JOURNAL OF

TAXATION

FEBRUARY 1998 VOL. 88 NO. 2

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MAKING GIFTS OF APPRECIATED STOCK—TIME TO SWITCH TO PRIVATE OPERATING FOUNDATIONS?

BY MARK E. REHN

Wealthy individuals have been able to take advantage of Section 170(e)(5), which permits them to deduct FMV—not just basis—of qualified appreciated stock donated to a private foundation. With this provision set to expire at the end of June, and not much chance that it will be extended again, taxpayers with deep pockets, charitable instincts, and a desire to retain some sort of control over their gifts may find themselves exploring the opportunities afforded by the private *operating* foundation.

As part of the Taxpayer Relief Act of 1997 (TRA '97; P.L. 105-34, 8/5/97), Congress retroactively extended Section 170(e)(5), which permits the deduction of the FMV of qualified appreciated stock donated to private foundations. The section had been scheduled to expire on 5/31/97, prompting an unprecedented flood of donations to private foundations.[1] Because the extension is only for a short period—until 6/30/98—this trend should continue as taxpayers try to take advantage of the appreciated stock rule before it expires for perhaps the last time.

Why the rush? What is it about private foundations as compared to other entities that has generated such interest? There are other privately funded entities—in particular, private *operating* foundations—that may accomplish the same purposes yet continue to obtain advantageous tax treatment for various types of donations (not just appreciated stock). Given that the tax break permitted by Section 170(e)(5) might finally expire, the wise practitioner will plan for an alternative form of tax-favored entity.

OVERVIEW

Private foundations were one of the major targets of the Tax Reform Act of 1969 (TRA '69). Abuses were disclosed both by the Treasury's 1965 *Report on Private Foundations* and by investigations conducted by Rep. Wright Patman (D-Tex.). As a result, Congress added a series of tough new sections to the Code that were intended to eliminate the alleged abuses by private foundations. Many of these sections remain intact today, although they have been modified and interpreted by Regulations, Revenue Rulings, and countless letter rulings. TRA '69 also added other sections to the Code that were designed to reduce the tax benefit of making a charitable contribution to a private foundation; these have been modified significantly in the years since their enactment.

Section 509(a) generally presumes that each charitable, educational, religious, or scientific organization that qualifies for tax exemption under Section 501(c)(3) is a private foundation unless it can prove the contrary. It sets forth nine different categories of organizations that are not private foundations. Some of these—churches, schools, and hospitals—permit an organization to automatically qualify as a nonprivate foundation. Other categories require an organization to satisfy a mathematical public support test, or a series of other tests that examine the relationship between the organization and other publicly supported organizations. The most commonly used categories of nonprivate foundations are:

1. Churches described in Section 170(b)(1)(A)(i).
2. Schools described in Section 170(b)(1)(A)(ii).

MARK E. REHN practices law in Western Springs, Illinois, specializing in estate planning. *He thanks Louis S. Harrison, a partner in the Chicago office of Lord, Bissell & Brook, for his comments and advice on this article.*

3. Hospitals and related organizations described in Section 170(b)(1)(A)(iii).

4. Publicly supported organizations that receive a substantial portion of their total support (usually one-third or more) from the government, other public charities, and a wide variety of other donors.

5. Publicly supported organizations described in Section 509(a)(2) that receive at least one-third of their income from the sale of goods or from providing services to a wide variety of participants and no more than one-third of their support from investment income.

6. Organizations described in Section 509(a)(3) that support other publicly supported organizations and that satisfy a set of tests in the Regulations.

PRIVATE FOUNDATIONS

Organizations that do not meet one of the statutory tests are private foundations. There are two disadvantages to being classified as a private foundation—limitations on tax deductions (Section 170) and operating restrictions (Section 4940 *et seq.*). Donors to an organization that qualifies as a private *operating* foundation (described below) receive the same favorable tax treatment they would get for contributions to a public charity, although the operating foundation still is subject to many of the operating restrictions (discussed in more detail below) that affect private foundations.

Two types of limitations affect an individual donor's tax deduction for gifts to a private foundation (other than a private operating foundation). First, for gifts of property other than cash, the deduction usually is limited to the donor's basis in the contributed property. (By contrast, for gifts of most long-term capital gain property to a public charity, the donor is entitled to deduct the FMV of the property.) The one exception relates to gifts of qualified appreciated stock to a private foundation, for which the donor *is* entitled to deduct the FMV of the stock. "Qualified appreciated stock" is defined in Section 170(e)(5)(B) as any stock of a corporation for which (as of the date of contribution) market quotations are readily available on an established securities market, and which if sold for FMV would result in long-term gain.

The Code generally presumes that each organization that qualifies for exemption is a private foundation unless it can prove to the contrary.

Second, once the amount of the deduction is established (i.e., basis or FMV), the donor is limited as to how much of the deduction can be taken in each year. For gifts to a private foundation (other than a private operating foundation), a donor is never allowed to take a deduction, in any year, that exceeds 30% of adjusted gross income (with certain adjustments). Gifts of property, including qualified appreciated stock, generally are limited to 20% of adjusted gross income. Deductions that cannot be used in the year of contribution because of these percentage limitations may be carried forward for up to five years. By contrast, for most gifts to a public charity, a donor is entitled to deduct up to 50% of adjusted gross income; a special 30% limit applies to specified capital gain property, including stock.

PRIVATE OPERATING FOUNDATIONS

A private operating foundation, defined in Section 4942(j)(3), is a hybrid that has characteristics of both a public charity and a private foundation. It must expend substantially all of its income directly for the active conduct of the charitable purposes for which it was organized—thus, a private operating foundation must carry on its own charitable function instead of supporting the charitable purposes of other charitable organizations. Because it operates its own charitable activities, the donors are entitled to more advantageous deduction limitations than are donors to private foundations: For purposes of the charitable contribution deduction, a private operating foundation is treated exactly like a public charity. Nevertheless, most private operating foundations are endowed largely by private funding sources and, therefore, are also subject to most of the restrictions and excise taxes that pertain to standard private foundations. Some examples of private operating foundations include The Getty, which (through the J. Paul Getty Trust) has the stated purpose of "the diffusion of artistic and general knowledge"[2] and currently operates a museum, five institutes, and a grant program; The George Lucas Educational Foundation,[3] which promotes innovative efforts to improve education, especially those that integrate technology with teaching and learning; and the Fund for the City of New York,[4] whose mandate is to respond to the opportunities and problems of New York City.

To qualify as a private operating foundation, an organization must meet both the "income test" and any one of three alternative tests—the "assets test," the "endowment test," or the "support test."[5] Although these tests are quite technical, most private foundations that qualify as private operating foundations do so because they either (1) hold substantial assets for charitable purposes rather than investment income, and expend at least 85% of their income each year to maintain those assets, or (2) spend at least 3.75% of the value of the assets that they do hold for investment on the direct conduct of charitable activities.

The Income Test

To satisfy the income test, Section 4942(j)(3)(A) requires that a private operating foundation make qualifying

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[1] More than 8,000 new foundations were created between 1990 and 1996, according to the Foundation Center, a New York-based organization that tracks these trends. See Langley, "All in the Family: A Tax Break Prompts Millionaires' Mad Dash to Create Foundations," Wall St. J., 1/27/97, page A1.

[2] For more information, see <http://www.getty.edu/gettrst.html>.

[3] For more information, see <http://glef.org/>.

[4] For more information, see <http://www.fcny.org>.

[5] Reg. 53.4942(b)-1(a)(1).

distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated. These distributions must equal substantially all[6] of the lesser of its adjusted net income or minimum investment return. This requirement has two main elements—first, the distribution must be a qualifying distribution, and second, the distribution must be directly for the active conduct of the activities constituting the organization's charitable, educational, or other similar exempt purposes.

Qualifying distribution. Under Reg. 53.4942(a)-3(a)(2), "qualifying distribution" is defined as:

1. Any amount paid to accomplish one or more charitable purposes described in Section 170(c)(1) or (c)(2)(B), other than contributions to (a) nonoperating foundations or (b) organizations controlled by either the contributing private foundation or one or more of the disqualified persons[7] with respect to such foundation.

2. Any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the charitable purposes of the organization.

3. Any amount set aside for charitable purposes approved by the IRS.

Active conduct. As explained in Reg. 53.4942(b)-1(b)(1), the second element of the income test for an operating foundation requires that qualifying distributions must be "used by the foundation itself, rather than by or through one or more grantee organizations." The Regulation lists some examples of direct distributions as:

1. Amounts paid to acquire or maintain assets that are used directly in the conduct of the foundation's activities, such as the operating assets of a museum, public park, or historic site.

2. Reasonable administrative expenses and other operating costs necessary to conduct the foundation's exempt activities (regardless of whether they are "directly for the active conduct" of such exempt activities).

3. Any amount properly set aside by a foundation for a specific project, such as the acquisition and restoration, or construction, of additional buildings or facilities that are to be used by the foundation directly for the active conduct of the foundation's exempt activities.

Grants to other organizations are considered to be indirect, rather than direct, distributions, even where the grantee organization's activities further specific charitable operations of the grantor.[8] Reg. 53.4942(b)-1(b)(2) provides that grants, scholarships, or other payments to individuals can be considered direct distributions if the foundation "otherwise maintains some significant involvement ... in the active programs in support of which such grants, scholarships, or other payments were made or awarded." "Significant involvement" exists where either (1) the charitable function is to relieve poverty or human distress, grants are made without intermediary organizations, and a salaried staff is maintained to supervise and direct the charitable activities, or (2) the foundation has developed some specialized skills, expertise, or involvement in the area of the grant, maintains a salaried staff to supervise or conduct the programs or activities that support and advance the foundation's work in its particular area of interest, and grants, scholarships or other payments to individuals are made to encourage and further the involvement of the recipients in that area.[9]

A private *operating* foundation receives favorable tax deduction treatment but still is subject to many of the operating restrictions that affect private foundations.

As stated earlier, the qualified distribution must be equal to substantially all of the *lesser* of the foundation's adjusted net income or minimum investment return. Section 4942(f) provides that adjusted net income is the foundation's gross income for the tax year less the sum of the deductions that would be allowed to a corporation for that year. Both gross income and deductions are determined with the modifications set out in Sections 4942(f)(2) and (3). Gross income does not include gifts, grants, or contributions received by the private operating foundation, but does include income from a functionally related business.[10] A private foundation's minimum investment return is 5% of the aggregate FMV of all the foundation's assets that are not used directly in carrying out its

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[6] "Substantially all" is 85% or more, according to Reg. 53.4942(b)-1(c).

[7] Under Section 4946(a)(1), a disqualified person with respect to a private foundation is (1) a substantial contributor to the foundation; (2) a foundation manager; (3) an owner of more than 20% of the total voting power of a corporation, the profits interest in a partnership, or the beneficial interest of a trust or unincorporated enterprise, which is a substantial contributor to the foundation; (4) a member of the family of any individual described in (1), (2), or (3); (5) a corporation of which persons described in (1), (2), (3), or (4) own more than 35% of the total combined voting power; (6) a partnership in which persons described in (1), (2), (3), or (4) own more than 35% of the profits interest; (7) a trust or estate in which persons described in (1), (2), (3), or (4) hold more than 35% of the beneficial interest; (8) for purposes of Section 4943, a private foundation that is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or substantially all of the contributions to the foundation in question were made (directly or indirectly) by the person or persons described in (1), (2), or (3), or members of their families.

[8] Reg. 53.4942(b)-1(b)(1).

[9] In Leckie Scholarship Fund, 87 TC 251 (1986), *acq.*, the Tax Court held that a foundation's program constituted "significant involvement" where the foundation granted college scholarships based on need, maintained contact with the recipients, assisted them in finding summer jobs in the county, introduced them to community leaders in the county, and undertook activities to promote the county as a desirable place to live. The court found that providing scholarships to local students who might return to the county to live and work was directly related to accomplishing the foundation's purpose to promote prosperity in the county, thus determining that the foundation is entitled to operating foundation status.

[10] Reg. 53.4942(a)-2(d)(1). A functionally related business is a trade or business that is not an unrelated trade or business, or is an activity carried on within a larger aggregate of similar activities or within a larger complex of other endeavors that are related to the charitable purpose of the foundation. See Section 4942(j)(4).

exempt purpose, after subtracting the acquisition indebtedness with respect to such assets.[11]

The Alternative Tests

As noted above, in addition to the income test, a foundation must meet one of the three tests—the assets test, endowment test, or support test—set forth in Section 4942(j)(3)(B) to qualify as an operating foundation.

The income test requires distributions equal to substantially all of the lesser of adjusted net income or minimum investment return.

The assets test. Under Reg. 53.4942 (b)-2(a), the assets test requires that substantially more than half[12] of the foundation's assets (1) be devoted directly to the foundation's charitable activities, to functionally related businesses, or both, or (2) are held as stock of a corporation controlled[13] by the foundation and substantially all of the corporation's assets (85% or more) are devoted to the charitable activities. An asset is devoted directly to the foundation's charitable activities only if that asset is actually used by the foundation directly for the active conduct of the activities. Examples include real estate, physical facilities, museum assets, classroom fixtures and equipment, and intangible assets (such as patents, copyrights, and trademarks) to the extent that they are used directly for the active conduct of the foundation's exempt activities.[14]

The endowment test. To satisfy the endowment test, the foundation must make qualifying distributions directly for the active conduct of the activities constituting the purpose or function of the foundation, to the extent of at least two-thirds of the foundation's minimum investment return. The definitions for the key terms are the same as for the income test. Therefore, if a foundation has a minimum investment return that is less than its adjusted net income, it will always satisfy the endowment test if the foundation meets the income test.

The support test. Under the support test, at least 85% of the operating foundation's support, other than gross investment income, must come from the general public and five or more unrelated exempt organizations; not more than 25% of the support, other than gross investment income, can be received from any one exempt organization; and not more than half of the support can be from gross investment income. Support includes gifts, grants, contributions, membership fees, gross receipts from admissions, sales of merchandise, performance of services, furnishing of facilities, net income from unrelated business activities, gross investment income, tax revenues, and the value of services or facilities furnished by a governmental unit (Section 170(c)(1)) without charge.[15] As a practical matter, private operating foundations rarely satisfy the support test.

Testing periods. Reg. 53.4942(b)-3(a) provides that an operating foundation may satisfy the income test and one of the alternative tests by satisfying such tests for any three tax years during a four-year period consisting of the tax year in question and the three immediately preceding tax years, or by aggregating all pertinent amounts of income or assets held, received, or distributed during that four-year period. The foundation must use the same method for satisfying each test. A foundation can use one method for satisfying the tests for one tax year and another method in a subsequent tax year. New foundations must satisfy the operating foundation tests in their first year of operation. During the second and third years of operation, the foundation must satisfy the tests by aggre-

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11 Section 4942(e)(1).

12 Defined as 65% or more in Reg. 53.4942(b)-2(a)(5).

13 Using the Section 368(c) test of 80% or more.

14 See Reg. 53.4942(b)-2(a)(2).

15 Section 509(d).

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gating all pertinent amounts of income or assets held, received or distributed during the respective two- or three-year period.[16]

FOUNDATIONS vs. PUBLIC CHARITIES

What is it about private foundations that has resulted in so many individuals forming these entities when they could obtain more generous deductions by making contributions to established public charities?

A donor always should first consider whether it is possible to either make a contribution to an established public charity or to create a nonprivate foundation. This is true even where it is clear that the donor is not interested in fundraising or grant-writing. As indicated above, certain types of organizations automatically qualify as nonprivate foundations. Accordingly, if a donor intends to form a church, a school, or a hospital or hospital-affiliated entity, the organization can easily qualify as a public charity.

Similarly, in some situations a donor might consider establishing a donor-advised fund at an established public charity. Such a fund permits a donor to make recommendations, which are usually followed, about how the donor's gifts should be used. At the same time, a donor-advised fund can be invested by the public charity to establish an endowment.

Yet another option is a Section 509(a)(3) supporting organization. A full analysis of such entities is beyond the scope of this article but, in very simple terms, if a donor is willing to control only 49% or less of the charity and be subjected to certain other restrictions on grant-making, a supporting organization is often the best alternative.[17]

Foundations

Sometimes donors do not want to relinquish control, however, and this is where private foundations—both operating and nonoperating—have a major advantage over the alternatives. The creation of a private foundation can provide a vehicle for establishing family participation and identification with particular fields of charitable giving over several generations. The major difference between a private foundation and a private operating foundation is that the private foundation is a grant-making organization while the private operating foundation actually conducts a charitable activity.

Sometimes donors do not want to relinquish control, and this is where private foundations have a major advantage over the alternatives.

Both organizations are primarily privately funded by a single family, a few donors, or a corporation. Typically, family members either run the foundation or sit on its board of directors. These foundations are not answerable to large public memberships, generally have smaller staffs and lower operating costs than public charities, and can tailor their particular charitable purpose to fit the desires of the donor. A controlling donor can use these organizations as a tool to prepare younger family members for future business careers.

Both types of organizations are entities legally distinct from their donors and typically take the form of nonprofit corporations or charitable trusts. The funds donated to these organizations accrue on a tax-free basis subject to only a 2% excise tax on investment income.

Disadvantages. As compared with direct charitable contributions to the ultimate charitable recipients, the formation of a private foundation or a private operating foundation may have the following disadvantages:

- Formation of both organizations requires separate filings of tax returns and other filings associated with a separate entity.
- The organization may incur administrative expenses in the hiring of a trust department or other fund manager to administer the funds (these expenses can be minimized if the donor or family members operate the foundation, subject to self-dealing rules).
- Donations to a private foundation do not receive the same preferential tax treatment as donations to public charities and private operating foundations.
- Most significant, private foundations and private operating foundations are subject to excise taxes and various restrictions.

Excise Taxes

Unless otherwise noted, the excise taxes discussed below apply equally to both private foundations and private operating foundations.

Net investment income. Section 4940 imposes a 2% excise tax on the net investment income of all private foundations, including interest, dividends, rents, royalties, and long- and short-term capital gains. If the foundation donates a sufficient amount to qualified charities in a given year, it may be entitled under Section 4940(e) to cut the rate in half, to 1%, for that year.

Certain private operating foundations—"exempt operating foundations"—are entirely exempt from the 2% excise tax, pursuant to Section 4940(d). Such an organization must have been previously publicly supported for at least ten years or have qualified as an operating foundation as of 1/1/83. In addition, at least 75% of the members of its board of directors must not be disqualified persons, and must be broadly representative of the general public. Finally, no disqualified person may be an officer of the foundation.

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16 Reg. 53.4942(b)-3(b)(1).

17 See, e.g., Friedman, "How to Qualify as a Supporting Foundation," 6 J. Tax'n Exempt Orgs. 51 (September/October 1994).

18 See note 7, *supra*.

19 Section 4942(a)(1).

20 Section 4943(c)(2).

21 Section 4945(g).

22 See Linden and Machen, "For Many of Today's Wealthy, the Joy's Not in the Having—But the Getting," Forbes, 5/19/97, page 152. For example, on 9/18/97 Ted Turner announced that he was pledging a gift of $1 billion for a new foundation to aid United Nations causes. Mr. Turner also called on other wealthy people to increase their gifts. See "Putting His Money...," Time, 9/29/97, page 32.

Self-dealing. Section 4941 imposes a 5% excise tax on the amount involved in an act of self-dealing. A private foundation cannot engage in any prohibited transaction with disqualified persons.[18] Prohibited transactions, set forth in Section 4941(d), include the sale or lease of the foundation's property, the lending of assets, the furnishing of goods, services or facilities, the payment of compensation or expenses (except for reasonable compensation paid for personal services), the transfer to or use by or for the benefit of a disqualified person of the foundation's income or assets, and payments to government officials.

Failure to distribute. The minimum distribution requirements of Section 4942 mandate that a private foundation make qualifying distributions of at least 5% of the aggregate FMV of the foundation's assets that are not used directly to conduct the foundation's exempt activities. Qualifying distributions must be made to public charities that are not controlled by the private foundation or its disqualified persons. The excise tax on failure to distribute income is 15% of the amount of such income remaining undistributed at the beginning of the second (or any succeeding) tax year following the tax year in question. Private operating foundations, however, are not subject to this tax.[19]

Excess business holdings. Section 4943 prohibits a private foundation from owning more than a 20% interest in any corporation or other business entity. For purposes of calculating the 20% limit, holdings of disqualified persons are aggregated with those of the foundation.[20] The excise tax is 5% of the value of the excess business holdings.

Risky investments. Jeopardy or speculative investments are prohibited by Section 4944. The excise tax is 5% of the amount of the jeopardy investment. Another 5% excise tax is imposed on any foundation manager who participated in the making of the investment unless such participation is not willful and was due to reasonable cause. No category of investments is treated as a per se violation by Reg. 53.4944-1(a)(2), but investments that will be scrutinized to determine whether the foundation managers have met the requisite standard of care and prudence include trading in securities on margin, trading in commodity futures, investments in working interests in oil and gas wells, the purchase of puts, calls, straddles, or warrants, and selling short.

Taxable expenditures. Section 4945 prohibits a private foundation from making taxable expenditures, which include payments for political campaigns and lobbying, and certain grants to individuals. If the foundation makes certain grants to individuals for education, travel, or similar purposes, it must first obtain written approval of the selection procedures governing the grants from the IRS, or the grants will be subject to the excise tax.[21] The excise tax is 10% of the amount of the taxable expenditure.

Termination. Section 507 governs the termination of a private foundation. The foundation must notify the IRS of its decision to terminate its private foundation status, and may become liable for a termination tax equal to the lesser of the aggregate tax benefit to all parties resulting from the exempt status of the foundation or the value of the net assets of the foundation at termination. This termination tax may be avoided by providing for the distribution of all of the private foundation's assets to one or more organizations that have complied with the public charity requirements of Section 170(b)(1)(A) for a continuous five-year period before the date of termination.

A nonoperating private foundation can easily convert to a private operating foundation because the transition does not involve the termination of private foundation status. The key is that the private foundation must now actively conduct a charitable activity instead of making grants to other charitable organizations.

CONCLUSION

Today, many wealthy individuals have stated that they intend to donate large amounts of their holdings to charity.[22] The record bull markets have resulted in tremendous amounts of long-term capital gain sitting in the stock portfolios of many individuals. Under Section 170(e)(5), if these individuals donate this stock to a private foundation they are able to receive a charitable deduction equal to FMV, limited to 20% of their adjusted gross income. The window of opportunity for such donations is set to close on 6/30/98, however.

Accordingly, similarly situated individuals should now consider the formation of private operating foundations. They still will be able to exercise the control that makes private nonoperating foundations so attractive. The only major difference is that instead of making grants to others, their charitable foundations will be directly conducting charitable activities. The family name still will be on the door and family members still can serve on the board of directors or in administrative capacities, if desired. Except for the excise tax on undistributed income, which does not apply to a private operating foundation, both types of foundations are subject to the same restrictions and excise taxes. Best of all, a donation of capital gain property to a private operating foundation is deductible up to FMV, limited to 30% of the donor's contribution base. ■

NEW DEVELOPMENTS

THIRD-PARTY FUNDRAISER WAS 'INSIDER' DESPITE ARM'S-LENGTH CONTRACT, RESULTING IN LOSS OF CHARITY'S EXEMPT STATUS

The harshest penalty in the exempt area—retroactive revocation of exemption—has been upheld in *United Cancer Council, Inc.*, 109 TC No. 17 (*UCC*). According to the IRS, the contingent-fee, professional fundraising organization used by UCC since 1984 was an "insider" to whose benefit a portion of UCC's net earnings had inured. In agreeing with the Service's conclusions, the court's analysis provides valuable guidance as to how far an exempt organization