonder donors expect an unreasonable amount of control over the assets they have donated. This expectation of control is central to the abuses perceived in the exempt organization context and will be explored more fully in the next section.

IV. Concerns with Supporting Organization Abuse

If you can't trust charities, who can you trust? The past few years have revealed disheartening examples of abuse of fiduciary power by leaders of both corporations and charities.[183] The corporate scandals of years past[184] were

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179. *Id.*

180. *Id.*

181. *Id.*

182. E. Kenneth Whitney, *Supporting Organizations, Sections 501(c)(3) and 509(a)(3)*, 75 CPA J. 61, 61 (2005).

183. For a review of some nonprofit scandals, see Carolyn M. Osteen et al., *Scams, Shams, and*

perhaps foreshadowing of the nonprofit scandals coming to light today.[185] In addressing scandals in the for-profit arena, the primary corrective legislation, the Sarbanes-Oxley Act,[186] focused on increased transparency and monitoring. While reformers have proposed that portions of the Sarbanes-Oxley Act be applied to nonprofits, some state legislatures are examining proposed Sarbanes-Oxley-type regulations aimed at increasing and improving nonprofit governance and accountability.[187] Scholars and lawyers alike agree that the time has come for charities to be more accountable to the public.[188]

A. Abuse Makes Headlines

Contemporary concern with the abuses existing in supporting organizations was sparked by a front-page *Wall Street Journal* article in 1998.[189] Although several years have passed since the article was published, it is still cited by politicians and reformers as evidence of the need for reform. The *Journal* article called supporting organizations "a suddenly hot charitable vehicle" and exposed the actions of several supporting organizations and their famous donors, namely Carl Icahn, Gerry Spence, and David Cammack.[190]

Scandals—Exempt Organizations Developments in 1999, *in* LEGAL PROBLEMS OF MUSEUM ADMIN. 369, 372 (Comm. on Continuing Prof'l Educ., A.L.I.-A.B.A. 2000).

184. Major corporate scandals of the early 21st century included WorldCom and Enron. *See, e.g.*, Peter Behr & April Witt, *Visionary's Dream Led to Risky Business: Opaque Deals, Accounting Sleight of Hand Built an Energy Giant and Ensured Its Demise*, WASH. POST, July 28, 2002, at A1; Susan Pulliam & Deborah Solomon, *Uncooking the Books: How Three Unlikely Sleuths Discovered Fraud at WorldCom*, WALL ST. J., Oct. 30, 2002, at A1.

185. For an overview of abusive tactics of directors and officers that have resulted in criminal and/or civil proceedings, see Marion R. Fremont-Smith & Andras Kosaras, *Wrongdoing by Officers and Directors of Charities: A Survey of Press Reports 1995-2002*, 42 EXEMPT ORG. TAX REV. 25 (2003).

186. Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745-810 (2002).

187. *See* Wendy K. Szymanski, *An Allegory of Good (and Bad) Governance: Applying the Sarbanes-Oxley Act to Nonprofit Organizations*, 2003 UTAH L. REV. 1303, 1304-05; *see also* Jonathan Small, *Issues of Governance and Financial Management: The Impact of Sarbanes-Oxley on Nonprofits*, *in* LEGAL PROBLEMS OF MUSEUM ADMIN. (Comm. on Continuing Prof'l Educ., A.L.I.-A.B.A. 2004). "Sarbanes-Oxley principles are now very much part of the landscape of considerations nonprofits need to bear in mind in running themselves and in reporting their activities to the public and to regulators." *Id.*

188. *See* James J. Fishman, *Improving Charitable Accountability*, 62 MD. L. REV. 218 (2003); Ellen W. McVeigh & Eve R. Borenstein, *The Changing Accountability Climate and Resulting Demands for Improved "Fiduciary Capacity" Affecting the World of Public Charities*, 31 WM. MITCHELL L. REV. 119 (2004).

189. Monica Langley, *Gimme Shelter: The SO Trend: How to Succeed in Charity Without Really Giving—A 'Supporting Organization' Lets the Wealthy Donate Assets, Still Keep Control—Carl Icahn's School Project*, WALL ST. J., May 29, 1998, at A1.

190. *Id.*

Ex-corporate raider Carl Icahn was looking for a way to donate some stock, retain as much control over that stock as possible, and get the most tax-deductible bang for his buck.[191] He found it—in a Type III supporting organization. By transferring the stock to a supporting organization of his own creation, Icahn maintained control of the stock, avoided capital gains taxes, and enjoyed an income tax deduction for the full value of the assets (a perk reserved for publicly supported charities; donations to private foundations are limited by cost basis[192]).[193] Icahn claimed only one "disadvantage" of his supporting organization: sharing board membership control with a majority of "outsiders" who represent the charity's interests.[194] Icahn stated that his supporting organization will ultimately benefit underprivileged children, but initially, the result was just a healthy tax break.[195]

David Cammack amassed his wealth through real estate investment.[196] When it came time for charitable giving, Cammack wanted to share his antique car collection with a museum.[197] Instead of making an outright donation of the cars to a museum, which would give the museum total discretion to display, and the power to sell, his valuable cars, Cammack's lawyer suggested that he place the cars in a supporting organization.[198] Cammack donated three Tuckers to his supporting organization and received an immediate tax deduction for their value.[199] Cammack did not immediately part with the vehicles, primarily because he imposed conditions on his "gift" to the Antique Automobile Club of America.[200] In order to exhibit his cars, they must first build a museum to his satisfaction, complete with a Cammack family wing.[201]

Gerry Spence, a famous trial attorney, created a supporting organization to preserve his Wyoming ranch in perpetuity and to keep it out of the hands of developers.[202] The supporting organization has a relationship with the Trial Lawyers College, and the ranch is often used by fledgling lawyers as a place to become skilled in trial techniques.[203] Although the land is arguably being put to a charitable purpose, the structure allows Spence to retain significant control over his "donation."[204]

The common theme among these supporting organizations is the continued

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191. *Id.*
192. I.R.C. § 170(e)(1) (2000).
193. Langley, *supra* note 189.
194. *Id.*
195. *Id.*
196. *Id.*
197. *Id.*
198. *Id.*
199. *Id.*
200. *Id.*
201. *Id.*
202. *Id.*
203. *Id.*
204. *Id.*

amount of control exercised over assets theoretically donated to charity. Although the donors were clearly well-advised and appeared to be abiding by applicable tax rules, the transactions violate the spirit of the laws designed to encourage philanthropy. The supporting organization structure allowed these multi-millionaire donors to keep an immediate tax benefit without exhibiting a clear or immediate charitable benefit—merely minimizing taxes while continuing to control the property.

Not all practitioners believe the *Wall Street Journal* article was even-handed. An article published on the Planned Giving Design Center website noted the negative tone of the *Journal* article and expressed concern that "people will read the article (including members of Congress and their tax writing staffs) and will reach a conclusion regarding supporting organizations that does not reflect reality in most cases."[205] Limiting the ability of donors to use supporting organizations because of the wrongdoings of a few individuals can deny society of substantial philanthropic help. The flexible nature of supporting organizations appeals to successful entrepreneurs who seek to address charitable needs through their talents as well as their funds, and this may be a "boon to the future framework of the charitable world."[206] Unduly criticizing supporting organizations is not without its costs.

B. Simultaneous Scandals

Around the time that the *Wall Street Journal* article made supporting organizations dinner table conversation,[207] another scandal involving supporting organizations was unfurling in the public eye. Several supporting organizations and private foundations affiliated with Reader's Digest were dismantled and their assets were distributed to public charities under the supervision of the New York State Attorney General.[208]

George Grune was the chief executive of Reader's Digest, chairman of two private foundations—the Lila Wallace-Reader's Digest Fund, Inc. and the

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205. Planned Giving Design Center, *The Supporting Organization: The Next Charitable Scapegoat?* (Mar. 17, 1999), http://www.pgdc.com/usa/item/?itemID=58145.

206. *Id.*

207. Admittedly not all families considered this to be scintillating dinner conversation.

208. For more background on the Reader's Digest charities, see Geraldine Fabrikant, *Cultural World Gets Painful Lesson in Finance*, N.Y. TIMES, Aug. 26, 1997, at D4; Joann S. Lublin & G. Bruce Knecht, *Tenure of Reader's Digest is Unabbreviated*, WALL ST. J., Jan. 9, 1998, at B1; Stacy Perman, *A Sad Story at the Digest*, TIME, Mar. 2, 1998, at 58; Linda Sandler, *Charitable Funds' Sale of Reader's Digest Shares at a Substantial Discount Is Raising Questions*, WALL ST. J., Feb. 13, 1998, at C2; Vince Stehle, *Falling Price of Reader's Digest Stock Is Big Blow to Wallace Funds*, CHRON. OF PHILANTHROPY, Feb. 26, 1998, at 21; Richard Teitelbaum, *The Plot to Shake Up Reader's Digest: A Low Stock Price Breeds No Charity*, FORTUNE, Mar. 2, 1998, at 44; *see also* Mark Rambler, Note, *Best Supporting Actor: Refining the 509(a)(3) Type 3 Charitable Organization*, 51 DUKE L.J. 1367, 1384-88 (2002) (providing an excellent discussion of the Reader's Digest scandal and citing the sources listed above).

DeWitt Wallace-Reader's Digest Fund, Inc.[209]—and a member of the board of seven supporting organizations.[210] The seven supporting organizations and the two private foundations were initially funded with Reader's Digest stock, and remained highly invested in this stock in 1996.[211] Together, the private foundations held seventy-one percent of the voting interest in Reader's Digest Association, Inc.[212] Consequently, whoever controlled the foundations controlled the company. George Grune controlled both.[213]

Throughout the late 1990s, the value of Reader's Digest stock fell precipitously, and dividends were scaled back dramatically. The stock lost about half of its value between 1992 and 1997,[214] and its dividends decreased by roughly fifty percent in July 1997.[215] Despite these losses, the supporting organizations did not diversify and saw the value of their shares plummet from $1.85 billion in 1992 to $0.7 billion in 1997.[216] Evidence suggested that the supported charities should have diversified, but George Grune's control—either direct or indirect—resulted in the supporting organizations clinging to rapidly depreciating assets.[217] Arguably, the supported charities should have had a stronger voice in the investment decisions of the supporting organizations.[218]

C. Loans to Donors: Abuse of a Different Color

A 2004 *Chronicle of Philanthropy* article, *Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts,* reawakened lawmakers' attention to the abuses occurring with supporting organizations.[219] Focusing largely on shady lending transactions, the article exposed several acts of questionable legitimacy.[220]

For example, the Muralt Family Foundation was founded by a father and son

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209. Teitelbaum, *supra* note 208, at 44.

210. Perman, *supra* note 208, at 58.

211. The supporting organizations (collectively) had relationships with thirteen charities, several of which are sophisticated and well-known: Colonial Williamsburg, Macalaster College, Memorial Sloan-Kettering Cancer Center, the Metropolitan Museum of Art, the Open Space Institute, the Scenic Hudson Land Trust, Inc., the Wildlife Conservation Society, Vivian Beaumont Theater, Inc., Philharmonic-Symphony Society of New York, Inc., and the Chamber Music Society of Lincoln Center, Inc. *See* Fabrikant, *supra* note 208, at D4.

212. Teitelbaum, *supra* note 208, at 44.

213. *Id.*

214. Perman, *supra* note 208, at 58.

215. Teitelbaum, *supra* note 208, at 44.

216. Rambler, *supra* note 208, at 1385-86.

217. Perman, *supra* note 208, at 58.

218. *See* Rambler, *supra* note 208, at 1388.

219. *See* Harvey Lipman & Grant Williams, *Donors Set Up Grant-Making Groups, Then Borrow Back Their Gifts*, CHRON. OF PHILANTHROPY, Feb. 5, 2004, at 12.

220. *Id.*

to support a children's shelter.[221] After funding the Foundation with $1.4 million, however, the founders borrowed back $758,000 and used the proceeds for personal purposes.[222]

Similarly, the Hill Family Foundation was generous in making loans to its founder. The Foundation was funded with real estate sold for $225,917—the bulk of which ($220,655) was returned to Spencer Hill, the founder and donor, in two loans.[223] The funds were used to pay off the donor's personal loans and to invest in real estate.[224] Any profits from the real estate investment belonged to the donor, not to the charity.[225]

The Malecha Family Foundation also loaned the majority of its assets to its donor. Four months after its initial funding of $1,000,000, the charity loaned Mr. Malecha $800,000 of his original donation. The contribution entitled Mr. Malecha to a charitable income tax deduction even though the loan allowed him to retain the use of the majority of the funds he had contributed.[226]

A fourth supporting organization, the Rock and Terri Ballstaedt Charitable Supporting Organization, returned its entire initial funding amount of $186,000 to its donors as a loan.[227] Mr. Ballstaedt originally secured the loan with his home, but, as debts to arm's-length creditors grew, the supporting organization released the security interest, leaving the loan unsecured.[228]

The *Chronicle* reported that these lending transactions, although surprising, are not uncommon enough.[229] An examination of IRS Form 990 data exposed eighteen organizations that extended loans of $100,000 or more to officers and directors between 1998 and 2001.[230] The loans totaled over $7 million, and in a majority of the cases, the foundation loaned out over half of its assets.[231]

Lending transactions between a supporting foundation and its donors are not illegal. Although private foundation tax laws ban loans between foundations and disqualified persons, these rules do not apply to supporting organizations.[232] Entering into these transactions is not illegal, but it is not what supporting organizations were intended to accomplish.

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221. *Id.*

222. The money was used to pay off a bank loan owed by the father and to invest in real estate and business prospects. *Id.*

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

230. *Id.* This data has since been presented to the Senate Finance Committee. *See* Gravelle Statement, *supra* note 4.

231. Lipman & Williams, *supra* note 219, at 13.

232. *See* I.R.C. § 4941(d)(2) (2000).

D. Legislative Response to Abuse Begins

After the *Wall Street Journal* and the *Chronicle of Philanthropy* brought these abuses into the spotlight, several senators initiated the reformation of supporting organizations.[233] On June 22, 2004, the Senate Finance Committee gathered a panel of experts and interested groups to testify and to discuss potential changes to the laws governing tax-exempt organizations.[234] The U.S. Senate Committee on Finance Roundtable on Tax Exemption generated not only ample concern regarding the abuses (and potential for abuse) in the supporting organization context, but it also found support for their good works and potential for accomplishing charitable goals.[235]

Mark Everson, the Commissioner of the Internal Revenue Service, testified before the Senate Finance Committee on June 22, 2004.[236] He explained the concerns relating to supporting organizations, but acknowledged the legitimate use of the structure:

> Let me emphasize here that we believe the vast majority of supporting organizations are entirely legitimate and upstanding charities. However, some tax planners see the supporting organization primarily as a means by which an organization's creator can effectively operate what would

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233. *See* Press Release, U.S. Senate Committee on Finance, Grassley, Baucus Plan to Take Aim at Abusive "Supporting Organizations" for Charities (Apr. 25, 2005) (on file with author), *available at* http://finance.senate.gov/press/Gpress/2005/prg042505.pdf [hereinafter Senate Committee on Finance Press Release]. The IRS has long been concerned with the potential for abuse in the supporting organization context. *See* Ron Shoemaker & Bill Brockner, *Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions*, EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION PROGRAM, Part G, Sept. 6, 2000, at 107.

234. *Charity Oversight and Reform: Keeping Bad Things From Happening to Good Charities: Before the S. Comm. on Finance*, 108th Cong. (2004), *available at* http://finance.senate.gov/sitepages/hearing062204.htm [hereinafter *Hearings*].

235. *Id.* The Senate Committee on Finance convened a Roundtable to discuss proposed reforms to tax-exempt organizations. The Roundtable was held June 22, 2004, immediately after the hearing, *supra* note 234. It was closed to the public. No transcript of the Roundtable proceedings could be located. *See* U.S. Senate Committee on Finance, Press Release (2004), *Grassley Announces Participants, Releases White Papers for Charitable Governance Roundtable*, *available at* http://www.senate.gov/~finance/press/Gpress/2004/prg072104d.pdf. A collection of papers submitted to the Committee during the Roundtable is available at http://www.finance.senate.gov/sitepages/round.htm. The Roundtable, as well as the hearing, *supra* note 234, was convened in response to a bipartisan staff discussion draft concerning the need for reforms in tax-exempt organizations. *See* Staff Discussion Draft, *available at* http://www.finance.senate.gov/hearings/testimony/2004test/062204stfdis.pdf.

236. *Id.*; *see Charitable Giving Problems and Best Practices: Before the S. Comm. on Finance*, 108th Cong. (2004) (statement of Mark W. Everson, Commissioner, IRS), *available at* http://finance.senate.gov/hearings/testimony/2004test/062204metest.pdf [hereinafter Everson Statement].

> ordinarily be a private foundation under the less restrictive rules applicable to public charities. Self-dealing and certain other transactions with substantial contributors to these organizations would be prohibited in the private foundation context. However, some of the abuses and promotions we have seen clearly are not consistent with tax-exempt status.[237]

Commissioner Everson gave examples of the abuses noted:

> [I]n one promotion we have uncovered there is, almost immediately after a purported charitable donation to a supporting organization, an unsecured loan of all or a significant portion of the funds back to the donor and creator. A key part of this transaction is the effort by the promoter to ensure a lack of oversight of the supporting organization by the public charity it purports to support. While too technical to outline in this testimony, we are seeing several strategies that frustrate the ability of the supported public charity to oversee its supporting organization, clearing the way for abuses.[238]

The Senate Finance Committee Roundtable also included testimony from the charitable community, including American Hospital Association representative Dan Coleman, President and Chief Executive Officer of John C. Lincoln Health Network in Phoenix.[239] He testified about the importance of the supporting organization structure; many hospital parent corporations are structured as supporting organizations and are operated legitimately.[240] In his testimony, Mr. Coleman explained that supporting organization status is often used in the hospital context to categorize the parent corporation, to secure tax-exempt status and avoid treatment as a private foundation.[241]

Coleman acknowledged the Finance Committee's legitimate concern that the supporting organization classification has been misused.[242]

> Private individuals who are establishing and securing tax-exemptions for organizations that are not organized or being properly operated as

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237. Everson Statement, *supra* note 236, at 14.

238. *Id.*

239. *Roundtable on Tax Exemption: Before the S. Comm. on Finance*, 108th Cong. (2004) (statement of Dan Coleman, President and CEO, John C. Lincoln Health Network), *available at* http://finance.senate.gov/Roundtable/Daniel_Cole.pdf.

240. *Id.* at 3.

241. *Id.* Mr. Coleman further testified:

> In the hospital context, the supporting organization charter typically names the hospital to be benefited and, as required by IRS regulations, provides for an interlocking board of directors or management (or both) with the hospital. Supporting organizations allow hospitals to create fundraising entities with separate boards that can focus exclusively on the foundation's support mission.

Id.

242. *Id.*

> supporting organizations should be subject to the full enforcement power of the IRS to revoke exempt status and/or impose intermediate sanctions. . . . [A]ny proposed elimination of these supporting organizations would greatly harm hospitals.[243]

Senators Charles Grassley[244] and Max Baucus[245] wrote to the Department of the Treasury on February 3, 2005, outlining the abuses that concerned them.[246] The senators expressed concern regarding the inappropriate use of charitable organizations for purposes of tax avoidance and evasion and particularly about "charitable organizations avoiding private foundation rules by claiming public charity status as a Type III supporting organization (SO) under section 509(a)(3) of the Code."[247] The senators encouraged the Department of Treasury to revisit the regulations creating Type III supporting organizations.[248]

The U.S. Senate Finance Committee issued a press release on April 25, 2005, in which senators commented on the apparent abuses in supporting organizations.[249] The press release quoted Senator Grassley extensively:

> "This is extremely troubling," Grassley said. "Individuals are using supporting organizations to play fast and loose with the tax rules intended to help charities and encourage giving. It's clear Congress and the administration will have to take steps to stop this abuse and ensure that charitable donations benefit the needy. I'm deeply disturbed that with a good number of supporting organizations, people are taking multi-million dollar tax deductions for what they claim are contributions to charity, yet too often the result is a thimbleful of benefit to charity.
>
> "Both a Congressional Research Service report and the Finance Committee's review have made it clear that the problem isn't limited to Type III supporting organizations. The snake oil salesmen have also figured out how to manipulate Type I and II supporting organizations for the benefit of themselves and their clients. Meanwhile, the charities are lucky if they receive enough money to buy a blanket for the homeless. While the taxpayers get bilked by this abuse, sadly the needy ultimately suffer because they're denied the benefits intended by the tax law.
>
> "The law intended to allow supporting organizations only for a narrow set of circumstances. Unfortunately, creative types are exploiting a loophole in the regulations by setting up supporting organizations to skirt the laws governing private foundations. You could drive a Mack truck

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243. *Id.*
244. Senator Grassley (IA) is chairman of the Committee on Finance.
245. Senator Baucus (MT) is ranking member of the Committee on Finance.
246. Senate Committee on Finance Press Release, *supra* note 235, at 2-3.
247. *Id.* at 2.
248. *Id.* at 3.
249. *Id.* at 1-3.

through that loophole."[250]

Senator Baucus was similarly critical: "The purpose of giving taxpayers a charitable deduction is to encourage charitable works—bestowing this tax benefit is a public trust. Unfortunately, many entities organized as supporting organizations are little more than private piggy banks for greedy individuals."[251]

E. Judicial Examination of Supporting Organizations

While the legislature works toward a resolution, the courts are refining the supporting organization structure bit by bit. In *Lapham Foundation, Inc. v. Commissioner*, the tax court held that a supporting organization that allegedly benefited a donor-advised fund failed several of the tests required for supporting organizations.[252]

Charles P. and Maxine V. Lapham (the "Laphams") created the Lapham Foundation (the "Foundation") in 1998. The Foundation, a nonprofit corporation incorporated in Michigan, was set up to "operate exclusively for the benefit of the American Endowment Foundation [(AEF)], a publicly supported charit[y]."[253] The Foundation's board of directors consisted of the Laphams and three other individuals, one of whom was a representative of the AEF. [254] The Foundation's only asset was a promissory note in the amount of $1,554,244, made by a corporation which the Laphams owned and which was payable to them individually.[255] The Foundation's income was to be "[d]onations from the Lapham family and its friends, including individuals and businesses," and "[i]nterest on investments."[256]

After being denied supporting organization status by the IRS, the Foundation filed a declaratory judgment action in Tax Court.[257] Because the Foundation claimed to operate in connection with a supported charity, it was analyzed under the Type III requirements.[258] The Foundation failed to meet the Attentiveness Test under the Integral Part Test for Type III organizations.[259]

The court recognized that the Foundation passed the Responsiveness Test as required for a Type III organization, but it still had to clear the Integral Part

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250. *Id.* at 1.

251. *Id.*

252. Lapham Found., Inc. v. Comm'r, 84 T.C.M. (CCH) 586 (2002), *aff'd*, 389 F.3d 606 (6th Cir. 2004); *see also* Joel Ugolini, Note, *The Difficulties of Establishing a Supporting Organization when Making Charitable Contributions to a Donor-Advised Fund Program:* Lapham Foundation Inc. v. Commissioner, 56 TAX LAW. 929, 929 (2003).

253. *Lapham Found.*, 84 T.C.M. (CCH) 586.

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

259. *Id.* The attentiveness requirement of the Integral Part Test is set forth in 26 C.F.R. § 1.509a-4(i)(3) (2005).

hurdle.[260] To meet the Integral Part Test, the Foundation must satisfy either the But For Test or the Attentiveness Test.[261] The Foundation fulfilled neither.[262]

In an attempt to satisfy the But For Test, the Foundation claimed that but for its involvement, the AEF would discontinue making grants to support activities in the southeastern Michigan area, the targeted area of the Lapham's charitable aims.[263] The court was quick to note that: "such grant-making activities cannot properly be characterized as something in which AEF *would be* engaged *but for* petitioner's support. Rather, distributing grant moneys is something in which AEF *is* and will continue to be engaged *regardless* of support from petitioner."[264] Thus, the Foundation failed the But For Test.[265]

The Foundation had one more chance: passing the alternative Attentiveness Test. The court analyzed the "criteria intended to cultivate attentiveness" to determine whether the Foundation's support was enough or earmarked for an essential activity so that the charity worked to ensure continued donations.[266] Initially, the court noted that "support significant in amount relative to the beneficiary's total support is generally the defining characteristic."[267] The court easily found that the Foundation's anticipated donation of $7600, when compared to the AEF's yearly donations of over $7 million, was insignificant to ensure AEF's attentiveness.[268] The Foundation also claimed that it met the second facet of the Attentiveness Test because its funds were earmarked for a substantial activity of AEF. In response, the court noted that the AEF was not required to use the Foundation's money as requested.[269]

The Foundation did not meet either alternative test of the integral part requirement.[270] The Foundation appealed to the Sixth Circuit Court of Appeals which affirmed the tax court's findings.[271]

Court guidance on qualifying supporting organizations, such as the analysis provided in *Lapham*, may help brighten the details of the supporting organization structure. Substantial reform, however, must come in the form of legislation, not litigation.

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260. *Lapham Found.*, 84 T.C.M. (CCH) at 586.

261. *Id.* The Attentiveness Test is referred to as the Substantially All Income Test in Part II of this Article.

262. *See id.*

263. *Id.*

264. *Id.*

265. *Id.*

266. *Id.*

267. *Id.* (citing 26 C.F.R. § 1.509a-4(i)(3)(iii)(d) (2005)).

268. *Id.*

269. *Id.*

270. *See id.*

271. Lapham Found., Inc. v Comm'r, 389 F.3d 606, 614 (6th Cir. 2004).

V. POTENTIAL FOR CHANGE

The Treasury seems poised for change, and various organizations have proposed reforms that aim to curb the abuses relating to supporting organizations while preserving the form of entity as a charitable alternative. The American Bar Association, the Council on Foundations, and the Panel on the Nonprofit Sector all offered suggestions for reform.

A. American Bar Association

The American Bar Association's Tax Section responded in writing to the Finance Committee Roundtable's proposal to eliminate Type III supporting organizations.[272] The Tax Section acknowledged that these organizations have been misused and that the Type III structure maintains its potential for abuse; however, the Tax Section was hesitant to support a complete elimination of Type III organizations, and it instead made several specific suggestions to reform supporting organization tax law.[273] The Tax Section believed the Type III structure's benefits outweigh its potential for abuses, noting that this structure "offers institutions and donors valuable flexibility."[274]

The Tax Section's recommendations were aimed at increasing the supported charity's involvement with the supporting organization. The Tax Section proposed that the supported charity and the Type III organization demonstrate their commitment to work together.[275] The Tax Section's recommendations included the following:

1. Require new Type III supporting organizations to include an attachment to their application for recognition of tax-exempt status (Form 1023). The attachment would include a document bearing the signature of an officer of the supporting organization stating that the charity agrees to be supported and has received copies of the supporting organization's governing documents.[276] If an officer of the supported charity has agreed to actively oversee the supporting organization's activities, that officer should also confirm that commitment on the attachment.[277]

2. Require existing Type III supporting organizations to provide a similar attachment to their annual tax filing (Form 990).[278]

3. Require Type III organizations that are organized as corporations to state

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272. *See* Letter from Richard A. Shaw, Chair of Am. Bar Ass'n Tax Section, to the Hon. Charles E. Grassley, Chairman Senate Comm. on Fin. and Hon. Max Baucus, Ranking Member of Senate Comm. on Fin. (July 19, 2004) (on file with author), *available at* http://www.abanet.org/tax/pubpolicy/2004/040719ba.pdf [hereinafter Shaw Letter]; *see also* Staff Discussion Draft, *supra* note 235, at 2.

273. Shaw Letter, *supra* note 272, at 2.

274. *Id.* at 2 app. B.

275. *Id.* at 4-5.

276. *Id.* at 2 app. B.

277. *Id.*

278. *Id.*

how often during the year the representative of the supporting organization attended board meetings or otherwise exerted influence over the supporting organization's corporations.[279] The supported organization should establish a minimum level of involvement; failing to meet this requirement could mean losing status as a public charity.[280]

4. Require all Type III organizations to report their activities annually to each public charity they support. The report should include detailed financial information so that the supported charity can "determine whether it wishes to separate itself from the Type III organization, to become more actively involved overseeing it or to take other appropriate action."[281]

5. Allow supported charities to withdraw their consent to be supported by a specific Type III organization.[282] It would be helpful if the IRS issued an information letter to charities informing them about procedures to notify the IRS of their withdrawal of consent to be named as a supported charity. This notice is important because the charity's consent to support will impact the supporting organization's tax-exempt status.[283]

The American Bar Association was not the only organization to acknowledge that problems existed and reform was needed. Other organizations answered the call for suggestions and focused on similar issues of reporting and cooperation between the supporting organization and the supported charity.

B. Council on Foundations

The Council on Foundations ("Council"), a membership organization representing the interests of private foundations, also weighed in on the proposal to eliminate or to reform supporting organizations.[284] Like the ABA Tax Section, the Council recognized that abusive supporting organizations exist but was not in favor of eliminating the Type III structure.[285] Instead, the Council submitted suggestions for change, aimed at improving reporting and communication between the supporting organization and its supported charity.[286]

The Council stressed the requirement that the supported charity consent to be supported by the Type III organization.[287] In order to effectuate this demonstration of support, a new Type III organization must submit a statement

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279. *Id.*

280. *Id.*

281. *Id.*

282. *Id.*

283. *Id.*

284. Council on Foundations, Comments on Proposals in the Staff Discussion Draft Affecting Donor-Advised Funds and Supporting Organizations (Aug. 13, 2004) (on file with author), *available at* http://www.cof.org/files/Documents/Legal/2004/COFonDAF.pdf.

285. *Id.* at 13-14.

286. *Id.* at 13.

287. *Id.*

reflecting the supported charity's consent at its initial tax-exempt application.[288] Additionally, during the application phase, the Council suggested that IRS staff make *specific* inquiries to determine what efforts the supporting organization made to gain the supported charity's consent.[289] Like the ABA Tax Section, the Council suggested that the Type III organization file an annual consent statement by the supported charity, attached to the existing Form 990.[290]

The Council further suggested that the IRS issue revenue procedures through which Type III organizations can substantiate their relationship with the supported charity.[291] These procedures could require the Type III organization to send both its charity and the IRS an accounting of its annual support (or reasons for lack thereof).[292] This accounting, like the consent statement, could be attached to and filed with the Form 990.[293] In light of these consent and disclosure requirements, the Council suggested that the supported charity should be able to withdraw its consent to be supported by a Type III organization.[294] The IRS should provide procedures by which this withdrawal can be accomplished.[295]

The Council believes that these procedures, enacted by a minimal amount of legislative and regulatory overhaul, will "significantly reduce the likelihood that supporting organizations will be able to serve as vehicles for inappropriate activities."[296]

C. Panel on the Nonprofit Sector

In June 2005, the Panel on the Nonprofit Sector, the panel of charitable experts charged with recommending changes to Congress and the Nonprofit Sector on Governance Transparency and Accountability, submitted its final report on Type III supporting organizations.[297] The Panel noted that while these organizations have potential for donor abuse, Type III organizations "add value to the charitable sector that cannot be replaced by other types of organizations."[298] Thus, the Panel submitted specific suggestions to Congress and the IRS aimed at deterring abuse and strengthening the relationship between

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288. *Id.*
289. *Id.* at 13 app. D.
290. *Id.*
291. *Id.*
292. *Id.*
293. *Id.*
294. *Id.*
295. *Id.*
296. *Id.*
297. *See* PANEL ON THE NONPROFIT SECTOR, STRENGTHENING TRANSPARENCY GOVERNANCE ACCOUNTABILITY OF CHARITABLE ORGANIZATIONS: A FINAL REPORT TO CONGRESS AND THE NONPROFIT SECTOR 45-48 (2005), *available at* http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf
298. *Id.* at 47.

the Type III supporting organization and its supported charity. The Panel's proposals were among the most radical and required more regulatory changes than either the ABA Tax Section or the Council on Foundations.

The Panel wanted Congress to amend governing regulations to ensure that a Type III organization supports a charity, not its donors. In order to achieve this goal, all supporting organizations should be required to donate at least five percent of their net assets to supported charities annually.[299] Also, a supporting organization should not be permitted to make any grant, loan, donation, or other compensation to its donor.[300] To further discourage donor abuse, a Type III organization should be prohibited from supporting any charity or other organization controlled by its donor.[301] A Type III organization must share its governing documents and financial information with its supported charity; specifically, the supporting organization should include a detailed calculation of support and projections of support for the next year.[302] Finally, to ensure that supported charities truly benefit from their supporting organizations, a Type III organization must not support more than five charities at a time.[303]

Included in its congressional recommendations, the Panel proposed specific changes to the Responsiveness Test for trusts and corporations in order to improve their significant voice in the supported charity.[304] The Type III organization "must demonstrate a close and continuous relationship with the governing board or officers of the supported organizations."[305] This would require an "actual operating relationship[] between the managers" of the Type III organization and its charity.[306] The amended regulations should also specify how supporting organizations can demonstrate this significant voice factor.[307]

The Panel also submitted specific recommendations to the IRS to improve the relationship between the supporting organization and its charity, and to help discourage abuse. The IRS should:

1. Revise Form 990 so supporting organizations can indicate whether they qualify as Type I, II, or III,[308] and;

2. Require every Type III organization to submit a letter from each charity it supports.[309] The letter should be submitted at the initial application as well as filed annually with the Form 990.[310] The supported organization must verify its consent to be supported and describe how the supporting organization provides

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299. *Id.* at 45.
300. *Id.*
301. *Id.*
302. *Id.*
303. *Id.*
304. *Id.* at 46.
305. *Id.* at 45-46.
306. *Id.* at 48.
307. *Id.* at 46.
308. *Id.*
309. *Id.*
310. *Id.*

support that "furthers the charitable purposes of the supported organization."[311]

D. Looking Beyond the Supporting Organization Regulations for Reform

The suggestions of the American Bar Association, Council on Foundations, and Panel on the Nonprofit Sector may well reduce abuses in the supporting organization context. Increasing IRS filings and requiring better communication between the supporting organization and the supported charities may serve to discourage noncompliance with the spirit of the supporting organization regulations.

Targeted anti-abuse rules, accompanied by penalties, should help to close the loopholes that permit self-dealing. Expanding the supporting organization regulations, however, adds complexity to a system that is already "fantastically intricate."[312] In addition to examining the supporting organization regulations themselves and to increasing Form 990 filing requirements, reformers should look beyond the immediate context of supporting organizations and consider the broader mechanisms for monitoring charitable behavior.

VI. A NEW SUGGESTION FOR REFORMING SUPPORTING ORGANIZATIONS

Why do some people (and the organizations they control) misbehave and exploit opportunities for abuse, and why, conversely, do others choose to behave properly and observe the rules? The choices individuals make are complex, but one thing is clear—people behave better when they are afraid of being caught.

The great philosopher Michel Foucault has theorized that actual observation is not necessary to motivate a person to regulate his own behavior; the mere *belief* that one is being watched is enough to promote obedience.[313] According to Foucault, regulation of societal behavior is based on surveillance.[314] His classic example is Jeremey Bentham's Panopticon.[315] The Panopticon was an eighteenth century prison design in which cells were monitored from a central tower.[316] This design prevented the prisoner from determining whether anyone was watching him.[317] The prisoner's behavior was therefore regulated, not by guards, but by the prisoner's subjective vulnerability to being watched.[318] Modern psychological research supports this theory: people simply are more inclined to regulate their behavior when they believe they are under

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311. *Id.*

312. Windsor Found. v. United States, No. 76-0441-R, 1977 U.S. Dist. LEXIS 13643, at *5 (E.D. Va. Oct. 4, 1977).

313. *See* MICHEL FOUCAULT, DISCIPLINE AND PUNISH: THE BIRTH OF THE PRISON 201-03 (Random House 1977) (1975).

314. *Id.*

315. *Id.* at 200.

316. *Id.*

317. *Id.* at 201.

318. *Id.*

surveillance.[319]

Lawmakers are aware of the phenomenon that monitoring—or the risk that activities may be monitored—encourages compliance with rules. Charities, including supporting organizations, are subject to the public disclosure regulations of section 6104(d) of the Internal Revenue Code.[320] These regulations require charities to reveal their informational returns, which include detailed financial information about the organization, to members of the public.[321] The disclosure of this information increases the probability that improper financial dealings will be revealed because the public and media, in addition to the IRS, may access this information. The public disclosure requirements of section 6104 mandate that a qualified organization make the following documents available for public inspection or provide copies upon request: the organization's annual return, exempt status application materials, exempt status notice materials, and reports of the organization's expenditures and contributions.[322]

The public disclosure requirements dramatically increase the probability that the public and the media will have access to a charity's records and thus misdeeds will not pass unnoticed.[323] Members of the public are more likely to seek out records of the publicly supported charities to which they have donated or from which they have sought services, and thereby monitor the charities themselves. But will the public also monitor the charities' supporting organizations? Section 6104 public disclosure requirements apply to supporting organizations in the same manner as all other tax-exempt organizations.[324] The truth is out there—but are people finding it?

By all appearances, the actions of supporting organizations are not heavily

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319. *See* Jeffrey H. Reiman, *Driving to the Panopticon: A Philosophical Exploration of the Risks to Privacy Posed by the Highway Technology of the Future*, 11 SANTA CLARA COMPUTER & HIGH TECH. L.J. 27, 41 (1995) ("To the extent that a person experiences himself as subject to public observation, he naturally experiences himself as subject to public review. As a consequence, he will tend to act in ways that are publicly acceptable."); *see also* Christopher Slobogin, *Public Privacy: Camera Surveillance of Public Places and the Right to Anonymity*, 72 MISS. L.J. 213, 243-45 (2002).

320. I.R.C. § 6104(d) (2000). Certain types of charities, such as hospitals and other health care organizations, are also regulated outside of the tax system. *See* William M. Sage, *Regulating Through Information: Disclosure Laws and American HealthCare*, 99 COLUM. L. REV. 1701 (1999) (discussing how transparency and disclosure are used to regulate the healthcare industry).

321. *Id.*; *see also* Sage, *supra* note 320, at 1810.

322. I.R.C. § 6104(d).

323. *See* Susan N. Gary, *Regulating the Management of Charities: Trust Law, Corporate Law, and Tax Law*, 21 U. HAW. L. REV. 593, 640 (1999). In favor of increased public disclosure to aid in protecting charities against fiduciary abuse, Gary noted that "[e]asier public access to information, more effective disclosure, and for certain transactions, increased disclosure, will help." *Id.* at 639.

324. 26 C.F.R. § 301.6104(d)-1(b)(2) (2005); *see also* Shoemaker & Brockner, *supra* note 233, at 119.

monitored. The potential for abuse in the supporting organization context stems in part from the method by which these organizations are overseen. Private foundations are overseen by the IRS.[325] Publicly supported charities are overseen by their donors and the general public.[326] Who oversees supporting organizations?

The structure of the supporting organization regulations assumes that the supported charity will act as a check on the supporting organization's behavior.[327] The supported charity itself has an economic interest in the affairs of the supporting organization, and it should, by the structure of the relationship, pay attention to the activities of the supporting organization. The supported charity, however, bears no responsibility for overseeing the supporting organization, and it suffers no legal or tax consequence if it chooses to neglect it. The supported charity has no duty to oversee.

Supported charities garner substantial benefit from the tax treatment of supporting organizations. If supporting organizations were abolished, the founders of these charities would likely create private foundations—subject to greater tax, but free from the ties to specific publicly supported charities. Although they are under no express duty to oversee them, supported charities are best served by maintaining the existence of 509(a)(3) organizations.

The supported charities, however, are obtaining these benefits without sufficient concomitant responsibility. The system is designed such that the supported charities are expected to be aware of and react to the activities of the supporting organizations.[328] Unfortunately not all do. When supporting organizations are managed improperly, insufficient oversight and low risk of exposure may be the reasons. Aside from the risk of financial loss arising from the supporting organization's wrongdoing, a risk that is in some cases insufficient, the supported charities have no responsibility for the actions of their supporting affiliate.

In banking law, the Office of the Comptroller of the Currency identifies certain types of risk that financial institutions must manage.[329] This concept of risk can also inform decisions about how to motivate the proper oversight of supporting organizations. Two relevant categories of risk are compliance risk

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325. *See* I.R.C. § 6104.

326. But whose public does a charity serve? *See* Brody, *supra* note 29, at 1036 (arguing that "this decision is legitimately made by private parties—donors, charity boards, and members—and so a charity's public is not necessarily the local community, the state, or any other public that constitutes the constituents of an attorney general, a legislature, or a judge").

327. *See* 26 C.F.R. § 1.509(a)-(4)(i)(3)(iii)(d).

328. *See* Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277-78 (7th Cir. 1979).

329. A "risk" is the potential for an event, arising from the business of banking, that would seriously damage a bank. *See, e.g.*, COMPTROLLER OF THE CURRENCY, DETECTING RED FLAGS IN BOARD REPORTS, A GUIDE FOR DIRECTORS 2 (2003), *available at* http://www.occ.treas.gov/rf_book.pdf (listing nine categories of risk: "credit, liquidity, interest rate, price, foreign currency translation, compliance, strategic, reputation, and transaction").

and reputational risk.[330] Compliance risk (also called legal risk) is "the risk to earnings or capital arising from violations of, or nonconformance with, laws, rules, regulations, prescribed practices, or ethical standards[,]" and reputational risk is "the risk to earnings or capital arising from negative public opinion."[331]

As the rules currently stand, supported charities bear no substantial compliance risk or reputational risk for the actions of their supporting organizations. Requiring the supported charity to be responsible for complying with the public disclosure rules for materials of their affiliated supporting organizations increases reputational risk to the supported charity. It also creates compliance risk, because the supported charity risks violating a tax regulation if it fails to collect and publicize the informational returns of the supporting organization. Sensitivity to the added reputational risk and compliance risk will motivate the supported charity to properly oversee the supporting organization.

It is time for supported charities to partner with the public in monitoring the actions of their supporting organizations. As the beneficiaries of the supporting organizations, supported charities are in a strong position to collect information about supporting organizations' activities and finances. Perhaps more importantly, the supported charities are visible establishments capable of garnering public attention and have the ability to *publish* that information. There is a gap between the activities of anonymous supporting organizations and the public; the supported charities are the bridge.

Supported charities should be required to disclose the information returns of their affiliated supporting organizations. The public disclosure regulations should be amended to require supporting organizations to disclose their materials two ways: directly and through their supported charities. A proposed addendum of a new final paragraph (subsection (9)) to the public disclosure regulations,[332] could read as follows:

> (9) *Special rules for organizations defined in section 509(a)(3) and organizations receiving support from organizations defined in section 509(a)(3).* An organization referred to in section 509(a)(3), hereinafter called a "supporting organization," shall, in addition to complying with paragraph (1) above, provide all materials described in paragraph (1) above to any organization it supports (within the meaning of section 509(a)(3) (hereinafter called a "supported charity")). A supported charity shall in turn disclose the materials described in paragraph (1) above relevant to those supporting organizations. A supported charity shall disclose the materials of its affiliated supporting organizations in the same manner it discloses its own materials, and the above rules and

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330. *Id.*

331. COMPTROLLER OF THE CURRENCY, BANK SUPERVISION PROCESS, COMPTROLLER'S HANDBOOK 21 (1996), *available at* http://www.occ.treas.gov/handbook/banksup.pdf. *See generally* FEDERAL RESERVE: BANK HOLDING COMPANY SUPERVISION MANUAL (2004), *available at* http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc0604.pdf.

332. *See supra* notes 320-22 and accompanying text.

> procedures shall apply equally to materials of the supported charity itself and those of its affiliated supporting organizations. The supporting organization shall reimburse the supported charity for its actual costs in complying with the disclosure requirement relative to the supporting organization.

The enactment of this additional disclosure requirement would dramatically increase the visibility and transparency of informational returns of supporting organizations. Members of the public are unlikely to troll the Internet for information on nameless supporting organizations, but they are more likely to review the financial information of charities to which they donate. When donors receive information about their charity, revealing the existence of affiliated supporting organizations, the donors (and the media) are more likely to explore the supporting organization's materials as well.

The availability of this information is increasing as charities choose to comply with the disclosure requirement through web posting on sites such as Guidestar.[333] The *Chronicle of Philanthropy* story on supporting organization abuse broke based upon information available on Guidestar. Perhaps if supporting organization returns were more widely posted on the web, they would be subject to greater exposure and greater monitoring. Supported charities could simply provide a link to supporting organization materials on the website where they post their own.

Reforming public disclosure requirements to increase the number of people who are likely to see the financial returns is an important first step. Additional steps should be taken, however, to insure that what is being disclosed, and the form in which it is communicated, is helpful to readers. As Nina Crimm has argued, "[t]o enhance the standards of accountability, states and the federal government should consider reforming the types of information and format of data required to be disclosed at foundations' formation, application for tax-exempt status, and annually thereafter."[334] There is much work to be done in improving institutional transparency and accountability.[335] Broader disclosure of supporting organization returns is progress toward this goal.

The drawback to revising the public disclosure rules is that it adds further burden and complexity to a heavily regulated sector. Over-regulation may backfire: "decision-makers of organizations that operate in regulatory environments, particularly in over-regulated environments such as those created

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333. Guidestar is a website run by Philanthropic Research Institute, Inc., a nonprofit corporation. The website provides information on charities (including tax returns). *See* www.guidestar.org (last visited Feb. 21, 2006).

334. Nina J. Crimm, *A Case Study of a Private Foundation's Governance and Self-Interested Fiduciaries Calls for Further Regulation*, 50 EMORY L.J. 1093, 1188 (2001).

335. *See* Frances R. Hill, *Targeting Exemption for Charitable Efficiency: Designing a Nondiversion Constraint*, 56 SMU L. REV. 675, 717 (2003) ("The nondiversion constraint . . . provid[es] the basis for operational transparency. . . . [and] establishes a workable framework for meaningful participation and accountability within exempt organizations.").

in the area of taxation, unfortunately may establish institutional standards and systems primarily focused on minimal satisfaction of the regulatory requirements rather than guided by an enthusiastic promotion of their purposes."[336] The additional regulatory burden here, however, is minimal compared to the alternative solutions.

The reports of supporting organization abuse are serious, and a serious response is needed. When supported charities abide by the proposed enhanced public disclosure rules with respect to their affiliated supporting organizations, the increased public scrutiny will encourage sounder compliance with existing tax laws. If, however, abuses continue—and the choice is to either eliminate Type III supporting organizations or to find a way to control them—the Treasury should consider enacting regulations that require the supported charity not only to participate in the public disclosure process, but to assume full responsibility for monitoring the activities of the supporting organization affiliated with it.

CONCLUSION

Supporting organizations are versatile and efficient vehicles for managing wealth for charitable purposes. They are also susceptible to abuse and over-reaching control. For supporting organizations to flourish in the current environment of institutional skepticism, they must submit to greater levels of transparency.

The supporting organization structure is not broken. Although complex, the rules surrounding supporting organizations are logical and were designed to enable the operation of a special kind of charity—one that does not fit soundly in the categories of public charity or private foundation. The intricate structure of the supporting organization rules relies upon the charities with which the supporting organizations affiliate to serve as checks on the supporting organization. The trouble and scandals emerging with respect to supporting organizations do not stem from the fact that these organizations are inherently bad or subject to abuse, but from the fact that they are not being overseen as originally designed.

The current supporting organization regulations and their historical enactment suggest a presumption that supporting organizations do not require the oversight of the IRS—and the more stringent rules that apply to private foundations—because of their close working relationship with publicly supported charities. Publicly supported charities are monitored by their donors, and the charities in turn are expected to monitor the activities of their affiliated supporting organizations.

Resting full responsibility for the oversight of supporting organizations on the charities they support may be a burdensome solution, but the cooperation of the supported charities in increasing public surveillance is a reasonable

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336. Nina J. Crimm, *Through A Post-September 11 Looking Glass: Assessing the Roles of Federal Tax Laws and Tax Policies Applicable to Global Philanthropy by Private Foundations and Their Donors*, 23 VA. TAX REV. 1, 154 (2003).

responsibility. Supported charities must assist the public and the media to monitor the actions of these supporting organizations, and they can most effectively cooperate with the public by sharing information. Amending the public disclosure regulations to require supported charities to disclose the information returns of the supporting organizations with which they affiliate will increase the transparency of supporting organizations. It will also result in wider availability of this information and help to insure that the supporting organizations behave ethically and appropriately.

Charity is a virtue, but not all charities are virtuous. In developing the notion of charitable accountability, transparency is essential. In the context of supporting organizations, transparency can transform a charitable structure plagued by exploitation into a philanthropic tool full of potential.

Appendix A
Supporting Organization Structure