

**PUBLIC CHARITY STATUS
UNDER INTERNAL REVENUE CODE SECTION 509(a)(3):
The Supporting Organization**

August 2008

I. INTRODUCTION

Tax-exempt status under Section 501(c)(3) permits a charitable organization to pay no tax on any surplus funds it may have at the end of a year. Moreover, it permits donors to claim a charitable deduction for their contributions.

The world of Section 501(c)(3) organizations is divided into two classes: private foundations and public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. The private foundation laws impose a nominal tax on investment income, limit self-dealing and business holdings, require annual distributions, prohibit lobbying entirely, and restrict the organization's operations in other ways. The regulatory scheme also limits the amount of tax deduction available to donors. In most circumstances, public charity status is preferable to private foundation status. Some charities, however, accept private foundation status because their funding is unavoidably dependent on a single individual, family, or corporation, or because their donors seek the closer control more often found in the governance structures of private foundations.

A Section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any one of three ways: (1) by being an institution that is traditionally viewed as publicly supported, such as a church, school, or hospital; (2) by meeting one of two mathematical public support tests; or (3) by qualifying as a supporting organization to another charity that falls in one of the first two categories.¹ This memo summarizes the requirements imposed on organizations following this last path to public charity status.

¹ Supporting organization status is also available to a 501(c)(3) organization that supports a social welfare organization exempt under Section 501(c)(4), a labor union exempt under Section 501(c)(5), or a trade association exempt under Section 501(c)(6), or a foreign charity, provided the supported organization has enough diversified sources of income to meet one of the mathematical public support tests. This memorandum only addresses the situation where the supported organization(s) are domestic nonprofits exempt under Section 501(c)(3). Some of the requirements discussed here would differ slightly if the supported organization were exempt under a section other than Section 501(c)(3), and Type 3 status is not available if the supported organization is a foreign entity.

II. QUALIFYING AS A SUPPORTING ORGANIZATION

To qualify as a supporting organization under Section 509(a)(3), an organization must meet all five of the following tests:

- A. The relationship test under Section 509(a)(3)(B);
- B. The organizational test of Section 509(a)(3)(A);
- C. The operational test of Section 509(a)(3)(A);
- D. Lack of donor control over the supporting organization under Section 509(a)(3)(C); and
- E. Lack of donor control over the publicly-supported organization(s) under Section 509(f)(2).

Each of these tests is discussed separately below. We refer to the organization that obtains public charity status under Section 509(a)(3) as the supporting organization or “SO.” We refer to the public charity or charities which the SO supports as the publicly-supported organization, or “PSO.”

A. The Relationship Test

The relationship test may be satisfied in any of three ways. These three possible SO/PSO relationships are known as Type 1, Type 2, and Type 3. In addition, Type 3 SOs are further divided into those that are functionally integrated with their PSOs and those that are not.

Type 1: The SO is operated, supervised, or controlled by the PSO. This relationship is equivalent to a parent-subsidary relationship. Generally, at least a majority of the board of the SO must be appointed by the PSO. The donor may appoint the rest of the Board. For some donors, having the tax benefits associated with public charity status for their donee is worth this loss of formal legal control.

Type 2: The SO is supervised or controlled in connection with the PSO. This is a brother-sister relationship, where the same people control and manage both the SO and the PSO.

Type 3: The SO is operated in connection with the PSO. This type requires the lowest level of control by the PSO of the SO. To meet this

test, the relationship between the SO and the PSO must satisfy **both** a responsiveness test **and** an integral part test (in one of two ways):

(i) The responsiveness test. The SO must show that it is responsive to the needs or demands of the PSO, by satisfying all of the following tests:²

- a. The PSO selects at least one director of the SO, or the SO and the PSO have a director in common, or there is a close and continuing relationship between the leaders of the SO and the PSO; and
- b. The PSO thereby has a significant voice in the SO's investment policies, grantmaking and other uses of the SO's income or assets; and
- c. The SO annually provides the PSO with all information that the IRS requires an SO to provide to its PSO (although the IRS has not yet issued any requirements for Type 3 annual reports to its PSO).

AND

(ii) The integral part test. The SO must show that it is significantly involved in the affairs of the PSO, so that the PSO depends on the SO. The SO and PSO satisfy the integral part in one of two ways, depending on whether they are or are not *functionally integrated*. A SO is functionally integrated with its PSO if it directly engages in activities that perform the functions of its PSO or carry out the purposes of its PSO, and would normally be conducted by the PSO if not for the SO. A SO that provides financial support to its PSO, rather than by conducting active programs on its behalf, is not functionally integrated with its PSO. In an Advance Notice of Proposed Rulemaking issued by the IRS in the fall of 2007, the IRS announced that it intended to promulgate regulations that, among other things, would set out two versions of the integral part test, one for functionally integrated Type 3 SOs and another for Type 3 SOs that are not functionally integrated. (As of this writing, the Treasury Department has not issued regulations implementing these proposed rules. It is, however, expected that the eventual regulations will follow the principles set forth in the Advance Notice, so we discuss them here.)

- a. *Functionally integrated Type 3 SOs:* The SO directly engages in activities that perform the functions of or carry out the purposes of

² Until fairly recently, a Type 3 supporting organization formed as a charitable trust could pass the "responsiveness test" by showing that the PSO was a beneficiary of the trust, with the power under state law to enforce the trust and compel an accounting by the SO. This alternative for passing the "responsiveness test" was eliminated by Section 1241 of the Pension Protection Act of 2006. IRS regulations have not yet been amended to reflect the new law.

the PSO, and would normally be conducted by the PSO (*e.g.*, a publishing house for a university) but for the activity of the SO, *and* the SO spends substantially all of the lesser of (a) its adjusted net income or (b) 5% of the aggregate fair market value of its investment assets on the active conduct of these activities, *and* the SO devotes at least 65% of the aggregate fair market value of all of its assets to the conduct of those activities. (This is adapted from, but more stringent than, the payout requirement for private operating foundations.)

- b. *Type 3 SOs that are not functionally integrated:* The SO pays to or for the use of its PSO an amount equivalent to 5% of the net fair market value of its investment assets. (This is the same payout requirement that private foundations must satisfy.) In addition, the SO may support no more than five PSOs.

An SO must report each year on its Form 990 whether it is a Type 1, 2 or 3 SO, and must also identify its PSOs.

B. The Organizational Test

This test is met if the SO's governing instrument—in California, its Articles of Incorporation or trust instrument—complies with four requirements.

1. The governing instrument must limit the purposes of the SO to one or more of the purposes set forth in Section 509(a)(3). That is, the SO must be organized “exclusively for the benefit of, to perform the functions of, or to carry out the purposes of” the PSO. The PSO must be one or more Section 501(c)(3) organizations which are classified as public charities under either Section 509(a)(1) or 509(a)(2).³
2. The governing document must not expressly empower the SO to engage in activities which are not in furtherance of those purposes.
3. The governing document must specify the PSO on whose behalf the SO is to be operated. The PSO can be specified either by name or by

³ The PSO may also be exempt under other sections of the Internal Revenue Code, so long as it would qualify as publicly supported.

class⁴ if the relationship is parent/subsidiary (Type 1) or brother/sister (Type 2); otherwise, the PSO must be specified by name.

4. The SO's governing document must not empower the SO to support or benefit any organization other than its PSO or PSOs (which, as noted above, may in some circumstances be a class of public charities).

C. The Operational Test⁵

The SO may make payments to or for the use of the PSO; it may make grants, conduct independent programs, raise funds, and engage in an unrelated trade or business. However, the permissible beneficiaries of its grants or programs are limited to:

1. The SO's PSO;⁶
2. Individual members of the charitable class served by the PSO, either through direct payments or benefits to the individuals, or earmarked for such individuals and given through an unrelated organization;
3. Other SOs that support the PSO; or
4. Public colleges and universities.⁷

D. Lack of Donor Control over the SO

This is a negative test. To satisfy this test, the SO must not be "controlled" directly or indirectly by "disqualified persons." For purposes of this test, "control" means either holding 50% of the combined voting power on the Board of Directors of the SO, or veto power

⁴ It is important, in the planning stages, to determine whether the SO intends to support only specific, named PSO's, or whether it wishes to support a category of public charities. In the latter case, the PSO should be defined by class – for example, for an SO interested in environmental preservation, the class could be "public charities which work to preserve wilderness and prevent pollution and environmental harm." However, SOs that support a class of PSOs should pay particular attention to the burdens imposed on grant-making donor advised funds and private foundations, explained in Part III of this memo.

⁵ For specific additional operational requirements applicable *only* to Type 3 SOs, see pages 3-4.

⁶ Recall that the PSO may be one charity, or several named charities, or a class of charities. If the PSO includes more than one charity, the SO may grant funds to any or all of them.

⁷ See Treas. Reg. Section 1.509(a)-4(e)(1).

over the SO's activities, unless it can be shown that actual control is held by some other party (for example, by the bishop of a church corporation). The term "disqualified person" means:

1. A substantial contributor (defined as any person or entity who gives more than the greater of \$5,000 or 2% of the total gifts received by the SO, including gifts from a spouse);⁸
2. If the SO is a trust, the creator of the trust;
3. An owner of more than 20% of a corporation, partnership, trust, or other enterprise that is a substantial contributor to the SO;
4. A family member of any person described in 1, 2, or 3 above ("family member" here means spouse, ancestor, child, grandchild, great grandchild, and any of their spouses);
5. A corporation, partnership, or trust in which persons described in 1, 2, 3, or 4 above hold more than 35% of the voting power, profits interest, or beneficial interest, respectively; and
6. Employees of any of the above.⁹

In reviewing a SO's compliance with this test, the IRS looks not only at direct control by disqualified persons but at indirect control as well. For example, the IRS views the presence of a disqualified person's attorneys, accountants, and other professionals on an SO's governing body as being evidence of indirect control by the disqualified person.¹⁰

An SO must certify each year on its Form 990 that it is not controlled, directly or indirectly, by one or more of the above disqualified persons.

⁸ Public charities (other than SOs) do not qualify as substantial contributors, but SOs and private foundations do.

⁹ Rev. Rul. 80-207, 1980-2 C.B. 113 (an employee of a disqualified person shares that status for purposes of the control test).

¹⁰ See <http://www.irs.gov/irm/part7/ch07s07.html> for the Internal Revenue Manual's discussion of these issues, including guidesheets used by IRS agents to test for the presence of direct or indirect control of a supporting organization by disqualified persons.

E. Lack of Donor Control over the PSO

This, too, is a negative test: the SO may not accept gifts or contributions from anyone who directly or indirectly controls any of its PSOs. Specifically, the SO cannot accept gifts from:

1. An individual, business, or nonprofit organization (other than a publicly supported charity) that directly or indirectly controls any PSO. A person is treated as controlling a PSO if the person can control the PSO either acting alone, or acting together with people or organizations described in 2 and 3 below.
2. A member of the family of an individual described above. Family members who cannot donate to the SO include the spouse of an individual described in 1, or his or her siblings, ancestors, children, grandchildren, great grandchildren, or the spouses of any of those relatives.
3. A business or trust owned 35% by the people described above. This includes any corporation in which persons described in 1 or 2 directly or indirectly own more than 35% of the voting power, or any partnership in which such persons own more than 35% of the profits interest, or any trust or estate in which such persons own more than 35% of the beneficial interest.

The consequences of failing this test are different, depending on the category of SO involved. If a Type 1 or Type 3 SO fails the test, it will revert to private foundation status. If a Type 2 SO fails the test, however, it will not lose its SO status, but it will be subject to the excess business holding rules applicable to private foundations.¹¹

III. ADDITIONAL RESTRICTIONS AFFECTING SUPPORTING ORGANIZATIONS

A. Further Restrictions on Type 3 SOs

A Type 3 SO, unless it is functionally integrated with its PSO as described at page 3 of this memo, is subject to additional restrictions resembling the requirements imposed on private foundations. For example, a Type 3 SO that is not functionally integrated is subject to excess business holding rules as well as the mandatory minimum distributions described earlier. Moreover, if a private foundation makes a grant to a non-functionally integrated Type 3 SO, the

¹¹ See Section 4943(f)(3).

grant will not count toward the private foundation's minimum required qualifying distributions.¹² These additional restrictions on Type 3 SOs are beyond the scope of this memo; if you would like additional information, please contact your Adler & Colvin attorney.

B. Excess Benefit Transactions

Certain transaction involving SOs will result in automatic excess benefit transactions under Section 4958. An SO is effectively prohibited from making (i) any loan to a disqualified person, or (ii) any grant, loan, compensation or other similar payment¹³ to a substantial contributor to the SO, his or her family members, or entities 35% controlled by either. The full amount of any such loan, compensation, or other payment is considered an automatic "excess benefit" under Section 4958; therefore, the substantial contributor will be subject to excise taxes and will have to return the full amount to the SO.

In addition, Section 4958 provides that any disqualified person of an SO is also a disqualified person of any PSO of the SO.¹⁴ This means, for instance, that if an officer or director of the SO receives any economic benefit from its PSO, that benefit is a potential excess benefit transaction under Section 4958 and should be reviewed accordingly.

C. Contributions from Donor Advised Funds

Sponsoring charities of donor-advised funds ("DAFs") must exercise expenditure responsibility over any distribution to a Type 1 SO, a Type 2 SO, or a Type 3 SO that is functionally integrated, *if* either the donor to or advisor of the DAF directly or indirectly controls any PSO supported by the SO. Where the DAF grantee is a non-functionally integrated Type 3 SO, there are no exceptions; expenditure responsibility is required in all cases.

As a result, if a sponsoring charity is considering a grant from a DAF to a SO, it must first determine what type of SO its proposed grantee is. If the SO is a Type 1, Type 2, or functionally integrated Type 3 SO, the sponsoring charity may require a list of the grantee's

¹² See Section 4943(f) (excess business holdings); Section 1241 of the Pension Protection Act of 2006 (uncodified language) (mandatory payout); Section 4942(g), Section 4945(d)(4) (private foundation grants); and Section 4966(c)(2)(A) and (d)(4) (donor advised fund grants). In addition, a private foundation must exercise expenditure responsibility over grants to Type 3 SOs that are not functionally integrated.

¹³ According to the Joint Committee on Taxation's explanation of the Pension Protection Act, "other similar payments" includes grants, loans, or payment of compensation such as expense reimbursement, but does not include payments made pursuant to a bona fide sale or lease of property with a substantial contributor. Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006*, JCX-38-06, p360, note 571 (August 3, 2006).

¹⁴ Section 4958(f)(1)(D).

PSOs from the grantee to determine whether any of the PSOs is controlled by the fund's donor or donor advisor (or any related parties). If such control exists, the DAF sponsor must exercise expenditure responsibility.¹⁵ If the proposed grantee is a non-functionally integrated Type 3 SO, the sponsoring charity must exercise expenditure responsibility over the DAF grant in any case.

D. Contributions from Private Foundations

Private foundations face additional challenges when making grants to SOs. They may not treat a grant to a SO as a qualifying distribution if the grantee is (i) a Type 3 SO that is not functionally integrated, or (ii) a Type 1 SO, a Type 2 SO, or Type 3 SO that is functionally integrated, if either the private foundation or a disqualified person of the private foundation directly or indirectly controls any PSO supported by the SO.¹⁶ If a grant is not a qualifying distribution under these restrictions, the private foundation must also exercise expenditure responsibility over the grant or it will be a taxable expenditure.¹⁷

As a result, a private foundation considering a grant to a Type 1, Type 2, or functionally integrated Type 3 SO may require a list of the potential grantee's PSOs from the grantee to determine whether any of the PSOs are controlled by disqualified persons of the private foundation.¹⁸

Any tax advice contained in this memorandum was not intended to be used, and cannot be used, for the purpose of avoiding penalties that may be imposed under federal tax law. A taxpayer may rely on our advice to avoid penalties only if the advice is reflected in a more formal tax opinion that conforms to IRS standards. Please contact us if you would like to discuss the preparation of a legal opinion that conforms to these rules.

¹⁵ See IRS Notice 2006-109.

¹⁶ Section 4942(g)(4).

¹⁷ Section 4945(d)(4)(ii).

¹⁸ See IRS Notice 2006-109.