PUBLIC CHARITIES, PRIVATE FOUNDATIONS, AND SUPPORTING ORGANIZATIONS FOR THE NON-EXEMPT ORGANIZATIONS SPECIALIST

PART II: SUPPORTING ORGANIZATIONS SIMPLIFIED (KIND OF)

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I. Introduction and Recap of Part I.

Considering the fact that entire treatises have been written about private foundations, the general tax practitioner might appreciate a more simplified explanation of the "fantastically intricate and detailed" rules that arise in this subset of tax-exempt laws. Much of the blame for the confusion surrounding supporting organizations rests with the shotgun-style statutory approach of the charitable and tax-exempt laws.

While none of the Internal Revenue Code of 1986, as amended ("Code") can be considered simple, the provisions outlining rules for private foundations are found not in Section 501(c)(3) (which might make sense) but in Section 509, Section 170, and throughout various penalty provisions in Section 4940 and subsequent sections. This can make proper statutory compliance an excruciating headache for tax lawyers (especially non-exempt tax specialists called upon for pro bono assistance). To add to the complexity, the new Section 4966 of the Code, added by the Pension Protection Act of 2006, creates a new penalty provision for subcategories of charitable organizations within supporting organizations. The rules are so convoluted, advising the simplest of nonprofits (with admittedly tight budgets) properly is a challenge for the tax practitioner who desires to help clients efficiently.

Part II: Supporting Organizations Simplified is a continuation of Part I: Public Charities and Private Foundations - A Statutory Roadmap published last year. Part I outlined the differences between a public charity and a private foundation, and described the Code's roundabout way of saying a private foundation is any Section 501(c)(3) organization that is NOT a private foundation. As discussed in Part I, a public charity is a tax-exempt Section 501(c)(3) organization which meets certain tests outlined in three subsections of Section 509, which will result in the organization NOT being a private foundation. Part I discussed the first two subsections (that is, Section 509(a)(1) and Section 509(a)(2)) which set forth requirements that qualify a tax-exempt organization for public charity status (by avoiding private foundation status). This Part II will focus on the third subsection, Section 509(a)(3), which covers supporting organizations (which also avoid private foundation status). Complete discussion of supporting organizations is not the intent here; rather, this Part II hopes to provide tax practitioners not familiar with these rules with some basics in assisting their clients.
II. It's Not a Private Foundation if it is Described in Section 509(a)(3)("Supporting Organizations"), but it Better Be a Type I, II, or Functionally Integrated Type III Supporting Organization.

Section 501(c)(3) organizations which cannot meet the various tests to avoid private foundation status as a public charity pursuant to Section 509(a)(1) and Section 509(a)(2), as discussed in the first Part to this two-Part Article, 6 may consider “supporting organization” classification under Section 509(a)(3) in the process of completing its Form 1023 (Application for Recognition of Tax Exemption).

Such classification is important if, for example, an existing public charity wants to "spin off" certain activities that are not necessarily charitable in and of themselves (such as administrative support functions solely for the public charity). Hence, Section 509(a)(3) organizations, called supporting organizations, may be considered when there are close ties with another organization or organizations that actually did meet Section 509(a)(1) or Section 509(a)(2) tests. Supporting organizations essentially "piggyback" the public charity status of other organizations.

Supporting organizations must meet three tests. In practice, the first two tests are relatively simple to apply. The third test, changed by PPA '06, created the term "Types" to clarify three Types of supporting organizations. PPA '06 also created two subcategories of the third Type. Such is the confounding way of typical tax legislation.

Meeting the three tests means that the organizational document (i.e., the Texas certificate of formation) must contain some technical provisions not typically seen by the average tax practitioner. The supporting organization analysis should be done before formation to avoid annoying amendments later on. Analysis is now more complicated with the PPA '06 revisions on the Types. The exact Type of supporting organization should be ascertained such that the first determination letter correctly names the Type (to avoid later IRS hassles to change or update the determination letter). The IRS determination letter will now state, for example, “We [the IRS] have determined that you are a Type 1 supporting organization under Section 509(a)(3))."

A. Section 509(a)(3)(A) - Organizational and Operational Test for a Supporting Organization.

The first test, set forth under Section 509(a)(3)(A), requires that a supporting organization be "organized, and at all times thereafter . . . operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified organizations described in paragraph (1) or (2)[specifically, Sections 509(a)(1) and (a)(2)]." The extensive Section 509 regulations expand upon this requirement in great detail. Stated simply, the certificate of formation needs to sufficiently describe who the supporting organization supports. This can be accomplished, by example, by stating in the certificate of formation that:

"The organization is organized, and at all times thereafter is operated, exclusively for the benefit of, to perform the functions of, or to carry out the
purposes of _________________, a [tax-exempt organization recognized as a public charity under Section 501(c)(3) and Section 509(a)(1), 509(a)(2), etc.]."

One easy way to do this is simply name (i.e. fill in the blank) the specified organizations in a manner that satisfy the Section 509 regulations. Guide Sheets published by the IRS will walk the practitioner through the necessary language in organizing documents. If there are one or more organizations that can be identified, naming those is best (and it is prudent, of course, to make sure they are actually organizations defined in Section 509(a)(1) and (a)(2)).

If the organization intends to benefit many existing or yet-to-be-created organizations, it is possible to refer to supported organizations without name, so long as such organizations are identified by class or purpose. For example, a church-affiliated Section 501(c)(3) organization can be a supporting organization under Section 509(a)(3)(A) where the articles of organization required it to care for the aged, which is a charitable class (because one of the church's purpose was to care for the aged via a home). In this example, the supporting organization shall "carry out the purposes of such organization or organizations qualified under Section 501(c)(3) and which provide home and medical care for the aged." In addition, the certificate of formation may describe the existence of a historic and continuing relationship such that there is a substantial identity of interests between the two organizations. In practice, the third test is rarely applied. It seems hard to argue a historic and continuing relationship where a new organization is being formed.

The certificate of formation must also refrain from expressly empowering the organization to engage in activities not in furtherance of the specified purpose, or support or benefit any other organization not named by purpose or class. Generally, once the practitioner gets past the part naming the exclusive beneficiary or class, any further expansions of power should be discouraged.

Supporting organizations under Section 509(a)(3) can also include those which support Section 501(c)(4), (5), or (6) organizations, so long as the Section 509(a)(2) public support tests are met by the (c)(4), (5), or (6) organization as if such organization's purpose were charitable rather social welfare, labor, or business league or other purpose permitted by (c)(4), (5) or (6). What all this means is that a supporting organization might be set up to conduct charitable activities under the watch of a (c)(4), (c)(5), or (c)(6) organization, but the supporting organization needs to be prepared to observe all limitations and restrictions applicable to charitable organizations and not otherwise applicable to the supported organization. Therefore, if this structure is considered, a certificate of formation cannot simply say that it is "organized and operated exclusively for" the benefit of the non-charitable exempt organization. Instead, a stand-alone Section 501(c)(3) charitable, educational, etc. purposes clause is required for organizations seeking supporting organization status when supporting a non-charitable tax-exempt organization under Section 501(c)(4), (5), or (6). Note, also, that where the supported organization is a (c)(4), (c)(5), or (c)(6) organization, the supporting organization will not be able to use the Section 509(a)(3)((A) organizational and operational test because it cannot name the (c)(4), (c)(5), or (c)(6) entity as a supported organization. Instead, it needs to rely solely under the Section 509(a)(3)(B), Type I or Type II category discussed in the Section 509(a)(3)(B) explanation below.
B. *Section 509(a)(3)(C) - Disqualified Person Prohibitions (Control Test).*

The second test, under Section 509(a)(3)(C), provides that disqualified persons\(^{15}\) (other than foundation managers) must not control directly or indirectly, the supporting organization. Stated differently, substantial contributors to the supporting organization cannot make up a majority of a supporting organization. In application this particular test can be tedious despite simplicity in concept, with all indirect corporate and entity ownership included.

C. *Section 509(a)(3)(B) (Relationship Test).*

The most difficult and confusing components of supporting organization tests are found in the third test, outlined in Section 509(a)(3)(B). These tests were the subject of recent changes under PPA '06. Subsection (B) now names three Types of Section 509(a)(3) supporting organizations by imposing some not easily objective relationship tests. The relationship tests require satisfaction through provisions in bylaws and other governing documents outside the basic certificate of formation.

The tax practitioner creating a new supporting organization should attempt to identify the Type of supporting organization in the certificate of formation, particularly as the IRS will now specifically list the Type in the determination letter. For organizations dependent upon grants from a broad range of public charities and private foundations, having the correct Type shown in the letter will facilitate contributions. As discussed later, major private foundations will find it preferable to contribute to Type I, Type II, or "functionally integrated" Type III supporting organizations due to the new excise taxes potentially imposed on distributions not made to such organizations. Types I and II are easy to identify; the "functionally integrated" Type III is much harder to identify and establish, and the determination of whether a Type III is "functionally integrated" has drawn many a nonprofit CEO to the brink of insanity since formerly generous donors now require new substantiation as a condition to receiving the generous grants.

1. *Section 509(a)(3)(B)(i) - Type I Supporting Organizations (Parent/Subsidiary).*\(^{16}\)

   Type I supporting organizations are “operated, supervised, or controlled by one or more organizations” which are public charities by virtue of Section 509(a)(1) or 509(a)(2). The key terms are "operated, supervised, or controlled by." This parent/subsidiary Type I is easiest to identify. The Regulations provide that the terms operated, supervised, or controlled “presupposes a substantial degree of direction” over the supporting organization, and requires that a majority of the directors of the supporting organization be appointed or elected by the supported organization.\(^{17}\) If a parent supported organization appoints or elects the majority of the subsidiary supporting organization's governing body, the supporting organization is clearly Type I.
2. **Section 509(a)(3)(B)(ii) - Type II Supporting Organizations (Brother/Sister).**

Type II supporting organizations are “supervised or controlled in connection with one or more such organizations.” Here, the key terms are "controlled in connection with." To be a Type II supporting organization, the control or management of a Type II must be vested in the same persons that control or manage the supported organization. In other words, there are typically overlapping directorates in Type II supporting organizations. For example, a majority of the “brother” supported organization is also a majority of the “sister” supporting organization.

3. **Section 509(a)(3)(B)(iii) - Type III Supporting Organizations (Just Friends (But Very Close Friends)).**

The practitioner can usually identify and request Type I and II status without too much fuss; Type III is harder to identify and establish. Type III supporting organizations are “operated in connection with one or more such organizations” and as such, do not have as much direct oversight from the supported organizations. The key term is simply "operated in connection with." The statutory terms are admittedly nebulous. For this reason – the perception that Type III supporting organizations strayed too far from the purposes and direction of the supported organization – the IRS created specialized rules relating to Type III supporting organizations with PPA ’06.

Type III supporting organizations must meet two tests. First, the Type III supporting organization must be “responsive to the needs of” (as opposed to controlled by) the supported organization. Second, the Type III supporting organization must be an “integral part” of the supported organization, by maintaining a significant involvement in the operations of the supported organization and such supported organizations are dependent upon the supporting organization for the type of support it provides. The integral part test now has additional relevance as it determines whether a Type III supporting organization will be classified as a “functionally integrated” or “non-functionally integrated” Type III supporting organization. The practitioner will want the formation documents and tax-exempt application to support functionally integrated Type III classification if possible due the disadvantages of non-functionally integrated Type III classification. New proposed Treasury regulations, issued on September 24, 2009, have considerably added to compliance headaches in this area.

(i) The “responsiveness” test is met if at least one of the Type III supporting organization's officers, directors, or trustees are elected or appointed by the supported organization, or if the officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship of the publicly supported organization. In addition, by reason of the common leadership position, the persons on the supported organization have a "significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients of such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization." So, the practitioner should try to ensure at least one common director or officer is in place, and such person or persons should be active and not simply a nominee director.
The “integral part” test can be met by satisfying one of two tests. New regulations break up the two “integral part” tests into tests that result in the Type III supporting organization being either “functionally integrated” or “non-functionally integrated.”

1. To be functionally integrated, a Type III supporting organization must meet yet two more subtests. First, the Type III supporting organization wishing to meet functionally integrated status must prove substantially all of its activities directly further the exempt purposes of the supported organization to which it is responsive. Second, “the activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.” In other words, this "but for" test asks, “is the supporting organization conducting an activity that the supported organization would otherwise need to conduct itself?”

2. If the above functionally integrated tests are not met, the Type III supporting organization can at least be a non-functionally integrated Type III supporting organization if it satisfies two other tests. The second test requires that the Type III supporting organization meet an annual distribution requirement and an “attentiveness” test. First, a non-functionally integrated Type III supporting organization must distribute annually roughly 5% of the fair market value of its non-exempt use assets to the organization or organizations it supports. This is called the organization’s “annual distributable amount.” Second, of the annual distributable amount, at least one-third or more must be distributed to supported organizations that are “attentive” to the operations of the Type III supporting organization and to which the supporting organization is “responsive.” “Attentiveness” can be shown if the Type III supporting organization distributes an amount equal to 10% of the supported organization’s total support, or, more generally, if the supported organization needs the Type III supporting organization’s money to avoid interruption of an activity or function of the supported organization.

There are excruciating rules continued in the proposed regulations, which outline what consists of “non-exempt use” assets and limitations where donor advised funds are considered. These rules will not be covered in this Article, nor will this Article cover the compliance and transitional rules. To recap, the point in this Article is that satisfaction of Section 509(a)(3) tests is desirable to avoid private foundation classification and the disadvantages thereof. If the satisfaction of Section 509(a)(3) is required, the practitioner must try to avoid non-functionally integrated Type III supporting organization status. The “bad” Type III supporting organizations are subject to restrictions that can affect fundraising from private foundations. In other words, private foundations (typically, exempt organizations set up by wealthy donors and controlled by such) will strongly disfavor contributions to a non-functionally integrated Type III supporting organization.
D. Why it is Bad to be a Non-Functionally Integrated Type III Supporting Organization.

The final component of this analysis looks to whether, once it is determined a Type III supporting organization exists, such Type III supporting organization is functionally integrated. Section 4943, in brief, provides that excise taxes on undistributed income of a private foundation can be imposed if a private foundation does not make sufficient "qualifying distributions." One of the key problems with private foundation status is the requirement to distribute a minimum amount of income as qualifying distributions. Under Section 4943(f), qualifying distributions cannot be made to Type III supporting organizations unless they are functionally integrated. Grants from a private foundation to a bad Type III supporting organization will be classified as taxable expenditures under Section 4945 unless the hassle of expenditure responsibility is complied with. Excess business holding rules now apply to bad Type III supporting organizations as well as private foundations. For these reasons, most large private foundations now require proof that a grant applicant that is a supporting organization prove that it is not a non-functionally integrated Type III supporting organization. If the IRS determination letter does not specifically state the Type, potential donor organizations require a "reasoned opinion of counsel" that a particular supporting organization meets the tests under Section 509(a)(3) to be a particular Type. The time and expense of doing such an opinion can be a sticky spot for tax practitioners and their clients.

III. Certificate of Formation Language.

Now that this Article has (somewhat) clarified what makes up a supporting organization, the tax practitioner should at least have a frame of reference in which to more knowledgeably draft formation documents for a tax-exempt organization. Common Texas corporate form resources delicately avoid suggesting any standard tax-compliant language. The author has noticed more than a few articles of incorporation/certificates of formation which include language that the Code requires for private foundations, above and beyond the standard purpose and dissolution clauses. The Code provisions that impact formation documents are worth revisiting.

For example, Section 508 of the Code (the Code section which references the tax-exempt application process) requires, as a condition for a private foundation to be tax-exempt, certain additional provisions in the articles of incorporation/certificate of formation. The provisions relate to the minimum distribution requirement (Section 4942), the self-dealing prohibition (Section 4941(d)), the excess business holdings prohibition (Section 4943(d)), the jeopardy investment provisions (Section 4944), and the taxes on taxable expenditures (Section 4945). To comply with Section 508, this messy language was present in many now-antiquated articles of incorporation for private foundations, but certainly they are not required in any entity that desires to avoid private foundation status. The practitioner should make sure these private foundation-only rules are not in the certificate of formation for a public charity.

Even if private foundation status is desired, the Texas Business Organizations Code ("TBOC") thankfully provides the Section 508 language by operation of Texas law. Section 2.107 of the TBOC (entitled "Standard Provision for Certain Charitable Nonprofit Corporations; Power to Exclude") recites the exact provisions that the federal Code requires and therefore,
incorporates federal Code requirements by operation of state law. Hence, there is no need to insert the Section 508 language in the formation documents of a Texas nonprofit corporation.

What follows, then, is suggested minimum tax language for the "Purposes" and “Dissolution” clauses of a Section 501(c)(3) organization. Some of these provisions have been drawn from the IRS’s instructions to Form 1023, other provisions are from the author’s own language used over years.

1. **Tax Paragraph 1 to Purposes Clause.** The Corporation is organized exclusively for charitable, educational, and scientific purposes under section 501(c)(3) of the Internal Revenue Code of 1986, as amended ("Code").

   Note: If a more specific description is desired, a statement elaborating on the specific purpose of the corporation can be inserted, but state that the specific purpose is within the general purpose as stated above; i.e. “More specifically, but within such general purpose . . .”

2. **Tax Paragraph 2 to Purposes Clause.** No part of the net earnings, gains, or assets of the Corporation shall inure to the benefit of or be distributable to its directors, officers, other private individuals, or organizations organized or operated for a profit, except that the Corporation shall be authorized and empowered to pay reasonable compensation for services rendered.

3. **Tax Paragraph 3 to Purposes Clause.** No substantial part of the activities of the Corporation shall be the carrying on of propaganda or otherwise attempting to influence legislation, and the Corporation shall be empowered to make the election authorized under section 501(h) of the Code. The Corporation shall not participate in or intervene in (including the publishing or distributing of statements) any political campaign on behalf of or in opposition to any candidate for public office.

4. **Tax Paragraph 4 to Purposes Clause.** Notwithstanding any other provision herein, the Corporation shall not carry on any activities not permitted to be carried on (i) by an organization exempt from federal income taxation under section 501(a) of the Code as an organization described in section 501(c)(3) of such Code, or (ii) by an organization, contributions to which are deductible under sections 170(c)(2), 2055(a)(2), or 2522(a)(2) of the Code.

5. **Tax Paragraph 1 to Dissolution Clause.** Upon the dissolution of the Corporation, after payment or provision for payment of the Corporation’s liabilities has been made, the Corporation’s remaining assets shall not be transferred to private ownership, but shall be distributed exclusively to a Qualified Recipient or Recipients (as hereinafter defined).

   Note: In supporting organizations, often the Corporation will desire assets to be distributed to the supported organization. Language should be included that ensures the supported organization is still qualified under Section 501(c)(3).
6. **Tax Subparagraph to Paragraph 1 to Dissolution Clause.** A "Qualified Recipient" shall mean either (i) an organization that is existing and qualified as exempt from federal income taxation under Section 501(a) of the Code as an organization described in Section 501(c)(3) of the Code and organized exclusively for the tax-exempt purposes as set forth in this Certificate (or such other tax-exempt purposes as may lawfully be conducted by an organization described in Section 501(c)(3) of the Code); (ii) a federal, State or local government, exclusively for such government's public purpose; or (iii) any entity which has been declared, by court order in a duly authorized court of competent jurisdiction, as an entity which shall best accomplish the general purposes for which the Corporation was organized.

IV. **Conclusion.**

With heightened interest in nonprofit organizations and frequent media coverage outlining abuses, the tax practitioner will continue to confront issues relating to Code requirements on tax-exempt organizations. The rules surrounding and defining Section 501(c)(3) organizations are amazingly convoluted and, it is hoped, the overviews provided in Part I and II will provide assistance as Texas tax lawyers continue to be involved in the nonprofit arena.

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4 Pension Protection Act of 2006 (PL 109-280)("PPA '06").


6 Id. p. 34 (discussing § 509(a)(1) and 509(a)(2) as ways an organization avoids private foundation status, which would otherwise subject it to excise taxes and charitable contribution limits not applicable to public charities).

7 I.R.C. § 509(a)(3)(A). The regulations to this section are unfortunately lengthy and found at Treas. Reg. § 1.509(a)-4 (and which have proposed regulations pending now).


10 Id. § 1.509(a)-4(d)(2)(b)(iv).

11 See supra no. 8.

12 Id. § 1.509(a)-4(c)(1)(iv).

13 More than one-third of its supports must derived from gifts, grants, contributions, or membership dues from permitted sources, and not more than one-third of its support is derived from the sum of gross investment and unrelated business taxable income. See supra n. 5 at 33.
“For purposes of paragraph (3) [which is § 509(a)(3) describing supporting organizations], an organization described in paragraph (2) [which is a § 509(a)(2) publicly supported organization] shall be deemed to include an organization described in section 501(c)(4), (5), or (6) [which are non-charitable types of exempt organizations] which would be described in paragraph (2) if it were an organization described in 501(c)(3).” I.R.C. § 509(a)(3) (brackets added in the off chance it might help). This provision apparently didn’t justify its own subsection in § 509(a)(3); rather, it is simply the last paragraph following § 509(a)(4). An IRS CPE noted, tongue in cheek, that this “provision had the dubious honor of being placed at least twice in the Gobbledygook column of the defunct Washington Star (D.C.).” Ron Shoemaker and Bill Brockner, Public Charity Status on the Razor’s Edge: IRS 509(a)(3) and the Complexities of the Operating in Connection with the Integral Part Texas, and Miscellaneous IRC 509(a)(3) Issues, 1997 IRS CPE TEXT, available at <<www.irs.gov/pub/irs-tege/eotopici97.pdf>>.

See supra n. 5 at 34 for the definition of a "disqualified person."

Just for kicks, Type I supporting organizations are also defined in new § 4966(d)(4)(B)(i), which uses identical language in the PPA ’06 codification to the new 20% excise tax on certain nonqualifying distributions.

Treas. Reg. § 1.509(a)-4(h)(1).

Now also defined in Section 4966(d)(4)(B)(ii).

Id. § 1.509(a)-4(h)(2).


Id. § 1.509(a)-4(i)(3)(iii).

Id. § 1.509(a)-4(i)(4)(i)(A)(1).

Id. § 1.509(a)-4(i)(4)(i)(A)(2).

Id. § 1.509(a)-4(i)(5)(ii).

Id. § 1.509(a)-4(i)(5)(iii).

Id.

Id.

Id.

Id.

See infra n. 5 at 34.


Id. at Appendix.