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# Defending Place-Based Philanthropy by Defining the Community Foundation

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# Defending Place-Based Philanthropy by Defining the Community Foundation

*Roger Colinvaux\**

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## INTRODUCTION

This Article is about the changing role of the community foundation in conducting philanthropy in the United States.

Community foundations are an important part of the U.S. philanthropic infrastructure. The nation's 789 community foundations hold roughly \$82 billion in assets<sup>1</sup> and account for over \$7.68 billion of charitable grants.<sup>2</sup> Many community foundations are the backbone of the social fabric in their communities, supporting basic human needs, health care, housing, K-12 education, civic engagement, and the arts.<sup>3</sup> Yet community foundations face new challenges to their niche and mission.

Historically, the purpose of a community foundation was to provide place-based philanthropy. Community foundations would raise money from local leaders and spend money for the benefit of the community served. Communities could be urban, rural, and even regional, but the main idea was to provide philanthropic support for identifiable communities under the guidance of community leaders—a bit like philanthropic banks for regional interests.<sup>4</sup> Today, however, the root idea that community foundations

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1. *Foundation Stats*, FOUND. CTR., <http://data.foundationcenter.org/#/foundations/all/nationwide/total/list/2014>, (last updated Oct. 2014).

2. IND. UNIV. LILLY FAMILY SCH. OF PHILANTHROPY, *GIVING USA 2017: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2016*, at 114 (2017).

3. See generally *Key Facts on Community Foundations*, FOUND. CTR. (Aug. 2012), [http://foundationcenter.org/gainknowledge/research/pdf/keyfacts\\_comm2012.pdf](http://foundationcenter.org/gainknowledge/research/pdf/keyfacts_comm2012.pdf).

4. A sample of community foundations captures the diversity: the New York Community Trust, the Rhode Island Foundation, the Oregon Community Foundation, the Central Indiana Community Foundation, the Baltimore Community Foundation, the Oklahoma City Community Foundation, the Foundation for the Carolinas, the Communities Foundation of Texas, and the largest, the Silicon Valley Community Foundation. The list goes on.

serve local needs is under threat. The community foundation is at risk of becoming more like a national bank, serving metaphysical communities and issues rather than people.

The main challenge to the community foundation identity is due to the enormous success of national charities that sponsor donor-advised funds (DAFs). Examples include organizations like the Fidelity Charitable Gift Fund, Schwab Charitable, and the Vanguard Charitable Endowment, to name three of the largest. These charities have catapulted into the ranks of the nation's biggest charitable fundraisers through the mass-marketing of DAFs.<sup>5</sup> With a DAF, a donor makes a charitable contribution to the sponsoring charity (e.g., Fidelity Charitable), gets a tax deduction, and then advises the sponsor on where to distribute the fund assets over time.

The DAF was once the province of community foundations and relatively obscure. Community foundations developed the DAF as a fundraising tool that appealed to donors who wanted to remain involved in advising how their donated funds should be spent.<sup>6</sup> After making a typically large gift a donor could consult with community foundation staff about how best to direct funds for the benefit of the community served. The model was consultative, between donor and institution, and mission focused—grounded by the place-based exempt purpose of the community foundation.

Yet today, DAFs are dominated by large, national organizations, not community foundations. In 2014, for the first time, assets held by Fidelity, Schwab, and Vanguard DAFs exceeded the

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5. In 2016, the Fidelity Charitable Gift Fund became the largest charity in the United States in terms of contributions received, beating the United Way for the first time. The Schwab Charitable Fund was fourth, the Vanguard Charitable Endowment Program was tenth. See Peter Olsen-Phillips & Brian O'Leary, *How Much America's Biggest Charities Raise: 27 Years of Data*, CHRON. PHILANTHROPY (Oct. 31, 2017), [https://www.philanthropy.com/interactives/philanthropy-400#id=table\\_2016](https://www.philanthropy.com/interactives/philanthropy-400#id=table_2016) (listing the top 400 charities, measured by amount of contributions received).

6. The New York Community Trust is credited as creating the first donor-advised fund in the 1930s. See Eleanor W. Sacks, *The Growing Importance of Community Foundations*, IND. UNIV. LILLY FAMILY SCHOOL OF PHILANTHROPY 1, 8 (2014), [https://philanthropy.iupui.edu/files/file/the\\_growing\\_importance\\_of\\_community\\_foundations-final\\_reduce\\_file\\_size\\_2.pdf](https://philanthropy.iupui.edu/files/file/the_growing_importance_of_community_foundations-final_reduce_file_size_2.pdf); see also Lila Corwin Berman, *Donor Advised Funds in Historical Perspective*, B.C. F. ON PHILANTHROPY & THE PUB. GOOD 5, 13-14 (2015), [https://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum\\_philanthropy/02\\_Berman.pdf](https://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum_philanthropy/02_Berman.pdf).

asset value of the DAFs held by the top 274 community foundations.<sup>7</sup> The result is not just that national DAF sponsors dwarf community foundation DAFs in fundraising, but more importantly, the mass-market success of the DAF affects indelibly the nature of the DAF and in turn the place-based giving culture that historically prevailed in community foundations.

Community foundations exist to serve a particular geographic area or region and are staffed by people who are connected to their communities. Traditionally, DAFs fit within this model. DAFs at national sponsoring organizations, however, have no connection to place or community but serve as a pass-thru for donors whose advice is simply to designate a 501(c)(3) organization, based anywhere in the United States, with no meaningful consultative role by the sponsoring charity. Because national fund sponsoring organizations now broadly set the standard for donor-advised funds, community foundations are becoming, willingly or not, subject to that standard. As a result, community foundations increasingly will cater to donor expectations of a national scope for charitable distributions, and a passive, individual-based model of advised giving, running counter to the traditional role of the community foundation.

Relatedly, the dominance of the national fund organizations impacts the regulation of community foundations. Because nationally sponsored DAFs have been controversial (and successful),<sup>8</sup> the DAF has risen to the forefront of policy debates about philanthropy.<sup>9</sup> Community foundations have thus become caught

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7. IND. UNIV. LILLY FAMILY SCH. OF PHILANTHROPY, GIVING USA 2016: THE ANNUAL REPORT ON PHILANTHROPY FOR THE YEAR 2015, at 90 (2016) (citing a survey by CF Insights, which surveyed the 274 community foundations that represent ninety percent of total community foundation asset value).

8. Since Fidelity Charitable obtained charitable status in 1991, legal and policy questions persist. See *infra* notes 71–83 and accompanying text.

9. See Alan M. Cantor, *Donor-Advised Funds and the Shifting Charitable Landscape: Why Congress Must Respond*, B.C. F. ON PHILANTHROPY & THE PUB. GOOD 131, 134 (2015), [http://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum\\_philanthropy/08\\_Cantor.pdf](http://www.bc.edu/content/dam/files/schools/law/pdf/academics/forum_philanthropy/08_Cantor.pdf); Lewis B. Cullman & Ray Madoff, *The Undermining of American Charity*, N.Y. REV. OF BOOKS (July 14, 2016), <http://www.nybooks.com/articles/2016/07/14/the-undermining-of-american-charity/>; Alex Daniels & Drew Lindsay, *Donor-Advised Funds Reshape the Philanthropy Landscape*, CHRON. PHILANTHROPY (Oct. 27, 2016), <https://www.philanthropy.com/article/Donor-Advised-Funds-Reshape/238188>; *The Rise of the Donor Advised Fund*:

up in a legal and policy debate directed primarily at national, commercially affiliated organizations.<sup>10</sup> As a result, not only may community foundations become subject to rules and regulations devised for other kinds of charities, but community foundations (as DAF sponsors) increasingly may be misunderstood by donors and policymakers and gradually lose their core identity.

The time therefore is ripe for an assessment of the community foundation's role in philanthropy.<sup>11</sup> This Article takes as a baseline approach that the appropriate role for the community foundation is to serve discrete geographic communities. Without that focus, there is little reason to distinguish community foundations from other fundraising organizations, and community foundations then, at a minimum, should be subject to any additional rules imposed on national donor-advised fund sponsors.<sup>12</sup>

The Article proceeds in three parts. Part I of the Article provides a historical overview of the tax-exempt status of community foundations, from inception to the present day. Part II shows how the settled wisdom on the tax status of community foundations has been upset by the rise of the nationally sponsored donor-advised fund, the extent to which community foundations are different from national donor-advised fund sponsors, and whether it would be beneficial to define the community foundation for tax

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*Should Congress Respond?*, B.C. L. SCH. MAG. (Oct. 26, 2015), <http://lawdigitalcommons.bc.edu/philanthropy-forum/donoradvised2015/>.

10. See Alicia Philipp & Terry Mazany, *The Special Standing of Community Foundations as Sponsors of Donor-Advised Funds*, B.C. F. ON PHILANTHROPY & THE PUB. GOOD 205, 209 (2015), <http://lawdigitalcommons.bc.edu/cgi/viewcontent.cgi?article=1024&context=philanthropy-forum> (noting that “[t]he DNA of a commercial gift fund is based on the profit-motive of the parent company” and that community foundations are different).

11. Legal scholarship has largely ignored the community foundation and its role in philanthropy. The main legal work on community foundations is CHRISTOPHER R. HOYT, *LEGAL COMPENDIUM FOR COMMUNITY FOUNDATIONS* (1996), which is now out of print. More recent scholarship includes Mark Sidel, *Law, Philanthropy and Social Class: Variance Power and the Battle for American Giving*, 36 U.C. DAVIS L. REV. 1145 (2003); Mark Sidel, *Recent Developments in Community Foundation Law: The Quest for Endowment Building*, 85 CHI-KENT L. REV. 657 (2010).

12. A companion piece to this Article is Roger Colinvaux, *Donor Advised Funds: Charitable Spending Vehicles for 21st Century Philanthropy*, 92 WASH. L. REV. 39 (2017), in which the author, Colinvaux, argues that DAFs within the national sponsoring organizations should be required to distribute contributions within a reasonable period of time. That article leaves open the question of whether DAFs sponsored by community foundations should be subject to the same requirement.

purposes in order to make them more distinct. Part III then considers the possible content of a definition of the community foundation in the Internal Revenue Code in terms of their purpose, governance, and operations, taking into account longstanding policy concerns about donor control of foundation assets and income accumulations.

The Article concludes that a strong affirmative Code-based definition of community foundation could help preserve place-based philanthropy. Although a definition might not seem in the short-term interest of community foundations, over the long-term, a definition should endow the community foundation with much stronger legal foundations and a clearer identity for the next century of philanthropy.

## I. HISTORICAL CONTEXT FOR THE TAX STATUS OF COMMUNITY FOUNDATIONS

### *A. Background of Public-Private Charity Distinction*

As a guiding principle, federal income tax law makes a crude but fundamental distinction between public and private charities, with public charity being the preferred form.<sup>13</sup>

Public charities tend to be more active; private charities more passive. In general, a charity is public in nature either because the activity gains widespread public support through donations (thus proving its public character), or because the activity is grounded in the local community, i.e., as a church, hospital, university, or museum. A charity is private in nature when it generally reflects the inclinations of an individual or family, and instead of conducting activities, makes grants over time.<sup>14</sup> To the extent donors control charitable resources, as with a “private” foundation, there is a

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13. For a general discussion of the distinction between public charity and private foundation, see STAFF OF JOINT COMM. ON TAXATION, 109TH CONG., HISTORICAL DEVELOPMENT AND PRESENT LAW OF THE FEDERAL TAX EXEMPTION FOR CHARITIES AND OTHER TAX-EXEMPT ORGANIZATIONS 82-99 (Comm. Print 2005).

14. *Id.*

greater risk that the public interest will not be served. Thus, private charities are subject to tougher rules.<sup>15</sup>

The community foundation is a distinct philanthropic type that has never fit neatly within the public-private dichotomy. The name itself suggests the conflict. The “community” in community foundation reflects the public side of serving a distinct community; the “foundation” suggests a private side, accumulating donor funds and making grants.

As discussed in this Part, for tax classification purposes, the public side prevailed in the end. Community foundations were classified as public charities, but in a manner so abstruse that the community foundation is largely hidden within the philanthropic taxonomy, a vague presence that seems important but is largely unknown to the wider public and to policymakers.

### *B. Community Foundation Origins*

The original community foundation was formed in Cleveland in 1914 to solve a problem of dead hand control.<sup>16</sup> At that time, the president of the Cleveland Trust Company (CTC), F.M. Goff, was frustrated by the workings of trust law.<sup>17</sup> Under ordinary trust principles, charitable trust funds held by CTC had to be used in accordance with the donor’s wishes unless a waiver could be obtained in court by use of the *cy pres* procedure.<sup>18</sup> *Cy pres* was expensive, time consuming, and not certain of success.<sup>19</sup> Thus, it was extremely difficult for CTC to try to vary a donor’s outdated wishes and escape from the “dead hand.”

As a way around the problem, Goff developed what became known as the “Cleveland Plan.”<sup>20</sup> Under this Plan, donors would

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15. Private foundations are subject to a wide range of excise taxes on operations, a payout requirement, a tax on investment income, and donors receive fewer benefits for donations. Public charities face far fewer restrictions. I.R.C. §§ 509, 4940-4945 (2012).

16. See HOYT, *supra* note 11, at 3; Norman A. Sugarman, *Community Foundations*, in 3 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 1689, 1689 (1977). Written for the Filer Commission, the Sugarman article is an excellent resource describing the history and role of community foundations as of the mid-1970s. Many of the questions raised by Sugarman remain relevant today.

17. Sugarman, *supra* note 16, at 1689.

18. *Id.*

19. *Id.*

20. *Id.* at 1689-90.



agree when funding the charitable trust that a committee would have the power to change the purpose of the trust and make distributions if the donor's intent became obsolete or conditions changed.<sup>21</sup> The distribution committee's membership would be selected by prominent local public officials and community leaders, who presumably would be among the best informed about community needs.<sup>22</sup>

The Cleveland Plan thereby established the initial characteristics of the community foundation. The basic idea was of a gift, made in trust, with a corporate bank as trustee, and with ultimate distribution authority placed in a specially constituted committee. The "community" in the community foundation thus appears to have come from both the makeup of the distribution committee as well as a reference to a geographic area. Goff's key innovation was that charitable trust funds ultimately would be managed, not by the dead hand of the donor, but by the community.<sup>23</sup>

Ultimately, the community foundation proved to be an attractive model of philanthropy, and community foundations were created across the country.<sup>24</sup> The initial philanthropic niche served

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21. This became known as the variance power. According to the Cleveland Foundation, Goff once explained the need to rid community trusts from the yoke of the dead hand to better allow donor contributions to be used by the community foundation's board for the benefit of the community for "such charitable purposes as will best make for the mental, moral, and physical improvement of the inhabitants of Cleveland." *See Our History*, CLEVELAND FOUND., <http://www.clevelandfoundation.org/about/history> (last visited Jan. 17, 2018).

22. In addition, CTC housed the investment authority of the trust funds with a professional corporate trustee (a bank), which acted as a fiduciary. *See id.*; *see also* Sugarman, *supra* note 16, at 1689.

23. Inevitably, the Cleveland Plan evolved. The original plan had one bank as trustee of the charitable funds. Over time, multiple banks in the community would serve as trustees within a single community foundation. In addition, the form of the community foundation expanded from its origins as a committee with oversight of charitable trust distributions, to the corporate form. Thus, instead of a free-standing committee with power to make distributions from a charitable trust, the corporate community foundation could accept and manage contributions directly, not necessarily in trust. A distribution committee would still be selected from the community but formally would be a part of the corporation. Some hybrids also emerged. Corporate community foundations might undertake the distribution role but use bank trustees to manage the investments, either in trust form, or not. Also, funding sources expanded to focus not just on bequests but also inter-vivos giving. Sugarman, *supra* note 16, at 1690-91.

24. The earliest foundations typically were established in large urban centers, but some community foundations had a broader geographic reach—including statewide foun-

by community foundations was to fund long-term community projects through bequests or large inter-vivos transfers and not for current spending.<sup>25</sup> This complemented more traditional approaches to charitable funding through organizations like the United Way, which focused on smaller gifts for immediate needs.<sup>26</sup> The community foundation—endowment funds professionally managed by and for the benefit of local communities—filled a gap in the private provision of philanthropy.

*C. Legal Status of the Community Foundation Before 1969  
and the Rise of Policy Concerns*

Because the early federal income tax law of charities did not distinguish among 501(c)(3) organizations, once community foundations were established as charitable tax-exempt organizations, they presented no special questions of further classification.<sup>27</sup> This changed in modest ways mid-century.

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dations to serve more rural populations (e.g., the Rhode Island Foundation was established in 1921).

25. See Berman, *supra* note 6, at 13–14.

26. Importantly, community foundations did not view the United Way funding model as competition. Rather the two charity types were seen as partners, with separate roles to play, that attracted different donations. Sugarman, *supra* note 16, at 1691. United Way served current needs and did not seek endowment funds, in part because doing so would discourage its regular donor base who might be dissuaded to give to an apparently wealthy organization. As stated by the executive director of the United Way in 1956:

Both endowment funds for future benefits and current funds for operating expenses should play a vital role in financing communal enterprises, but it would seem best not to mix the two in a single organization. . . . Community foundations constitute ideal partners for Community Chests and United Funds in rounding out the financing picture . . . .

*Id.* (quoting a speech by Ralph Blanchard).

27. The 501(c)(3) status of a community foundation was never in doubt and is long established. From the outset, the Code has provided exemption for any corporation or a “community chest, fund, or foundation” organized and operated exclusively for an exempt purpose. I.R.C. § 501(c)(3) (2012). Under this standard, a community foundation that collects and administers funds to be paid for charitable, educational, religious, scientific, or literary purposes qualifies as a 501(c)(3) organization, whether the foundation takes the corporate or the trust form. For convenience, the Code section 501(c)(3) is used although the original section number was different.

### 1. *Anti-abuse rules*

The first significant change for present purposes was in 1950 when Congress passed a series of anti-abuse rules targeted at private foundations.<sup>28</sup> Like community foundations, private foundations were a known philanthropic type. Typically founded and controlled by a single donor or family, private foundations presented special problems of donor control and abuse. Specifically, Congress was concerned about self-dealing, accumulations of income, risky investments, and spending that was not for charitable purposes.<sup>29</sup>

The desire to regulate a portion of the charitable sector, but the absence of a legal definition for any charitable subtype meant that Congress had to create categories.<sup>30</sup> Conceptually, Congress drew a line between public and private charities. Public charities would escape the new rules because public organizations were “not believed likely to become involved” in the prohibited transactions.<sup>31</sup>

To establish the public-private distinction, Congress defined the target in the negative, imposing rules of general applicability, with exemptions for large swaths of “public” 501(c)(3) organizations. Exempted charities included: churches, schools, hospitals, and a more generic category of publicly supported organizations.<sup>32</sup>

Significantly, the 1950 legislation also established the public support category as a generic public charity classification that escaped extra regulation.

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28. See Laurens Williams & Donald V. Moorehead, *An Analysis of the Federal Tax Distinctions Between Public and Private Charitable Organizations*, in 4 RESEARCH PAPERS SPONSORED BY THE COMMISSION ON PRIVATE PHILANTHROPY AND PUBLIC NEEDS 2099, 2101 (1977). Congress was also concerned with abuses at charitable trusts.

29. *Id.* at 2101-02.

30. Congress had also started drawing lines for purposes of filing requirements and payment of taxes on unrelated business income.

31. S. REP. NO. 81-2375 (1950). One set of rules, deemed “prohibited transactions,” were directed at self-dealing. Under these rules, certain transactions with insiders, such as loans, compensation, or sales, were prohibited unless the transaction was at arm’s length. Another set of anti-abuse rules focused on best practices. These rules barred unreasonable accumulations of income, investments that jeopardized exempt purposes, and substantial spending for non-charitable purposes. The penalty under both regimes was loss of exempt status. For additional discussion, see Williams & Moorehead, *supra* note 28, at 2101-02.

32. Williams & Moorehead, *supra* note 28, at 2102.

## 2. Charitable deduction rules

In the same time period, Congress changed the charitable-deduction rules to reflect a preference for public charities. Initially, donors were subject to a single cap, which limited the amount donors could claim as charitable deductions each year as a percentage of adjusted gross income. In 1954, Congress created a second, higher percentage limit, enabling greater deductibility for contributions to certain 501(c)(3) organizations.<sup>33</sup> Congress singled out contributions to churches, schools, and hospitals as eligible for the higher cap.<sup>34</sup> By default, gifts to all other charities, including community foundations, remained subject to the lower percentage limit.

Through this action, Congress created a lasting category of *per se* or automatic public charities. The church, school, and hospital were singled out as quintessentially public institutions, presumably because of their function and clear role in civic life.<sup>35</sup> There were no special requirements, apart from being a church, school, or hospital. In essence, Congress made the determination, based on its judgment, that these institutions merited preferential treatment over other charities under the tax laws.

Ten years later, in 1964, Congress added publicly supported organizations to the list of charities eligible for the higher percentage limit.<sup>36</sup> This generic category filled in the gap caused by the 1954 legislation. Although some “public” institutions like churches, schools, and hospitals are easy to identify by their core function, many other charities arguably are no less public but harder to describe legislatively. The legislative history cited the

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33. *Id.*

34. *See id.* at 2102-03.

35. In 1952, Congress raised the generally applicable percentage limitation. At that time, the Senate Finance Committee report provided that: “Your committee is of the opinion that by increasing the 15-percent limit to 20 percent, much-needed relief will be given to colleges, hospitals and other organizations who are becoming more and more dependent upon private contributors to enable them to balance their budgets and carry on their programs.” S. REP. NO. 82-1584 (1952). When these organizations received their own distinct limitation in 1954, the legislative history provided simply: “This amendment is designed to aid these institutions in obtaining the additional funds they need, in view of their rising costs and the relatively low rate of return they are receiving on endowment funds.” Williams & Moorehead, *supra* note 28, at 2101 (quoting S. REP. NO. 83-1622 (1954)).

36. Revenue Act of 1964, Pub. L. No. 88-272, § 209(a), 78 Stat. 19, 43-47.

“many cultural and educational organizations and major charitable organizations” that perform “many beneficial activities.”<sup>37</sup> Unlike with the anti-abuse rules, this time Congress defined the publicly supported category as one that normally received a substantial part of its support from the government or from the general public.<sup>38</sup>

Thus, after the 1964 legislation, 501(c)(3) organizations could claim a preferred status for charitable deduction purposes in one of two ways: based on core function or just because the group had sufficient support from the public. Community foundations would have to qualify, if at all, by virtue of being publicly supported. Private foundations, almost by definition, would not qualify.<sup>39</sup>

Subsequently, the Treasury Department wrote regulations to define the publicly supported category.<sup>40</sup> The regulations used two alternative tests: a mechanical public-support test and a test based on the facts and circumstances.<sup>41</sup> Because community foundations relied extensively on bequests for support, and support could be sporadic, it would likely be difficult for community foundations to satisfy the mechanical test. Nevertheless, the Treasury Department made the judgment that community foundations were public charities and provided an example in the regulations showing that a community foundation could satisfy the facts and circumstances test.<sup>42</sup> The key facts and circumstances were having a fundraising program that attracted public support, a publicly representative governing body, and the publication of annual reports.<sup>43</sup>

In sum, community foundations were not “public” enough based on their function to qualify for per se public charity status.

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37. S. REP. NO. 88-830 (1964).

38. Public support did not include “exempt function income,” i.e., program service revenue. *Id.*

39. Lest there was any doubt, the legislative history was clear: the benefit was “not available in the case of a private foundation.” *Id.*

40. Treas. Reg. § 1.170-2(c) (1968).

41. *Id.*

42. *Id.* § 1.170-2(c)(5), Example 1 (1968).

43. In addition, the regulations recognized the community foundation, in trust form, as a single entity for tax purposes, rather than a handful of separate trusts. See Sugarman, *supra* note 16, at 1700-01.

However, in the judgment of the Treasury Department they were considered publicly supported and thus eligible for favorable treatment under the charitable deduction rules as public charities.

#### D. The 1969 Act

Even as the 1964 regulations were being written, private foundations were under intense scrutiny in Congress and at the Treasury Department. Hearings conducted by Representative Wright Patman into abusive practices at private foundations led to the seminal Treasury Department Report on Private Foundations,<sup>44</sup> which in turn provided the base for rules adopted in the Tax Reform Act of 1969.<sup>45</sup>

As is well known, the 1969 Act finally codified the distinction between public charity and private foundation, cementing this distinction as the principal sorting device for 501(c)(3) organizations through the present day. Notably, the distinction largely followed the policy concerns and categories that animated the 1950, 1954, and 1964 legislation. Self-dealing, accumulations of income, risky investments, and spending not for charitable purposes all continued to be regulated, but with bright-line rules and excise taxes<sup>46</sup> instead of arm's-length standards and loss of exempt status.<sup>47</sup>

For community foundations, classification as public or private became magnified in importance. Not only did even more favorable charitable deduction rules turn on the distinction,<sup>48</sup> but the operational constraints of the private-foundation excise-tax regime would have cramped the community foundation model, not to

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44. U.S. TREASURY DEP'T., 89TH CONG., TREASURY DEP'T REP. ON PRIVATE FOUNDATIONS (Comm. Print 1965).

45. Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487. See generally Thomas A. Troyer, *The 1969 Private Foundation Law: Historical Perspectives on Its Origins and Underpinnings*, 27 EXEMPT ORG. TAX REV. 52 (2000).

46. I.R.C. §§ 4941-4945 (2012).

47. STAFF OF JOINT COMM. ON TAXATION, 91ST CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, 29-60 (Comm. Print 1970).

48. Congress added private operating foundations and conduit foundations to the list of favored charities (for deduction purposes). See Williams & Moorehead, *supra* note 28, at 2111. Congress also largely eliminated the incentive to give noncash property to private foundations, making public charity classification even more important. See Roger Colinvaux, *Charitable Contributions of Property: A Broken System Reimagined*, 50 HARV. J. ON LEGIS. 263, 273 n.58 (2013).

mention the loss of exemption from tax on investment income. Further, as primarily a grant-making charity, community foundations shared some characteristics with private foundations, raising anew the question of whether community foundations were distinct.

There was reason to believe, however, that Congress did not intend for community foundations to be placed in the “private” charity category. For one thing, private foundations, not community foundations, were the focus of the Patman hearings and the Treasury Report.<sup>49</sup> Further, in the 1969 Act, Congress retained the “publicly supported” category from the 1964 legislation, which, pursuant to Treasury regulations, included community foundations. Thus it could be argued that Congress in 1969, by remaining silent, broadly agreed with the Treasury Department that community foundations were publicly supported charities.<sup>50</sup>

Nevertheless, the elevated significance of the public-private distinction in the 1969 Act led the Treasury Department to write new regulations on the publicly supported category.<sup>51</sup> Although the new regulations kept the frame of the earlier ones by adopting a mechanical public-support test and a facts-and-circumstances test (known as the ten-percent-of-support test), the Treasury Department changed the content of the facts-and-circumstances test.<sup>52</sup> Under the new test, public support had to be garnered within a four-year period.<sup>53</sup> Community foundations would find the test hard to satisfy if the main source of funding was by bequest.<sup>54</sup> Further, it was not clear under the regulations whether a loose assemblage of trusts, which typified the community foundation, would count as an organization for purposes of being a publicly supported organization.<sup>55</sup>

In short, for present purposes, from the standpoint of community foundations, what emerged from the 1969 Act regulations was uncertainty. Some community foundations received public-

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49. U.S. TREASURY DEP'T, *supra* note 44.

50. See Sugarman, *supra* note 16, at 1701.

51. *Id.*

52. *Id.*

53. *Id.*

54. *Id.* at 1701-02.

55. See *id.*

charity status, but not all. As summarized by one commentator at the time:

The community foundations without favorable public-charity rulings are in limbo; they have no assurance or recognition by the I.R.S. of public-charity classification nor a set of rules for achieving that status. The unevenness of the present situation is a deterrent to many community foundations which it is hoped will be corrected in the near future.<sup>56</sup>

### *E. The Community Foundation Regulations*

#### *1. Significance of the regulations*

Correction came in 1976 in the form of regulations for community foundations.<sup>57</sup> The regulations cemented the public-charity status of community foundations through special rules that constructed the public-support test to ensure that community foundations could qualify as public charities. Although the regulations formally apply only in the community trust context (as opposed to a corporate structure), they nonetheless have a broader significance.

At the outset, it is important to note the significance of having community foundation regulations at all. Critically, it meant that the Treasury Department through regulations, and not Congress through the Internal Revenue Code, made the determination of community foundation status. Thus, although community foundations achieved their goal of public-charity status, the tax classification occurred through an obscure regulatory interpretation of the Code, not directly by Congress.

In addition, as a special interpretation of the publicly supported category, the tax status of community foundations ultimately rests on a regulatory judgment. Just as Congress named the church, school, and hospital as per se public charities, the Treasury Department assessed the community foundation archetype and determined that community foundations were per se public charities. In other words, the Treasury Department was persuaded

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56. *Id.* at 1702.

57. Treas. Reg. § 1.170A-9(f)(10)-(11) (as amended in 2011). Regulations were proposed in 1971; Community Trusts and Effect of Restrictions and Conditions upon Distributions of Net Assets, 36 Fed. Reg. 19598 (Oct. 8, 1971).



that community foundations, as a specific type of charity, categorically *should* qualify as public charities and that it was necessary to write special rules to ensure that conclusion.

The judgment of the Treasury Department is illustrated in the introduction to the regulations, which describes the community foundation in general terms, before setting out prescriptive rules.

Community trusts have often been established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions have come initially from a small number of donors. While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body.<sup>58</sup>

In a descriptive not prescriptive sense, the Treasury Department took notice of the funding model, governance structure, and purpose of the community foundation. The Treasury Department acknowledged through this language that the community foundation is a distinct type of charity that is public in nature and outlines its essential characteristics, which date to Goff's original vision.

## *2. Special public-support test for community foundations*

The main operative rule of the regulations provides community foundations a special way to satisfy the facts-and-circumstances public-support test. The Treasury Department takes into account the unique funding model for community foundations and provides that

[the] requirement of attraction of public support . . . generally will be satisfied, if [community trusts] seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust companies, through attorneys or other professional persons, or in other appropriate ways which call attention to the community trust as a potential recipient of

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58. Treas. Reg. § 1.170A-9(f)(10).

gifts and bequests made for the benefit of the community or area served.<sup>59</sup>

In other words, the regulations conclude that for purposes of satisfying the public-support test, what matters is that ongoing public support is *sought*, and sought *from the community served*. The requirement that ongoing public support is sought helps to distinguish community foundations from private foundations, which do not need to seek ongoing support. The requirement that support is sought from the community served helps establish, as a matter of law, that there is a public base of support (the community), and because of the support, the community served will be sufficiently vested in the community foundation to provide effective oversight.

Further, the regulations then distinguish the community foundation from the other models of public support (as typified by the United Way):

A community trust is not required to engage in periodic, community-wide, fundraising campaigns directed toward attracting a large number of small contributions in a manner similar to campaigns conducted by a community chest or united fund.<sup>60</sup>

This distinction drives home the point that for community foundations the “public” aspect of their support is found more through an established relationship between the organization and the community than in any specific funding formula.

### *3. Ensuring community foundation autonomy*

Special rules for the public-support test are but one part of the regulations. The remaining, more extensive rules address technical problems with recognizing community foundations in trust form as public charities and concerns about donor control of foundation assets. The rules are important to outline because they establish a baseline for the public-charity status of the community foundation.

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59. *Id.* Again, this language is from the introduction to community trust regulations.

60. *Id.*

As a technical matter, the need for rules arose because when a community foundation oversees a number of trusts, the “entity” for tax purposes is each individual trust.<sup>61</sup> Legal title to trust assets resides in the trust, not the foundation. Accordingly, as a formal matter, each trust would be viewed distinctly for exemption purposes and inevitably would be classified as a private foundation with one source of support (the trust donor). A related, more substantive concern was that, as a trust, the donor might retain significant influence over, if not effective control of, trust assets.

To get around the technical problem, the regulations took a substance-over-form approach by creating a legal fiction of the community trust as a single entity. As such, each individual trust is viewed as a component of a larger fund, not as a separate entity. This allows all the component funds of the community foundation to be the basis for the public-support test and thus allows the community foundation to qualify as a public charity.

There are several requirements for a community foundation to be treated as a single entity in the trust context.<sup>62</sup> These are known as the “single-entity test.”

- “The organization must be commonly known as a community trust, fund, foundation or other similar name conveying the concept of a capital or endowment fund to support charitable activities . . . in the community or area it serves” (the “name” test).<sup>63</sup>
- “All funds of the organization must be subject to a common governing instrument” (the “common instrument” test).<sup>64</sup>
- “The organization must have a common governing body or distribution committee . . . which either directs or . . . monitors the distribution of all funds exclusively for charitable purposes” (the “common governing body” test).<sup>65</sup>

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61. George Johnson & David Jones, *Community Foundations*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1994, at pt. 4 (1994).

62. See Treas. Reg. § 1.170A-9(f)(11).

63. *Id.* § 1.170A-9(f)(11)(iii).

64. *Id.* § 1.170A-9(f)(11)(iv).

65. *Id.* § 1.170A-9(f)(11)(v)(A).

- “[T]he governing body must have the power [the ‘variance power’] . . . to modify any restriction . . . on the distribution of funds,” and to replace any trustee, either for breach of fiduciary duty or for failure to make a reasonable investment return.<sup>66</sup> Further, the governing body must commit itself (by resolution or otherwise) to the exercise of these powers and to achieving a reasonable investment return.<sup>67</sup>
- “The organization must prepare periodic financial reports treating all the funds [it holds], . . . either directly or in component parts, as funds of the organization” (the “reporting” test).<sup>68</sup>

These requirements, woven into the fabric of the community foundation identity, are simple to state and to satisfy, but also to overlook. Their significance, however, deserves emphasis.

The name test, although arguably superficial, importantly speaks to the sense in which a community foundation is linked by name to a specific community. To be considered public, community foundations *must* be named for and known by the community or area served. In other words, the “community” identity is a key aspect of classification as a public charity.

The common-instrument and common-governing-body tests are of obvious importance to show that the component funds are subject to a single governance structure and, therefore, generally independent from donor control. The reporting test also helps to prove that the component funds are treated as a whole, not as distinct parts.

For purposes of countering donor control and ensuring foundation autonomy, the variance power is the most important test. As a matter of law, ultimate power over trust funds must be vested in the “sole judgment” of the governing body, not the donor. Recall that the variance power was F.M. Goff’s solution to dead-hand control,<sup>69</sup> and as exemplified in the regulations, was

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66. *Id.* § 1.170A-9(f)(11)(v)(B)(1)–(3).

67. *Id.* § 1.170A-9(f)(11)(v)(E)–(F). Failure to use the power when circumstances indicate use should result in loss of public charity status.

68. *Id.* § 1.170A-9(f)(11)(vi).

69. *See supra* Section I.B.

central to the legal classification of the community foundation as a public charity.

In addition to the single-entity test, which applies at the community foundation level, the “component part” test applies to each fund.<sup>70</sup> The component-part test permits the fund to be considered a part of the community foundation (and so not itself a separate entity) and is intended to prevent donor control of trust assets.<sup>71</sup>

The component-part test has two parts. First, the trust or fund must be created by gift or other transfer to a community foundation that is treated as a single entity under the regulations.<sup>72</sup> This requirement protects against donor control by making clear that the gift is *to* a foundation that satisfies the name, common-instrument, common-governing-body, variance power, and reporting tests. The effect is to make clear that it is the community foundation, through satisfaction of the single-entity requirements, and not the trust that has control over trust assets.

Second, the donor may not subject the trust or fund assets to any material restriction.<sup>73</sup> In general, the no-material-restriction rules allow donors to designate a charitable recipient at the time of gift and provide advice, but not direction, regarding distributions after the gift is made.<sup>74</sup> The point of the material restriction rules is to restrain donor control.<sup>75</sup> Thus, it is a built-in condition of public charity status for community foundations that the donor cannot materially restrict fund assets.

Taken all together, the regulations following the codification of the public-private distinction take a two-step approach to public charity status for community foundations. First, the regulations deem that community foundations are publicly supported based on a fundraising standard that merely requires that the foundation seek funds from a “wide range of potential donors in the

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70. Treas. Reg. § 1.170A-9(f)(11)(ii).

71. Johnson & Jones, *supra* note 61, at pt. 4, § B.

72. Treas. Reg. § 1.170A-9(f)(11)(ii)(A).

73. *Id.* § 1.170A-9(f)(11)(ii)(B).

74. “Material restriction” is defined elsewhere in the regulations and discussed in more detail *infra* text at notes 104 to 113.

75. The single entity test is a more indirect restraint on donor control.

community.”<sup>76</sup> Then, the regulations include indirect (the single-entity test) and direct (the component-part test) protections against donor control of funds, so as to justify not subjecting community foundations to the private foundation anti-abuse regime. In both cases, a key idea is that the power to oversee and distribute fund assets rests with the community (the public face of the foundation), *not* the donor.

#### *F. Summary*

From a historical perspective, as Congress developed distinctions among charitable organizations, community foundations worked their way into the favored, public-charity class. With promulgation of the community foundation regulations, the community foundation successfully carved out a niche within the U.S. model of philanthropy. The community foundation, uniquely, raised endowment funds from multiple sources for the benefit of a geographic area. Community foundations were not seen as presenting the same level of risk of donor control and lack of public oversight as private foundations, even though both philanthropic types primarily are grant-making organizations. The Treasury Department deliberately took steps in regulations to define the publicly supported charity category in a way to include community foundations but also recognized the need to protect against donor control. So although community foundations ended up as a public charity, intervention by the Treasury Department was required.

## II. THE CHALLENGE TO COMMUNITY FOUNDATION IDENTITY

### *A. National Sponsoring Organizations and Donor-Advised Funds*

The final Treasury regulations provided community foundations a path to public charity status and secured their role in philanthropy, for a time. However, at the turn of the century, the advent of national sponsoring organizations (NSOs) upset the status quo. National sponsoring organizations present a challenge to

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76. Treas. Reg. § 1.170A-9(f)(10).

community foundations because both types of charities engage in the same activity: the sponsoring of donor-advised funds (DAFs).<sup>77</sup>

Community foundations pioneered the donor-advised fund in the early 1930s.<sup>78</sup> The main idea is that donors make a completed gift to a sponsoring organization (which could be any charity), the sponsoring organization segregates the gift into a distinct account typically in the donor's name (the DAF),<sup>79</sup> and then the donor advises the sponsoring organization on an ongoing basis about how to distribute fund assets for charitable purposes.<sup>80</sup> The donor's advice, though usually followed, is not binding on the sponsoring organization, which formally owns and controls the funds.<sup>81</sup> In general, DAFs are attractive because DAFs provide donors with a charitable contributions deduction for federal income tax purposes in the year of the gift, while allowing donors to delay indefinitely the decision about which charity to support.

The donor-advised fund was relatively obscure until the rise of NSOs. An NSO is a public charity with a national focus that administers DAFs as its main activity.<sup>82</sup> Many NSOs are affiliated with a large investment firm, like Fidelity, Schwab, or Vanguard (to name three of the biggest). NSOs with commercial affiliations

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77. DAF-sponsoring organizations include NSOs, community foundations, and other charities, such as universities and religious organizations, which use DAFs as a supplemental giving tool. NAT'L PHILANTHROPIC TR., 2015 DONOR-ADVISED FUND REPORT (2016), <https://www.nptrust.org/daf-report/pdfs/donor-advised-fund-report-2015.pdf>. The National Philanthropic Trust divides sponsors into three categories: national sponsors, community foundations, and single-issue sponsors. The Treasury Department offers a similar taxonomy. See U.S. DEP'T OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS 21 (2011) (noting that sponsoring organizations include "charitable organizations formed by financial institutions for the principal purpose of offering DAFs, community foundations, universities, [supporting organizations], and other tax-exempt organizations").

78. See Berman, *supra* note 6, at 13.

79. I.R.C. § 4966(d)(2)(A) (2012) (defining donor-advised fund).

80. See MOLLY F. SHERLOCK & JANE G. GRAVELLE, CONG. RESEARCH SERV., AN ANALYSIS OF CHARITABLE GIVING AND DONOR ADVISED FUNDS 3 (2012) [hereinafter CRS REPORT].

81. I.R.C. § 170(f)(18)(B). *But see* SHERLOCK & GRAVELLE, *supra* note 80 (noting that "[e]vidence suggests . . . that donors to DAFs have effective control over grants, and to some extent investments, because sponsoring organizations typically follow the donor's advice"); U.S. DEP'T OF THE TREASURY, *supra* note 77, at 69 (noting that one respondent thought that DAFs "appear to give DAF donors de facto control over investment and distribution decisions").

82. See U.S. DEP'T OF THE TREASURY, *supra* note 77, at 69 (stating that "nearly all, if not all" of their activity "is administering DAFs").

have access to a ready supply of potential donors and reason to solicit them.<sup>83</sup> The first commercially sponsored NSO, the Fidelity Charitable Gift Fund, became a 501(c)(3) charity with minimal IRS review in 1991 and today is the largest charity in the United States in terms of annual fundraising—an incredible ascent.<sup>84</sup> Two other NSOs, the Schwab Charitable Fund and the Vanguard Charitable Endowment Program, are fourth and eleventh respectively.<sup>85</sup>

At the outset, NSOs attracted considerable scrutiny.<sup>86</sup> Critics questioned whether NSOs had a legitimate exempt purpose,<sup>87</sup> whether they were improperly organized for the benefit of the affiliated private investment firms,<sup>88</sup> if conflicts of interest between the NSO charity and the for-profit firm could be resolved,<sup>89</sup> the extent of donor control retained over donated funds,<sup>90</sup> and the lack of any mandated distribution rule for donated assets.<sup>91</sup> Several of the issues were resolved in litigation<sup>92</sup> and through the exemption

83. Typically, the investment managers employed by the commercial entity retain management of funds contributed to the NSO and so continue to benefit from DAF accounts. See Cantor, *supra* note 9, at 132.

84. See Peter Olsen-Phillips & Brian O’Leary, *How Much America’s Biggest Charities Raise: 27 Years of Data*, CHRON. PHILANTHROPY (Oct. 31, 2017), [https://www.philanthropy.com/interactives/philanthropy-400#id=table\\_2016](https://www.philanthropy.com/interactives/philanthropy-400#id=table_2016) (listing the top 400 charities, measured by amount of contributions received).

85. *Id.*

86. It is beyond the scope of this Article to examine all the issues relating to NSOs. For discussion, see Colinvaux, *supra* note 12.

87. Albert R. Rodriguez, *The Tax-Exempt Status of Commercially Sponsored Donor-Advised Funds*, 17 EXEMPT ORG. TAX REV. 95, 95–97 (1997).

88. *Id.* at 100–02.

89. See Ronald J. Shoemaker & Amy Henchey, *Donor Directed Funds*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1996, at 15–16 (1996); see also Cantor, *supra* note 9.

90. Ron Shoemaker et al., *Donor Control*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1999, at 299–300 (1999) [hereinafter *Donor Control*].

91. See U.S. DEP’T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION’S FISCAL YEAR 2001 REVENUE PROPOSALS 105, 106 (2000) (proposing a distribution rule).

92. The exempt purpose of NSOs as collecting and distributing charitable funds was affirmed in *National Foundation, Inc. v. United States*, 13 Cl. Ct. 486 (1987). The court relied on an IRS Revenue Ruling, in which the IRS held that an organization “formed for the purpose of providing financial assistance to several different types of [501(c)(3)] organizations” was itself a 501(c)(3) organization. Rev. Rul. 67–149, 1967–1 C.B. 133; see also *Fund for Anonymous Gifts v. IRS*, 194 F.3d 173 (D.C. Cir. 1999).



application process.<sup>93</sup> Eventually, the IRS lost in court on exempt purpose, private benefit, and control issues,<sup>94</sup> and ultimately yielded to the fact of the NSO by granting public charity status to the Vanguard Charitable Endowment after extensive review and negotiation.<sup>95</sup>

The NSO's controversial success has had two main, related effects on community foundations. The first is practical. NSOs have focused attention on the donor-advised fund as an activity to be regulated, regardless of the type of sponsoring organization.<sup>96</sup> As a result, community foundations are pulled into legal and policy debates not necessarily of their own making and face regulation that may not be appropriate to their idealized giving model. The second is equally, if not more, serious: because NSOs represent such a dominant force in philanthropy, community foundations are pulled toward the national, non-consultative NSO-model of giving and away from their roots as serving place-based communities. Both effects, discussed next, dilute the identity of the community foundation and weaken its ability to fulfill its traditional

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93. The IRS scrutinized exemption applications and signaled in non-precedential guidance that it would be guided by the material restriction rules in assessing the exempt status of non-community foundation DAFs. Thus, new DAFs were encouraged to fall on the right side of the donor advice versus donor direction line. A related issue was whether donor directed funds counted as "public support" for purposes of the public support test. In addition, the IRS also cited voluntary compliance with a five percent payout as a positive factor for exempt status. Ron Shoemaker & Bill Brockner, *Control and Power: Issues Involving Supporting Organizations, Donor Advised Funds, and Disqualified Person Financial Institutions*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 2001, at 119-22 (2001).

94. *Nat'l Found., Inc. v. United States*, 13 Cl. Ct. 486 (1987); *Donor Control*, *supra* note 90. The control issues were resolved on the ground that the corporate sponsoring organization, as a separate and distinct entity, formally had dominion and control over donated funds. So long as the sponsoring organization has the clear legal right not to follow donor advice, donor advisory privileges are not a bar to a charitable deduction.

95. Steve Arkin, Alysa McDaniel & Marc Owens, *Vanguard's Successful March To (c)(3) Exemption, Public Charity Status: A Charitable Gift Fund Case Study*, 3 PAUL STRECKFUS' EO TAX J. 33 (1998).

96. Emmett D. Carson, *21st-Century Community Foundations: A Question of Geography and Identity*, GRANTCRAFT (2015), [http://www.grantcraft.org/guides/21st-century-community-foundations?\\_ga=1.84948633.1430162731.1467123650](http://www.grantcraft.org/guides/21st-century-community-foundations?_ga=1.84948633.1430162731.1467123650) ("One of the most perplexing aspects about the current discussions on donor-advised funds is that they seldom acknowledge the unique differences between donor advised fund providers . . . . Donor advised fund providers are not the same in mission, purpose, or operation . . . .").

exempt purpose, potentially turning the community foundation into just another sponsor of donor-advised funds.

*B. The Donor-Advised Fund as a Regulated Activity*

After the IRS yielded to the NSO as a bona fide 501(c)(3) organization, the debate on DAFs shifted to the legislative arena. The first salvo was a Treasury Department proposal for DAF legislation as part of the President's fiscal year 2001 budget.<sup>97</sup> The Treasury proposal (which did not become law) would have required all donor-advised funds held by a sponsoring charity to pay out (in the aggregate) five percent of assets each year.<sup>98</sup> The proposal also would have restricted the class of eligible DAF grantees.<sup>99</sup> Although community foundations were not mentioned in the proposal, they would have been subject to the rules.

In crafting the proposal, the Treasury Department was concerned, among other things, about "[t]he lack of uniform guidelines governing the operation of donor advised funds . . . ."<sup>100</sup> The Treasury Department appears to have concluded that it was appropriate to regulate DAFs as an activity, without regard to sponsoring organization. Community foundations appeared to be caught up in rules that were prompted by the activity of other types of charitable organizations, namely NSOs, notwithstanding that the DAF had long been used uncontroversially by community foundations.

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97. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2001 REVENUE PROPOSALS 105 (2000).

98. *Id.*

99. *Id.* at 106. Under the proposal, for an organization that sponsored DAFs as its primary activity (meaning over fifty percent of assets held in DAFs), public charity status was available only if: there was no material restriction on any one DAF, DAF distributions could be made only to public charities, and, in the aggregate, five percent of total DAF assets were paid out each year. *Id.* Failure to satisfy any of the three conditions resulted in private foundation treatment for the sponsoring organization and, therefore, the DAFs under its control. *Id.* In addition, the proposal applied to the DAFs of organizations that did not offer DAFs as a primary activity (giving as an example, a school that operates a DAF). *Id.* If such a DAF did not satisfy the three conditions, then it became subject to the private foundation rules, though the public charity status of the sponsor was not affected. *Id.* at 106-07.

100. *Id.* at 106. Treasury cited as reasons for legislation the dramatic growth of DAFs, concerns about delayed charitable benefits, and the uncertainty regarding their legal status.

The Treasury proposal was not re-proposed,<sup>101</sup> but the general concern about DAFs as an activity without regard to sponsor remained. In 2005, IRS Commissioner Mark Everson testified before the Senate Finance Committee about abuses relating to DAFs.<sup>102</sup> Shortly thereafter, amid mounting concerns, DAF legislation was enacted in 2006 as part of the Pension Protection Act (PPA).<sup>103</sup>

The PPA's DAF legislation applies equally to all DAFs (as defined), regardless of the DAF's sponsor.<sup>104</sup> This followed the lead of the Treasury Department's goal of uniform ground rules. The PPA rules are animated by concerns about donor control and the abuse that can result. Accordingly, the rules prohibit most transactions between a DAF and a donor-advisor or related party (e.g., sales, loans, compensation) even if at arm's length. The rules also bar DAF grants to individuals or grants for a noncharitable purpose.<sup>105</sup> A payout was dropped in the final legislation and replaced by limits on the amount of holdings a DAF may maintain in any one business.<sup>106</sup>

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101. The Treasury proposal coincided with the last year of the Clinton Administration and was not renewed by the incoming Bush Administration. U.S. DEP'T OF THE TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2002 REVENUE PROPOSALS (2001).

102. Letter from Mark W. Everson, Comm'r of Internal Revenue, to Charles E. Grassley, Chairman, S. Comm. on Fin. (Mar. 30, 2005), <https://www.finance.senate.gov/imo/media/doc/Letter%20from%20Everson.pdf> (describing abuses at donor-advised funds as a top compliance problem) ("We have found that certain promoters encourage individuals to establish purported donor-advised fund arrangements that are used for a taxpayer's personal benefit, and some of the charities that sponsor these funds may be complicit in the abuse. The promoters inappropriately claim that payments to these organizations are deductible . . . . Also, they often claim that the assets transferred to the funds may grow tax free and later be used to benefit the donor[] . . . to reimburse them for their expenses, or to fund their children's educations.").

103. For a description of all the rules imposed on DAFs, see STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 109TH CONGRESS 624-44 (2007). The author was involved in the drafting of the donor-advised fund legislation.

104. There is one exception. DAFs held by a private foundation are not subject to the rules. I.R.C. § 4966(d) (2012).

105. *Id.* §§ 4966, 4967.

106. The Tax Relief Act of 2005, S. 2020, 109th Cong. § 331 (as passed by the Senate, Nov. 18, 2005). The anti-abuse rules largely utilize concepts and rules from the private foundation regime, either explicitly adopting the private foundation rules or paralleling their substance and bright-lines approach. For additional discussion, see Roger Colinvaux, *Charity in the 21st Century: Trending Toward Decay*, 11 FLA. TAX REV. 1, 60-63 (2011). Thus, to

The PPA also required the Treasury Department to report to Congress on a variety of issues relating to DAFs. The subsequent Treasury Department report, released in 2011, takes careful note of the different types of sponsoring organizations but does not make distinctions among sponsoring organizations in its recommendations to Congress.<sup>107</sup>

Subsequently, DAFs have remained in the spotlight, with some commentators recommending high payouts and limited life for donor-advised funds without regard to sponsor.<sup>108</sup> Perhaps most significantly, in 2014 the Chairman of the Ways and Means Committee Dave Camp proposed a five-year payout for all donor-advised fund contributions as part of tax reform.<sup>109</sup>

In sum, since the rise of NSOs the unmistakable trend is to view DAFs as an activity to be regulated, without regard to sponsor. For community foundations, what was once a useful fundraising tool that attracted little attention has become a point of national debate.<sup>110</sup> The practical impact on community foundations is that new donor-advised fund rules inevitably will apply to them unless efforts are made to distinguish sponsoring organizations legislatively.

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the extent new burdens are imposed on DAFs, these are burdens already borne by private foundations.

107. DEPARTMENT OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS (2011). In conclusions largely favorable to the status quo, the report concludes that the favorable deduction rules for DAFs are appropriate because DAFs are not controlled by the donor (unlike a private foundation). In addition, Treasury reasoned that although there may be a delay between the timing of the deduction and the delivery of charitable benefits, this delay also exists at other public charities, which nonetheless benefit from the favorable rules. The report also concluded that a payout on DAFs would be premature based on the limited data available. The report did leave open the door to future analysis of pay out trends and to work with Congress on whether additional regulation or legislation would be necessary.

108. Lewis B. Cullman & Ray Madoff, *The Undermining of American Charity*, N.Y. REV. OF BOOKS (July 14, 2016), <http://www.nybooks.com/articles/2016/07/14/the-undermining-of-american-charity/>.

109. Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014) § 5203 (introduced by Rep. Dave Camp).

110. *Supra* notes 10-11.

### *C. NSOs and Harm to the Community Foundation Identity*

The NSOs' domination of the DAF debate and culture also raises a more fundamental issue for community foundations. Not only are they potentially subject to new regulations because of NSOs, but competition with NSOs is spurring an erosion of the traditional role community foundations play in performing, and in helping donors perform, effective philanthropy for place-based communities.

#### *1. Contrasting roles of community foundations and NSOs*

As a general matter, community foundations have long been regarded as having the primary purpose of using grants to support a place-based community.<sup>111</sup> A community foundation historian describes their "local focus," "local impact," support of the "local non-profit infrastructure" and as covering a "defined geographic region."<sup>112</sup> The local focus reflects community foundation origins and purpose—to raise funds locally for the benefit of the community from which the funds were raised.<sup>113</sup> A focus on geographical location is exemplified in the community foundation regulations, discussed in Part I, which stress the importance of serving community needs in terms of a "particular community or area" and being named accordingly.<sup>114</sup>

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111. As noted in Part I, exempt status for community foundations has its roots in the original tax code, when exemption was provided for a "community chest, fund, or foundation."

112. See Sacks, *supra* note 6, at 5.

113. The Supreme Court noticed the role played by community foundations when they secured an early amendment to the charitable deduction rules that allowed charitable deductions made to a trust, for the use of a charity. *Davis v. United States*, 495 U.S. 472, 480 (1990) (noting that the legislative history to the Revenue Act of 1921 "indicated that numerous communities had established charitable trusts, charitable foundations, or community chests so that individuals could donate money to a trustee who held, invested, and reinvested the principal, and then turned the principal over to a committee that distributed the funds for charitable purposes."); see also Hoyt, *supra* note 11, at 8.

114. Treas. Reg. § 1.170A-9(f)(10) (as amended in 2011). It could be argued that use of the disjunctive "or" in the phrase "community or area" implies that "community" and "area" delineate distinct types of community, with "area" referring to geography and "community" representing something broader. However, the use of "or area" after "community" appears to be intended as a defining limitation on the potential breadth of the word "community," i.e., the two words are intended as synonyms. This interpretation is consistent with the prevailing view of community foundations as place-based philanthropies.

The sense of community as place-based is echoed in the field. For instance, the definition of community foundation offered by the Council on Foundations provides, in part:

A community foundation is a tax-exempt, nonprofit, autonomous, publicly supported, philanthropic institution composed primarily of permanent funds established by many separate donors [for] the long-term diverse, charitable benefit of the residents of a defined geographic area. Typically, a community foundation serves an area no larger than a state.<sup>115</sup>

Relatedly, community foundations are meant to play a substantive role in setting the philanthropic agenda. A key function of the community foundation board (which is meant to hail from the community served) is “identifying and funding community priorities . . . .”<sup>116</sup> In general,

No matter where they are located community foundations are a reflection of the communities in which they operate and their times. They are human institutions and as such are an expression of the values of their founders, their boards and their donors. Ideally, the problems that community foundations identify and address through their grantmaking and programs reflect the most pressing needs in their local areas.<sup>117</sup>

The community focus also should carry over to donor-advised funds held by the community foundation. Because donor contributions to DAFs are assets of the community foundation, the expectation is (or should be) that community foundations will play an active consultative role in the distribution of advised funds. DAFs should be used for the benefit of the community served, with expertise of the community foundation furnished to donors as they formulate their advice.

An active role by the community foundation in guiding fund distributions (whether or not from a DAF) was solidified by the material restriction rules of the community foundation regulations.<sup>118</sup>

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115. *Glossary of Philanthropic Terms*, COUNCIL ON FOUNDATIONS, <http://www.cof.org/content/glossary-philanthropic-terms>, (last visited Jan. 17, 2018).

116. Sacks, *supra* note 6, at 5.

117. *Id.* at 9.

118. Treas. Reg. § 1.507-2(a)(8).

The rules require active involvement by the community foundation (in trust form) in order for a fund to be considered a component part of the foundation and so not a private foundation. For instance, under the regulations, some or all of the following factors indicate that there is no material restriction on a gift, and thus are encouraged as best practices:

- Investigation of the donor's advice by the community foundation, which shows that the advice is consistent with specific charitable needs most deserving of support in the community.
- Published guidelines listing the specific charitable needs of the community, and that the donor's advice is consistent with those guidelines.
- An educational program that advises donors and other persons of its guidelines that list the specific charitable needs most deserving of support.
- The disbursement by the community foundation of other funds to the same or similar organizations or charitable needs as those recommended by a specific donor.
- Solicitations that state that the community foundation will not be bound by any advice the donor offers.<sup>119</sup>

Taken together, these factors contemplate that the community foundation is meant to be more than a mere intermediary. The community foundation is expected to *investigate* donor advice, add its expertise of community needs to guide donors better to benefit the community, and ensure that advice is consistent with the specific needs of the community served.

The place-based consultative model of the community foundation, however, is in stark contrast to the model offered by NSOs. An NSO is primarily a fundraising organization,<sup>120</sup> with a national focus, that is organized to collect funds and pay them out upon donor advice. The NSO performs its exempt purpose through

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119. *Id.* § 1.507-2(a)(8)(iv)(A)(2)(i)-(v); George Johnson & David Jones, *Community Foundations*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1994, at 11-12 (1994).

120. Rev. Rul. 67-149, 1967-1 C.B. 133; *see* Colinvau, *supra* note 12.

spending, not by developing philanthropic priorities based on community needs or by building community-based relationships.<sup>121</sup> NSOs are designed to be as efficient and low cost as possible, meaning that for all practical purposes, NSOs by design play the limited role of processing donor advice.<sup>122</sup> NSOs mainly just approve grants to other 501(c)(3) organizations without regard to any community or area.<sup>123</sup> A national focus makes their administrative task easier, by diluting the grant-making performed to the widest possible field.

Again, the material-restriction regulations provide a good illustration. These regulations, in addition to showing best practices, set forth the factors that indicate the presence of a material restriction on donated funds. If a material restriction exists, donor control is considered a concern and the trust fund should be treated as a private foundation. The reasoning is that the fund exists

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121. For instance, as described by the Treasury Department: “The main characteristic of both NDAF groups is that the sponsorship of the DAFs and other similar accounts or funds generally appears to constitute the principal activity performed by the sponsoring organization. The organizations largely focus on receiving contributions, converting non-cash donations into a more liquid form, facilitating grant-making, and managing the investment of DAF assets, rather than the direct provision of charitable services.” DEPT OF THE TREASURY, REPORT TO CONGRESS ON SUPPORTING ORGANIZATIONS AND DONOR ADVISED FUNDS 49 (2011). DAFs are but one of several activities for a community foundation. According to the Treasury Department, “[c]ommunity foundations commonly raise funds and make grants to support numerous charitable initiatives in their communities, and they hold endowments for local charitable projects in a number of funds, often including DAFs.” *Id.* at 51.

122. While NSOs principally just sponsor DAFs, community foundations use DAFs as one of several fund options to attract donors. One scholar categorized four fund types, based on the restrictions imposed on the community foundation by the donor: unrestricted funds (no restrictions), field of interest funds (funds for a designated purpose), designated funds (the charity is designated in advance), and advised funds (the charity is advised over of time). Hoyt, *supra* note 11, at 5–6.

123. See CRS REPORT, *supra* note 80, at 6 (noting that donor advice is almost always approved and is little more than a formality). As one of the leading commentators pointed at the time NSOs were developing: “Community foundations often provide to donors much greater resources, legal interpretations, reviews of organizations and practical advice than do most commercially initiated funds. One commercially initiated fund has been described as performing reviews of grant suggestions that consist of a ‘live body walking through a room containing an IRS listing of tax-exempt charitable organizations.’ Other commercial funds assert that they are providing what the marketplace wants, that is, more laissez-faire grantmaking than community foundation regulations and policies would appear to allow.” Victoria B. Bjorkland, *The Emergence of the Donor-Advised Fund*, 6 EO TAX JOURNAL 15, 18 (May 1998).



more to execute the preferences of the donor than that of any independent charity (i.e., a community foundation).

Notably, the positive material restriction factors are uncannily descriptive of donor-advised funds at an NSO. As a leading example, if the “only criterion considered by the [community trust] in making a distribution of income or principal from the donor’s fund is advice offered by the donor,” then a material restriction exists.<sup>124</sup> Arguably, a donor’s advice is not the only criterion considered by NSOs because NSOs require that the organization selected by the donor is a valid charity. This criterion, however, is a legal baseline for DAF distributions, not an independent criterion of the sponsoring organization.<sup>125</sup> Thus, as a practical matter, so long as the donor picks a charity recognized by the IRS, the only criterion typically used by NSOs in approving distributions is donor advice.<sup>126</sup> Accordingly, almost by definition, donor-advised funds at NSOs have material restrictions and, but for the corporate structure, each fund would be treated as a private foundation.

Other factors from the regulations also point to the fact that DAFs at NSOs are laden with material restrictions. A material restriction is indicated when:

- Solicitations [by the organization] state or imply that the donor’s advice will be followed[,] [or there is] a pattern of conduct that creates an expectation the donor’s advice will be followed.
- The donor’s advice is limited to distributions of amounts from his or her fund and the community [foundation] has not: (1) done an independent investigation to evaluate whether the donor’s advice is consistent with the charitable needs most deserving of support in the community; or (2) established guidelines that list the specific charitable needs of the community.

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124. Treas. Reg. § 1.507-2(a)(8)(iv)(A). In general, NSOs perform the administrative function of checking whether an organization is eligible to receive charitable deductions, but otherwise, donor advice is the main criterion for distributions.

125. In general, distributions from a donor-advised fund must be to a 501(c)(3) organization or penalty taxes apply. There are exceptions but only if the sponsoring organization exercises extensive due diligence with respect to the distributions. *See* I.R.C. § 4966 (2012).

126. CRS REPORT, *supra* note 80, at 6.

- The community foundation only solicits advice from the donor regarding distributions from the donor's fund and no procedure is provided for considering advice from others.
- The community foundation follows the advice of all donors concerning their funds substantially all the time.<sup>127</sup>

Applying these factors to an NSO: the NSO is built largely on the expectation that donor advice will be followed; in general, the NSO does the bare minimum in terms of investigation in order to keep costs down; NSO accounts are segregated by donor (and donor advisor); and advice is almost always followed.

In short, the community foundation and the national sponsoring organization have contrasting forms. The vision for community foundations to make grants, with community-based expertise that will benefit the community. For community foundations, donor-advised funds are one tool, and as originally conceived, the ideal is that the community foundation guides the donor-advisor toward effective grant-making. The vision of the NSO is quite different. The NSO's main purpose is to raise funds, invest the funds at low cost, and follow donor advice with minimum oversight, for the benefit of any eligible charity without regard to community.

## *2. Impact of NSOs on community foundations*

Mindful that community foundations and NSOs have distinct roles, the question is whether NSOs are having an adverse impact on the community foundation. Although impact is difficult to quantify, there are reasons to believe that the dominance of the NSO in the philanthropic ecosystem directly harms the place-based mission of the community foundation.<sup>128</sup>

One reason relates to the success of the national sponsoring organization. Although NSOs are few in number (4.7% of all DAF

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<sup>127.</sup> Johnson & Jones, *supra* note 61, at 12-13 (citing Treas. Reg. § 1.507-2(a)(8)(iv)(A)(3)(i)-(iv)).

<sup>128.</sup> Other factors also undoubtedly challenge the traditional community foundation form, such as globalization, a mobile population, and changing donor preferences. As discussed next, however, by coopting the community foundation model and fundraising techniques, the NSO is certainly a leading factor.

sponsors),<sup>129</sup> they account for a disproportionate amount of all DAFs, grants, and contributions.<sup>130</sup> This means that NSOs, to a considerable extent, set the standard in the marketplace for the donor-advised fund. The low-cost, minimal-to-no investigation model becomes what donors expect. This puts pressure on community foundations to conform, both by minimizing the advisory role of the community foundation and by expanding the focus of donor funds outside of the traditional community.<sup>131</sup>

This risk to community foundations is described by Emmett Carson, the CEO of the Silicon Valley Community Foundation (the nation's largest community foundation):

By their very names, community foundations are more than a charitable bank account for individual donors. If not, commercial gift funds and donor-focused community foundations are distinctions without a difference. If donor-focused community foundations represent the future, they will be eclipsed by commercial gift funds, which are more efficient and offer more investment choices. The real lesson to be drawn from burgeoning donor advised funds is that the convening and community building roles of traditional community foundations have enormous value – a value commercial gifts funds and donor-focused community foundations are incapable of replicating.<sup>132</sup>

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129. NAT'L PHILANTHROPIC TRUST, 2015 DONOR-ADVISED FUND REPORT 3 (2015).

130. For 2015, national sponsoring organizations sponsored roughly 57% of all DAFs, made 49% of all grants, collected 57% of all contributions, and held nearly 49% of DAF account asset value. *Id.* at 8-9 (percentages calculated from Figures 7, 8, 9, and 10).

131. See, e.g., Gabriel Kasper, Justin Marcoux & Jess Ausinheiler, *What's Next for Community Philanthropy: Making the Case for Change*, MONITOR INSTITUTE (June 2014), <http://monitorinstitute.com/communityphilanthropy/site/wp-content/uploads/2014/07/Overview.pdf> ("Little by little, a host of different organizations have been chipping away at what was once primarily the domain of community foundations. Every service can now be provided by some other player in the marketplace, often better, cheaper, or faster than community foundations. Online giving platforms like GlobalGiving and Razoo are already effectively 'disintermediating' community foundations, linking social programs around the world directly to new donors—particularly young, tech-savvy donors. Commercial charitable gift funds are providing DAFs at extremely low price points. Identity-based funds are tailoring their appeals and services to meet the specific needs of rapidly growing racial and ethnic populations.").

132. Emmett D. Carson, *A Crisis of Identity for Community Foundations*, in NAT'L COMM. FOR RESPONSIVE PHILANTHROPY, *THE STATE OF PHILANTHROPY* 2002, at 7 (2002).

Put another way, there is a risk that NSOs will lead DAFs at community foundations to become donor-centric, not community-centric, thereby resembling NSOs.

Related to a shifting focus on donors is a changing notion of community away from one based on place. Again, as described by Carson, NSOs are forcing community foundations “to redefine their value proposition relative to commercial gift funds,”<sup>133</sup> a process that is causing a “profound identity crisis.”<sup>134</sup> Carson asks: “What is the meaning of community when it comes to community foundations?”<sup>135</sup> He notes that “[t]here are a growing number of community foundations that are experimenting with broadening their reach to accommodate the changing needs of donors,” “experimenting with the elasticity of community in the 21st century,” and “rejecting the tradition of using geographic designation” to define community.<sup>136</sup>

In its place is a different definition of community, one that emphasizes the “shared interest” of a group of people.<sup>137</sup> Due to growing mobility, people increasingly are connected not by place but by interest:

Connection over shared interests has traditionally happened in person in shared spaces, perhaps a church or a coffeeshop [sic] or a library. Now, people can easily maintain their relationships to different places around the world through technology regardless of the distance involved . . . [through] an almost infinite number of online communities in which they never physically meet.<sup>138</sup>

Carson explores the evolving notion of community with an open mind. The concept of “community” should be flexible enough, he argues, to include both place-based and interest-based communities, arguing that it makes sense for community foundations to “meet[] donors where they are.”<sup>139</sup>

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133. Carson, *supra* note 96, at 9.

134. *Id.* at 3.

135. *Id.* at 10.

136. *Id.*

137. *Id.* at 5.

138. *Id.*

139. *Id.* at 9.

Surely Carson is correct that there are multiple ways to define a community. The question is whether the “community” in community foundation, as a specific type of charity, should have legal content. The geographic definition Carson cites as “traditional,” also happens to be the basis for conferring public charity status on the historical community foundation.<sup>140</sup> This is not to say that an organization that serves a nontraditional community cannot or should not be recognized as a 501(c)(3) organization, but rather that a place-based community is a principal basis for distinguishing a community foundation from a private foundation or any other type of charitable fundraising organization.

Implicit in this discussion is that the NSO has facilitated the shifting notion of community away from geographic place and toward issues and ideas. To attract and keep donors, community foundations with DAFs face pressure to expand their “communities.” According to one study,

Even the definition of community itself is shifting to include affinities based not only on common geographies, but also issues and identities. And in some cases, the community is defined by who is *giving* the resources (the community of donors in a particular place, who may give to causes all over the world), while in others, the focus is on who is *receiving* assistance (where funds may come from anywhere to benefit residents in a particular place).<sup>141</sup>

Relatedly, the NSO form also has undermined the place-based legal standards that framed the 501(c)(3) status of community foundations. As noted, the community foundation regulations were conceived to address problems that arose when community foundations were organized in the trust form.<sup>142</sup> Nevertheless, the regulations set forth best practices for community foundations to follow, even if not in trust form, in order properly to attain public charity status. Thus, the standards of the regulations have guided community foundations even if they technically do not apply.

Indeed, when NSOs emerged and presented legal questions, the IRS turned to the community foundation regulations as analogous.

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140. Sugarman, *supra* note 16, at 1690; Treas. Reg. § 1.170A-9(f)(10) (as amended in 2011).

141. Kasper et al., *supra* note 131, at 4.

142. *See supra* Section I.E.3.

Specifically, the IRS wanted to impose the material-restriction rules on NSOs but ultimately did not succeed.<sup>143</sup> The Treasury Department too invoked the community foundation regulations as an answer to regulating DAFs, but also failed.<sup>144</sup> The result has been that, with the passage of time, what were once best practices in the community foundation context (regardless of form) now are both of limited applicability and denuded of meaning. In other words, before the advent of NSOs, a community foundation would be wary of emphasizing a national community or allowing material restrictions with respect to its funds. Now, there is little reason (for corporate community foundations) to adhere to either regulatory standard.

It is notable here to consider the claim of one of the largest NSOs, the Vanguard Charitable Endowment, from its application to the IRS for tax-exempt status as a public charity. The challenge for Vanguard was to find an analogy it could use to justify public-charity status. Vanguard chose the community foundation.

The Endowment considers itself to be a “national community foundation” (not a trust) in the sense that it will operate in a manner that is similar to many community foundations, albeit on a nationwide scale. For example, community foundations typically use the vehicle of donor-advised funds as a means to attract substantial charitable contributions from persons who wish to have some continuing involvement in suggesting how such funds may be used. Community foundations also have procedures for investigating donor recommendations, and the Endowment has been guided by the literature on community foundations in the establishment of its own operating procedures. Finally, community foundations serve as important educational resources in the philanthropic field, providing information to prospective donors about the benefits of charitable giving, as well as information about prospective grantees.<sup>145</sup>

By describing itself as a community foundation, Vanguard co-opted the community foundation identity to its benefit, while

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143. See *supra* notes 89–90.

144. *Supra* note 97 (seeking to apply material restriction rules on DAFs).

145. Paul Streckfus, *Vanguard’s Successful March To (c)(3) Exemption, Public Charity Status: A Charitable Gift Fund Case Study*, 3 EO TAX JOURNAL 33, 88–89 (1998). Contrast Vanguard’s representation to the IRS with common understanding in the field.

pledging to abide by best practices that technically do not apply. Put another way, from the outset, the NSO has been sheltered under the community foundation form but without the rigor. The result has been to dilute, not enhance, the form—pulling the community foundation away from its historical roots.

### III. A CODE-BASED DEFINITION OF THE COMMUNITY FOUNDATION

The rise of the nationally sponsored donor-advised fund challenges the role of the community foundation in the philanthropic ecosystem and jeopardizes place-based philanthropy. The blurring of the lines among DAF-sponsoring organizations causes policymakers, the public, and even community foundations themselves, to conflate the role and purposes of the two distinct organization types. Donor-advised funds, regardless of sponsor, are a regulatory focus if not a target.<sup>146</sup>

One remedy would be to define the community foundation in the Internal Revenue Code as a *per se* public charity. On the positive side, a Code-based definition would centralize the rules and standards applicable to community foundations, and thus provide a basis for distinguishing community foundations from NSOs for regulatory purposes. For example, if donor-advised funds were in the future required to distribute contributions within a certain time period, community foundations could be excepted from the rule by reference to their definition.<sup>147</sup> More broadly, over time, a positive legal definition for community foundations could help secure the future for place-based philanthropy, educate policymakers and the public about the role the community foundation has in the U.S. philanthropic system, and enhance the overall charitable status of the community foundation.

On the negative side, from a community foundation perspective, a definition also doubles as a target. So to the extent community foundations become embroiled in scandal or negative associations, new, adverse, regulatory proposals directed specifically at community foundations likely would arise from time to time,

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146. *See supra* Section II.B.

147. This cannot be easily achieved under current law because community foundations are not defined.

which would require defensive lobbying. Indeed, community foundations may have benefited in the past from having a generic public-charity status based on public support—thereby allowing them, to a certain extent, to escape notice or legislation targeted directly at community foundations. The rise of the donor-advised fund in the public consciousness has changed that, however, raising the stakes.

This part of the Article considers the possible content for a legal definition of a community foundation. In general, a definition should capture the institutional value of the community foundation as a civic leader that utilizes its expertise for the benefit of the long- and short-term needs of place-based communities. Any definition should also address the historic policy concerns that attach to grant-making charities, especially where donor involvement continues after the gift.

#### *A. A Baseline Definition*

One approach to creating a baseline definition of a community foundation would be to codify the community foundation regulations. As discussed in Part I, the central characteristics of the community foundation as reflected in the regulations are service to a geographic area or community, active solicitation of ongoing support, emphasis on long-term community projects or priorities, and protection against donor control via an absence of material restrictions on gifts and through the variance power.

Adding to the list of organizations eligible for the favorable charitable deduction rules would be one way to codify the regulations. The list would include “a community foundation established to attract contributions of a capital or endowment nature for the benefit of a particular community or area.”<sup>148</sup> This would also have the effect of classifying community foundations as public charities.<sup>149</sup> In general, explanatory legislative history would

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148. The statutory change would be to I.R.C. § 170(b)(1)(A), perhaps to include a new § 170(b)(1)(A)(ix). It would replace the current basis for favorable treatment for community foundations as a publicly supported organization under I.R.C. § 170(b)(1)(A)(vi) (and the community foundation regulations thereunder). The language tracks the introductory language from the community foundation regulations; *supra* text accompanying note 58.

149. This assumes no changes to I.R.C. § 509(a)(1).



direct the Treasury Department to apply the existing community foundation regulations to both trust *and* corporate form foundations. For trust form foundations, codification would not change the underlying law since the regulations already apply. For corporate form foundations, codification would directly impose the regulations, matching the spirit of the law to the letter.

Codification of the regulations would provide a statutory basis for distinguishing community foundations from other 501(c)(3) organizations, including DAF-sponsoring organizations. Thus, for example, in the context of a legislative proposal to impose a restriction on DAFs, it would be easy as a technical matter to make an exception to the proposal for the DAFs of community foundations by simple reference to the new term, assuming policymakers could be persuaded that an exception was warranted. Codification would not directly protect community foundations from generally applicable new rules.

Merely codifying the community foundation regulations, however, could prove ineffective. One reason to seek a definition would be to distinguish the community foundation from other charitable organizations. The current regulations, because of their history, may prove insufficient to that task. National sponsoring organizations were able to argue in general terms that the NSO qualified with the spirit of the community foundation rules.<sup>150</sup> In other words, NSOs did not believe the community foundation regulations necessarily presented a bar to the NSO model.

Further, codification would be a missed opportunity. The community foundation regulations were drafted forty years ago. Establishing a definition represents an opportunity to make the case for community foundations as per se public institutions, with sufficient protections against donor control and income accumulation, as well as a sound community-based vision that is key to addressing vital civic needs.

*B. Codification as a Per Se Public Charity, with New Standards*

Any community foundation definition would likely be forged in a challenging legal climate. The underlying theory of public

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150. *See supra* text accompanying note 128.

charity status is that the “public” aspect of the charity will protect against abuses by insiders or substantial contributors.<sup>151</sup> The automatic or per se public charity classification conferred on certain charitable types—churches, hospitals, and schools—also reflects a consensus that the charitable mission of such institutions is clear and sufficiently important to their constituencies that the possibility of abuses does not warrant overly intrusive regulation.<sup>152</sup> This theory, however, has been severely tested in recent years.

Churches, though likely immune from serious legislative initiatives, were the subject of a congressional inquiry and report.<sup>153</sup> Hospitals have had their charitable purpose (and motives) challenged as not providing sufficient community benefit, with special legislation as a result.<sup>154</sup> Rising tuition and growing endowments at many colleges and universities have drawn attention to income accumulations and institutional priorities and the prospect of legislative reform.<sup>155</sup> Abuses at publicly supported credit counseling organizations led to targeted legislation that imposed governance standards and operational restrictions on these organizations.<sup>156</sup> The general policy of supporting grant-making organizations and endowment funds with taxpayer subsidies is being questioned, whether the organization is a traditional private foundation, donor-advised fund, supporting organization, or per se public charity.<sup>157</sup>

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151. See, e.g., *Quarrie v. Comm’r*, 603 F.2d 1274, 1277 (7th Cir. 1979) (“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.”).

152. *Supra* text accompanying notes 26–27.

153. See, e.g., Laurie Goodstein, *Tax-Exempt Ministries Avoid New Regulation*, N.Y. TIMES (Jan. 7, 2011), <http://www.nytimes.com/2011/01/08/us/politics/08churches.html>.

154. I.R.C. § 501(r) (2012). See, e.g., Robert Gebelhoff, *Tax-Exempt Hospitals Spend Just as Much on Charity Care as For-Profits, Study Finds*, WASH. POST (Aug. 4, 2015), <https://www.washingtonpost.com/news/to-your-health/wp/2015/08/04/tax-exempt-hospitals-spend-just-as-much-on-charity-care-as-for-profits-study-finds/>.

155. See, e.g., Victor Fleischer, *Stop Universities from Hoarding Money*, N.Y. TIMES (Aug. 19, 2015), <https://www.nytimes.com/2015/08/19/opinion/stop-universities-from-hoarding-money.html>.

156. I.R.C. § 501(q).

157. See, e.g., Tax Reform Act of 2014, H.R. 1, 113th Congress (2014) (introduced by Rep. Dave Camp) (proposing a tax on the net investment income of private colleges and universities and private operating foundations).

In this climate, favorable treatment for community foundations might be promoted by a *per se* public charity definition that directly addresses policy concerns on the key issues of public purpose, governance, and payout.

*1. Purpose*

The purpose of the community foundation is central to any case for a *per se* public charity definition. As noted earlier, the 501(c)(3) exempt status for community foundations is not in doubt. Historically, community foundations have been organized and operated exclusively to raise, manage, and distribute endowment funds for the benefit of a particular community. Unquestionably, this is an exempt purpose.

The issue is to what extent the purpose is sufficiently “public” to support a determination that community foundations automatically should be treated as public charities. As a *per se* public charity, no public-support test is involved, which means that the issue is more a matter of judgment than measurement. Automatic public charity status is or should be granted based in part on the inherent public characteristics of the philanthropic entity. However, it has never been clear what this entails. Automatic status was granted historically to institutions that were actively involved in the direct provision of services to the community, such as religious, educational, and health services.

The community foundation does not neatly fit this model of a *per se* public charity because it is primarily a grant-making institution.<sup>158</sup> But no less than these other institutions, the mission of the community foundation is to help meet community needs. The community foundation takes on, or should take on, an institutional philanthropic identity within the community much like a university, hospital, or church. The community foundation is not merely a conduit. Rather the community foundation should fill a niche within a community by bringing community leaders and donors together to invest in long- and short-term community needs, to work with other public charities in the community to

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158. Although some community foundations do provide direct charitable services as part of the mix of activities offered to the community.

determine where funds are most needed, and to develop and fund innovative programs for the community – a niche that other public charities do not meet.

Central to this idea is the importance of community. Starting with their names, community foundations are named for a community, not for a family or donor. This is important both as a matter of form and substance. The name reflects that the purpose of the community foundation is to serve community preferences, rather than the philanthropic vision of a family or a particular donor. The regulations already require that a community foundation have an appropriate name.<sup>159</sup> A per se definition should go one simple step further and require that the community served be identified in the foundation's organizing documents in terms of a particular geographic region.<sup>160</sup> By so fixing the foundation primarily to the needs of a particular community, the foundation resembles other per se public charities also devoted, by their physical presence, to a particular region.

Some have questioned whether the "community" served by a community foundation must be limited to a geographic area,<sup>161</sup> or whether community could include a more issue-based community, e.g., the environmental or human rights "community."<sup>162</sup> A meta-physical community, however, should not qualify under the per se public charity definition of a community foundation. The idea of a per se public charity has always been rooted in providing public benefits that relate to an identifiable location, in large part because a fixed location creates ongoing, stable relationships that foster oversight and support for a community foundation's mission.

In addition, the purpose of community foundations is not just to benefit a community but to raise funds for community needs.<sup>163</sup>

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159. Treas. Reg. § 1.170A-9(f)(11)(iii) (as amended in 2011).

160. A community foundation national in scope would not qualify. The geographic area served must be appropriate to the population of the area. Community foundations in more rural areas naturally would cover larger surface areas than community foundations in more urban areas.

161. Wendell R. Bird, *How to Establish Donor-Advised Funds and Community Foundations*, 13 TAX'N EXEMPTS 68, 77 (2001).

162. *Id.*

163. Treas. Reg. § 1.170A-9(f)(10).

This purpose *is* the unique reason for community foundations to exist as part of a (public charity) philanthropic system. The purpose of community foundations is not to educate students, provide spiritual nourishment, or heal the sick. But every community has needs that, absent government intervention, may go unmet. The niche of the community foundation is to address this need.<sup>164</sup>

Relatedly, community foundations help keep wealth in the community. Without community foundations, local donors inclined toward endowment giving would find it harder to endow funds for community purposes. Such donors might gravitate toward private foundations or national sponsoring organizations, neither of which have the institutional commitment of a community foundation to serve a community in perpetuity.

Further, and by way of contrast, although national sponsoring organizations and private foundations both serve important philanthropic ends, neither should qualify for *per se* public charity status. The comparison with community foundations is plain: the community served by either vehicle is amorphous. National sponsoring organizations are national in scope and generally perform the function of a conduit—collecting, administering, and then distributing funds upon donor advice. They have no community-based mission. Private foundations, unlike national sponsoring organizations, are directed more to specific ends and programmatic agendas. But these need not be focused on any given community. Moreover, it is the nature of national sponsoring organizations and private foundations to be driven largely by donors rather than community preferences. This is not to criticize either private foundations or national sponsoring organizations but rather to recognize that their role in philanthropy is different from the community foundation and less inherently public.

In brief, a strong argument can be made that the purpose of community foundations is sufficiently public to warrant *per se* public charity status and that community foundations categorical-

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164. Related issues include the extent to which community foundations must, consistent with the goal of raising endowment funds, offer donors a range of options, provide advice to donor-advisors, and actively direct distributions to community projects. Each of these issues relates less to purpose in the abstract and more to operational concerns and is addressed below.

ly are different from either national sponsoring organizations or private foundations in this regard. A modest step would be to require, as part of the definition of a community foundation, that the community served be geographic and identified in organizational documents.

## *2. Accountability: Responsiveness to the community*

Notwithstanding its strengths, a purpose of serving the needs of an identifiable community by raising endowment and unrestricted funds likely is insufficient to support an automatic public charity classification for community foundations. The abstract purpose must become more concrete through operational structures that will support a legal conclusion of *per se* public charity status. In other words, it must be clear that community foundations are operated for the community, not for donors.

At this stage, the strength of the theoretical underpinnings of the distinction between public charities and private foundations becomes relevant. Public charities were excepted from the private foundation rules primarily based on the belief that abuses relating to control of the charity by insiders were unlikely in the public charity form.<sup>165</sup> In large part, this belief was rooted in the argument that, because public charities serve a community, the reciprocal relationship would provide effective oversight, and therefore additional regulation was not necessary.<sup>166</sup>

As noted above, in recent years scandals and policy concerns relating to a broad spectrum of public charities have substantially undermined this argument.<sup>167</sup> Accordingly, if community foundations seek automatic public charity status, the burden will be on community foundations to prove the theory – that is, to prove that the public charity definition really does help to inoculate the charity from abuse. Community foundations could be pioneers in this

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165. *See, e.g.,* *Quarrie v. Comm’r*, 603 F.2d 1274, 1277 (7th Cir. 1979) (“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.”).

166. *Id.*; *see also supra* note 31 and accompanying text.

167. Public charities implicated in scandal and controversy have included both charities automatically classified as public and those considered public based on a public support test.

respect, establishing improved legal standards for the public charity category.

Further, community foundations may appear to be more vulnerable than other public charities to the undue influence of insiders, thereby increasing the burden of proof. This is because ongoing relationships with donors through donor advice are an integral part of community foundation operations. Thus, there is an almost institutionalized propensity for conflict between promoting the interests of the donor and the interests of the community and knowing which is which.

A starting point for community foundations to establish accountability to the community, by definition, is through rules relating to the composition of the governing board.<sup>168</sup> In theory, the board should represent the community served and be independent. Many community foundations likely already meet this goal. Nevertheless, without governance rules that attach to per se public charity status, community foundations will remain vulnerable to the argument that they are governed more for the benefit of donors than the community. Strong governance rules could help rebut this argument.

Governance rules could take a variety of forms. A minimum requirement of per se public charity status should be that a majority (or supermajority) of community foundation board members represents different charitable interests in the community and is selected because of members' knowledge of and experience with the community served. Board members should come from the principal philanthropic sectors of the community. Requiring widespread representation of the community on the board likely would not be a change in current best practice. But in this context, codifying best practice is important to reinforce the purpose of community foundations as community service organizations.

Another measure would be to consider term limits for board service. A self-perpetuating board can run the risk of becoming too entrenched, serving primarily special interests within the community or members' own self-interest. Term limits would

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168. The regulations currently are silent as to board composition. The regulations require a common governing body and a common governing instrument, but these are incident to the single entity test. Treas. Reg. § 1.170A-9(f)(11)(iv)-(v)(A).

help counter this effect by ensuring regular, new representation from the community. Term limits could take the form of two terms of service or, more leniently, not more than three consecutive terms. A cap on term length could also be considered, e.g., terms of no more than five years. The permutations are several, but the main idea is to ensure, by rule, that the foundation through board membership remains vibrant and connected to evolving community needs.

In addition, governance rules to prevent undue influence or control by insiders or those with vested interests in community foundation operations should be weighed. A straightforward requirement would be to provide that substantial contributors, related parties, and institutional trustees of community foundation funds, in the aggregate, do not constitute a board majority (or even a lesser percentage). An additional layer of protection would require that no single category of insider could constitute more than, for example, one-fifth or one-third of the board.

In short, confidence in the governing board is a critical part of a legal conclusion that a community foundation, as a per se public charity, is operated for the benefit of the named geographic area and not individual donors.

### *3. Operational rules*

The abstract purpose of serving the needs of an identifiable community as well as governance rules to ensure sound community representation are important but not likely to be sufficient for a comprehensive public charity community foundation definition. Areas of concern remain, rooted in the inherent tensions between a grant-making charity and ongoing donor involvement. Even a strong public purpose and model governance rules likely will not protect against the charge that community foundations accumulate funds more for the benefit of donors than the community. Apart from issues of donor control, there are separate policy questions about income accumulations and the extent to which they should be permitted.<sup>169</sup> Thus, operational rules directed at

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<sup>169</sup>. See generally Daniel Halperin, *Is Income Tax Exemption for Charities a Subsidy?*, 64 TAX L. REV. 283 (2011).



minimizing donor influence and promoting both an active board and a payout should make up the third part of the automatic public charity community foundation definition.

There are several issues to consider and no single answer. Arguably the most important feature of the current legal characterization of community foundations is the requirement in the regulations that the governing body have the variance power and that it be committed to its exercise.<sup>170</sup> Without this power, notwithstanding the rules against material restrictions,<sup>171</sup> ultimate authority over disposition of a gift may remain with the donor.

Notably, because the Treasury Department required not only the fact of the variance power but also a specific commitment to its exercise, the expectation was that the variance power should and would be used in appropriate circumstances.<sup>172</sup> Thus, an important empirical question for community foundations is the frequency of use of the variance power in such circumstances. Although a positive definition of community foundations probably cannot do more than require a commitment to use the variance power, reporting on the use of the power could be made part of the Form 990 for community foundations.<sup>173</sup>

Related to the use of the variance power is whether to mandate a permissible length to advisory privileges of donors. Advisory privileges that survive the death of the donor are a form of dead-hand control. By designating an advisor to succeed the don-

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170. Treas. Reg. § 1.170A-9(f)(11)(v)(B)(1)-(3), (E)-(F). See *supra* text accompanying notes 66 and 67.

171. Treas. Reg. § 1.507-2(a)(8)(iv). The no material restriction rules on donor contributions are critical however and should be retained. They reflect the distinction between donor direction and donor advice and generally relate to whether there is a completed gift for charitable deduction purposes. Thus, the rules are needed to establish formal legal control in the foundation.

172. However, the regulations also acknowledge that State law might trump variance power exercise. *Id.* § 1.170A-9(f)(11)(v)(D).

173. Some sanction short of loss of public charity status could be developed for failure to use the power in appropriate circumstances. The regulations hold out loss of public charity status as a consequence for failure to exercise the power, stating: "The governing body will be considered not to be so committed [to exercise the power] where it has grounds to exercise such a power and fails to exercise it by taking appropriate action." *Id.* § 1.170A-9(f)(11)(v)(E).

or, the donor retains a semblance of control over donated funds.<sup>174</sup> Relatedly, skepticism that community foundations have an active role in determining the distribution of community funds increases the longer the tenure of advice.<sup>175</sup>

That said, although a limit on intergenerational advisory privileges helps make the case for the per se public charity status of community foundations, alternative (or additional) measures are also relevant. The overarching issue is the extent to which the community foundation can establish that it actively shapes charitable distributions, notwithstanding advisory privileges.

Again, the contrast with national sponsoring organizations is helpful. As intermediaries, NSOs do not purport to add value to donor preferences. Community foundations, though, are meant to use specialized knowledge of the community to develop plans for long-term (and short-term) needs. It should be possible to show that donor-advisors are affected in their advice by the direct input of the community foundation. This may be hard to measure or implement in terms of a legal test, but possibly it could take the form of a requirement that donor advice be limited primarily to a menu established by the community foundation. This would have the effect of clearly limiting most donor-advice to choices established or influenced by the community foundation.

Relatedly, it should be made clear in a definition of community foundation that donor-advised funds are not the exclusive activity. Community foundations traditionally have offered donors a variety of choices: field of interest funds, designated funds, or other types of funds that do not require further input of the donor.<sup>176</sup> In addition, some community foundations conduct their own charitable initiatives. The larger the mix of such funds and initiatives within the overall activities of a community foundation, the more the identity of the community foundation is reinforced as independent of donors. A bright line test may not be desirable

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174. Paradoxically, an intergenerational advisory privilege raises questions of whether the privilege actually is a right, which potentially could cross the line into donor control. Presumably, as a mere privilege, the ability to advise is not subject to the rule against perpetuities; whereas a property right would be so subject.

175. This is a concern that also applies to other DAF-sponsoring organizations.

176. Johnson & Jones, *supra* note 61, at 3.A. (discussing types of funds).

in this context (e.g., over fifty percent of assets managed may not be in donor-advised funds), but a general requirement that a mixture of funds be offered and used, combined with annual reporting, will help to show that a community foundation is more than a conduit for donor advice.

#### 4. Payout

The question of whether community foundations should be subject to a mandatory payout of assets would have to be addressed in any community foundation definition. A detailed examination of payout issues is beyond the scope of this Article, but an outline of options and a sketch of the main points is important to frame the debate.

Currently, community foundations are not subject to a payout, though whether to impose a payout on donor-advised funds, without regard to sponsor, is a central issue.<sup>177</sup> In the context of defining a community foundation, payout should be considered both with respect to all investment assets held by the foundation (not just those in donor-advised funds) and to whether a distinct payout rule on donor-advised funds should apply to the donor-advised funds of community foundations—taking into account the defining characteristics of the community foundation.

Current law provides for four broadly different approaches to payout: no payout, a payout based on perpetual life,<sup>178</sup> a payout based on the facts and circumstances,<sup>179</sup> and a mandatory spend-down of assets over a short period.<sup>180</sup> Historically, the default rule is no payout: organizations generally are free to determine whether and when to spend assets for the exempt purposes of the organization. Mandatory payouts then arise in three broad circumstances: in light of the exempt purpose of the organization, concerns about accumulations of income by the organization, and, relatedly, concerns about donor control of assets.

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177. See Colinvaux, *supra* note 48; Cullman & Madoff, *supra* note 9.

178. I.R.C. § 4942 (2012) (requiring an annual five percent payout based on investment assets).

179. Rev. Rul. 64-182, 1964-1 C.B. 186.

180. See *infra* sources cited in note 188.

In considering payout, an important background principle is that an organization with the exempt purpose of making grants to other charitable organizations has an implicit obligation, as a condition of exempt status, to pay out funds.<sup>181</sup> In other words, an organization that accumulated income and never paid out would not be operated for an exempt purpose and should not have exempt status.<sup>182</sup>

From this principle, different rules have arisen. Prior to 1969, Congress required that organizations with unreasonable accumulations of income lose their exempt status.<sup>183</sup> In addition, in the 1960s, the IRS developed a rule that an organization with the exempt purpose of making grants for charitable purposes must have a spending program “commensurate in scope” with the organization’s financial resources.<sup>184</sup> This rule, known as the commensurate in scope test, was devised to help grant-making organizations with unrelated business activity qualify for exempt status, but subsequently has been applied to charitable fundraising organizations as a condition of exempt status.<sup>185</sup>

In 1969, the tax on unreasonable accumulations of income was replaced with a bright-line payout rule that applies to the investment

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181. Rev. Rul. 67-149, 1967-1 C.B. 133 (holding that an organization “formed for the purpose of providing financial assistance to several different types of [501(c)(3)] organizations” was itself a 501(c)(3) organization and that distributions were required). The ruling is derived from a 1924 Supreme Court decision. *Trinidad v. Sagrada Orden de Predicadores*, 263 U.S. 578 (1924).

182. Regulations require that § 501(c)(3) organizations be operated for an exempt purpose. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii) (2016).

183. See Williams & Moorehead, *supra* note 28, at 2102.

184. Rev. Rul. 64-182, 1964-1 C.B. 186.

185. For discussion of the commensurate in scope test, see Jack B. Siegel, *Commensurate in Scope: Myth, Mystery, or Ghost? – Part One*, TAXATION OF EXEMPTS 26 (2008). See also Thomas Kelley, *Rediscovering Vulgar Charity: A Historical Analysis of America’s Tangled Non-profit Law*, 73 FORDHAM L. REV. 2437, 2487 (2005) (noting that the role of the commensurate in scope doctrine “appears to be to permit decision makers to approve of charitable status for commercial charities that have appealing missions and that spend most of their commercially raised funds on their charitable purposes”); INTERNAL REVENUE SERV., *Special Emphasis Program – Charitable Fund-Raising*, in EXEMPT ORGANIZATIONS CONTINUING PROFESSIONAL EDUCATION TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1989, at 13 (1989) (“Whether a fund-raising organization’s activity may be said to accomplish exempt purposes often centers on the issue of whether there has been a sufficient turnover of funds to charity. This issue is resolved through use of the ‘commensurate test’ . . .”).

assets of private foundations.<sup>186</sup> The main reasons for the private foundation payout are to protect against unreasonable accumulations and to ensure that private foundations are being used for current public benefit.<sup>187</sup>

In addition, other approaches to payout exist for certain types of public charities. As a condition of public charity (and so not private foundation) status, conduit foundations must pay out all contributions within two and a half months of the end of the foundation's fiscal year.<sup>188</sup> This type of payout is consistent with the nature of the organization's exemption. As a conduit organization, there is little reason for the contributions to remain with the conduit for any period of time. Similarly, medical research organizations<sup>189</sup> and agricultural research organizations must be committed to spend each contribution for research purposes within roughly five years.<sup>190</sup>

An issue for community foundations is where they fit on the spectrum. In the context of private foundations and the 1969 Act, payout was one of several prophylactics against donor control.<sup>191</sup> Because community foundations eventually qualified as publicly supported organizations, the payout did not apply to them. Relative to present law, community foundations that by definition adopted tightened purpose, governance, and operational restrictions

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186. I.R.C. § 4942 (2012 & Supp. 2017); STAFF OF JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, H.R. 13270, 91st Cong., 36-37 (1970).

187. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1969, *supra* note 186. It is outside the scope of this paper to discuss whether perpetuity is appropriate or whether the payout rate on private foundations should be increased. For additional discussion, see Brian Galle, *Pay it Forward? Law and the Problem of Restricted-Spending Philanthropy*, 93 WASH. U. L. REV. 1143 (2016).

188. I.R.C. §§ 170(b)(1)(A)(vii), 170(b)(1)(F)(ii) (2012 & Supp. 2017); Treas. Reg. § 1.170A-9(h) ("Private nonoperating foundation distributing amount equal to all contributions received . . ."). Pooled income funds also receive favorable treatment but must pay out its net income before 2½ months after the end of its taxable year. Private operating foundations also receive favorable treatment but are required to pay out substantially all of their income—an easy task given the nature of this type of foundation as operating charitable programs. I.R.C. § 4942 (2012 & Supp. 2017).

189. Treas. Reg. § 1.170A-9(d)(2)(i).

190. Protecting Americans from Tax Hikes (PATH) Act of 2015, Pub. L. No. 114-113, § 331 (2015) (codified as amended at 26 U.S.C. § 170(b)(1)(A)(ix)); Treas. Reg. § 1.170A-9(d)(2)(i).

191. Troyer, *supra* note 45.

designed to prevent donor control may reasonably demur on a payout.

Furthermore, community foundations already report aggregate payouts in excess of the private foundation five percent rate.<sup>192</sup> Thus, imposing the private foundation payout could be redundant, if not counterproductive. If, for example, the private foundation payout was applied to community foundations, the payout could have the paradoxical effect of standardizing a five percent rule as the default, resulting in reduced payout rates.<sup>193</sup>

The main payout issue for community foundations relates to their donor-advised funds. As the author has argued elsewhere, a spend-down rule, similar to that which applies to medical and agricultural research organizations is appropriate for national sponsoring organizations, in large part because of the nature of the NSO's exemption as a fundraising organization.<sup>194</sup> As previously argued, however, community foundations, at least in idealized form, have a different purpose and serve a different constituency.<sup>195</sup> To the extent the definition of community foundation proposed here reduces material restrictions and enhances the advisory role played by community foundations with respect to their donor funds, community foundations may be able to claim that their donor funds are and should be different from donor funds housed within national sponsors.

In the absence of a fund-based payout, however, community foundations should at a minimum require mandatory distributions from inactive funds, with fund terminations (by distribution of fund assets to the community foundation general fund) to occur, for instance, upon a third mandatory distribution. A rule on inactive funds need not be so specific, but some rule generally defining an inactive fund, with a clear requirement on distribution

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192. NAT'L PHILANTHROPIC TRUST, 2016 DONOR-ADVISED FUND REPORT 10 (2016) (reporting that for 2015 the payout rate at community foundation donor-advised funds was 15.4%).

193. That said, concerns about accumulations at public charities (per se and otherwise), quite apart from the issue of donor control, suggest that adopting a payout rule as part of the community foundation definition should be considered, if only for political expediency. Adopting the private foundation payout could make sense as a matter of tax exemption, given that community foundations are similar to private foundations in that both primarily are grant-making institutions.

194. See Colinvaux, *supra* note 12.

195. *Supra* Section II.C.1.

and fund termination, would help address concerns about the lag in charitable benefits and donor control and should be part of the community foundation definition. Many community foundations have adopted inactive fund policies and already require donors to make distributions within a certain period of time.

##### *5. DAF anti-abuse rules*

A final issue is whether a community foundation that is defined as a public charity should remain subject to the PPA DAF anti-abuse rules. For purposes of these rules it may make sense not to distinguish among sponsoring organizations, thereby retaining uniformity. Nonetheless, one of the benefits that would come from having a positive definition of a community foundation in the Code is that it would be easier to make exceptions for community foundations from broadly applicable rules in appropriate circumstances. Accordingly, to the extent a rule is unnecessary because of strong community foundation rules on purpose, governance, and operations, community foundations can make the case for an exception.

#### CONCLUSION

Community foundations have long been a recognized and important part of the U.S. philanthropic system. Their niche is to serve the needs of an identifiable place-based community. But that niche is under threat. The success of the nationally sponsored donor-advised funds has compromised the identity of the community foundation, pulling it to a more donor-focused, national model.

This Article has argued that it is time to consider defining the community foundation in the Internal Revenue Code as a per se public charity. Although community foundations already are considered public rather than private charities, their public status has been obscure and left to Treasury Department regulations. A Code-based definition would affirm the public nature of the community foundation as an institution on equal terms with other key public institutions. A Code-based definition could also validate the community foundation for policymakers and the public, leading to a greater understanding of the role community foundations play in community service and thus strengthening the institution of place-based philanthropy. Importantly, a Code-based

definition would provide a basis for distinguishing the community foundation from other DAF sponsors for regulatory purposes.

There is no single best definition of the community foundation. Any definition, however, should take into account historical policy concerns about governance, donor control, and income accumulation. As this Article outlines, a definition should emphasize the purpose of serving the needs of an identifiable community, governance rules that promote an independent board comprised of persons who represent the broad charitable interests of the community, and operational rules that protect against donor control.

A strong definition of the community foundation would carve a persuasive identity into the Code and help secure the niche of the foundation as a vital part of the U.S. philanthropic framework for the twenty-first century.



