

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

October 2007

Tax-exempt status under Section 501(c)(3) of the Internal Revenue Code 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 one or more public charities that fall 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 III status is not available if the supported organization is a foreign entity.

In 2006, Congress passed significant new restrictions affecting supporting organizations and their donors in an attempt to address perceived taxpayer abuse of this charitable vehicle.² Part I, Section E and Part II of this memo in particular address restrictions recently imposed on supporting organizations. As of the date of this memo, the IRS has not yet issued regulations interpreting these new restrictions. More information regarding how the IRS currently reviews supporting organizations can be found on the IRS website, www.irs.gov/charities.

I. 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:

1. The relationship test under Section 509(a)(3)(B);
2. The organizational test of Section 509(a)(3)(A);
3. The operational test of Section 509(a)(3)(A);
4. Lack of donor control over the supporting organization under Section 509(a)(3)(C); and
5. 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 three ways. The SO and the PSO must satisfy one of the three types:

Type I: The SO is operated, supervised, or controlled by the PSO. This relationship is equivalent to a parent-subsidiary relationship. Generally, at least a majority of the board of the SO must be appointed by the PSO. The donor may

² See the Pension Protection Act of 2006, signed into law on August 17, 2006. The effective dates for the different charity-related provisions of the Act vary. For instance, most provisions related to supporting organizations took effect as of August 17, 2006; however, the Form 990 reporting requirements related to supporting organizations became effective for taxable years ending after August 17, 2006, while the provisions regarding excess benefit transactions involving supporting organizations under Section 4958 are retroactive, applying to any transaction occurring after July 25, 2006.

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 II: 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 III: 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 tests³:

- 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 III 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, by satisfying one of the following two tests:

- a. The SO directly engages in activities that perform the functions of or carry out the purposes of the PSO, and would normally be conducted by the PSO (e.g., a publishing house for a university); *or*
- b. The SO pays at least 85% of its income to or for the use of the PSO, and this amount is important enough to the PSO to insure that the PSO will be attentive to the operations of the SO.

³ Until fairly recently, a Type III 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 (in uncodified language). IRS regulations have not yet been amended to reflect the new law.

An SO must report each year on its Form 990 whether it is a Type I, II or III 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 organizations which are classified as public charities under either Section 509(a)(1) or 509(a)(2).⁴

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. One or more PSOs can be specified either by name or by class⁵ if the relationship is parent/subsidiary (Type I) or brother/sister (Type II); otherwise, each 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 TEST

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

⁴ Section 509(a)(1) includes agencies of government. The PSO may also be exempt under other sections of the Internal Revenue Code, so long as it would qualify as publicly supported. See footnote 3.

⁵ 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 involved with grants from donor advised funds and private foundations, explained in Part II of this memo.

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.

D. LACK OF DONOR CONTROL OVER THE SO

This is a negative test, requiring that the supporting organization not directly or indirectly be "controlled" 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 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)⁷;
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); and
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.

In determining whether an organization is *indirectly* controlled by one or more disqualified persons, the IRS will consider whether a disqualified person is in a position to influence the decisions of Board members who are not themselves disqualified persons. For instance, if a majority of the Board consists of employees of a disqualified person, the organization will fail the control test because a disqualified person is in a position to influence the decisions of the employee Board members.

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

⁷ Public charities (other than SOs) do not qualify as substantial contributors, but SOs and private foundations do.

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.

E. LACK OF DONOR CONTROL OVER THE PSO

This also is a negative test, newly enacted in 2006, requiring that the supporting organization not accept gifts or contributions from anyone who directly or indirectly controls any of its PSOs. If a Type I or Type III SO fails this test, it will revert to private foundation status. If a Type II SO fails this test, it will be subject to the excess business holding rules applicable to private foundations but will otherwise remain a public charity.⁸ To pass this test, 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 more than 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.

II. ADDITIONAL RESTRICTIONS AFFECTING SUPPORTING ORGANIZATIONS

A. FURTHER RESTRICTIONS ON TYPE III SOS

A Type III SO, unless it is “functionally integrated”⁹ with its PSO, is subject to additional restrictions resembling the requirements imposed on private foundations. For example, a Type III SO that is not functionally integrated is subject to excess business holding

⁸ See Section 4943(f)(3).

⁹ A functionally integrated Type III SO is one which meets the integral part test described in Part I, Section A above due to the *activities* of the SO related to performing the functions of, or carrying out of the purposes of, the PSO, rather than through payments to the PSO.

rules and will be subject to a mandatory payout requirement (although the IRS has not yet promulgated rules defining the amount of the payout). As described in Part III, it also cannot receive grants from private foundations or donor advised funds unless the grantor follows “expenditure responsibility” procedures, and if a private foundation makes a grant, the grant will not count as a qualifying distribution.¹⁰ A further discussion of the additional restrictions imposed on Type III SOs is beyond the scope of this memo. More information regarding supporting organization requirements, and Type III supporting organizations in particular, can be found on the IRS website, www.irs.gov/charities.

B. EXCESS BENEFIT TRANSACTIONS

Certain transactions 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 payment¹¹ to a substantial contributor to the SO, his or her family members, or entities more than 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.¹² This means, for instance, that if an officer or director of the SO receives any economic benefit from a PSO, that benefit is a potential excess benefit transaction under Section 4958 and should be reviewed accordingly.

C. CONTRIBUTIONS FROM DONOR ADVISED FUNDS

Sponsoring public charities cannot make distributions from a donor advised fund (“DAF”) to a Type I SO, a Type II SO, or a Type III SO that is functionally integrated without exercising expenditure responsibility for the distribution, *if* either the donor to or advisor of the DAF directly or indirectly controls any PSO supported by the SO. Sponsoring public charities cannot make distributions from a DAF to a non-functionally integrated Type III SO at all without exercising expenditure responsibility.

As a result, a sponsoring public charity considering a grant from a DAF to a Type I, Type II, or functionally integrated Type III SO may require a list of the grantee’s PSOs from the grantee to determine whether any of the PSOs is controlled by the fund’s donor or donor

¹⁰ See Section 4943(f) (excess business holdings); Section 1241 of the Pension Protection Act of 2006 (uncodified provision) (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).

¹¹ 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).

¹² Section 4958(f)(1)(D).

advisor (or any related parties). If such control exists, the DAF sponsor must exercise expenditure responsibility.¹³

D. CONTRIBUTIONS FROM PRIVATE FOUNDATIONS

Most private foundations are “non-operating,” meaning that they make grants rather than operate their own direct programs. Contributions from non-operating private foundations do not count as qualifying distributions if made (i) to a Type III SO that is not functionally integrated, or (ii) to a Type I, Type II, or Type III 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.¹⁴ If a grant does not qualify as a qualifying distribution under these restrictions, the private foundation must also exercise expenditure responsibility over the grant or it will be a taxable expenditure.¹⁵

As a result, a private foundation considering a grant to a Type I, Type II, or functionally integrated Type III supporting organization 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.¹⁶

¹³ See IRS Notice 2006-109.

¹⁴ Section 4942(g)(4).

¹⁵ Section 4945(d)(4)(ii).

¹⁶ See IRS Notice 2006-109.