ADVANCING PHILANTHROPIC GOALS WHILE DIVESTING EXCESS BUSINESS HOLDINGS

Many options are available beyond just selling all or part of the foundation's stock.

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The excess business holdings rule, with all its complexities, has been in place for 40 years, having been enacted as part of the Tax Reform Act of 1969. While most exempt organization advisors can recite the basic requirements of the rule, it is not always easy to explain why a foundation must divest itself of long-held family securities or other corporate holdings, especially in an economic downturn that significantly reduced their value. Regardless of the historical reasons for this rule, however, excess business holdings must be addressed eventually. In many cases, resolution lies in the simple—and sometimes not so simple—sale of a foundation's excess holdings. In other cases, however, the problem can be viewed as more than just an inconvenience that has to be resolved. It can be an opportunity to enhance a foundation's philanthropic mission.

Although private foundations typically distribute grants to charities in cash, it is equally easy to give grantees marketable securities. For a private foundation that has excess business holdings, gifts of stock can offer a number of advantages. Besides the obvious benefit of reducing excess holdings, a foundation can also save on excise taxes on net investment income it would have to pay if it sold the assets. In an economic downturn, a foundation and its grantees may also be able to maximize the amount of capital available for charitable activities if grantees receive stock and have the flexibility to wait for the markets to rebound before selling the assets. In contrast, a foundation that is caught in a significant market decline when it is forced to dispose of excess business holdings may have to sell at a substantial loss. More importantly, a foundation that must dispose of excess holdings has the option to partner with a variety of charitable organizations to align its long-term philanthropic goals with the short-term need of complying with the excess business holdings rule.

Overview

Congress enacted the excess business holdings rule to limit the ability of individuals to retain control of business enterprises by setting up private foundations to hold substantial or controlling stakes in these businesses (it applies equally to nonoperating and operating foundations). The rule defines the percentage

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of holdings a private foundation may have in a business, provides a fixed time period during which a foundation must dispose of excess business holdings, and limits the ability of the foundation to sell its holdings to disqualified persons.

Permitted holdings. A private foundation may own up to 20% of the voting stock of a corporation, reduced by the percentage of voting stock owned by the foundation's "disqualified persons."[1] Any greater amount of stock ownership, termed "excess business holdings," will be subject to a penalty tax equal to 10% of the value of the excess holdings. There is no limitation on the amount of non-voting stock a foundation may own, provided that all disqualified persons do not hold more than 20% of a company's voting stock.[2] If, however, disqualified persons do hold more than 20% of the voting stock, any non-voting stock owned by the foundation will also constitute excess business holdings.

Under a special rule, a foundation and all disqualified persons together may own up to 35% of the corporation's voting stock if it is established that "effective control" of the corporation is in one or more non-disqualified persons. The regulations define "effective control" to mean "the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a business enterprise, whether through the ownership of voting stock, the use of voting trusts, or contractual arrangements, or otherwise."[3] The "reality of control" is determinative in applying this rule, not "its form or the means by which it is exercisable."[4] A foundation that seeks to take advantage of this more lenient rule must therefore affirmatively show that an unrelated party or cohesive group of third persons exercises control over the corporation.[5]

The regulations also provide a *de minimis* safe harbor rule, which allows a private foundation to own stock constituting not more than 2% of the voting stock *and* 2% of the value of all outstanding shares of all classes of stock of a corporation, regardless of the percentage held by disqualified persons. For purposes of calculating the 2% holdings, the ownership of the foundation and all related foundations are aggregated.[6] A related foundation is defined as a private foundation that is under common effective control with the foundation in question, or that received substantially all of its contributions from the same or closely related sources as the foundation in question.[7]

Special permitted holdings. There are numerous exclusions and exceptions to the general excess business holdings rule. Two particular exceptions, however, are useful to keep in mind. First, the regulations provide an exception to the limitations of the excess business holdings rule for ownership in the stock of a "functionally related business."[8] A functionally related business is either a business enterprise that does not constitute an unrelated trade or business (as defined under the UBIT rules) or an activity that is carried on within the larger scope of a foundation's activities and is related to the foundation's exempt purposes.[9] For example, a museum's cafeteria and snack bar, operated for the convenience of visitors, would qualify as a functionally related business.

Second, a foundation's program-related investments (PRIs) are also not subject to the excess business holdings rule. Program-related investments are investments made for the purpose of accomplishing the foundation's exempt purposes.[10] The most common type of PRIs are low-interest loans made to a grantee, but an equity investment by a foundation in a for-profit enterprise made primarily to accomplish a charitable purpose could also qualify as a PRI.[11]

Time for divestiture. A private foundation must dispose of its excess business holdings within 90 days from the time it knows or has reason to know that is has such holdings. This

[1] In general, "disqualified persons" includes substantial contributors, foundation managers, the family members of substantial contributors and foundation managers, more-than-20% owners of substantial contributors, entities more than 35%-owned by any of the previous persons, and other private foundations that are effectively controlled by the same person or persons who control the foundation in question ("related foundations").

[2] Section 4943(c)(2)(A).

[3] Reg. 53.4943-3(b)(3)(ii).

[4] *Id.*

[5] See Rev. Rul. 81-111, 1981-1 CB 509.

[6] Section 4943(c)(2)(C).

[7] Section 4946(a)(1)(H). The Pension Protection Act of 2006 (PPA) subjects donor advised funds and certain supporting organizations to the excess business holdings rules. The IRS has not issued regulations for these provisions, and it is unclear whether these entities could be treated as a "related foundation" for purposes of the 2% *de minimis* rule.

[8] Reg. 53.4943-10(b).

[9] Section 4942(j)(4); Reg. 53.4942(a)-2(c)(3)(iii).

[10] Section 4944(c).

[11] See, e.g., Ltr. Rul. 200610020 (equity investment in an angel investment fund).

period is automatically extended to include the period during which federal or state securities laws prevent the foundation from disposing of its excess business holdings. In order to take advantage of the 90-day period, the disposition must not have any restrictions or conditions that prevent the recipient of the interest from freely using or disposing of the interest, except for restrictions or conditions required by federal or state securities laws or by the gift or bequest through which the foundation acquired the interest.[12]

The 90-day disposition period is extended to five years if a private foundation has excess business holdings because the foundation or a disqualified person receives an interest in a business by gift or bequest (or in any way other than by purchase).[13] In the case of a gift or bequest by will or trust, the five-year period will not begin until the date of the distribution of such holdings to the foundation. The five-year disposition period also applies if stock ownership exceeds maximum ownership limits because of an increase in holdings as a result of a redemption in stock by a business enterprise (the self-dealing rules allow a private foundation to participate in a corporate redemption program).[14]

The five-year grace period does not apply if a foundation has excess business holdings as a result of receiving stock from a related foundation described in section 4946(a)(1)(H) with respect to the foundation. The grace period also does not apply to transactions that are part of a plan whereby disqualified persons will purchase additional holdings in the same business enterprise at the start of the five-year period.[15]

The IRS has discretion to extend the five-year divestiture period by an additional five years in the case of an "unusually large gift or bequest of diverse holdings or holdings with complex corporate structures" if all of the following factors are present:[16]

- The foundation made diligent efforts to dispose of excess holdings within the initial five-year period.
- Disposition within the initial five-year period has not been possible (except at substantially below fair market value) by reason of the size and complexity of holdings.
- The foundation submits a detailed plan to the IRS and state attorney general for disposing of its excess business holdings within the additional five years.
- The IRS determines that the plan can reasonably be carried out prior to the close of the extension period.

A foundation need not request an extension for the full additional five years, and can limit the extension period to whatever additional time it will take to dispose of the excess holdings.[17] The IRS is unlikely to grant an extension if the foundation has been unable to divest publicly traded securities, unless the foundation is able to show that circumstances beyond its control prevented disposition during the initial five-year period.[18]

Key considerations when giving stock to grantees

The excess business holdings rule broadly excludes "public charities" from the definition of disqualified persons. Therefore, a private foundation may be able to divest its excess business holdings by transferring stock to a public charity.[19] There are many types of public charities. Among them are publicly supported organizations (including community foundations), schools and educational organizations, medical research organizations, churches and certain religious organizations, and supporting organizations.

Before transferring stock to a grantee, a foundation should assess the benefits and limitations that may apply to such a plan.

Benefits under the private foundation rules. The private foundation rules may pro-

[12] Reg. 53.4943-2(a)(1)(iv).

[13] Reg. 53.4943-6(a)(2).

[14] Reg. 53.4943-6(d)(4).

[15] Reg. 53.4943-6(c)(1), (2).

[16] Section 4943(c)(7)(A).

[17] See, e.g., Ltr. Rul. 200119062 (18 months); Ltr. Rul. 200040037 (one year); Ltr. Rul. 9211067 (seven months).

[18] See, e.g., Ltr. Rul. 200833018 (IRS granted extension to dispose excess holdings where foundation was unable to dispose of all shares due to securities law requirements limiting number of shares that could be sold, thin trading volume, stock price lagging for an extended period, and company's own policy limiting sales of stock by officers and directors).

[19] A private foundation may also solve an excess business holdings problem by converting to a public charity instead of gifting stock. In this case, the foundation will have to carefully follow the termination rules of Section 507(b)(1)(B), terminating its private foundation status by operating as a public charity. See, e.g., Ltr. Rul. 9407029 (converting to a supporting organization); Ltr. Rul. 8617119 (converting to a supporting organization); GCM 36600, 2/27/76 (converting to a supporting organization).

vide two different benefits to a foundation that gives stock, rather than cash, to a grantee. First, under the payout requirement, a private foundation must distribute at least 5% of its net investment assets each year for charitable purposes. A foundation that makes qualifying distributions in excess of the minimum amount required may carry forward the excess for five years to reduce the distributable amount in those future years. Thus, if a foundation needs to divest itself of a large amount of excess business holdings, it may be able to carry forward excess distributions for five years for purposes of meeting its payout requirement.

A second benefit to paying grants out in stock, rather than cash, is that the foundation may not have to pay excise tax on any gains when the securities are transferred to the grantee. In most cases, a foundation will sell its assets if it needs to generate cash to pay grants. If the foundation recognizes a gain on sale of the securities, it will have to pay a 2% excise tax on such gain.[20] Only private foundations are subject to this tax, however. A public charity that sells stock it received from a private foundation will not pay tax on any gains when it sells the assets to finance its activities. In effect, by transferring stock to a grantee, the foundation is able to maximize the amount of assets available for charitable purposes.

Material restrictions on transferee. There is an important limitation on the utility of stock transfers in reducing excess business holdings. If a private foundation transfers shares to a third party, but imposes "any material restrictions or conditions that prevent the transferee from freely or effectively using or disposing of the transferred interest," the foundation will be treated as continuing to own the interest until all the restrictions or conditions are eliminated.[21] The regulations do not explain what restrictions or conditions would prevent the transferee from freely and effectively using or disposing of the transferred stock. The IRS has reviewed the material restriction rule in only a few letter rulings, but those rulings do provide some guidance.

In Ltr. Rul. 9551033, a private foundation proposed disposing of its excess business holdings by transferring stock to a designated fund at a community foundation. In concluding that the transfer was not subject to a material restriction, the Service looked to the private foundation termination rules that determine whether a private foundation has made a "completed" transfer of its assets when it is winding down.[22] The Service ruled that whether a restriction is material is determined based on all the facts and circumstances, including (1) whether the transferee is the owner in fee of the transferred assets,[23] (2) whether the transferred assets are to be held and administered by the transferee in a manner that is consistent with its exempt purposes, (3) whether the governing body of the transferee has ultimate authority and control over the transferred assets,[24] and (4) whether, and to what extent, the governing body of the transferee is organized and operated so as to be independent from the transferor.

In Ltr. Rul. 8416033, a private foundation proposed to divest its excess business holdings by transferring stock in a closely-held company to a newly created supporting organization that would support an educational organization. Three members of the supporting organization's five-member board were appointed by the school and the remaining two members were appointed by the closely-held company (qualifying the organization as a Type I supporting organization). Before the foundation transferred the stock to the supporting organization, the closely-held company wanted to obtain—from the supporting organization as well as from all other shareholders—a stock purchase agreement that gave the company a right of first refusal if the stock were sold. The company would have the right to redeem the stock at fair market value as determined by an independent appraisal at the time of the proposed sale, and in no event, at a price less than the price offered by a bona fide purchaser. The IRS ruled that the right of first refusal provision would not be a material restriction because it was imposed by the company on all shareholders and did not

[20] In general, the excise tax can be reduced to 1% if the foundation increases the amount of its qualifying distributions each year. See Section 4940(e).

[21] Reg. 53.4943-2(a)(1)(iv).

[22] Reg. 1.507-2(a)(8).

[23] The regulations indicate that a right of first refusal is generally considered an adverse factor in determining if a transfer is subject to a material restriction. However, as Ltr. Rul. 8416033 indicates, a right of first refusal can be drafted in such a way that it might not be a material restriction.

[24] The donor may not, directly or indirectly, reserve the right to the designate the charitable beneficiaries or reserve the right to direct the timing of the distributions (although it may be possible to limit distributions to income, as opposed to principal, in the instrument of transfer).

restrict the right of the supporting organization to dispose of the stock freely and effectively.

Transfer to publicly supported organizations

A private foundation can dispose of its excess business holdings by transferring stock to one or more publicly supported charities.[25] Unless the transfer is subject to a material restriction, as discussed above, the transferred shares will not be attributed back to the foundation for calculating the excess business holdings. If a foundation must divest a large amount of stock, both the foundation and the public charity should determine if the grantee will be able to continue to satisfy the public support test, either under the 33-1/3% public support test or the 10% facts-and-circumstances test.[26] A large grant may "tip" the grantee into being treated as a private foundation, which the grantee would want to avoid.[27]

Most public charities that receive gifts of stock will sell the securities immediately or shortly after receipt, then invest the proceeds in accordance with their investment policies. However, a large, well-endowed public charity (such as a university) may have some flexibility (due to the size of its investment pool) to hold on to a gift of securities without liquidating immediately.

Transfer to supporting organizations

A supporting organization qualifies as a public charity because it must have a close connection with another publicly supported charity. There are benefits to working with a supporting organization, rather than a publicly supported organization, when disposing of large amounts of excess holdings. One benefit is that a supporting organization is not subject to the public support test, and therefore it does not have to be concerned that a large grant will cause it to become a private foundation. Another benefit is that the foundation (and family members controlling the foundation) may be able to retain greater involvement—though not outright control—in the governance and operations of a supporting organization. This may allow the foundation to expand its philanthropic scope and profile in a community far more than it could simply by transferring stock to a publicly supported charity.

The disadvantage of using a supporting organization over a publicly supported charity is that the regulations that apply to a supporting organization are more complex.[28] However, with the appropriate governance structures and policies in place, operating a supporting organization should provide no significant obstacles.

Choosing the appropriate supporting organization. Supporting organizations are classified into several types—Type I, Type II, functionally integrated Type III, and all other Type III.[29] A supporting organization's type is determined according to the relationship and connection it has with the charity or charities it supports. A Type I supporting organization has a "parent-subsidiary" relationship with its supported organization and is typically used when a supported organization wants to create a supporting organization for itself, to hold an endowment, for example. A Type II orga-

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[25] See, e.g., Ltr. Rul. 200825050 (foundation holding 100% of the voting stock of a company planned to distribute 80% of the stock to public charities), Ltr. Rul. 200526021 (plan for disposition included the option of donating stock to college, universities, and hospitals), Ltr. Rul. 9750015 (foundation had been distributing shares to public charities).

[26] Reg. 1.170A-9(e). In September 2008, the IRS published temporary regulations that significantly revised the public support test, including changing the computation period for the public support test. It had been the four years prior to the current year. The temporary regulations changed that to a five-year period that includes the current year. The regulations apply to tax years beginning after 2007. See T.D. 9423, 2008-43 IRB 966; REG-142333-07 2008-43 IRB 1008. Some charities (including churches, schools, and hospitals) are automatically considered public charities regardless of their actual level of public support. Sections 509(a)(1), 170(b)(1)(A).

[27] A foundation will not be held responsible for causing a grantee's status to change from a public charity to a private foundation as long as (1) the grantee has a valid IRS determination letter at the time the grant is made, (2) the IRS has not revoked the letter and the foundation is not aware of imminent action by the IRS to do so, and (3) the foundation does not control the grantee. See Rev. Proc. 89-23, 1989-1 CB 844. The grantee could also try to exclude the contribution from its public support calculation as an "unusual grant"—one that is unusual or unexpected and that might adversely affect the organization's status as publicly supported due to its amount. See Reg. 1.170A-9(e)(6)(ii); Rev. Proc. 81-7, 1981-1 CB 621.

[28] One court referred to the rules drafted for Type III supporting organizations as "fantastically intricate and detailed regulations to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes." Windsor Foundation, 40 AFTR2d 77-6004, 77-6006 (DC Va., 1977).

[29] Section 509(a)(3). In brief, a Type I is "operated, supervised or controlled by" the supported organization (Section 509(a)(3)(B)(i); Reg. 1.509(a)-4(g)). A Type II is "supervised or controlled in connection with" the supported organization (Section 509(a)(3)(B)(ii) and Reg. 1.509(a)-4(h)). A Type III is "operated in connection with" the supported organization (Section 509(a)(3)(B)(iii); Reg. 1.509(a)-4(i)). A functionally integrated Type III—to be defined more precisely by future regulations—carries on activities that the supported organization would have to undertake but for the supporting organization (Section 4943(f)(5)(B); REG-155929-06, 72 Fed. Reg. 42335 (8/2/07).

nization is sometimes characterized as having a "brother-sister" relationship with its supported organization and is often used by the parent supported organization to segregate illiquid assets, such as buildings, over which it wants to retain control. The main characteristic of this relationship is that the supported organization has full control of the supporting organization through a substantially overlapping (or sometimes identical) board. A Type III organization has the most flexible relationship with its supported organization and is typically used by a donor who wants to retain close involvement with the governance of the organization without the restrictions imposed by the private foundation rules.

Prior to the Pension Protection Act of 2006 (PPA), supporting organizations offered the advantages of a publicly supported organization without the restrictions imposed on a private foundation. But the benefits were not to last. After Congress and the IRS uncovered examples of significant abuses of supporting organizations by donors, Congress enacted numerous restrictions in how supporting organizations are governed and operated.[30] In determining which type of supporting organization is appropriate for disposing of excess business holdings, three changes are especially noteworthy.

THE REGULATIONS DO NOT EXPLAIN WHAT WOULD PREVENT 'FREELY AND EFFECTIVELY USING OR DISPOSING OF' THE TRANSFERRED STOCK.

First, the excess business holdings rule now applies to (1) non-functionally integrated Type III supporting organization and (2) Type II supporting organizations if the donor(s) to the supporting organization control the supported organization. The Treasury has the authority to exempt these types of supporting organizations from the excess business holding rule if an organization demonstrates that its holdings are consistent with the purpose or function constituting the basis of its exempt status.[31] An additional exemption from the excess business holdings rule applies to Type III supporting organizations that, as of 11/18/05, held excess business holdings for the benefit of the community pursuant to the direction of a state attorney general or a state official with jurisdiction over the Type III supporting organization.[32] The excess business holdings rule does not apply to Type I and functionally integrated Type III supporting organizations.

Second, the PPA enacted a payout requirement for non-functionally integrated Type III supporting organizations. No specific amount or method is prescribed in determining the distribution. The statute directs the Treasury to prepare regulations requiring these organizations to make distributions of a "percentage of either income or assets to supported organizations ... in order to ensure that a significant amount is paid to such organizations."[33]

Third and finally, the PPA enacted new requirements for private non-operating foundations making grants to a supporting organization. A private non-operating foundation that makes a grant to a non-functionally integrated Type III supporting organization will have to exercise expenditure responsibility and will not be able to count the grant as a qualifying distribution for purposes of its payout requirement. The same holds true for grants by a private non-operating foundation to any other type of supporting organization, *but only if* a disqualified person of the foundation directly or indirectly controls the supporting organization or a supported organizations, or the Treasury determines by regulation that a distribution is inappropriate.[34]

The practical result of these rules is that, in most cases, only a Type I supporting organization will be a viable recipient for excess business holdings. While a Type II supporting organization could, in theory, receive a grant of such holdings, the burden of having to prove that the supporting organization's donor or donors do not control the supported organi-

[30] Several years prior to the enactment of the PPA, the IRS had already characterized supporting organizations as "sailing on the razor's edge between public charity and private foundation status." Shoemaker and Brockner, "Public Charity Status on the Razor's Edge," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1997* (1996), at 105. Later, the IRS specifically referred to Type III organizations as "razor edge" organizations. See Shoemaker and Brockner, "Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2001* (2000), at 110.

[31] Section 4943(f)(2). See also Staff of the Joint Committee on Taxation, "Technical Explanation of H.R. 4, the 'Pension Protection Act of 2006,' as Passed by the House on July 28, 2008, and as Considered by the Senate on August 3, 2006" (JCX-38-06, 8/3/06), at 361. What appears to be the first published ruling to apply Section 4943(f)(2) is Ltr. Rul. 200822041. There, the Service exempted a non-functionally integrated Type III supporting organization that held more than 2% voting stock of a public corporation from the excess business holdings rule because the holdings were consistent with the organization's exempt purposes.

[32] Section 4943(f)(6).

[33] See section 1241(d) of the PPA, P.L. 109-280, 8/17/06.

[34] Section 4942(g)(4), Section 4945(d)(4)(A), Section 4945(d)(4)(B).

zation, and so avoid the application of the excess business holdings rule to the supporting organization itself, will often be significant. As for functionally integrated Type III supporting organizations, the IRS has yet to define the requirements for this category.

Requirements to qualify as a Type I supporting organization. To qualify as a Type I supporting organization (SO), an organization must meet specific requirements of an organizational test, an operational test, a control test, and a relationship requirement.[35]

The organizational test requires that a Type I SO's organizing documents (e.g., articles of incorporation) limit its purposes to supporting one or more publicly supported charities.[36] This requirement leaves significant room for flexibility, which includes naming the supporting organization after the foundation or family members. The organization can be set up with narrow or broad charitable purposes and support a class of supported organizations, or it can support one or more designated supported organizations. The SO may designate the supported organization in its organizing document, either by name or by class or purpose. For example, the SO may designate that it provides support to public charities whose functions and purposes are to support at-risk youth or to provide scholarships pursuing degrees in teaching. The SO also may designate a supported organization by name *and* identify a class of supported organizations by purpose. If several different charitable purposes are contemplated, separate SOs can be set up for each of them. In addition, specific grantmaking criteria can be drafted as part of the supporting organization's organizational documents to ensure that its activities are aligned with the foundation's philanthropic goals.

The operational test requires a Type I SO to operate in a manner described in its organizing documents.[37] This also means that, while an organization is not required to distribute a fixed percentage of its assets like a private foundation, it cannot "park" its assets without making some distributions to its supported organizations. As a general rule, the SO should adopt a spending policy that requires the organization to make distributions to its supported organization each year. For example, the organization could adopt a spending policy that requires it to distribute approximately 5% of its assets valued over a three-year rolling average. If the SO supports more than one supported organization, it can vary the amount of support it provides among the supported organizations. The SO's assets do not generally have to be fully diversified, so the SO could hold a majority of its assets in the transferred stock.[38] However, there must be no restrictions preventing the SO from selling excess business holdings a foundation transfers to it.

The control test prohibits disqualified persons (other than foundation managers) from controlling a supporting organization.[39] Control generally is present if the disqualified persons can aggregate a majority of the voting power. Veto power also constitutes control. In addition, control by disqualified persons may be present, even in the absence of a majority of the voting power or veto power, if the disqualified persons control decisions based on all of the facts and circumstances. The IRS also may assert that disqualified persons control the supporting organization if such persons control the primary assets of the supporting organization.[40] In light of these restrictions, it may be permissible to have the foundation's executive director serve as board member of the supporting organization, but additional

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[35] The IRS has published guidelines for processing applications for tax-exempt status submitted by supporting organizations. They are useful in identifying the types of issues and red flags the IRS may focus on when reviewing the governance of a supporting organization. The guide sheet is incorporated into section 7.20.7 of the Internal Revenue Manual (IRM, effective 4/11/08), and is also available at http://www.irs.gov/charities/article/0,,id=174956,00.html.

[36] Section 509(a)(3)(A); Reg. 1.509(a)-4(c), Reg. 1.509(a)-4(c)(d). As a practical matter, the supported organization will have to consent to serving as the supported organization of the SO.

[37] Reg. 1.509(a)-4(e).

[38] Charitable organizations with investment assets must manage their assets in accordance with prudent investment standards. In general, prudence requires a certain degree of diversification. See, e.g., Uniform Prudent Management of Institutional Funds Act, § 3 (2006).

[39] Reg. 1.509(a)-4(j). Disqualified persons consist of all the disqualified persons defined in Section 4946, except foundation managers who are disqualified persons solely because of their status as foundation managers and Section 509(a)(1) or (a)(2) organizations. Section 4946 defines disqualified persons to include (1) substantial contributors (including another private foundation); (2) foundation managers (officers, directors, trustees, and persons with similar powers); (3) individuals with 20% or more voting power of a corporation (or profits interest in a partnership or beneficial interest in a trust) that is a substantial contributor; (4) a lineal descendent or ancestor of a family member of the individuals above; or (5) a corporation, partnership, or trust in which those described in (1)-(4) above own more than 35% of the profit interests.

[40] See Reg. 1.509(a)-4(j)(1); IRM 7.20.7.2.3.

involvement by the disqualified persons of the foundation should be monitored and limited.[41]

Finally, to qualify as a Type I supporting organization, the relationship test requires that the organization must be "operated, supervised or controlled by" one or more publicly supported charities. This requirement is met if the majority of the SO's officers, directors, or trustees are appointed or elected by a supported organization's officers, directors, trustees or membership. In addition, the organization may not accept gifts or contributions from any person (other than a public charity described in Section 509(a)(1), (a)(2), or (a)(4)) that directly or indirectly controls the governing body of a supported organization.[42] If the organization designates the supported organizations by class or purpose, the relationship test is satisfied even if only one supported organization (or a set number of supported organizations) appoints the majority of the supporting organization's officers or directors.

Transfer to medical research organizations

A foundation also can contribute stock to a new or existing "medical research organization" (MRO) directly engaged in the continuous active conduct of medical research in conjunction with a hospital. A medical research organization is classified as a public charity,[43] and can be created and controlled by the foundation or its disqualified persons.

The key disadvantage of an MRO, in contrast to a supporting organization, is that an MRO must be engaged in conducting direct charitable activities, as opposed to just making grants as the supporting organization would be allowed to do. If a foundation chooses to create a new MRO, it may face significant start-up costs. On the other hand, establishing a successful MRO could significantly raise the profile and legacy of the foundation and its disqualified persons within a community, in addition to exploring new philanthropic activities.

To qualify as an MRO, the organization must (1) maintain an active research relationship with one or more nonprofit or government hospitals and (2) annually spend an amount equal to or greater than 3.5% of its endowment directly on, or in support of, its research activities with these hospitals.[44] An MRO can demonstrate its research relationship with a hospital in a variety of ways, including (1) formally documenting the relationship between the MRO and the hospital (such as by a memorandum of understanding or research guidelines), (2) conducting medical research activities in the hospital, (3) using the hospital's facilities/assets (such as medical equipment or case studies) to conduct its medical research, or (4) demonstrating close cooperation with hospital staff (such as active participation by hospital staff in the MRO's research).

To calculate the value of the endowment for the payout rule, all assets must be included except those that are related to the MRO's medical research activities. For an asset to be "related" to its medical research, the MRO must be using the actual property for medical research (e.g., medical equipment or intellectual property used in its own research). Qualifying distributions include all expenditures on medical research, including administrative overhead and salaries to employees. Qualifying distributions do not include funds the MRO distributes to other organizations (such as partner hospitals or other nonprofit organizations) to conduct medical research.

Transfer to advised funds

There are a number of charitable organizations that offer donors the ability to set up separate funds or accounts within the organization to direct or advise a donor's philanthropic giving. Such funds exist, for example, at community foundations, commercial gift funds, and other public charities.

There are several types of funds, each created to meet specific philanthropic goals. Some of the most common types are donor-advised funds, designated funds, and field-of-interest funds. Giving stock to a fund is similar to transferring it to a publicly supported charity, except that a fund may provide greater con-

[41] See, e.g., TAM 200827038 (ruling that the control test does not prohibit a supporting organization from being controlled by disqualified persons of a private foundation that is a substantial contributor to the supporting organization, provided that these same individuals are not disqualified persons with respect to the supporting organization).

[42] Alone or together with family members or an entity in which the donor holds more than a 35% interest.

[43] Reg. 1.170A-9(c)(2).

[44] Alternatively, an MRO could seek to meet the "assets test" by devoting more than one half of its assets to medical research activities. The assets test is more difficult to satisfy than the endowment test, however.

trol to the foundation over how the assets are used. Another advantage of using a fund is that the foundation will be able to benefit from the grantmaking expertise of the sponsoring organization's staff, who will also conduct the necessary due diligence when distributing grants from the fund. One disadvantage of setting up a fund is that the sponsoring organization of the fund will generally charge annual investment management and administration fees based on the fund's balance.

Donor-advised funds give donors the most control by making distributions to charitable organizations based on the donor's non-binding advice or recommendation. Such funds have become one of the most popular philanthropic vehicles in recent years. They no longer provide a good option for receiving excess business holdings, however, because the PPA applied the excess business holdings rule to them as well.

The two other types of funds provide for less donor control, but are not subject to the excess business holdings rule.[45] They also may be well-suited to achieve and even expand a foundation's charitable programs.

A designated fund makes distributions to charitable organizations that are specifically named by the donor at the time the fund is created. For example, a donor can name a university as the sole beneficiary of the designated fund. A designated fund should generally only make distributions to a single charity, but may be established to benefit a limited number of charities.[46] In that case, the donor has to fix the allocation of the distributions among the beneficiaries when the fund is created and cannot subsequently change the allocation or substitute other beneficiaries.[47]

A field-of-interest fund makes distributions to charitable organizations in a particular program area, such as education, health, youth, or the environment. An advisory committee makes recommendations to the sponsoring organization for grants. In this case, a foundation's representative (e.g., the executive director or a board member) or its designee could serve on the advisory committee, but could not control the committee. Moreover, in establishing such a fund, the foundation could limit the purposes of fund, thereby ensuring that the assets transferred by the foundation to the fund are used for purposes consistent with the foundation's mission. Thus, through the use of a designated fund or a field of interest fund, a foundation can transfer sufficient holdings to comply with the excess business holdings rule, yet still retain influence over the use of the funds.

Conclusion

No foundation wants to be forced by the excess business holdings rule to divest itself of corporate holdings, especially not in the sort of market that now exists. There are, however, many options available other than simply selling all or part of the foundation's stock. For both foundation managers and advisors, working out a plan to comply with the excess business holdings rule is an opportunity—albeit one forced on the foundation—for creative thinking. Through the use of stock grants and transfers, a foundation will be able to reduce its excess business holdings without compromising its long-term charitable goals. ■

[45] The PPA excludes designated funds from the definition of a donor-advised fund, while the IRS is authorized to exempt field-of-interest funds from being treated as donor-advised funds. See Sections 4966(d)(2)(B)(i), (C).

[46] The regulations appear to treat a fund that makes distributions to five or fewer charities as a designated fund. See Regs. 1.170A-9(e)(11)(v)(F) and -9(e)(13)(x).

[47] The sponsoring organization of the fund can change the beneficiaries and the allocations if the donor releases the restrictions. In that case, however, the fund would become an unrestricted fund. The sponsoring organization could voluntary choose to maintain the restrictions, but would not be bound by them.