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ARTICLES

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

ALYSSA A. DIRUSSO*

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

Andrew Carnegie¹

SUMMARY

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

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* Assistant Professor of Law, Samford University, Cumberland School of Law; J.D., University of Texas School of Law; B.S., Carnegie Mellon University. The author wishes to thank the Cumberland School of Law for a summer research grant that supported work on this Article, participants in the faculty seminar at Cumberland, faculty who attended the presentation of this Article at Florida State University, and the following individuals for their comments and assistance: research assistant Andrea Weed, Brannon Denning, Joshua Tate, Joseph Dodge, Kathleen M. Sablone, Jim Exum, Jedidiah McKeehan, and Ayanna Sterling-Jones.

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

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

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

C. Promoting Supporting Organizations Too Hard

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

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

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

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

IV. CONCERNS WITH SUPPORTING ORGANIZATION ABUSE

If you can't trust charities, who can you trust? The past few years have revealed disheartening examples of abuse of fiduciary power by leaders of both corporations and charities.¹⁸³ The corporate scandals of years past¹⁸⁴ were

179. *Id.*

180. *Id.*

181. *Id.*

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

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

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

A. Abuse Makes Headlines

Contemporary concern with the abuses existing in supporting organizations was sparked by a front-page *Wall Street Journal* article in 1998.¹⁸⁹ Although several years have passed since the article was published, it is still cited by politicians and reformers as evidence of the need for reform. The *Journal* article called supporting organizations “a suddenly hot charitable vehicle” and exposed the actions of several supporting organizations and their famous donors, namely Carl Icahn, Gerry Spence, and David Cammack.¹⁹⁰

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

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

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

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

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

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

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

190. *Id.*

Ex-corporate raider Carl Icahn was looking for a way to donate some stock, retain as much control over that stock as possible, and get the most tax-deductible bang for his buck.¹⁹¹ He found it—in a Type III supporting organization. By transferring the stock to a supporting organization of his own creation, Icahn maintained control of the stock, avoided capital gains taxes, and enjoyed an income tax deduction for the full value of the assets (a perk reserved for publicly supported charities; donations to private foundations are limited by cost basis¹⁹²).¹⁹³ Icahn claimed only one “disadvantage” of his supporting organization: sharing board membership control with a majority of “outsiders” who represent the charity’s interests.¹⁹⁴ Icahn stated that his supporting organization will ultimately benefit underprivileged children, but initially, the result was just a healthy tax break.¹⁹⁵

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

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

The common theme among these supporting organizations is the continued

191. *Id.*

192. I.R.C. § 170(e)(1) (2000).

193. Langley, *supra* note 189.

194. *Id.*

195. *Id.*

196. *Id.*

197. *Id.*

198. *Id.*

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.*

203. *Id.*

204. *Id.*

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

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

B. Simultaneous Scandals

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

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

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

206. *Id.*

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

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

DeWitt Wallace-Reader's Digest Fund, Inc.²⁰⁹—and a member of the board of seven supporting organizations.²¹⁰ The seven supporting organizations and the two private foundations were initially funded with Reader's Digest stock, and remained highly invested in this stock in 1996.²¹¹ Together, the private foundations held seventy-one percent of the voting interest in Reader's Digest Association, Inc.²¹² Consequently, whoever controlled the foundations controlled the company. George Grune controlled both.²¹³

Throughout the late 1990s, the value of Reader's Digest stock fell precipitously, and dividends were scaled back dramatically. The stock lost about half of its value between 1992 and 1997,²¹⁴ and its dividends decreased by roughly fifty percent in July 1997.²¹⁵ Despite these losses, the supporting organizations did not diversify and saw the value of their shares plummet from \$1.85 billion in 1992 to \$0.7 billion in 1997.²¹⁶ Evidence suggested that the supported charities should have diversified, but George Grune's control—either direct or indirect—resulted in the supporting organizations clinging to rapidly depreciating assets.²¹⁷ Arguably, the supported charities should have had a stronger voice in the investment decisions of the supporting organizations.²¹⁸

C. Loans to Donors: Abuse of a Different Color

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

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

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

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

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

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

213. *Id.*

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

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

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

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

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

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

220. *Id.*

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

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

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

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

The *Chronicle* reported that these lending transactions, although surprising, are not uncommon enough.²²⁹ An examination of IRS Form 990 data exposed eighteen organizations that extended loans of \$100,000 or more to officers and directors between 1998 and 2001.²³⁰ The loans totaled over \$7 million, and in a majority of the cases, the foundation loaned out over half of its assets.²³¹

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

221. *Id.*

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

223. *Id.*

224. *Id.*

225. *Id.*

226. *Id.*

227. *Id.*

228. *Id.*

229. *Id.*

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

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

232. See I.R.C. § 4941(d)(2) (2000).

D. Legislative Response to Abuse Begins

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

Mark Everson, the Commissioner of the Internal Revenue Service, testified before the Senate Finance Committee on June 22, 2004.²³⁶ He explained the concerns relating to supporting organizations, but acknowledged the legitimate use of the structure:

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

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

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

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

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

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

Commissioner Everson gave examples of the abuses noted:

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

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

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

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

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

238. *Id.*

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

240. *Id.* at 3.

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

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

Id.

242. *Id.*

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

Senators Charles Grassley²⁴⁴ and Max Baucus²⁴⁵ wrote to the Department of the Treasury on February 3, 2005, outlining the abuses that concerned them.²⁴⁶ The senators expressed concern regarding the inappropriate use of charitable organizations for purposes of tax avoidance and evasion and particularly about “charitable organizations avoiding private foundation rules by claiming public charity status as a Type III supporting organization (SO) under section 509(a)(3) of the Code.”²⁴⁷ The senators encouraged the Department of Treasury to revisit the regulations creating Type III supporting organizations.²⁴⁸

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

“This is extremely troubling,” Grassley said. “Individuals are using supporting organizations to play fast and loose with the tax rules intended to help charities and encourage giving. It’s clear Congress and the administration will have to take steps to stop this abuse and ensure that charitable donations benefit the needy. I’m deeply disturbed that with a good number of supporting organizations, people are taking multi-million dollar tax deductions for what they claim are contributions to charity, yet too often the result is a thimbleful of benefit to charity.

“Both a Congressional Research Service report and the Finance Committee’s review have made it clear that the problem isn’t limited to Type III supporting organizations. The snake oil salesmen have also figured out how to manipulate Type I and II supporting organizations for the benefit of themselves and their clients. Meanwhile, the charities are lucky if they receive enough money to buy a blanket for the homeless. While the taxpayers get bilked by this abuse, sadly the needy ultimately suffer because they’re denied the benefits intended by the tax law.

“The law intended to allow supporting organizations only for a narrow set of circumstances. Unfortunately, creative types are exploiting a loophole in the regulations by setting up supporting organizations to skirt the laws governing private foundations. You could drive a Mack truck

243. *Id.*

244. Senator Grassley (IA) is chairman of the Committee on Finance.

245. Senator Baucus (MT) is ranking member of the Committee on Finance.

246. Senate Committee on Finance Press Release, *supra* note 235, at 2-3.

247. *Id.* at 2.

248. *Id.* at 3.

249. *Id.* at 1-3.

through that loophole.”²⁵⁰

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

E. Judicial Examination of Supporting Organizations

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

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

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

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

250. *Id.* at 1.

251. *Id.*

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

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

254. *Id.*

255. *Id.*

256. *Id.*

257. *Id.*

258. *Id.*

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

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

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

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

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

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

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

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

262. *See id.*

263. *Id.*

264. *Id.*

265. *Id.*

266. *Id.*

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

268. *Id.*

269. *Id.*

270. *See id.*

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