BEST SUPPORTING ACTOR: REFINING THE 509(A)(3) TYPE 3 CHARITABLE ORGANIZATION

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INTRODUCTION

Donors who contribute financially to certain charitable, educational, scientific, and religious organizations may receive tax deductions for their contributions.[1] Although the reasons the government foregoes these taxes are debated, the most widely accepted explanation is that the government is subsidizing the charitable organizations in return for the tangible and intangible societal benefits they provide.[2] Because it is imperative that society receive the benefits the government has subsidized, the analysis and improvement of Internal Revenue Service (IRS) regulations pertaining to charitable organizations is a significant endeavor.

According to the IRS, these organizations are divided into "public charities" and "private foundations."[3] The public charities defined in Internal Revenue Code § 509(a) include universities, churches, hospitals, museums, and ballet companies, and generally are engaged in "inherently public activities," meet one of several public support tests, or support one of the above-noted organizations.[4] These support requirements each allow for some form of supervision by the general

1. I.R.C. § 170 (1994).

2. John D. Colombo, *The Marketing of Philanthropy and the Charitable Contributions Deduction*, 36 WAKE FOREST L. REV. 657, 659, 682 (2001) (noting that many have written on the § 170 deduction and explained it in several ways).

3. In this Note, "public charity" refers to the categories of charitable organizations listed in I.R.C. § 170(b)(1)(A). "Private foundation" refers to nonoperating private foundations.

4. I.R.C. § 509(a)(1)–(3); 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) (defining "inherently public activities"). Public charities also include organizations that test for public safety. I.R.C. § 509(a)(4).

public, thus making substantial governmental oversight unnecessary.[5] "Private foundations," defined by the Code as organizations *not* described in § 509(a), do not have to receive public support, and they receive less favored tax status than public charities.[6]

The § 509(a)(3) "supporting organization" is a hybrid of the public charity and the private foundation. Like private foundations and unlike public charities, supporting organizations do not need to satisfy any public support requirements.[7] For tax deduction purposes, however, supporting organizations are treated like public charities.[8] Theoretically, supporting organizations escape private foundation taxes and regulations because their close relationships with publicly supported organizations ensure public supervision.[9] Practically, this is not always the case.

A recent settlement involving Reader's Digest Association, Inc., illustrates how inadequate public supervision of supporting organizations can harm the public charities they are intended to support. Over the past two decades, seven supporting organizations endowed by the founders of *Reader's Digest* magazine, Lila and DeWitt Wallace, granted $900 million to public charities such as Lincoln Center, Colonial Williamsburg, and Memorial Sloan-Kettering Cancer Center.[10] On April 30, 2001, however, New York Attorney General Eliot Spitzer presided over a long-discussed settlement resulting in the dissolu-

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5. William F., Mable E., and Margaret K. Quarrie Charitable Fund v. Comm'r, 70 T.C. 182, 190 (1978).

6. I.R.C. § 509. Although contributions to a private foundation are limited to 30% of the donor's adjusted gross income for cash contributions and 20% for contributions of appreciated assets, the limits for contributions to supporting organizations are the same as for public charities: 50% and 30%, respectively. *Id.* § 170(b)(1). In addition, contributions of appreciated property to public charities are deductible at fair market value, while they are limited to basis for private foundations. *Id.* § 170(e)(1), (3). Also, the reporting requirements and the excise taxes that restrict the activities of private foundations—on investment income, acts of self-dealing, failure to distribute 5% of its assets annually, excess business holdings, investments that jeopardize the foundation's charitable purpose, and certain taxable expenditures—do not apply to public charities. *Id.* §§ 4940–4948, 6033, 6056, 6685, 7207.

7. *Id.* § 509(a)(3).

8. *Id.* § 170(b)(1).

9. *Quarrie Charitable Fund*, 70 T.C. at 190.

10. Ralph Blumenthal, *13 Institutions Obtain Control of Vast Bequest*, N.Y. TIMES, May 4, 2001, at A1. Among the organizations were the Lila Acheson Wallace Fund for the Metropolitan Museum of Art, the Lila Acheson and DeWitt Wallace Fund for Lincoln Center, the DeWitt Wallace Fund for Macalester College, the Lila Acheson and DeWitt Wallace Fund for the Hudson Highlands, the DeWitt Wallace Fund for Colonial Williamsburg, the Lila Acheson Wallace Fund for Wildlife Conservation, and the DeWitt Wallace Fund for Memorial Sloan-Kettering Cancer Center. *Id.*

tion of all seven supporting organizations and the transfer of the organizations' $1.7 billion endowment directly into the coffers of the public charities.[11] When Attorney General Spitzer finally announced the settlement, he said, "There was a sense that there wasn't as much independence as the beneficiary-entities wanted."[12] It appears that Attorney General Spitzer believed that Reader's Digest executives were exercising too much control over the supporting organizations' decisionmaking, and, therefore, that the supporting organizations were not properly "supporting" the public charities.

This Note discusses an element of supporting organizations that commentators and courts have not addressed at length: the inadequacy of the "significant voice" requirement for Type 3 supporting organizations.[13] As long as the Internal Revenue Code treats supporting organizations as public charities for tax deduction and tax exemption purposes, all supporting organizations—including Type 3 organizations—must be responsive[14] to the public charities they support. This Note argues that, as defined by the regulations, a "significant voice" does not guarantee enough responsiveness. The supported public charities need a more effective instrument to ensure that they receive the support that the government intends.

First, this Note discusses the origins of and the distinctions among some charitable organizations. Although the legislative history reveals that there was much disagreement among scholars and politicians about the definitions of charitable organizations, it also exposes some important common ground. Next, the Note discusses the Type 3 supporting organization and its problems. The Reader's Digest settlement demonstrates how a Type 3 supporting organization might be manipulated to the public charity's detriment. Last, the Note recommends refining rather than eliminating the Type 3 structure. Although tax counsel to the House Ways and Means Committee have considered eliminating the Type 3 structure, this hybrid structure is a

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11. Dewitt Wallace–Reader's Digest Fund, Inc., Assurance of Discontinuance, Office of the Attorney General of New York, ¶ 1.1, at 2 (Apr. 30, 2001) (on file with the *Duke Law Journal*) (acquired by a request through the New York Freedom of Information Law); Blumenthal, *supra* note 10, at A1.

12. Anne Marie Chaker, *Reader's Digest Funds Revamp, Give Control of Assets to Charities*, WALL ST. J., May 4, 2001, at B4.

13. Treas. Reg. § 1.509(a)-4(i)(2)(ii) (as amended in 1981). A Type 3 supporting organization is "operated in connection with" the supported public charity or charities. *Id.* § 1.509(a)-4(i).

14. *See infra* Part II.B.

useful element of charitable giving in the United States.[15] This Note recommends requiring that if a supporting organization is not a charitable trust, it be a membership corporation. The majority of this membership corporation's members should be appointed by supported public charities and should vote for the corporation's directors. Although the members would not vote out directors often, this power would be an important safeguard to ensure that the supporting organization is responsive to the needs of the public charity that it supports. This reform would help protect the Type 3 organization from abuse while ensuring that philanthropists do not refrain from creating Type 3 organizations for fear of having them dismantled by authorities.

I. HISTORY AND STRUCTURE OF TAX-EXEMPT ORGANIZATIONS

A. Private Foundation Abuses

Charity always has held a favored position in the United States's taxation scheme. In 1894, an income tax law first established the concept of tax-exempt organizations.[16] In 1913, when the individual income tax was enacted,[17] a charitable deduction proposal was rejected,[18] but four years later, when the War Revenue Act included high income tax rates to support the war, individuals were allowed to deduct charitable contributions.[19] Senator Henry Hollis explained that the deduction was used to encourage philanthropy: "Usually people contribute to charities and educational objects out of their surplus. . . . Now, when war comes and we impose these very heavy taxes on incomes, that will be the first place where the wealthy men will be

15. *Edited Transcript From the January 15, 1999 ABA Exempt Organizations Committee Meeting*, 24 EXEMPT ORG. TAX REV. 67, 73 (1999) (statement of Tim Hanford). According to Tim Hanford, who was tax counsel to the House Ways and Means Committee at the time, "Some have suggested to us that we might consider elimination of the type three supporting organization on the theory that [it] is a fairly loose test for exemption from private foundation status." *Id*.

16. *See* Act of Aug. 27, 1894, ch. 349, § 32, 28 Stat. 509, 556 ("[N]othing herein contained shall apply . . . to corporations, companies, or associations organized and conducted solely for charitable, religious, or educational purposes . . . ."). One year later, for reasons unrelated to the subject matter of charitable exemptions, §§ 27–37 of the Act were held unconstitutional by the Supreme Court. Pollack v. Farmers' Loan & Trust Co., 158 U.S. 601, 635–37 (1895).

17. Act of Oct. 3, 1913, Pub. L. No. 63-16, 38 Stat. 114.

18. 50 CONG. REC. 1259 (1913).

19. War Revenue Act of 1917, Pub. L. No. 65-50, § 1201(2), 40 Stat. 300, 330.

tempted to economize, namely, in donations to charity."[20] Even though the deduction decreased the amount of taxes collected, Congress justified this depletion in 1938 "based upon the theory that the Government is compensated for the loss of revenue by its relief from financial burden which would otherwise have to be met by appropriations from public funds, and by the benefits resulting from the promotion of the general welfare."[21]

The difference in tax treatment between charitable deductions for donations to private foundations and to public charities has its origins in the Internal Revenue Code of 1954.[22] Under that Code, donors to hospitals, schools, and churches were subject to a 30% limitation rather than the 20% limitation for other tax-exempt organizations.[23] Congress explained that this benefit would encourage contributions to these particular institutions.[24] In 1964, the 30% group was expanded to include organizations that received "substantial" public support.[25] Here, Congress explained that the purpose of this additional deduction was to increase the immediately spendable contributions to certain charitable organizations.[26]

Because these tax deductions divert money from the public treasury to the charitable organizations, it is not surprising that the Tax Reform Act of 1969 was hotly debated in Congress. This Act proposed to create a definition of "private foundation" and distinguish this entity from public charities.[27] Leading the charge for additional taxes and restrictions on private foundations was House Banking and Currency Committee Chairman Wright Patman, who focused his grievances on the foundations' politically charged projects.[28] In some cases, Patman and other reactionary politicians wanted to stop the larger foundations from pursuing esoteric scholarship and

20. 55 CONG. REC. 6728 (1917) (statement of Sen. Hollis).

21. H.R. REP. NO. 75-1860, at 19 (1938).

22. Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3.

23. *Id.* § 170, 68A Stat. at 58.

24. H.R. REP. NO. 83-1622, at 29 (1954); *see also* S. REP. NO. 83-1622, at 29 (1954), *reprinted in* 1954 U.S.C.C.A.N. 4621, 4660 (citing "rising costs and the relatively low rate of return [the institutions] are receiving on endowment funds" as reasons for encouraging contributions).

25. I.R.C. § 170 (1964).

26. S. REP. NO. 83-830, at 58 (1964).

27. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487 (codified in scattered sections of the Internal Revenue Code).

28. H.R. REP. NO. 90-1985, at 48–49 (1968).

progressive change.[29] Conservative members of Congress complained that foundations were advocating against the Vietnam War, calling for the abolition of the House Un-American Activities Committee, and recommending admission of "Red China" to the United Nations.[30] Patman and his colleagues argued for restrictive antilobbying laws that would prevent foundations—which were growing more and more wealthy[31]—from formulating stances on social issues.[32] Patman was so fanatical that he was accused of manipulating congressional procedure.[33] Patman's war against the evasion of "moral responsibility to the Nation"[34] has led to a characterization of these debates as "an aberrant spasm of Congressional anger at foundations."[35]

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29. Some of the anger toward foundations is reminiscent of the more recent National Endowment for the Humanities debates:

> While our cities decay, and while those of us not fortunate enough to merit the tax-exempt status of the foundations pay a 10 percent surtax to keep the nation more or less solvent, the Bollingen Foundation of New York City, a creation of the Mellon banking family of Pittsburgh, spends tax-free dollars on such esoteric research subjects as: "The works of Hugo von Hofmannsthal," "The phenomenology of the Iranian religious consciousness," "The origin and significance of the decorative types of medieval tombstones in Bosnia and Herzegovina."

115 CONG. REC. 22,605 (1969) (statement of Rep. Patman). But some of the resistance to foundations had insidious racial overtones. For example, Representative John Ashbrook of Ohio introduced statements that "it was the general view in Cleveland that the Ford Foundation had materially affected the results" of the election in which Carl Stokes was elected mayor of Cleveland; that the Ford Foundation had been "accused" of "exerting influence over key Board of Education Members" in its New York City school decentralization project; that the Ford Foundation had given substantial financial assistance to Harlem's Intermediate School 201, "despite continuous manifestations of anti-Semitism, racism and violence"; and that the Ford Foundation set a goal "to increase the number of Negro members of Congress from nine to 30." *Id.* at 4960 (statement of Rep. Ashbrook). Representative Albert Watson of South Carolina lamented that while the Ford Foundation's programs claimed to be "educational," they in fact promoted "racial strife." *Id.* at 10,888 (statement of Rep. Watson).

30. *E.g.*, *id.* at 29,507 (statement of Rep. Blackburn).

31. *See, e.g.*, 114 CONG. REC. 17,966 (1968) (statement of Rep. Madden) (reporting that a study by the Treasury Department found that 596 foundations under evaluation were valued at $10.2 billion in 1960, as compared to $15.1 billion in 1966).

32. *E.g.*, 115 CONG. REC. 22,611 (1969) (statement of Rep. Boland).

33. Representative Silvio Conte, ranking minority member of the House Small Business Subcommittee on Foundations, said:

> I rise to point out in fact that I do not have the slightest knowledge or information about what my subcommittee is investigating. . . . [T]he only time I ever hear anything about the activities of my Foundations Subcommittee is when I pick up the paper to see that Chairman Patman has issued another installment of his treatise.

114 CONG. REC. 8382 (1968) (statement of Rep. Conte).

34. 115 CONG. REC. 22,603 (1969) (statement of Rep. Patman).

35. Thomas Troyer, *The 1969 Private Foundation Law: Historical Perspective on its Origins and Underpinnings*, TAX NOTES TODAY, Sept. 20, 2000; *see also* 115 CONG. REC. 22,611 (1969)

But while Patman and his followers may have been overzealous in punishing foundations for "moral" abuses, they were justified in policing the foundations' fiscal abuses. Several Treasury Department reports carefully detailed serious mistreatments of the charitable deductions by some foundations. For example, a 1965 Treasury report revealed that although a preponderant number of private foundations were performing their functions without subverting the tax laws, a minority operated abusively.[36] These abuses included self-dealing between foundations and those who controlled them, undue delay in the distribution of foundation income, and excessive foundation involvement in business.[37] The debates for the Tax Reform Act of 1969 also included discussion of another Treasury report that described 154 individuals who earned at least $200,000 each in 1966, but manipulated charitable deductions so that they did not pay any income tax.[38]

Conservative and progressive members of Congress found common ground on closing the loopholes identified by the Treasury Department. Even Senator Charles Goodell, who believed the laws preventing private foundations from any lobbying-like actions represented "a punitive attack upon the very essence of private philanthropic activities in this country," urged reform.[39] "For sure," Goodell said, "certain areas of foundation tax treatment are in need of overhaul. There have been a number of foundation abuses which must be corrected. Self-dealing between a foundation and its donors must be prohibited. The misuse of tax exemption for private influence or gain should be curtailed."[40] Politicians on both sides of the aisle agreed that the incidents of self-dealing and fraudulent transactions in private foundations had to be eliminated.[41]

(statement of Rep. Boland) (observing that "[s]ome are angry with foundations and say it is acceptable to punish them").

36. STAFF OF HOUSE COMM. ON WAYS AND MEANS, 89TH CONG., TREASURY REPORT ON PRIVATE FOUNDATIONS 5–10 (Comm. Print 1965).

37. *Id.*

38. 115 CONG. REC. 22,577 (1969) (statement of Rep. Ullman).

39. *Id.* at 26,508 (statement of Sen. Goodell).

40. *Id.*

41. *See also Tax Reform Act of 1969: Hearing on H.R. 13270 Before the S. Comm. on Fin.*, 91st Cong. 10 (1969) (statement of Dan Throop Smith, Professor of Finance, Harvard University):

> As regards private foundations, the prohibitions on self-dealing seem thoroughly reasonable and desirable. There have been significant abuses and the proposed constraints would not appear to hamper any reasonable objectives of foundations. The same statement seems valid with respect to the limitation on stock ownership and the use of assets . . . .

B. Donor Control of Private Foundations

While politicians poured over the Treasury reports offering statistical evidence to support policing private foundations, they also considered the foundation structure. This structure is more susceptible to donor abuse than the public-charity structure because donors can retain some control over foundations in ways they cannot retain control over public charities. One commentator has explained the difference between private foundations and public charities as Congress saw it in 1969:

> The very nature of the private foundation made it peculiarly vulnerable to use for personal purposes. Typically established by one individual or family, endowed solely from their funds, and devoted to purposes which they selected, private foundations were likely to be dominated entirely by their donors during the donors' lives and, for at least some substantial period after their deaths, by their families or narrow groups of trusted associates. . . . As a practical matter, subject only to the outside chance of an IRS audit—before 1969 a very outside chance indeed—foundations' operations commonly were carried on from year to year without the knowledge, interest, or intervention of any outside party. . . . The nature of public charities, on the other hand, was generally quite different. Ordinarily they were *controlled by—or, at a minimum, open to the review and intervention of—parties independent of any single donor.*[42]

For a charitable organization to qualify as a public charity, it would have to be subject to the "intervention" of parties independent of the donor. This "intervention" would be necessary to ensure that the donor did not directly or indirectly control the foundation. As early as 1964, House Banking and Currency Committee Chairman Wright Patman focused on the control permitted by the private foundation:

> Patman: Would you agree that it is a simple matter for anyone to form a foundation as a trust or non-profit corporation under state law and personally to designate the trustees or directors to manage its affairs?
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> Harding: I think that is right, yes, sir.
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> . . .

42. Troyer, *supra* note 35 (emphasis added).

> Patman: Would you agree that there is ample evidence that some donors find it hard to forget that the foundation's assets once belonged to them?
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> Harding: I think that we have seen some of that, yes, Mr. Chairman.
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> . . .
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> Patman: Would you agree that, when directors of a foundation are selected because of their familial relationship or personal loyalty to the donor, it is too much to expect that they will rigidly adhere [to fiduciary standards] in approving the donor's self-dealing?
>
> Harding: I think it raises a very difficult problem, Mr. Chairman.[43]

Throughout this exchange, Patman's constant references to the donors' control demonstrate his concern that the donors received benefits at the expense of the public fisc.

Today, "control" remains an important reason tax-deduction policy treats public charities more favorably than private foundations. One example of how the current Code uses "control" to distinguish the two entities is found in a regulation that requires a private foundation to transfer all its assets to a public charity upon dissolution.[44] This regulation allows the private foundation to escape taxation under § 507(c) as long as the private foundation donor does not "control" the contribution. The regulation prevents this control by precluding the donor from creating a "material" restriction that would prevent the public charity "from freely and effectively employing the transferred assets, or the income derived therefrom, in furtherance of its exempt purposes."[45] Whether a restriction is "material" depends on the particular facts and circumstances, including

> (A) Whether the public charity (including a participating trustee, custodian, or agent in the case of a community trust) is the owner in fee of the assets it receives from the private foundation; (B) Whether such assets are to be held and administered by the public charity in a manner consistent with one or more of its exempt purposes; (C) Whether the governing body of the public charity has the ultimate authority and control over such assets, and the income de-

43. *Tax Exempt Foundations and Their Impact on Small Business: Hearings Before the House Subcomm. on Founds. of the House Select Comm. on Small Bus.*, 88th Cong. 281–83 (1964) (statements of Rep. Patman and Bertrand Harding, Acting Commissioner, IRS).

44. Treas. Reg. § 1.507-2 (as amended in 1981).

45. *Id.* § 1.507-2(a)(8)(1).

> rived therefrom; and (D) Whether, and to what extent, the governing body of the public charity is organized and operated so as to be independent from the transferor.[46]

Here, it is clear that the public charity must exercise control over a taxpayer's contribution to qualify the contribution as a deduction.[47] A deduction for donating to a public charity is justified only when the public charity exercises "full control" sufficient to guarantee the charity discretionary use of donated funds to carry out the charity's functions and purposes.[48]

This "control" element is also important in the international framework. For instance, contributions to a domestic organization that transmits all or some of its funds to foreign transferees will be deductible only if the board of directors of the domestic organization has "discretion and control" over the use of the contributions.[49]

Therefore, the practical decision of whether a donor should create a private foundation or an organization that qualifies for better tax treatment depends on the amount of control the donor wants. One commentator explains:

> The main advantage of a private foundation over the alternatives can be summarized in one word: *Control*. . . . If the donor is willing to give up some or all control over her gift, she can gain other advantages, including greatly reduced administrative responsibilities and costs. For a donor who is committed to becoming a philanthropist, no alternative other than the private foundation may provide a degree of control sufficient to allow the donor to achieve her goals . . . . This broadest latitude is the reason that private foundations are recognized as the free agents of the charitable world: They are not answerable to large public memberships or required continuously to raise funds, as are most public charities.[50]

This "latitude" allows a foundation donor to provide in the foundation's governing documents as few or as many restrictions as desired.

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46. *Id.*

47. Rev. Rul. 62-113, 1962-2 C.B. 10, 11.

48. *Id.; see also* Davis v. United States, 861 F.2d 558, 562–66 (9th Cir. 1988) (explaining that taxpayers could otherwise earmark funds and, by characterizing the contributions as charitable contributions, receive deductions for what are in fact personal gifts). Section 262 of the Internal Revenue Code proscribes the deduction of personal expenses, which include personal gifts. I.R.C. § 262 (1994).

49. Priv. Ltr. Rul. 96-51-031 (Dec. 20, 1996) (citing Rev. Rul. 66-79, 1966-1 C.B. 48).

50. Bjorklund, *supra* note 4, at 78–79.

For example, "the founder of a family foundation can include a provision requiring that at least 60% of the directors or trustees be his or her direct lineal descendants."[51]

Donor control of supporting organizations can give these donors inequitable tax advantages, such as the ability to accelerate the tax benefits of future years' charitable contributions. A donor who wants to offset high income in a particular year would contribute the maximum deductible amount to her supporting organization and, through her control of the supporting organization, arrange for the use of the supporting organization's assets to make charitable gifts in later years.[52] Congress did not worry much about abuses like these in public charities because the public-charity structure was inherently more "responsive to the needs of the public."[53]

C. Supporting Organizations

The legislative history of supporting organizations is scant. The fervent 1969 private foundation hearings, which included the testimony of dozens of university presidents, law professors, scientists, and chief executives, never addressed the particulars of § 509(a)(3).[54] In his testimony, Logan Wilson, president of the American Council on Education, merely stated that § 509(a)(3) was "included in an attempt to exclude from the definition of 'private foundation' entities which are in fact organized, operated and controlled in the public interest."[55] The Senate Report included only a brief explanation:

> In general, the problems that gave rise to the statutory provisions of the bill discussed above appear to be especially prevalent in the case of some organizations presently in the 20-percent group. However, it appears that certain other organizations presently in the 20-percent

51. Robert A. Boisture & Lloyd H. Mayer, *Weighing the Alternatives: Private Foundations*, 11 J. TAX'N EXEMPT ORG. 257, 257 (2000).

52. The "donor-advised fund" (DAF) may permit this very situation. Bjorklund, *supra* note 4, at 101–03. With the DAF, the donor makes nonbinding recommendations to the fund as to which charitable organization should receive grants from the fund. *Id.* at 103. Although a discussion of DAFs is outside the scope of this Note, it is interesting to note that the IRS recently has stressed that in order to qualify for public-charity status, a DAF "must have appropriate control over the donated assets." *Id.* at 104.

53. H.R. REP. NO. 91-413, at 41 (1969); S. REP. NO. 91-552, at 57 (1969).

54. *Tax Reform Act of 1969: Hearings on H.R. 13270 Before the House Comm. on Fin.*, 91st Cong. 115–43, 218–20 (1969).

55. *Id.* at 34 (statement of Logan Wilson, President, American Council on Education).

> category generally do not give rise to the problems which have led to the restrictions and limitations described above.[56]

In passing such a huge law in such a short time,[57] Congress did not consider supporting organizations in detail. Section 509(a)(3) supporting organizations were deemed to be the kind of organizations that should not be considered private foundations simply because in theory they should not have, as the Senate Report stated, the "problems which have led to the restrictions and limitations" on private foundations.

The supporting organization recently has become a popular charitable organization.[58] These § 509(a)(3) organizations are attractive because they are flexible organizations that are not subject to the taxes and restrictions of private foundations.[59] Although the regulations governing supporting organizations are, according to one federal judge, "fantastically intricate and detailed," they are simple enough when explained.[60] In return for increased tax benefits and freedom from restrictions, supporting organizations are subject to three tests: the "organizational test," the "control test," and the "operational test." To qualify as a supporting organization, not as a private foundation, a supporting organization must meet each of the elements of the three tests.

The organizational test requires that the organization's articles of incorporation: (1) limit the purposes of such organization to one or more purposes set forth in § 509(a)(3)(A) of the Code; (2) not expressly empower the organization to engage in activities that are not

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56. S. REP. NO. 91-552, at 56 (1969). The House Report said even less. *See* H. REP. NO. 91-413, at 40 (1969) (explaining that the new § 509 included "adjustments to ['private foundation'] in order to adapt it to the objectives of this part of the bill").

57. *See* 115 CONG. REC. 22,613 (1969) (statement of Rep. Casey) (noting that the bill exceeded 350 pages in length, had a two-part committee report that is several hundred complex pages in length, and involved the reallocation of $7 billion in tax liability); *id.* at 22,579 (statement of Rep. Utt) (noting that Congress moved "like a race horse in the final 10 days just to get something, anything to the floor" and that "there were massive changes made 2 days before we reported the bill—and some corrections after it was reported—and we were given 1 day after reporting the bill to file any minority or additional views").

58. Carolyn M. Osteen et al., *Scams, Shams, and Scandals—Exempt Organizations Developments in 1999*, *in* 1 LEGAL PROBLEMS OF MUSEUM ADMINISTRATION 369, 372 (Comm. on Continuing Prof'l Educ., A.L.I.–A.B.A. 2000); Monica Langley, *The SO Trend: How to Succeed in Charity Without Really Giving*, WALL ST. J., May 29, 1998, at A1 (describing supporting organizations as "a suddenly hot charitable vehicle").

59. *See supra* note 6 and accompanying text (discussing limitations on private foundations).

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

in furtherance of the purposes referred to in § 509(a)(3)(A) of the Code; (3) name the publicly supported organizations on behalf of which such organization is operated; and (4) not expressly empower the organization to operate to support or benefit entities other than those named.[61]

The control test requires that the supporting organization not be controlled (control is defined as 50% voting power or veto power) "directly or indirectly by one or more disqualified persons," other than foundation managers or § 509(a)(1) or 509(a)(2) organizations.[62] A "disqualified person" is (1) a substantial contributor (contributing more than $5,000 or 2% of the total contributions received by the supporting organization); (2) a person with more than a 20% interest in a corporation, partnership, trust, or unincorporated enterprise that is a substantial contributor to the supporting organization; (3) a family member of any individual described in (1) or (2); or (4) a corporation, partnership, trust, or estate in which a person described in (1), (2), or (3) has more than a 35% interest.[63]

The operational test requires the supporting organization to engage solely in activities that support or benefit the specified publicly supported organization described in § 509(a)(1) or (2). Furtherance of any purpose other than supporting or benefiting the specified organization would prevent qualification.[64] The operational test also requires that a supporting organization be "operated, supervised, or controlled by or in connection with one or more organizations described in [§ 509(a)(1) or (2)]" of the Internal Revenue Code.[65] This requirement creates three different types of supporting organizations.[66] Type 1 supporting organizations are "operated, supervised, or

61. Treas. Reg. § 1.509(a)-4(c)(1) (as amended in 1981).

62. I.R.C. § 509(a)(3)(C) (1994); Treas. Reg. § 1.509(a)-4(j)(1); *see, e.g.*, IRS Exemption Ruling, Atid XXXIII Foundation, May 19, 1999, *available at* 1999 WL 421334 (deciding that a foundation does not qualify under I.R.C. § 509(a)(3) when its donor members are "likely to be substantial contributors" and when these members sit on the board of trustees); IRS Exemption Ruling, Atid XXXIV Foundation, May 19, 1999, *available at* 1999 WL 421336 (same); IRS Exemption Ruling, Atid XXXV Foundation, May 19, 1999, *available at* 1999 WL 427325 (same).

63. I.R.C. § 4946.

64. Treas. Reg. § 1.509(a)-4(e)(1). A supporting organization's expansion of its governing documents to include new supported organizations is consistent with Treas. Reg. § 1.509(a)-4(e)(1). Priv. Ltr. Rul. 98-42-030 (July 17, 1998).

65. I.R.C. § 509(a)(3)(B).

66. Treas. Reg. § 1.509(a)-4(f)(2).

controlled by" the supported organization.[67] Type 2 supporting organizations are "supervised or controlled in connection with" the supported organization.[68] Type 3 supporting organizations, however, are only "operated in connection with" a publicly supported organization.[69]

Although donors and advisers often prefer Type 3 supporting organizations because this type allows less control by the publicly supported organization than the other two types, there is a price to be paid for this increased donor autonomy.[70] A Type 3 organization must meet two additional tests that are not required of Type 1 and Type 2 organizations: the "integral part test" and the "responsiveness test." The integral part test requires that the Type 3 supporting organization maintain "significant involvement" in the operations of the publicly supported organization, and that the publicly supported organization depend on the Type 3 supporting organization for the specific support it provides.[71]

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67. *Id.* § 1.509(a)-4(g)(1). The relationship between the supporting organization and the supported organization is akin to that between a parent corporation and its subsidiary. The supported organization's governing body or membership must elect or appoint a majority of the supporting organization's officers, directors, or trustees. *Id.*

68. *Id.* § 1.509(a)-4(h)(1). Here, the supporting organization and the supported organization have a brother-sister relationship. The supporting organization must be controlled by the same individuals who control the publicly supported organization. *Id*. For example, the supported organization's board members would serve on the board of the supporting organization.

69. *Id.* § 1.509(a)-4(i)(1)(i).

70. Gerald B. Treacy, Jr., *Is IRS Taking Closer Look at Supporting Organizations?*, CHARITABLE GIFT PLAN. NEWS, July/Aug. 2000, at 2, 5.

71. Treas. Reg. § 1.509(a)-4(i)(3)(i). This test may be met in one of two ways. The first option, known as the "functional support test," is based on the nature of the activities the supporting organization engages in to support the supported organization. The functional support test dictates that the Type 3 supporting organization's activities benefit the supported organization by performing its functions or carrying out its purposes and that, but for the involvement of the supporting organization, these activities would be performed by the publicly supported organization. *Id.* § 1.509(a)-4(i)(3)(ii).

Another way for a Type 3 to fulfill the integral part test is the "financial support test," which is based on the supporting organization's financial support for the supported organization. In the financial support test, the supporting organization first must show that it pays substantially all of its income to, or for the use of, the publicly supported organization. *Id*. "Substantially all" of the organization's income has been determined to be at least 85%. Priv. Ltr. Rul. 2000-45-033 (Aug. 15, 2000); Rev. Rul. 76-208, 1976-1 C.B. 161, 162 (relying on Treas. Reg. § 53.4942(b)-1(c)).

Then, the supporting organization must show that this support is sufficient to ensure the publicly supported organization's "attentiveness" to the supporting organization's operations. Treas. Reg. § 1.509(a)-4(i)(3)(iii). The regulations do not specify what percentage of a supported organization's support must be received, but the IRS has stated that, alone, less than 10% would not be likely to ensure attentiveness. Gen. Couns. Mem. 36,379 (Aug. 15, 1975).

This Note proposes that the second required test, the responsiveness test, be refined. The responsiveness test is intended to assure revenue officials that the supporting organization receives sufficient input from the supported charitable organization. The regulations explain two alternative ways to demonstrate that the management of the supporting organization is responsive to the needs of the supported organization and therefore meets this responsiveness test.[72] One way for a Type 3 supporting organization to fulfill the responsiveness test is the "accountability test." The accountability test establishes the supporting organization as a charitable trust under state law for the benefit of the supported organization, with the supported organization having the right to enforce the trust.[73]

The other way to fulfill the responsiveness test is the "interrelationship test." This test is flawed and should be changed. Currently, the interrelationship test requires that the officers, directors, or trustees of the supported organization have a "significant voice" in the activities of the supporting organization. A "significant voice" requires one of the following to be true:

> a) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations; [or]
>
> b) One or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organizations; or
>
> c) The officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the

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This test can be used only if the supporting organization engages in activities (for example, performing publishing or printing functions for a college) as opposed to simply making grants.

72. The third way to meet the responsiveness test, the "historic relationship test," states that if before November 20, 1970, an organization was supporting or benefiting an organization described in I.R.C. § 509(a)(1) or (2), "additional facts and circumstances, such as a historic and continuing relationship," may be taken into account. Treas. Reg. § 1.509(a)-4(i)(1)(ii). This regulation will not be discussed because this Note focuses on the future creation of supporting organizations.

73. This accountability test is met if:

> a) The supporting organization is a charitable trust under state law;
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> b) Each specified publicly supported organization is a named beneficiary under such charitable trust's governing instrument; and
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> c) The beneficiary organization has the power to enforce the trust and compel an accounting under state law.

Treas. Reg. § 1.509(a)-(4)(i)(2)(iii).

> officers, directors or trustees of the publicly supported organizations.[74]

Then, once one of the above relationships is established, the organization must demonstrate that, because of the relationship, "the officers, directors or trustees of the publicly supported organization have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making [the grants,] . . . and in otherwise directing the use of the income or assets of [the] supporting organization."[75]

Herein lies the trouble. The interrelationship test clearly aims to establish that the supported public charity has a great deal of influence—a "significant voice" in the day-to-day operations of the supporting organization. A "significant voice" is necessary because since the Type 3 supporting organization receives public-charity status, it must be responsive to the needs of the supported public charity from which it derives its status. The donors who are receiving benefits as if they are contributing to public charities should not be able to control the supporting organization to the public charity's detriment.

Although "significant voice" is a desired state of affairs, the law requires only a single public-charity director on the supporting organization's board.[76] This might be enough, but it might not, and the IRS does not have the time or the resources to analyze the inner workings of supporting organization boardrooms for evidence of a "significant voice."[77] A survey of recent private letter rulings demonstrates that the IRS does not apply this analysis.[78] Even if the IRS could accomplish such analysis, it is easy for corporate officers prone to fraudulent behavior to create phony evidence by, for example, planting comments into the minutes of board meetings.

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74. *Id.* § 1.509(a)-4(i)(2)(ii)(a), (b), (c). Private Letter Ruling 98-37-037 describes a complicated relationship that the IRS approved. Priv. Ltr. Rul. 98-37-037 (June 18, 1998).

75. Treas. Reg. § 1.509(a)-4(i)(2)(ii)(d).

76. The IRS has ruled that mere representation on an organization's selection committee for making grants does not meet this responsiveness test if an independent trustee has sole and complete authority over all other aspects of the trust's administration. Rev. Rul. 75-437, 1975-2 C.B. 218, 219–20.

77. *See, e.g.*, Carolyn Wright, *IRS Has High Hopes for Intermediate Sanctions, Owens Says*, TAX NOTES TODAY, June 10, 1996 (noting that, "in a good year," the IRS audits ten thousand exempt organizations with fewer than one hundred of these reviews being comprehensive).

78. *See, e.g.*, Priv. Ltr. Rul. 99-52-088 (Dec. 29, 1999) (explaining that the responsiveness test is satisfied merely "if one or more of the trustees of the publicly supported organization are also trustees of, or hold important offices in, the supporting organization").

II. PROBLEMS WITH SUPPORTING ORGANIZATIONS

Contrary to Congress's intent, Type 3 supporting organizations seem to be demonstrating some of the "problems which have led to the restrictions and limitations" on private foundations.[79] In fact, in two recent instances, Congress has demonstrated that it does not have faith in Type 3 supporting organizations. In the Agricultural Risk Protection Act of 2000, Congress empowered the government to make certain payments to any organization that "is described in section 509(a)(3) of [the Internal Revenue Code] and is *controlled* by an organization described in section 509(a)(2)."[80] And in some temporary tax provisions concerning charitable deductions for real property, Congress stated that "an organization that is not itself publicly supported but nevertheless is qualified as a 'public charity' (under [§ 509(a)(3)]) would be eligible if it is *controlled* by a government or publicly supported organization."[81] In each case, Congress's insertion of "control" language clearly indicates that it wants to ensure that a Type 3 organization, which a public charity would not control, is not used.

Tim Hanford, tax counsel to the House Ways and Means Committee, has said that Type 3 supporting organizations "look an awful lot like private foundations."[82] Hanford explained that Congress was wary of Type 3 organization abuses:

> We have become aware recently, or over the long term, depending on your perspective, that there have been arrangements developed that give donors substantially all of the tax benefits of contributing to a public charity, [and] substantially all of the control of contributing to a private foundation, without any of the rules that apply to private foundations . . . .[83]

A. Reader's Digest

In 1998, the New York Attorney General began investigating one such double benefit arrangement with Reader's Digest's sup-

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79. *See supra* notes 57–59 and accompanying text.

80. Agricultural Risk Protection Act of 2000, Pub. L. No. 106-224, § 211(a)(2)(D), 114 Stat. 358, 406 (emphasis added).

81. S. REP. NO. 96-1007, at 14 (1980), *reprinted in* 1980 U.S.C.C.A.N. 6736, 6749–50 (emphasis added).

82. *Edited Transcript From the January 15, 1999 ABA Exempt Organizations Committee Meeting*, *supra* note 15, at 73.

83. *Id*. at 72.

porting organizations.[84] At the time, Reader's Digest Association, Inc., already was mired in potential conflicts of interest. It was reported that the company's board of directors was "in the grip" of Reader's Digest chief executive George Grune.[85] Grune was able to control the board because he was also chairman of the Lila Wallace–Reader's Digest Fund, Inc., and the DeWitt Wallace–Reader's Digest Fund, Inc., private foundations the Wallaces created in 1969.[86] The Wallaces designed the two funds to maintain control of Reader's Digest Association, Inc., by having the funds hold a large amount of the company's stock.[87] In 1998, the funds held 71% of the company's voting shares,[88] and four of the funds' five directors served on Reader's Digest's board or were paid by the company.[89] The directors could not be ousted by the shareholders because the shareholders were the directors.[90] Because the funds held 71% of the voting shares of Reader's Digest, whoever controlled the funds essentially controlled the company.

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84. Jon Elsen, *Vacco Probes Why Mag's Woes Are Hard to Digest*, N.Y. POST, Feb. 4, 1998.

85. Stacy Perman, *A Sad Story at the Digest*, TIME, Mar. 2, 1998, at 58. Grune served as chief executive of Reader's Digest from 1984 to 1994 and retired as its chairman in 1995. READER'S DIGEST, INC., 1997 ANNUAL REPORT 1 (1998) (on file with the *Duke Law Journal*). In 1997, James Schadt resigned as chief executive and Grune returned as "interim" chief executive. Perman, *supra*, at 58.

86. Joann S. Lublin & G. Bruce Knecht, *Tenure of Reader's Digest Acting CEO Is Unabbreviated*, WALL ST. J., Jan. 9, 1998, at B1. George Grune had been chairman of the funds since 1984, after the death of Lila Wallace, who had survived her husband. *Id.*

87. Vince Stehle, *Falling Price of Reader's Digest Stock Is Big Blow to Wallace Funds*, CHRON. PHILANTHROPY, Feb. 26, 1998, at 21, 21. The Wallaces had drawn up their wills hastily just two months before the Tax Reform Act of 1969 went into effect, limiting the amount of stock of a single company that a private foundation could hold to 20%. *Id.* Since foundations are permitted fifteen years after the death of a donor to dispose of excess business holdings, and Lila Wallace, who survived her husband, died in 1984, the two funds had to reduce their voting shares percentage down to 50% or less by 2000. *Id.*; *see also* Priv. Ltr. Rul. 90-16-003 (Oct. 31, 1989). This Private Letter Ruling, acquired via a New York Freedom of Information Law request, includes names and numbers redacted from the published version and is on file with the *Duke Law Journal*.

88. Richard Teitelbaum, *The Plot to Shake Up Reader's Digest*, FORTUNE, Mar. 2, 1998, at 44. In 1999, that percentage was decreased to 50% to avoid tax penalties for excess business holdings that would go into effect fifteen years after the 1984 death of the donor, Lila Wallace. Lila Acheson & DeWitt Wallace Fund for the Hudson Highlands, IRS Form 990 (1997) (on file with the *Duke Law Journal*). Still, this is more than the 20% allowed in funds set up after the 1969 law. In a 1989 private letter ruling, the IRS considered excess business holdings issues and blessed the Reader's Digest pre–initial public offering reorganization, which made the funds majority controlling shareholders. Priv. Ltr. Rul. 90-16-003, *supra* note 87. A different decision would have gone a long way toward avoiding the conflict of interest problems discussed herein.

89. Teitelbaum, *supra* note 88, at 44.

90. *Id.*

Other charitable entities held a significant percentage of Reader's Digest stock: the seven supporting organizations (SOs).[91] Significantly, Grune sat on the board of each of the seven SOs.[92] These seven SOs supported thirteen public charities: Colonial Williamsburg; Macalester 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; the Metropolitan Opera Association, Inc.; the New York City Ballet, Inc.; the New York City Opera, Inc.; Vivian Beaumont Theater, Inc.; Philharmonic-Symphony Society of New York, Inc.; and the Chamber Music Society of Lincoln Center, Inc.[93]

When Reader's Digest was paying healthy dividends and its stock price was rising, the interests of the funds and the company were aligned perfectly. But in the last ten years, Reader's Digest had seen its subscriber base age and its most popular product lose appeal.[94] By January 1998, the company was faltering.[95] Soon, the stock price dropped to about half of its 1992 high of $56.38.[96] And due to deteriorating earnings, Reader's Digest had cut its dividends by 50% in the summer of 1997.[97]

The declining stock price and the slashed dividends greatly affected the SOs, the assets of which in 1997 were 50.7% Reader's Digest stock.[98] At their height in 1992, the shares held by the seven SOs were worth $1.85 billion, but by the end of 1997 they were worth

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91. These seven SOs owned a total of 42% of the nonvoting shares. Geraldine Fabrikant, *Faith Ebbs on Reader's Digest Stock*, N.Y. TIMES, Jan. 16, 1998, at D1.

92. *Id*.

93. *Id.*

94. Wendy Bounds, *Reader's Digest Parent Struggles over Table of Contents*, WALL ST. J., Sept. 16, 1998, at B4.

95. Between 1993 and 1998, subscriptions in the United States had fallen by a million, and when the magazine was not prospering, the rest of the company's ventures—books, music, and videos—could not profit either. Perman, *supra* note 85, at 58. In 1998, the company announced that operating profits had fallen for four straight years, and that earnings had decreased for the sixth straight quarter. *Id*.

96. *Id*.

97. 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. At a December 1997 shareholders meeting, shareholders were "angry" and "demanded" that Reader's Digest change management and cut its dividend again. Jon Elsen, *Shareholders Tear into Reader's Digest*, N.Y. POST, Dec. 13, 1997, at 16.

98. Geraldine Fabrikant, *Cultural World Gets Painful Lesson in Finance*, N.Y. TIMES, Aug. 26, 1997, at D4.

$1.15 billion less.[99] In addition, the 1997 halving of the dividends caused the combined annual income of the SOs to fall from $58.7 million to $29.4 million.[100] This single stock was ruining some of the country's most venerable public charities.

The public charities had wanted to diversify for years.[101] Any sophisticated public charity would not want large amounts of funds in undiversified form—especially in a single stock that was decreasing in value. But after an initial 1990 public offering of Reader's Digest stock, and a secondary offering a year later, the SOs did not sell any stock for seven years.[102] Throughout the 1990s, the company stock fell as the stock market soared; indeed, it was only the SOs' not selling that prevented the company's stock price from falling further.[103] The *New York Times* determined the performance of each SO's portfolio over a period in which they did not buy or sell any Reader's Digest stock. The results were eye-opening. For example, during the bull market from the end of fiscal 1991 to the end of fiscal 1997, the value of the Reader's Digest stock for Wildlife Conservation Society, the Metropolitan Museum of Art, and Lincoln Center lost 17%.[104] The change in value of the three SOs' other investments were all positive: 71%, 48%, and 24%, respectively.[105]

The reason the SOs did not sell the Reader's Digest stock has never been disclosed, but the supported charities should have had more power to influence this decision. Had they diversified, the charities potentially could have saved hundreds of millions of dollars.[106]

The media have speculated that one reason the SOs did not sell their stock was that they were "affiliates" of Reader's Digest.[107] If the

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99. Stehle, *supra* note 87, at 21.

100. Teitelbaum, *supra* note 88, at 44.

101. Perman, *supra* note 85, at 58; *see also* Fabrikant, *supra* note 91, at D1 ("Many of the cultural beneficiaries had been pushing for the right to sell some of their shares . . . ."). None of the beneficiaries would speak to this on the record, citing confidentiality agreements that were signed in last year's settlement. Interview with James E. Nicholson, Partner, Faegre & Benson, representing Michael S. McPherson, President of Macalester College (Oct. 8, 2001).

102. Blumenthal, *supra* note 10, at A1.

103. *Id.*

104. *Id.*

105. *Id.*

106. *Id.*

107. *See id.* (explaining that the supporting organizations were "restricted under federal securities law from freely trading the stock without the Digest's permission" and that the organizations "would have been permitted to sell 1 percent of their Digest holdings every three months"); Fabrikant, *supra* note 91, at D1 (explaining that "the Government restricts the sale of a big block of stock held by an affiliate").

SOs were, in fact, affiliates, they would be limited by federal securities law in the volume of securities they could sell over a period of time.[108] But the SOs may not have been affiliates. An "affiliate" is a person that directly or indirectly controls, or is controlled by, or is under common control with, the person specified; "control" means the possession of the power to direct the management and policies of a person through voting stock or otherwise.[109] Although George Grune was on the boards of both the SOs and Reader's Digest, the SOs held only nonvoting shares. There should not have been control overlaps that would have required the SOs to be affiliates. Yet, the SOs did not sell the stock and "could only watch as they missed better investment possibilities."[110]

Why could the supported public charities only watch? Some of the directors of the SOs, it seems, were not fulfilling their fiduciary duties.[111] According to a newspaper article, "there [was] talk that some decision-makers were keener to maintain good relations with Reader's Digest than to create a prudent investment portfolio and were fearful that a fuller divestment could be interpreted as an affront."[112] If this characterization is accurate, it suggests that SO directors were breaching their fiduciary duty. The remark also suggests that the supported public charity's voice was not heard. Christine DeVita, president of the Wallace–Reader's Digest Funds, stated that the supported public charities did participate in the decisions. She said that the six-member boards of the SOs had only two directors from the funds, and the decisions not to sell throughout the two decades "were investment decisions in which the institutions participated."[113] Although the precise composition of each board was

108. According to Rule 144(e), the maximum amount of securities that may be sold by an "affiliate" in a three-month period is the greater of (i) one percent of the shares of the class outstanding; (ii) the average weekly reported volume of trading in the securities on all national securities exchanges and NASDAQ during a specified four-week period; or (iii) the average weekly volume of trading in the securities reported through the consolidated transaction reporting system contemplated by Rule 11Aa3-1 under the Exchange Act during the same four-week period. 17 C.F.R. § 230.144(e)(1) (1999).

109. *Id.* § 230.405.

110. Blumenthal, *supra* note 10, at A1.

111. Evelyn Brody, *The Limits of Charity Fiduciary Law*, 57 MD. L. REV. 1400, 1490 (1998) (arguing that diversification should be a "necessary component of the charity fiduciary's duty of care").

112. *Id.* at 1404 (quoting Jill J. Barshay, *Macalester's Stock Lagging: As Reader's Digest Shares Go, So Goes College Endowment Fund*, STAR TRIB. (Minneapolis), May 22, 1997, at D1).

113. Blumenthal, *supra* note 10, at A1.

unique, there were generally two directors from the funds, two independent directors, and only two directors from the supported public charities.[114]

This composition of a supporting organization board—one-third fund directors and one-third supported charity directors—seems not to compromise their tax status. With only two of six directors being "disqualified persons," and without veto power, these SOs pass the control test.[115] The Type 3 interrelationship test calls for at least one director appointed by or overlapping with the supported organization such that the supported organization has a "significant voice."[116] Each of the supported public charities had at least two directors sitting on the boards of their respective SOs.[117] Although the composition of these boards of directors fell within the legal limits of the Code, New York Attorney General Spitzer saw problems.[118] He said that the charitable structure "appeared to create a tension between the interest of the parent company and the interests of the charity."[119]

This tension was surely most acute in the supporting organization boardrooms. An interesting example of boardroom decisionmaking occurred in 1998, when the Reader's Digest board finally agreed to arrange for the seven supporting organizations to sell 12% of the nonvoting stock in a trust arrangement—the first time the organizations had been allowed to sell stock since 1991.[120] In the end, however, the details of the arrangement benefited Reader's Digest while hurting the organizations.[121] Of this deal, which reduced the sale price of

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114. Dewitt Wallace–Reader's Digest Fund, Inc., IRS Form 990 (1998) (on file with the *Duke Law Journal*).

115. *See supra* notes 63–64 and accompanying text.

116. Treas. Reg. § 1.509(a)-4(i)(2)(ii)(d) (as amended in 1981).

117. This information is available on each organization's IRS Form 990, which are on file with the Office of the Attorney General of New York. The author's notes, which summarize this information, are on file with the *Duke Law Journal*.

118. Most likely the attorney general focused on several sections of the New York Not-For-Profit Corporation Law. *See* N.Y. NOT-FOR-PROFIT CORP. LAW § 717(a) (Consol. 2001) (imposing an affirmative duty on directors of a not-for-profit corporation to discharge their duties "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions"). In addition, section 715 of the NPCL contains specific rules regarding required conduct when there is a conflict of interest between directors and the not-for-profit corporation. *Id.* § 715.

119. Blumenthal, *supra* note 10, at A1.

120. Elsen, *supra* note 84. By law, charitable funds cannot issue stock, and therefore must execute offerings through trusts. Sandler, *supra* note 97, at C2.

121. Sandler, *supra* note 97, at C2. According to the plan, the stock was sold in the form of a hybrid security known as a traces offering. Stehle, *supra* note 87, at 21. Although the supporting

the stock by 25%, a Morgan Stanley analyst said, "It's not a particularly good deal for the sellers."[122] Critics argued that Mr. Grune orchestrated the deal to benefit the company.[123] In a case such as this, the supported public charities need a way to ensure that their Type 3 supporting organizations are responsive to their needs.

B. The Responsiveness Requirement

Because Type 3 supporting organizations only have to be "operated in connection with" a public charity, the supported organizations have a reduced ability to ensure that their needs are addressed. One commentator explains the peculiar trade-off of Type 3 supporting organizations:

> Here, the donors give money to a supporting organization that is not controlled by the [public charity]. Rather the [public charity] only has authority to appoint one member to the supporting organization's board, so the donors, while they can't control the entity, don't have to give up control of it to the [public charity]. The cost of that is the integral part test, which requires that 85 percent of the organization's net income each year has to flow up through the [public charity].[124]

This commentator notes that the public charity can "only" appoint one director to the Type 3, but says that the "cost" is the integral part test. But the integral part test only ensures a percentage of net income. What if the charity has a need other than simply income? As in the Reader's Digest example—in which the supporting organizations had a sufficient number of public-charity directors—a supported organization might want the supporting organization to diversify the SO's portfolio. Hypothetically, if artwork is donated to a supporting organization, the supporting organization should be responsive to the public charity's interests and sell that artwork should the public charity need it to be sold. This kind of control cannot be guaranteed by the integral part test.

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organizations would get the dividends that they would have received for the next three years, as well as a portion of any appreciation in the stock over those three years, they would get cash for only three quarters of the value of their stock. *Id*.

122. Sandler, *supra* note 97, at C2.

123. Stehle, *supra* note 87, at 21.

124. *Edited Transcript of the October 13, 2000 ABA Tax Section Exempt Organizations Committee Meeting*, 30 EXEMPT ORG. TAX REV. 283, 304 (2000) (statement of Caplin & Drysdale Attorney Doug Varley).

In addition to the integral part test, the supporting organization should be restricted by the responsiveness test. The purpose of the responsiveness test is to ensure that the supporting organization "is responsive to the needs or demands of the publicly supported organizations."[125] This "significant voice" does not pertain just to net income; the supported organization must be able to influence "the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization."[126]

In public policy terms, the responsiveness test is important because the supporting organization's public-charity status is derivative of the public charity that it supports. Put another way, "the public constituency that monitors a supporting organization's operations does so through the filter of an intervening public charity. It is to that public charity or charities that the supporting organization must respond regarding its organization, operation and on-going relationship with the supported public charity or charities."[127] The supporting organization must be responsive to the public charity such that the supporting organization deserves its public-charity status.

One or two public-charity directors on a board cannot ensure this responsiveness. One commentator explained the problems with Type 3 supporting organizations when—as in the Reader's Digest situation—the donor chooses one or two trustees of a five-person board, or the donor is one of three directors.[128] The commentator said, "The charity . . . is not in a control position there, and then the independent trustee is the donor's lawyer, the donor's advisor, the donor's accountant, the donor's friend, and is somebody who will basically help the donor accomplish his objectives, and it does become something of a private foundation substitute."[129] When the IRS has problems with donor control over a Type 3 organization, "usually the problem is resolved by putting an extra charity rep on the board."[130]

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125. Treas. Reg. § 1.509(a)-4(i)(2)(i) (as amended in 1981).

126. *Id.* § 1.509(a)-4(i)(2)(ii)(d).

127. Victoria B. Bjorklund, *When Is a Private Foundation the Best Option?*, TR. & EST., Aug. 1993, at 12, 16.

128. *Edited Transcript of the January 12, 2001 ABA Tax Section Exempt Organizations Committee Meeting*, 31 EXEMPT ORG. TAX REV. 437, 468 (2001) (statement of Ropes & Gray Attorney Carolyn M. Osteen).

129. *Id.*

130. *Id.*

But if the IRS does not ask questions, and the donor who organizes the supporting organization is not scrupulous, what option does a supported public charity have to ensure responsiveness? If a Type 3 supporting organization is a charitable trust, this problem is solved: the accountability test requires that the supported public charity be named beneficiary, and that the supported public charity have the power to enforce the trust.[131] But if the public charity is supported by a Type 3 supporting organization that is not a trust, it must rely on the interrelationship test's "significant voice" test—which requires at its most stringent only one director.[132] In this situation, the letter of the law does not give a public charity enough power to ensure that its voice is heard.

III. PROPOSAL: MEMBERSHIP CORPORATIONS

One solution to these problems is simply to recommend the elimination of the Type 3 supporting organization. A better answer, however, would be to maintain some form of organization that is different from the Type 1 and the Type 2. More variety in charitable organizations offers donors more choices for giving and can have only a positive impact on philanthropy.[133]

When considering changes to the § 509(a)(3) regulations, one must keep in mind that "the removal of [the donor's] control dominates every part of this definition."[134] The Seventh Circuit Court of Appeals has stated that for a supporting organization to maintain public-charity status, the donor's control cannot interfere with the supported public charity's needs:

> Public charities were excepted from private foundation status on the theory that their exposure to public scrutiny and their dependence on public support would keep them from the abuses to which private foundations were subject. Supporting organizations are similarly excepted in so far as they are subject to the scrutiny of a public charity. The Treasury Regulations therefore provide that the supporting or-

131. Treas. Reg. § 1.509(a)-4(i)(2)(iii).

132. *Id.* § 1.509(a)-4(i)(2)(ii).

133. *See* Laura Brown Chisolm, *Accountability of Nonprofit Organizations and Those Who Control Them: The Legal Framework*, 6 NONPROFIT MGMT. & LEADERSHIP 141, 152 (1995) ("Both diversity and accountability are better served by structuring the legal rules so as to allow and encourage formation and development of a variety of institutions, such that individuals can find or form organizations that respond to their diverse preferences and priorities.").

134. Bjorklund, *supra* note 4, at 91.

> ganization must be responsive to the needs of the public charity and intimately involved in its operations.[135]

Here, the court stressed that the legislative history calls for a sound responsiveness test. According to one commentator, "the public constituency that monitors a supporting organization's operations does so through the filter of an intervening public charity."[136] But the "intervening public charity" needs a tool to intervene and ensure responsiveness.

The responsiveness test should be changed to require that a Type 3 supporting organization fulfill either the accountability test or a revised interrelationship test. If the Type 3 supporting organization is a trust, the regulations require two safeguards. The accountability test requires both that the organization be a "charitable trust" and that the supported organization have the right to "enforce the trust"—to bring abuses of the trust provisions to a court's attention.[137] First, if the supporting organization is a "charitable trust," this means that its object is to benefit the community rather than private individuals, and therefore the attorney general may enforce the trust.[138] If the charitable assets are jeopardized, the state attorney general has the power to file suit or intervene by invoking the court's equitable powers.[139] Second, because the supported public charity must be named as a beneficiary of the trust, it also has the legal power to enforce the trustees' duty to comply with the terms of the trust.[140]

The new interrelationship test should include as much protection as this accountability test. Since a Type 3 supporting organization that is not a charitable trust will not be supervised in the same manner by the state attorney general, the refined interrelationship test should provide the public charity with significant control. The public charity should be able to "enforce" its supporting organization.

The nonprofit organization should be a membership corporation in which the majority of the members are elected by the supported

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135. Quarrie Charitable Fund v. Comm'r, 603 F.2d 1274, 1277–78 (7th Cir. 1979).

136. Bjorklund, *supra* note 4, at 90.

137. Treas. Reg. § 1.509(a)-(4)(i)(2)(iii) (as amended in 1981). The standard rule in trust law is that the beneficiary has the power to enforce the trustee's performance of her duties. RESTATEMENT (SECOND) OF TRUSTS §§ 197–199 (1959).

138. JAMES J. FISHMAN & STEPHEN SCHWARZ, NONPROFIT ORGANIZATIONS 62 (2d ed. 2000).

139. *Id.* at 116.

140. Davis v. United States, 495 U.S. 472, 483 (1990).

public charity or charities and have the power to vote the directors out of office.[141] The articles of incorporation and the bylaws of the nonprofit membership corporation should contain appropriate provisions.[142] This structure, like a stock corporation in which shareholders vote for directors,[143] would be the principal check on the directors' opportunities to be unresponsive to the supported public charity.[144]

If the public-charity members of the supporting organization consider a decision to be important enough, these members can bring that decision to the attention of the board of the supporting organization. If the board of the supporting organization listens to the members, then the supported organization has had a "significant voice." If the board does not act according to the wishes of the members, then the members can vote off the directors. Thus, the supported public-charity representatives who are members of the supporting organization serve as watchdogs.[145]

The rationale for public-charity support tests is that an organization dependent on the public for support, of necessity, will be responsive to the public will.[146] Here the rationale for the membership requirement is that a board of directors that is dependent on public-charity representatives for support, of necessity, will be responsive to the public charity. If donors want to avoid the restrictions and taxes on private foundations, they must allow the public charity to demand responsiveness.

Practically, the provision should not change the way Type 3 supporting organizations operate. The donors still will have the flexibility to which they have become accustomed, and the donors never should have expected the organization to be unresponsive to the public

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141. The articles or the bylaws of the corporation should establish the criteria and procedures for admission of the members. REVISED MODEL NONPROFIT CORP. ACT § 6.01(a) (1988).

142. *See id.* § 2.01 (stating that the articles of incorporation for a nonprofit corporation must state whether it will have members and may state the powers that its members will have).

143. MODEL BUS. CORP. ACT § 8.03 (1984) (establishing the number and election of directors); *id.* § 8.04 (providing for the election of directors by certain classes of shareholders); *id.* § 8.08 (providing for the removal of directors by shareholders).

144. Whether they are treated as just one species of corporation or as a special nonprofit corporation, nonprofit membership corporations exist in every jurisdiction. Charles H. Steen & Michael B. Hopkins, *Corporate Governance Meets the Constitution: A Case Study of Nonprofit Membership Corporations and Their Associational Standing Under Article III*, 17 REV. LITIG. 209, 218 (1998).

145. *But see* Bjorklund, *supra* note 4, at 105 ("In the Type 3 trust, the named charities must have the right to enforce the trust under state law but query whether one of 50 named beneficiaries would risk the donor's ire . . . to compel enforcement.").

146. Change-All Souls Hous. Corp. v. United States, 671 F.2d 463, 465 (Ct. Cl. 1982).

charity's needs. As promotional literature for U.S. Trust Corporation, a company that has handled the assets for many of the country's wealthiest philanthropists, states: "donors to a supporting organization must yield control of the organization to the public charity being supported."[147]

Although this new provision would increase the amount of control that the public charity would have over its Type 3 organization, it would not effectively eliminate the advantages of the Type 3. The directors still would be responsible for the corporation's day-to-day decisions, and the public-charity members of the supporting organization would not have any role in the operation of the supporting organization.[148] These members would be loath to vote off the directors because they would want to foster productive relationships on the supporting organization board. And the public charity would be loath to encourage its member-representatives to vote off the supporting organization directors because it would want to maintain cooperative relationships with its donors. This power would be reserved for extreme situations.

Although some supporting organizations that are membership corporations with the majority of their members appointed by the supported public charities would naturally qualify as Type 1 or Type 2 supporting organizations, this would not necessarily be the case. In order for an organization to qualify as a Type 1 supporting organization, a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, officers acting in their official capacity, or the membership of the publicly supported organizations.[149] And the organization could qualify as a Type 2 supporting organization if the control of the supporting organization is vested in the same persons that control or manage the publicly supported organizations.[150] But organizations in which the public charities merely appoint members who they think will represent their interests would not qualify as Type 1 or Type 2. In this case, donors could work with the supported public charities to choose the

147. U.S. Trust, *Philanthropic Advisory Services*, *available at* http://www.ustrust.com/ustrust/html/individual/TrustsandEstates/Philanthropicadvisory.html (last visited Jan. 13, 2002) (on file with the *Duke Law Journal*).

148. REVISED MODEL NONPROFIT CORP. ACT § 8.01(b) (1988) (stating that "[e]xcept as provided in this Act or subsection (c), all corporate powers shall be exercised by or under the authority of, and the affairs of the corporation managed under the direction of, its board").

149. Treas. Reg. § 1.509(a)-4(g)(1) (as amended in 1981).

150. *Id.* § 1.509(a)-4(h)(1).

members of the Type 3 supporting organization. Donors still would be able to be more involved in the administration of the Type 3 organization than of the Type 1 or Type 2.

The argument could be made that a refinement is not necessary because the IRS already has the tools to curtail abuses of the Type 3 organization. After all, § 501(c)(3) states that a donor cannot enter into any transactions that might result in inurement or excessive private benefits.[151] And more importantly, the organization must pass the control test, which mandates that a supporting organization cannot be controlled by disqualified persons.[152] The Internal Revenue Code states that a supporting organization cannot be controlled even *indirectly* by substantial contributors to the fund. The regulations note that this determination of whether a disqualified person does in fact indirectly control an organization is a matter of "facts and circumstances."[153] In fact, in the 2001 Continuing Professional Education (CPE) text for exempt organizations, the IRS states that Type 3 supporting organizations "have a greater proclivity to display facts and circumstances tending to show that [disqualified persons] directly or indirectly control the [supporting organizations],"[154] and indicated that it will step up enforcement. In this CPE text, the IRS stresses that disqualified persons cannot indirectly control Type 3 organizations and gave four examples of "control."[155]

But the basic § 501(c)(3) protection and the § 509(a)(3) control test are not enough. There are myriad ways a supporting organization might be unresponsive to its supported public charity. The IRS cannot evaluate all of these complex relationships behind the closed doors of boardrooms and carry out the sophisticated analysis necessary to determine if the supporting organization is responding to the

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151. I.R.C. § 501(c)(3) (1994).

152. *Id.* § 509(a)(3)(C).

153. Treas. Reg. § 1.509(a)-4(j)(1).

154. Ron Shoemaker & Bill Brockner, *IRS, Continuing Professional Education Text for Fiscal 2001: Topic G, Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions*, TAX NOTES TODAY, Sept. 8, 2000.

155. The first example stated that employees of a disqualified person will be considered in the "facts and circumstances." *Id.* The second example stated that a partner in a law firm that represents a disqualified person also may be disqualified. *Id.* The third example analyzes a complex hypothetical trustee structure and notes that the IRS will look closely at any board members that a disqualified person selects for the board, any committees controlled by disqualified persons that nominate board members, and any bylaws that provide that disqualified members cannot be removed, even for cause. *Id.* In the last example, the IRS explains that it will consider any of the supporting organization's assets that are controlled by a disqualified person. *Id.*

public charity's needs. In fact, the IRS seems daunted by such a prospect; in one recent private letter ruling, the Service did not even analyze whether the public charity had a "significant voice" before it blessed the supporting organization.[156] Empowering the public charities with this new responsiveness test will allow the supported public charities to police themselves.

CONCLUSION

One tax commentator has stated that "[t]he advantages of the supporting organization over the private foundation are of such significance that rarely, if ever, will the private foundation constitute the preferred format in a particular instance."[157] Supporting organizations provide an important option for philanthropists. It should not be the case, however, that foundations are "rarely, if ever" preferred.

After the Reader's Digest settlement was announced, New York Attorney General Spitzer said, "'The charitable entities that will receive the money will now be in a position to control their own fate and pursue their charitable ends in their own way without being dependent in any way on any control by Reader's Digest.'"[158] The way in which the Type 3 organizations had been operated denied the public charities the "control" that they deserved.

Public charities will have more control if they can ensure that Type 3 supporting organizations are responsive to their needs. This responsiveness can be accomplished by requiring the Type 3 organizations to be either enforceable charitable trusts or corporations whose members are elected by the supported public charity. Responsiveness is vital because as long as Type 3 supporting organizations receive the tax treatment of a public charity, the government is losing those funds. And as long as the government is losing those funds, the donations should be used as the public charity wants and needs. A donor who desires more day-to-day involvement in her supporting organization still should choose a Type 3, but she must concede that should the public charity have needs that are not being met, it may act to fulfill those needs.

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156. Priv. Ltr. Rul. 99-52-088 (Oct. 1, 1999).

157. Gerald B. Treacy, Jr., *Supporting Organizations: A Good Alternative to Private Foundations*, 24 EST. PLAN. 17, 21 (1997).

158. Blumenthal, *supra* note 10, at A1 (quoting Eliot Spitzer, Attorney General, State of New York).