

# SUPPORTING ORGANIZATIONS IN THE SPOTLIGHT

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All tax-exempt organizations described in Section 501(c)(3) are either private foundations or public charities. By default, these organizations are private foundations unless they qualify as public charities described in Section 509(a)(1), (2), (3), or (4). Section 509(a)(1) organizations generally are churches, schools, hospitals, and other organizations publicly supported by gifts, grants, and contributions. Section 509(a)(2) organizations generally are publicly supported by gifts, grants, contributions, and gross receipts from the performance of their exempt functions. Section 509(a)(4) organizations are those formed for the purposes of testing for public safety.

Unlike these organizations, Section 509(a)(3) organizations, or “supporting organizations” do not have to be formed for a partic-

ular charitable purpose or have to raise a certain amount of public support. Instead, these organizations qualify as public charities because they support the exempt activities of other public charities.<sup>1</sup> Absent this relationship with an existing public charity, supporting organizations generally would be treated as private foundations.

## Where we are now

Due to the complexity of the supporting organization rules, satisfaction of each of the nuanced requirements is not straightforward. Failure to meet each of these ongoing technical requirements generally results in the organization defaulting to private foundation status as of the first day of the tax year during which the failure occurred. In some cases, supporting organizations give little, if any, thought to continued compliance with these rules after the issuance of the IRS determination letter.

For tax years beginning in 2014, a revised Form 990, “Return of Organization Exempt from Income Tax,” Schedule A, Parts IV and V spotlight the filing organization’s claim to Section 509(a)(3) status by focusing on governance relationships, organizational structure, operational activities, and procedural rules. This new checklist of requirements may result in an un-

**Legislative and regulatory attempts to curtail abuses have damaged the viability of supporting organizations.**

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suspecting supporting organization discovering that it fails to qualify as a public charity and that is has defaulted to private foundation status as of the first day of the tax year. As a result, the provisions of Chapter 42 of the Code apply retroactively and may prove costly.

### Why this happened

Donors and public charities alike enjoy the flexibility afforded supporting organizations. They generally avoid the restrictive prohibitions imposed on private foundations while simultaneously enabling donors to deduct charitable contributions at the higher adjusted gross income limitations enjoyed by public charities.<sup>2</sup> To a certain extent, supporting organizations may also provide limited control to the founders or donors of the organization while escaping the scrutiny of the general public. In addition, it may be beneficial to place certain assets or activities in a separate legal entity, which would not independently qualify as a public charity, to insulate assets from liability or to facilitate separation of functions.<sup>3</sup>

## Controversy surrounding the use of supporting organizations has grown over the years.

Although supporting organizations have existed as a form of public charity since 1969, when the concepts of a private foundation and a public charity were first introduced, controversy surrounding their use has grown

over the years. In 2005, Senator Charles Grassley (R-Iowa) and former Senator Max Baucus (D-Mont.), then the Chairman and the Ranking Member, respectively, of the Senate Finance Committee, sent a letter to the Secretary of the Treasury detailing their concerns regarding the inappropriate use of supporting organizations. The letter focused on three abusive situations in which a donor contributed assets to a supporting organization, which enabled the donor to claim a large charitable deduction while serving very few charitable purposes:

1. Keeping the donated assets under the effective control of the donor while generating very little income for the charity.
2. Directing the organization to engage in offshore investment activities and effectively returning the money to the taxpayer while enabling the charitable deduction and avoiding tax on capital gains.
3. Receiving a loan back from the organization shortly after donating the same sum.<sup>4</sup>

After years of newspaper articles, Congressional studies, and IRS comments about abuses of supporting organizations, Congress significantly changed the supporting organization regime through the enactment of the Pension Protection Act of 2006 ("the PPA").<sup>5</sup> However, as further discussed below, the legislative and accompanying regulatory changes have had the unintended consequence of affecting legitimate supporting organizations and jeopardizing their ability to continue to qualify as public charities.

<sup>1</sup> Certain Section 501(c)(4), Section 501(c)(5), and Section 501(c)(6) organizations may also qualify to be supported by supporting organizations even though they are not public charities. Section 509(a), flush language; Reg. 1.509(a)-4(k). However, for ease of reference and discussion, this article will focus solely on Section 501(c)(3) publicly supported organizations.

<sup>2</sup> Section 170(b)(1). Donations to public charities generally are limited to 50% of adjusted gross income (AGI), or 30% of AGI for contributions of property. On the other hand, donations to private foundations generally are limited to 30% of AGI, or 20% of AGI for contributions of property.

<sup>3</sup> Panel on the Nonprofit Sector, *Strengthening Transparency Governance Accountability of Charitable Organizations*, (Independent Sector 2005), Page 45, available at [www.independentsector.org/uploads/Accountability\\_Documents/Panel\\_Final\\_Report.pdf](http://www.independentsector.org/uploads/Accountability_Documents/Panel_Final_Report.pdf).

<sup>4</sup> Committee on Finance Press Release, "Grassley, Baucus Plan to Take Aim at Abusive 'Supporting Organizations' for Charities," 4/25/05, available at [www.finance.senate.gov/newsroom/ranking/release/?id=25a3942f-87f9-461f-9f48-b6a702f7e533](http://www.finance.senate.gov/newsroom/ranking/release/?id=25a3942f-87f9-461f-9f48-b6a702f7e533).

<sup>5</sup> P.L. 109-280, 8/17/06; 120 Stat. 780.

<sup>6</sup> Section 509(a)(3)(A); Reg. 1.509(a)-4(b)(1).

<sup>7</sup> Section 509(a)(3)(B); Reg. 1.509(a)-4(f)(1).

<sup>8</sup> Section 509(a)(3)(C); Reg. 1.509(a)-4(j)(1).

<sup>9</sup> Reilly and Jones, "Basic Determination rules for Publicly Supported Organizations and Supporting Organizations," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1993* (1992), available at [www.irs.gov/pub/irs-tege/eotopicj93.pdf](http://www.irs.gov/pub/irs-tege/eotopicj93.pdf)

<sup>10</sup> Section 509(a)(3)(B)(i); Reg. 1.509(a)-4(g).

<sup>11</sup> Section 509(a)(3)(B)(ii); Reg. 1.509(a)-4(h).

<sup>12</sup> Section 509(a)(3)(B)(iii); Reg. 1.509(a)-4(i).

<sup>13</sup> Reg. 1.509(a)-4(f)(3).

<sup>14</sup> Former Reg. 1.509(a)-4(i)(2)(ii). The former regulations were issued as part of TD 7784, 1981-2 CB 133.

<sup>15</sup> Former Reg. 1.509(a)-4(i)(2)(iii).

<sup>16</sup> Former Reg. 1.509(a)-4(i)(3)(i).

<sup>17</sup> Former Reg. 1.509(a)-4(i)(3)(ii).

<sup>18</sup> Former Reg. 1.509(a)-4(i)(3)(iii).

<sup>19</sup> See generally, Government Accountability Office, *Tax-Exempt Organizations: Collecting More Data on Donor-Advised Funds and Supporting Organizations Could Help Address Compliance Challenges* (GAO-06-799, July 2006), available at [www.gao.gov/new.items/d06799.pdf](http://www.gao.gov/new.items/d06799.pdf)

<sup>20</sup> See, e.g., Section 509(j)(1) (requiring Type III supporting organizations to meet certain notification requirements and preventing such organizations from supporting foreign supported organizations).

## **Supporting organization background**

To qualify as an organization described in Section 509(a)(3)—a “supporting organization”—an entity must meet four tests: (1) organizational, (2) operational, (3) relationship, and (4) control. The organizational and operational tests generally require the supporting organization to be organized and at all times operated for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified “supported organizations” described in Section 509(a)(1) or (2).<sup>6</sup> The relationship test generally requires the supporting organization to be operated, supervised, or controlled by; or controlled in connection with; one or more specified supported organizations.<sup>7</sup> The control test generally requires that the supporting organization not be controlled, directly or indirectly, by one or more disqualified persons, other than foundation managers or one or more specified supported organizations.<sup>8</sup> These tests generally seek to define the extent of control or involvement by the supported organization and the lack of control or involvement of others.<sup>9</sup>

The relationship test generally creates three types of relationships between the supporting and supported organizations, described as follows:

1. A Type I supporting organization is operated, supervised, or controlled by its supported organization(s).<sup>10</sup>
2. A Type II supporting organization is supervised or controlled in connection with its supported organization(s).<sup>11</sup>
3. A Type III supporting organization is operated in connection with its supported organization(s).<sup>12</sup>

Each relationship requires that the supporting organization be responsive to the needs and demands of its supported organization(s) (the “responsiveness test”) and that the supporting organization constitute an integral part of, or maintain a significant involvement in, the operations of its supported organization(s) (“the integral part test”).<sup>13</sup> A Type I supporting organization generally satisfies these requirements through the substantial degree of control its supported organization has over its conduct. Similarly, a Type II supporting organization generally satisfies these requirements through the presence of common supervision or control among the governing bodies of all organizations involved, such as the presence of common directors. However, due to the attenuated relationship that a Type III supporting organization has with its supported organization(s), additional requirements must be

met to satisfy each of the responsiveness and integral part tests.

## **Pre-Pension Protection Act**

Prior to the PPA, a Type III supporting organization could meet the responsiveness test in one of two ways. First, through the relationship between the supporting organization’s officers, directors, or trustees and those of the supported organization(s), the supported organization(s) retained a significant voice in the supporting organization’s investment policies, timing and manner of making grants, selection of grant recipients, and otherwise directing the use of its income or assets.<sup>14</sup> Second, as a charitable trust under state law that named each supported organization as a named beneficiary in the trust’s governing instrument, provided that state law empowered each beneficiary organization to enforce the trust and compel an accounting.<sup>15</sup>

In addition, the pre-PPA integral part test for Type III supporting organizations generally required the supporting organization to maintain a significant involvement in the operations of its supported organization(s) that were dependent on the supporting organization for the type of support it provided.<sup>16</sup> A Type III supporting organization could meet this requirement through the satisfaction of either the “but for” test or the “payout” test:

1. Under the “but for” test, the supporting organization had to demonstrate that its activities performed the functions or carried out the purposes of its supported organization(s) and, but for the supporting organization’s involvement, would normally be engaged in by the supported organization(s).<sup>17</sup>
2. The “payout” test required the supporting organization to make payments of substantially all of its income to or for the use of its supported organization(s), which was sufficient to ensure the attentiveness of such supported organization(s) to the operations of the supporting organization. Furthermore, the supporting organization had to pay a substantial amount of its total support to its supported organization(s) that met the attentiveness requirement.<sup>18</sup>

## **Pension Protection Act and forward**

In response to perceived abuses of supporting organizations, including the concern that supported organizations were unaware of their supporting organizations,<sup>19</sup> Congress enacted new provisions, primarily targeting Type III supporting organizations.<sup>20</sup> Con-

gress officially separated Type III supporting organizations into two subcategories, bestowing more favorable treatment on those that are “functionally integrated.” As defined in Section 4943(f)(5), a functionally integrated Type III supporting organization is one that is not required to make payments to supported organizations due to the activities of the organization related to performing the functions, or carrying out the purposes, of such supported organization. Congress required Treasury to promulgate new regulations on payments required by non-functionally integrated Type III supporting organizations, with such payments to be made as a percentage of income or assets.<sup>21</sup> However, Congress left to Treasury and the IRS how to define “functionally integrated” and “non-functionally integrated.”

On 12/28/12, Treasury and the IRS promulgated final, temporary, and proposed regulations regarding the requirements to qualify as a Type III supporting organization, reflecting the changes required by the PPA.<sup>22</sup> In addition to detailing the notification requirement<sup>23</sup> and updating the responsiveness test to remove the alternate test for charitable trusts,<sup>24</sup> the final regulations establish criteria for satisfying the integral part test as a functionally integrated Type III supporting organization<sup>25</sup> and through

mandatory distributions as a non-functionally integrated Type III supporting organization.<sup>26</sup>

Under the regulations, a Type III supporting organization satisfies the integral part test as functionally integrated if it meets one of the following three tests:

1. *'But for' test.*<sup>27</sup> This test requires that the activities of the supporting organization (a) directly further the exempt purposes of one or more supported organizations to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s); and (b) but for the involvement of the supporting organization, would normally be engaged in by such supported organization(s). Although similar to the “but for” test from the pre-PPA regulations, this test is more onerous in that it generally excludes fundraising, grant-making, and investing and managing non-exempt use assets.<sup>28</sup>
2. *'Parent' of supported organization(s).* The supporting organization must (a) exercise a substantial degree of direction over the policies, programs, and activities of the supported organization, and (b) appoint or elect a majority of the supported organization's officers, directors, or trustees.

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3. *Supporting a governmental entity.* Currently,<sup>29</sup> this test requires first that a supporting organization support a governmental entity to which the supporting organization is responsive. Second, it requires that a supporting organization engage in activities for or on behalf of that governmental supported organization that (a) perform the functions of, or carry out the purposes of, that governmental supported organization and that, (b) but for the involvement of the supporting organization, would normally be engaged in by the governmental supported organization itself. This test is nearly identical to the pre-PPA “but for” test.

Failure to meet one of the foregoing tests results in the organization being categorized as a non-functionally integrated supporting organization subject to the mandatory distribution requirements. Under the regulations, a non-functionally integrated Type III supporting organization generally must make annual distributions totaling the greater of 3.5% of its non-exempt use assets or 85% of its income.<sup>30</sup> This requirement is similar to the “payout” test of the pre-PPA regulations; however, it ensures that even an organization with no or limited income will still distribute a portion of its assets. Also similar to the prior payout test, the regulations require that at least one-third of the distributable amount be paid to supported organizations that are attentive to the operations of the supporting organization and to which the supporting organization is responsive.<sup>31</sup>

## Impact of the changes

Although the PPA changes to the supporting organization rules eliminated some of the more prevalent abuses, they also narrowed the ability of a number of non-abusive supporting organizations to continue to qualify while preserving their existing governance structure and activities. The PPA enacted only limited changes for Type I and

Type II supporting organizations, while most Type III supporting organizations felt a seismic shift in their operating environments. For most organizations, these changes took effect for tax years beginning in 2007. However, some of the most significant changes did not occur until the IRS promulgated final regulations in 2012, generally effective for tax years beginning in 2013.

**Time to report.** For tax years beginning in 2014, a supporting organization is required to demonstrate how it meets the organizational and operational tests under Section 509(a)(3) on its Form 990, Schedule A. Many organizations are meeting these new questions with confusion as the 2014 Form 990 represents the first time that most organizations will need to provide a thorough explanation as to their claimed type classification. Although difficult in the first year of compliance, the significant changes to the Form 990, Schedule A are long overdue and will be a welcome change in years to come as organizations are able to ensure that they are meeting the complex rules that have so often evaded them.

**Types of confusion.** Before the PPA, a supporting organization’s type classification (i.e., Type I, II, or III) had little meaning, with the payout requirement for certain Type III supporting organizations serving as one of the only operational differences. In fact, an IRS determination letter to a supporting organization before 2007 generally reflected its status as an organization described in Section 501(c)(3) and as a public charity described in Section 509(a)(3), but stopped short of classifying its type. Coupled with minimal compliance efforts, the pre-PPA supporting organization environment encouraged limited understanding among organizations and their advisors of the complex organizational and operational rules applicable to such organizations.

When the PPA changes took effect for tax years beginning after 8/17/06, organizations started to act. They asked the IRS for procedures to convert to other types of public charities<sup>32</sup> and,

<sup>21</sup> Note 5, *supra*, section 1241(d)(1); 120 Stat. 1103.

<sup>22</sup> TD 9605 12/19/12, 2013-11 IRB 587, 77 Fed. Reg. 76,382 (2012); REG-155929-06, 2013-11 IRB 650.

<sup>23</sup> Reg. 1.509(a)-4(i)(2). Generally, a Type III supporting organization must provide, by the due date of its annual information return (not including extensions) written notice to each of its supported organizations describing the amount and type of support it provided in the most recently completed tax year. It must also include a copy of its most recently filed Form 990 and, to the extent not previously provided, a copy of its governing documents (e.g., articles of incorporation and bylaws).

<sup>24</sup> Reg. 1.509(a)-4(i)(3). Other than the removal of the alternate test for charitable trusts, the responsiveness test remains virtually identical to that contained in the pre-PPA regulations.

<sup>25</sup> Reg. 1.509(a)-4(i)(4).

<sup>26</sup> Reg. 1.509(a)-4(i)(5).

<sup>27</sup> Reg. 1.509(a)-4(i)(4)(ii).

<sup>28</sup> Reg. 1.509(a)-4(i)(4)(ii)(C).

<sup>29</sup> The regulations reserved on these requirements. Reg. 1.509(a)-4(i)(4)(iii). However, the IRS provided interim guidance in Notice 2014-4, 2014-2 IRB 274.

<sup>30</sup> Temp. Regs. 1.509(a)-4T(i)(5)(ii)(B), (C).

<sup>31</sup> Reg. 1.509(a)-4(i)(5)(ii).

<sup>32</sup> Ann. 2006-93, 2006-2 CB 1017.

to the extent possible, otherwise took steps to no longer be described in Section 509(a)(3).<sup>33</sup> However, many supporting organizations rely on that classification to qualify as a public charity and had to take steps to comply with the new rules.

**Missing notice.** However, the confusion as to the proper type classification caused problems with one of the more straightforward administrative requirements established by the PPA. Specifically, a Type III supporting organization must provide notice to each supported organization to demonstrate its responsiveness.<sup>34</sup> An organization that fails to meet this requirement by the due date prescribed in the regulations<sup>35</sup> fails to qualify as a Type III supporting organization. If it cannot meet the definition of another type of supporting organization or another type of public charity, it defaults to private foundation status for that tax year. However, neither the Code nor the regulations provides procedures to correct a failed notification requirement.

If, for example, a Type III supporting organization inadvertently fails to meet the notification requirement by a single day, it has technically failed to qualify as a supporting organization for its most recently completed tax year. Similarly, a supporting organization that does not comply with the notification requirement because it believes it is a Type II supporting organization but, upon completion of its annual Form 990, discovers that it is a Type III supporting organization will fail to qualify. Currently, the only way to remedy these missteps is to file a private letter ruling request with the IRS requesting “9100 relief”—i.e., a request for extension of time for making an election.<sup>36</sup>

This situation causes significant uncertainty for organizations, their advisors, return preparers, and independent auditors. Does the organization continue to file Forms 990 while preparing its ruling request and waiting for a ruling from the IRS? Is the organization cur-

rently subject to the excise taxes applicable to private foundations?

**But not integration.** Perhaps one of the biggest changes is found not in statute but in regulations—the definition of “directly furthering” the supported organization’s exempt purposes.<sup>37</sup> Under the pre-PPA regime, one way an organization qualified as a Type III supporting organization was to demonstrate that its activities performed the functions of, or carried out, the purposes of its supported organization(s).<sup>38</sup> The regulations did not further enumerate how the organization could accomplish such a task. To meet the same qualification under current law, and qualify as a “functionally integrated Type III supporting organization,” the entity must “directly further” the exempt purposes of one or more of its supported organizations, which generally does not include fundraising, grantmaking, or investing or managing non-exempt use assets.<sup>39</sup>

The IRS and Treasury reasoned that an organization that “operates substantial, direct charitable programs itself may need more flexibility in structuring its annual operational budget than the annual payout requirement for non-functionally integrated Type III supporting organizations would allow.”<sup>40</sup> Therefore, a supporting organization will fail to qualify as functionally integrated solely because it supports (1) a community foundation or other publicly-supported grantmaker, (2) a religiously-affiliated entity, (3) an entity with which the supporting organization has a close historic and continuing relationship, or (4) an organization that created the supporting organization specifically to house fundraising, grantmaking, or investment activities. As a result, such a supporting organization needs to change its governance structure or its operations to avoid classification as a non-functionally integrated Type III supporting organization or private foundation.

<sup>33</sup> E.g., certain “dual-status” organizations—i.e., those that are not subject to tax by reason of both being recognized as described in Section 501(c)(3) and being affiliated with a governmental entity—sought to relinquish their exempt status under Section 501(c)(3).

<sup>34</sup> Section 509(f)(1)(A); Reg. 1.509(a)-4(i)(2).

<sup>35</sup> A Type III supporting organization must provide written notice to each of its supported organization by the last day of the fifth month following the close of its tax year (e.g., a calendar year taxpayer’s deadline would be May 31 of the following year).

<sup>36</sup> Reg. 301.9100-3. The current user fee for a 9100 relief ruling request is \$9,800. Rev. Proc. 2015-1, 2015-1 IRB 79.

<sup>37</sup> Reg. 1.509(a)-4(i)(4)(ii)(C).

<sup>38</sup> Former Reg. 1.509(a)-4(i)(3)(ii). See note 14, *supra*.

<sup>39</sup> Reg. 1.509(a)-4(i)(4)(ii)(C).

<sup>40</sup> TD 9605, *supra* note 22.

<sup>41</sup> Reg. 1.509(a)-4(i)(4)(i)(B).

<sup>42</sup> Reg. 1.509(a)-4(g).

<sup>43</sup> See Section 4943(f)(3)(A).

<sup>44</sup> See, e.g., Tax Reform Act of 2014 Discussion Draft, section 5304 (repealing Type II and Type III supporting organizations), available at [http://waysandmeans.house.gov/UploadedFiles/Statutory\\_Text\\_Tax\\_Reform\\_Act\\_of\\_2014\\_Discussion\\_Draft\\_022614.pdf](http://waysandmeans.house.gov/UploadedFiles/Statutory_Text_Tax_Reform_Act_of_2014_Discussion_Draft_022614.pdf) (last accessed 8/16/15).

In a large, multi-entity system, it is not unusual to have many supporting organizations. Although somewhat counterintuitive, one may serve as the “parent” of the system, directing the system’s overall operations and goals and qualifying as a functionally integrated Type III supporting organization.<sup>41</sup> A tier-two subsidiary may be directly controlled by one of the publicly supported public charities, holding investment assets and qualifying as a Type I supporting organization.<sup>42</sup> A similar entity that has majority board overlap with one of the publicly supported public charities qualifies as a Type II supporting organization. However, the rules relegate an organization formed for the same purposes, but without this majority overlap or control over the board, to non-functionally integrated Type III status. As previously discussed, this status requires mandatory payout requirements, limits the types of holdings it may have,<sup>43</sup> and effectively forecloses the possibility of receiving funds from private foundations. These facts remain true despite the close connection the organization has with each of the supported organizations and even though the grantmaking it conducts would otherwise be conducted by each of the supported organizations themselves.

## Conclusion

Nine years ago, the PPA changed the course of supporting organizations, and nearly three years ago, Treasury and the IRS tightened the vise on these entities. Despite these changes and limitations, Congress continues to call for more stringent standards for supporting organizations, even going as far as suggesting that they should be eliminated.<sup>44</sup>

As supporting organizations continue to operate in this restrictive environment, they can use the revised Form 990, Schedule A, as a checklist to ensure continued compliance with the tax law. In particular, this approach may serve to be invaluable to a supporting organization that contemplates organizational or operational changes.

While the future of supporting organizations remains uncertain, with careful attention to governance relationships, organizational structure, operational activities, and procedural rules, operating as a supporting organization can continue to serve as an option for certain types of organizations seeking public charity classification. Nevertheless, they should proceed with caution because the law includes numerous traps for the unwary. ■