Focus on Foundations: Certain Supporting Foundations under Fire

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Foundations known as "Type III Supporting Organizations" have been under increasing scrutiny by Congress, the IRS and the press. This scrutiny is very likely to result in the elimination of this type of foundation, or a significant tightening of the rules applicable to them.

By way of background, most of our clients who have created foundations have created private non-operating foundations, not supporting foundations. Private foundations generally must distribute 5% of the fair market value of their assets annually. There are also more restrictive limits on income tax deductions for contributions to private foundations. For example, if you contribute real estate to your private foundation, your deduction is limited to the lesser of your income tax basis or fair market value. But if you contribute that same property to a supporting foundation, you may be able to deduct the fair market value of the property (even if your basis is much lower). Thus, from a tax perspective, a supporting foundation and its contributors enjoy greater tax benefits than a private non-operating foundation and its contributors.

A "supporting foundation" is a foundation that supports one or more public charities. Type I and Type II supporting foundations must be "operated, supervised or controlled by" the supported organization, or "supervised or controlled in connection with" the supported organization. But a "Type III" supporting foundation need not have the same degree of connection or accountability to the supported organization. Instead, the Type III foundation need only maintain a "close" relationship to the supported organization and have "significant involvement" with that charity.

One significant drawback of any supporting organization (from the perspective of the foundation's creators) is that the foundation's creators cannot control the foundation or its board. Nevertheless, there is a sense among many members of Congress and others, that the looser relationship between Type III foundations and their supported...
organizations causes the Type III organization to be more likely to operate in ways that are not within the spirit of the supporting organization rules. For example, there is a perception that certain Type III foundations effectively remain under the control of their creators. Some Type III foundations have not been particularly generous to their supported organizations and have provided support over long periods of time at levels significantly less than the 5% annual payout required of private foundations. Other perceived abuses involve the valuation of contributions (of closely held business interests, for example) and the support of foreign charities.

The good news is that those families who have created private foundations should not be affected by these anticipated rule changes. But all charitable organizations should be mindful of the increasing scrutiny that is being brought to bear on all types of foundations and public charities. For those who have created Type III supporting organizations, you should be alert to possible law changes (and we expect to advise you of those changes in future Updates). If you have questions about these rules and how your foundation might be affected, you should contact your foundation’s tax advisor.

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