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COMPLEX PUBLIC SUPPORT ISSUES

by

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I. Introduction

Section 501(c)(3) organizations are classified as either public charities or private foundations. There are important consequences of an organization’s classification. For example, private foundations face greater restrictions on their activities, including an absolute prohibition on lobbying. They are also subject to an excise tax on net investment income, as well as other potential excise taxes not imposed on public charities. Donors receive less favorable treatment on the deductibility of contributions to private foundations. Public charities are not subject to the same restrictions as private foundations because their publicly supported nature helps to ensure that they will operate to provide important public benefits and remain publicly accountable.

Generally, Section 501(c)(3) organizations are presumed to be private foundations unless they are described in Sections 509(a)(1), 509(a)(2), or 509(a)(3). Some organizations are classified as public charities by virtue of their activities, some qualify by meeting one of a series of tests designed to assess the level of public support that the organization receives, and some obtain their status derivatively. This outline focuses on the complications that often arise when assessing whether an organization meets the applicable public support test or wishes to qualify as a supporting organization. While a variety of organizations can qualify as a public charity under Section 509(a)(1), this outline focuses on organizations that are classified as public charities because they “normally” receive substantial support from the government and the general public within the meaning of Section 170(b)(1)(A)(vi).

II. Specific Issues Under Section 509(a)(1)

A. Overview

Section 509(a)(1) includes organizations that are classified as public charities because they are specifically enumerated under the statute – such as churches and conventions or associations of churches, colleges and universities, and hospitals and medical research organizations\(^1\) – as well as organizations that “normally” receive substantial support from the government and the general public within the meaning of Section 170(b)(1)(A)(vi).

\(^1\) These organizations are set forth in Sections 170(b)(1)(A)(i) through (v) and include Section 170(c)(1) governmental units and organizations formed for the benefit of certain state and municipal colleges and universities.
In order to be classified as an organization that “normally” receives substantial support from the government and the general public, the organization must meet one of two tests. The first is the 33 1/3 percent support test which requires that the organization normally receive 33 1/3 percent or more of its total support from public sources.\(^2\) The second is the 10 percent “facts and circumstances” test which, among other aspects, requires that the organization “normally” receive 10 percent or more of its total support from public sources.\(^3\) An organization “normally” meets the applicable test for a taxable year and the taxable year immediately succeeding that year, if, for the taxable year being tested and the four preceding taxable years, the organization meets the test on an aggregate basis.\(^4\)

Both tests require an organization to divide its public support by its total support. Total support includes: gifts, grants, contributions, and membership fees (where the purpose is to provide support for the organization rather than to purchase admissions, merchandise, services, or use the organization’s facilities); net income from unrelated business activities, whether or not carried on regularly or as a trade or business; gross investment income (as defined in Section 509(e)); tax revenues levied for the benefit of an organization and paid to or expended on behalf of the organization; and the value of services or facilities (exclusive of services or facilities furnished to the public without charge) provided without charge by a Section 170(c)(1) governmental unit.\(^5\) Total support does not include: contributions of services for which a deduction is not allowable, exempt function income; the value of exemption from federal, state, or local tax or a similar benefit; capital gains; loan repayments; and unusual grants.\(^6\)

Public support generally includes grants, contributions, and support from governmental units described in Section 170(c)(1).\(^7\) Governmental support provided for a service or facility for the direct benefit of the public counts as public support, but governmental support provided for a service or facility that meets the direct and immediate needs of the government does not count as public support.\(^8\) Public support also includes the full amount of contributions from Section 170(b)(1)(A)(vi) organizations, and from other Section 170(b)(1)(A) organizations, such as a church, that could also qualify for classification as a Section 170(b)(1)(A)(vi) organization.\(^9\) Contributions by an individual, trust, or a corporation also count towards public support but only to the extent that the total amount of contributions from a particular donor does not exceed two percent of the organization’s total support for the computation period.\(^10\) In applying the two percent limitation, all contributions made by a donor and by certain persons standing in certain relationships to the donor are treated as made by one person.\(^11\)

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\(^3\) Treas. Reg. § 1.170A-9(f)(3).
\(^5\) Section 509(d).
\(^6\) Section 509(d); Treas. Reg. § 1.170A-9(f)(7).
\(^7\) Treas. Reg. § 1.170A-9(f)(6)(i).
B. Meeting the “Facts and Circumstances” Test:

If an organization does not meet the 33 1/3 percent support test then it can still qualify as a publicly supported organization under Section 170(b)(1)(A)(vi) on the basis of the 10 percent “facts and circumstances” test. This test requires the organization to “normally” receive at least 10 percent of public support and to be organized and operated so as to attract new and additional public or governmental support on a continuous basis.\textsuperscript{12} The following “facts and circumstances” will be taken into account:

- The organization’s percentage of public support exceeds 10 percent (the higher the percentage, the better);
- The organization receives support from a representative number of persons rather than from members of a single family;
- The organization has a governing body representative of the broad public interest of the public (e.g., public officials, community leaders, or persons elected by a broadly based membership), rather than the personal and private interests of a limited number of donors or persons in a relationship to such donors;
- The availability of the organization’s facilities and services to the public and/or public participation in programs and services;
- Members of the public with special knowledge or expertise, public officials, or civic or community leaders participate in or sponsor the organization’s programs;
- The organization maintains a definitive program to accomplish its charitable work in the community (e.g. slum clearance or developing employment opportunities); and
- The organization receives a significant portion of its funds from a charity or a governmental agency to which it is accountable as a result of the funds.\textsuperscript{13}

If it appears that an organization will not meet the 33 1/3 percent public support test during a given year, then it should review whether it can alternatively meet the 10 percent “facts and circumstances” test. Some organizations that tend to qualify under the 33 1/3 percent public support test from year to year may struggle with meeting the “facts and circumstances” if they have not engaged in some advance planning by considering factors such as the composition of the board and the availability of its services, facilities, or programs on an ongoing basis.

\textsuperscript{12} Treas. Reg. § 1.170A-9(f)(3).
\textsuperscript{13} Treas. Reg. § 1.170A-9(f)(3).
C. Receiving Funds from the Government

The 509(a)(1) public support test allows an organization to treat the full amount of grants and contributions from the government as public support. In some cases, however, the government may not be the direct payor of funds to the organization; instead, the organization may receive all of its support through an organization that is a contractor to a governmental entity. In Private Letter Ruling 792320924, the IRS ruled that the United States Agency for International Development earmarked its funds to a 501(c)(3) organization by virtue of its approval of the organization’s contract regarding the work. As a result, the 501(c)(3) organization could treat the receipt of funds under the contract as support from a governmental unit for purposes of the public support test.

In other cases, an organization needs to carefully analyze the purpose of the government’s payment. For example, some organizations receive governmental funds for the provision of certain tools and information. Depending on the nature of the tools or information, the support will be treated as either exempt function income (and therefore excluded from the public support calculation) or as a contribution from the government fully includible as public support. The key is identifying whether the payment meets the direct and immediate needs of the government or provides a service to or maintains a facility for the direct benefit of the public which may be counted in full towards public support. Examples of payments that are made for the direct benefit of the public include amounts paid for the maintenance of public library facilities, or to nursing homes or homes for the aged to provide care to residents under government programs.\(^\text{14}\)

D. Contributions from Partnerships

The Treasury Regulations accompanying Section 170(b)(1)(A)(vi) provide that contributions by “an individual, trust, or corporation” are taken into account as public support.\(^\text{15}\) The Treasury Regulations do not include a reference to the treatment of contributions by partnerships for purposes of the 509(a)(1) public support test, but the partnership rules offer some guidance. Sections 703(a)(2)(C) and 702(a)(4) provide that a partnership cannot take a charitable contribution deduction, although the deduction may be taken by an individual partner for the partner’s distributive share of the contribution. This has provided a basis for some 509(a)(1) organizations to treat support from partnerships as received from the individual partners rather than the partnership when computing support under the 509(a)(1) test.

Whether a contribution is treated as made by a partnership or by the individual partners for purposes of the public support test has important consequences. If the organization treats the contribution as made by the partnership then the full amount of the contribution is subject to the 2% limitation making it a challenge to meet the 509(a)(1) support test in the absence of a substantial number of other contributions, particularly those from publicly supported 509(a)(1) organizations.\(^\text{16}\) If, however, the organization treats the

\[^{14}\text{Treas. Reg. § 1.170A-9(f)(8).}\]
\[^{15}\text{Treas. Reg. § 1.170A-9(f)(6)(i).}\]
\[^{16}\text{Treas. Reg. § 1.170A-13(f)(15).}\]
grant as made from the individual partners then it is less of a challenge to meet the 509(a)(1) support test, even though those contributions may be subject to the 2% limitation; provided that a substantial number of the donors don’t stand in a relationship to one another that would require aggregation.

E. **Foreign Charities**

Many foreign organizations apply for 501(c)(3) exemption and classification as a public charity can help facilitate receipt of grants from U.S. private foundations. In fact, the Treasury Regulations specifically provide that an organization may qualify as a Section 509(a)(1) organization regardless of the fact that it does not satisfy Section 170(c)(2) because its funds are not used within the United States or its possessions, or it was created or organized outside of the United States.\(^\text{12}\)

Because public support includes the full amount of contributions received from governmental units described in Section 170(c)(1), a question arises as to whether contributions from foreign governments (which aren’t described in Section 170(c)(1)) can also count fully towards public support. In Revenue Ruling 75-435, the IRS ruled that contributions from a foreign government can count fully towards an organization’s public support. The IRS has issued subsequent guidance indicating that the full amount of support from foreign governments cannot be counted as public support, but this subsequent guidance has not overruled Revenue Ruling 75-435. Many organizations take the position that support from a foreign government counts fully as public support.

F. **Large Contributions and Endowments**

Endowments generate investment income, and organizations with large endowments can have trouble meeting the Section 509(a)(1) test because investment income is not included as public support. One option is to place the endowment in a supporting organization of the public charity. Supporting organizations are described below in Section IV and are classified as public charities based on their relationship to one or more 509(a)(1) or 509(a)(2) organizations. Placing an endowment in a supporting organization allows the 509(a)(1) organization to maximize growth of its endowment without the accompanying concern about its impact on public charity status.

A similar consequence arises when private foundations make a large grant to a public charity. Because a grant from a private foundation is subject to the 2 percent limitation, these grants could potentially “tip” the recipient from public charity to private foundation status. Organizations need to carefully monitor their public support and ensure that significantly large grants that are subject to the 2 percent limitation do not jeopardize the organization’s public charity classification.

\(^{12}\) Treas. Reg. § 1.509(a)-2(a).
III. Specific Issues Under 509(a)(2)

A. Overview

Section 509(a)(2) provides a path to public charity status for organizations that generally draw their support from a combination of donative sources and exempt function income. An organization seeking classification under Section 509(a)(2) must qualify in two ways as measured by mechanical tests on the Form 990: (1) one third of its total support must come from public sources,\(^{18}\) and (2) it cannot derive more than one third of its total support from income from investments and unrelated business activities (post tax).\(^{19}\)

As with Section 170(b)(1)(A)(vi), the Section 509(a)(2) public support test divides an organization’s public support by its total support, but the tests very much depart in the definition of public support.\(^{20}\) For Section 509(a)(2) purposes, public support includes only revenue from governmental units, Section 509(a)(1) organizations, and other persons who are not disqualified persons as defined by applying Section 4946(a) (the regulations refer to these as “permitted sources”).\(^{21}\) In addition, public support generally includes two distinct buckets of revenue: (1) gifts, grants, contributions, and membership fees, and (2) gross receipts from exempt function activities.\(^{22}\) These sources of support face very different treatment. For donative and membership support, revenue from permitted sources is not subject to any limitations; that is, 100% of every gift, grant, contribution, and membership fee from a permitted source gets included as public support.\(^{23}\) But when it comes to exempt function income, amounts from each permitted source is only includable to the extent of the greater of $5,000 or 1% of total support for the taxable year.\(^{24}\)

As a result, there are two frontline questions in characterizing revenue for the purposes of 509(a)(2): (1) Is it from a permitted source (which will determine whether it is included in public support)? (2) Is it donative in nature or exempt function income (which will determine whether any included revenue is subject to limitation)? However, things often get complex and confusing in answering these questions.

Section 509(a)(2) is less forgiving than Section 170(b)(1)(A)(vi) – the one-third public support requirement and the one-third income limitation are bright lines; organizations that fail one or both of these tests for two consecutive years do not have a facts and circumstance to fall back on and are no longer described in Section 509(a)(2). For this reason, organizations that hover near or trend towards the one-third marks should take extra care in their planning. In addition, the lack of a safety net raises the stakes for appropriately characterizing income and accurately completing the tests.

\(^{18}\) Section 509(a)(2)(A).
\(^{19}\) Section 509(a)(2)(B).
\(^{20}\) It follows that the definitions of total support vary as well; Section 509(a)(2) includes gross receipts from related activities.
\(^{21}\) Treas. Reg. § 1.509(a)-3(a)(2)(ii).
\(^{22}\) Treas. Reg. § 1.509(a)-3(a)(2)(i)-(ii).
\(^{23}\) Section 509(a)(2)(A) (see flush language).
\(^{24}\) Treas. Reg. § 1.509(a)-3(b)(1).
B. **(Mis)Calculating Donative Support**

Because public support excludes any support from disqualified persons, Section 509(a)(2) may not be appropriate for organizations that historically have been or will become primarily donative in nature. If such an organization can pass the Section 509(a)(2) test, it almost assuredly qualifies under Section 170(b)(1)(A)(vi). On the other hand, there are many Section 170(b)(1)(A)(vi) organizations that will simply fail the Section 509(a)(2) test for lack of exempt function income or a sufficiently diverse donor base. However, from time to time, donative organizations will sometimes misclassify themselves under Section 509(a)(2) in large part because they include support from disqualified persons, but other complexities can arise in appropriately characterizing donative support.

1. **Identifying Substantial Contributors**

Disqualified persons include officers, directors or trustees of the organization, certain of their family members, and their 35% controlled entities. But perhaps the most important category of disqualified persons – especially for organizations that receive significant support from individuals and foundations over time - is the substantial contributor.

A substantial contributor is any person (other than a permitted source) who has contributed more than $5,000 to the organization if that amount is greater than 2% of the total contributions (including bequests) received since its inception. For many organizations, most major donors will meet this definition and will therefore be disqualified persons. Moreover, once obtained, the substantial contributor classification is all but impossible to shake.

As a result, Section 509(a)(2) organizations need to keep track of contributors historically in a way that most other public charities do not. Failure to do so may result in some sticky situations, particularly for organizations that claim material amounts of donative support in their total calculation of public support.

2. **Grants versus Gross Receipts**

Sometimes, it can be difficult to distinguish between a donative grant and a contract for services, but the distinction is important. Assuming that the contract revenue would be treated as exempt function income, it would be subject to the 1% limitation in calculating public support. On the other hand, grant revenue could be fully includable in public support; however, a large enough grant could make the grantor a substantial contributor, which will result in the grant’s exclusion altogether.

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25 See Section 4946(a)(1) and corresponding regulations.
26 Section 4946(a)(2) (cross referencing Section 507(d)(2)).
27 Section 507(d)(2)(A).
28 Section 507(d)(2)(C).
In general, a grant is made to encourage the grantee to conduct activities that further its exempt purposes; incidental benefits to the grantor do not change this characterization. 29 A contract for services, on the other hand, is characterized by activities that provide a direct and immediate benefit to the payor and not the general public. The fact that the activities are also commercially available tends to show that the payments are for services and not grants. 30

This analysis can be nuanced based on the purposes of the grant or contract as well as the parties, as illustrated by some of the examples in the regulations. In two examples, the same organization receives different treatment from payments from governmental agencies. In one example, a Bureau of Solid Waste Management paid an exempt organization to conduct a feasibility study for a particular waste disposal system and to deliver a final report to the Bureau. The example concludes that this report is the result of scientific research and is being provided for the public good and the general functions of government, not a direct governmental need. The payment is therefore characterized as a grant. 31 On the other hand, a payment to the same organization by a local municipality was characterized as gross receipts where the payment funded a study of possible locations for a sewage disposal plant and a recommendation for the best location based on cost. 32

3. Section 509(a)(1) and Earmarking

As noted above, grants from Section 509(a)(1) organizations are includable in full as public support. However, an anti-abuse provision prohibits disqualified persons of the Section 509(a)(2) organization from earmarking a donation to the Section 509(a)(1) for the benefit of the Section 509(a)(2) organization. Such a grant to the Section 509(a)(2) organization will be treated as an indirect contribution and excluded from public support. 33

C. Issues in Determining Gross Receipts

1. Permitted Sources Still Subject to Limit

Despite the fact that 100% of donative support from permitted sources is includable in public support, exempt function gross receipts from each permitted source is subject to the 1% limitation - even Section 509(a)(1) public charities and governmental units.

For this purpose, each governmental bureau or agency is treated as a separate person; as a result, gross receipts from separate agencies are not aggregated when applying the 1% limitation. Within the federal government, a bureau or agency

29 Treas. Reg. § 1.509(a)-3(g)(1).
30 Treas. Reg. § 1.509(a)-3(g)(2).
31 Treas. Reg. § 1.509(a)-3(g)(3), Example 6.
32 Treas. Reg. § 1.509(a)-3(g)(3), Example 7.
33 Treas. Reg. § 1.509(a)-3(j)(2).
generally refers to the highest operational unit of government under a policy or administrative level led by a Level V Presidential appointment. Sometimes, this analysis may not be obvious.

2. Collected Payments/Payments on Behalf of Others

A single payment from a governmental body or another entity that aggregates funds collected from – or are paid on behalf of – a group of other persons may be attributable to the group and not the payor. If so, the payment is not aggregated for the purposes of the 1% limitation. For instance, the patients are treated as the payors of bulk Medicare or Medicaid payments made by a government agency.\(^34\) Similarly, hospitals that collect and remit to a blood bank fees collected from individual patients are not treated as the payor for the purposes of Section 509(a)(2).\(^35\)

D. One-Third Investment Income Limitation Issues

1. Social/Impact Investing: Gross Receipts or Investment Income?

The appropriate characterization of revenue as either exempt function gross receipts or investment income can be critically important, especially for organizations approaching the one-third investment income limitation. To this end, appropriately structured charitable debt or equity investments can result in exempt function income. The regulations provide that rental and loan income from a charitable class is considered gross receipts and not investment income to the extent the activities contribute importantly to the exempt organization’s purposes.\(^36\) In, PLR 200508018, the IRS applied this principle to an organization that made loans and purchased equity interests in various businesses in a foreign country pursuant to a federally sponsored development initiative.\(^37\) Notably, the basis for this organization’s exemption was lessening the burdens of government and not providing relief to the poor and distressed or some other charitable class.

2. Investment Income and Supporting Organizations

Public charities often create Section 509(a)(3) supporting organizations (discussed below) to perform a variety of functions. Fundraising and investment management constitutes common purposes for supporting organizations, particularly with respect to Section 509(a)(1) organizations. However, the one-third investment limitation potentially makes this an abusive strategy for Section 509(a)(2) organizations: such organizations approaching the limitation could simply dump the investments in a supporting organization and avoid reclassification as a public charity. To avoid this, the investment income resulting from assets transferred to a supporting organization from a Section 509(a)(2)


\(^{35}\) Rev. Rul. 75-387, 1975-2 CB 216.

\(^{36}\) Treas. Reg. § 1.509(a)-3(m)(2).

\(^{37}\) PLR 200508018 (Nov. 29, 2004).
organization will be attributed to the Section 509(a)(2) organization.\textsuperscript{38} Similarly, anti-abuse rules apply where the purpose of creating a supporting organization is to avoid failing the Section 509(a)(2) tests.\textsuperscript{39}

IV. \textbf{Specific Issues Under 509(a)(3)}

A. Overview

Section 509(a)(3) supporting organizations are a special class of public charities that do not have to pass a public support test. Instead, they derive public charity status by being organized and operated to benefit, perform the functions of, or carry out the purposes of one or more related public charities (or Section 501(c)(4), (5), or (6) organizations that would meet the Section 509(a)(2) tests if they were Section 501(c)(3) organizations). Supporting organizations are subject to their own organizational and operational tests (in addition to the threshold tests for Section 501(c)(3) status), and are further classified into three types (Types I, II, III) based on their relationships with their supported organizations.

To combat perceived tax abuses, Congress tamped down on supporting organizations in the Pension Protection Act of 2006 (“PPA”).\textsuperscript{40} Specifically, provisions of the PPA made it more difficult for donors to make an end run around the private foundation rules using the supporting organization form, particularly Type III. The PPA drew a distinction between Type III supporting organizations that are “functionally integrated” with their supported organizations and those that are not. Then, it subjected the latter to a set of restrictions, including imposing a new payout requirement, applying the excess business holdings rules, and severely curtailing grants from private foundations and donor advised funds.

Treasury and the Internal Revenue Service followed the PPA with several administrative actions, ultimately issuing final and temporary regulations at the end of 2012\textsuperscript{41} and additional guidance at the end of 2013 to provide interim answers to remaining questions.\textsuperscript{42} Collectively, this guidance sets forth the tests for supporting organizations to qualify as either functionally integrated or non-functionally integrated Type III supporting organizations, delineates the payout requirement for non-functionally integrated Type IIIIs, and provides grantors with processes to distinguish among the various types of supporting organizations.

The rules for supporting organizations are complex in and of themselves and beyond a full treatment for the purposes of this outline. However, a few common and outstanding issues are explored below.

\begin{itemize}
\item \textsuperscript{38} Treas. Reg. § 1.509(a)-5(a).
\item \textsuperscript{39} Treas. Reg. § 1.509(a)-5(b).
\item \textsuperscript{40} Pub. L. No. 109-208, 120 Stat. 780 (2006).
\item \textsuperscript{41} T.D. 9605 (Dec. 21, 2012).
\item \textsuperscript{42} Notice 2014-4, 2014-2 IRB 274.
\end{itemize}
B. Keeping Up With Donors

As a threshold matter, supporting organizations cannot be controlled by their disqualified persons determined in reference to Section 4946 (excluding foundation managers and other public charities). Primarily, this prohibition will relate to substantial contributors and their family members. The PPA added some additional complexity in the number and nature of the persons that some supporting organization must keep an eye on; it now prohibits a Type I or III supporting organization from receiving contributions from a donor (other than another public charity that is not a supporting organization) who controls the supported organization of the supporting organization (alone or together with the following), his or her family members, or his or her 35% controlled entities. Corollary rules for donor advised funds and private foundations prohibit grants to a supporting organization where the donor advisor or disqualified persons (respectively) control the supported organization. As a result, both supporting organizations and funders need to be aware of these possible relationships.

1. Uncertain Application for Section 501(c)(4), (5), or (6) Organizations

The rule prohibiting donations to a Type I or III supporting organization from a donor that controls the supported organization does not apply where the donor is another public charity. In other words, a public charity can control the supported organization (typically, another charity) and still contribute to the supporting organization. However, Section 501(c)(4), (5), and (6) organizations often have affiliated charities and supporting organizations, but do not appear to have the same treatment as charities in this regard. Notably, Congress made a technical fix to the PPA regarding a similar provision of Section 4958 to explicitly include non-charitable supported organization. This uncertainty particularly can be an issue in a complex family of organizations that are exempt on several bases.

C. Type III Sub-classification

Under the new regulations, a Type III supporting organization must satisfy a notification requirement, a responsiveness test, and an integral part test. The integral part test is the most critical factor, as it determines whether the organization is considered to be functionally integrated with its supported organization. If it is not functionally integrated, it must meet a different integral part test to be considered non-functionally
integrated and must adhere to a payout requirement. If it fails to meet either integral part test, it will not be considered a Type III supporting organization and classified as a private foundation unless it can qualify as a public charity on other grounds.

1. **Integral Part Test; Functionally Integrated:** A Type III supporting organization can qualify as functionally integrated through one of the three ways:

   a. **But For Test:** First, it can conduct activities substantially all of which (as determined under the facts and circumstances) directly further the exempt purposes of its supported organizations. For this purpose, such activities would, but for the involvement of the supporting organization, normally be performed or carried out by the supported organizations.

   (i) **Fundraising, Grantmaking, and Investment Management Disfavored:** Very importantly, certain activities commonly performed by supporting organizations are not considered to directly further the exempt purposes of supported organizations, including fundraising, grantmaking (whether to the supported organization or to third parties), and investing and managing nonexempt use assets (e.g., market rate endowment investments). As a result, a Type III supporting organization established to fundraise for or make grants in conjunction with its supported organizations is at risk of failing to be described as functionally integrated.

   b. **Parent Test:** A Type III can be considered functionally integrated if it is the parent entity of its supported organizations. For this purpose, a parent must appoint a majority of its supporting organizations’ governing body or officers of its supported organizations and exercise a substantial degree of direction over the activities, programs, and policies of the supported organizations. This type of relationship is commonly seen in complex health care organizations, but it could be appropriate in other families of exempt organization managed by central exempt coordinating entity, such as with affordable housing or charter school organizations. Often times, these organizations may be conducting what might not otherwise qualify as charitable activities, and must meet the threshold requirements of Section

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501(c)(3) under what is known (a bit confusingly) as the “integral part doctrine.” As the name suggests, this ends up being a somewhat of a circular analysis in this particular context. In any event, the supporting organization as parent model can have interesting interactions with other applicable tests, such as the responsiveness test.

c. **Supporting a Government Entity:** The final way for a Type III to be functionally integrated is by supporting a government entity. The 2012 regulations failed to provide guidance on the contours of this test, instead reserving the regulation for future action. The 2013 interim guidance, however, provides a temporary definition that supporting organizations and their funders may rely on. Until final regulations are published, a Type III supporting organization will be considered meet this functionally integrated test if (1) it supports one or more supported organization that is a governmental entity to which it is also responsive, as described above, and (2) it engages in activities that perform the functions of, or carry out the purposes of, such governmental organization, that, but for the involvement of the supporting organization, would normally be engaged in by the governmental entity itself. It is important to note that, unlike the general but-for test applicable to organizations supporting non-governmental entities, this current guidance does not explicitly exclude fundraising, grantmaking, or investment management activities, which are vital functions of supporting organizations to governmental organizations. However, the IRS has yet to propose regulations on this matter, and this position could be subject to change.

2. **Integral Part Test; Non-Functionally Integrated:** Generally, for a supporting organization to be considered non-functionally integrated, it must meet a distribution requirement and an attentiveness requirement. The distribution requirement establishes the “pay out” percentage required by the PPA, currently the greater of 85% of the supported organization’s adjusted net income and 3.5% of the fair market value of its non-exempt assets from the prior year. The attentiveness requirement ensures that at least one-third of such distributions are directed towards one or more supported organizations that are attentive to the supported organization’s operations and to which the supporting organization is responsive. A supported organization will be considered attentive to the supported organization if (i) the supporting organization provides to the supported organization at least 10% of the supported organization’s total support for the prior year; (ii) the supporting organization’s support is necessary to

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avoid the interruption of a substantial program or activity of the supported organization; or (iii) under the facts and circumstances. 60

D. Type IIIs and Grantor Reliance

Private foundations and donor advised funds cannot make grants to Type III non-functionally integrated supporting organizations. 61 The issue, of course, is how a grantor is to make such a determination. Revenue Procedure 2011-33 provides that grantors may rely on a supporting organization’s classification contained in the IRS Business Master File. 62 However, the IRS did not start classifying types of supporting organizations until after the PPA, and there is a multitude of supporting organizations that have not sought IRS determination as to type. For these organizations, the IRS issued procedures that grantors could follow in Notice 2006-109, 63 which were reinforced by Notice 2014-4 following the issuance of final regulations. 64 These procedures permit the grantor to rely on a written opinion of counsel or certain representations and documents provided by the organization. Each notice contains an applicable standard for Type III functionally integrated supporting organizations; critically though, the standards are materially different. Most notably, Notice 2006-109 applied a broader but-for standard based on the pre-PPA regulations that did not explicitly disfavor fundraising, grantmaking, or investment management. As a result, grantors could make grants to organizations that now no longer qualify under the current standards. Accordingly, grantors should not rely on any documentation provided pursuant to Notice 2006-109 going forward and should seek new documentation pursuant to Notice 2014-4 prior to making a grant.

Unfortunately, many Type III supporting organizations may not be aware that grantmaking, fundraising, and investment management are not appropriate activities for them (if substantial), which can put grantors in uncomfortable positions when representations do not match governing documents or other information. Moreover, the regulations are not clear as to what portion, if any, of a supporting organization’s activities may be devoted to the disfavored activities. 65

To further complicate things, the IRS may have issued determination letters classifying organizations as Type II functionally integrated based on standards that no longer apply. By way of background, following the PPA, the IRS announced its intentions for proposed regulations with an advance notice of proposed rulemaking on August 2, 2007. 66 This ANPR contemplated rules for Type III analogous to private operating foundations. EO

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60 Treas. Reg. 1.509(a)-4(i)(5)(i).
64 Section 4966(d)(4)(A); Section 4945(d)(4)(A)(ii); Section 4942(g)(4)(A)(i).
Determinations followed up with an internal memorandum authorizing determination letters indicating Type III functionally integrated status based on these standards.\textsuperscript{67} However, the IRS received significant pushback on these standards, and issued proposed regulations in 2009 that looked very different.\textsuperscript{68} After several years, the IRS tweaked things even further when final regulations were issued in 2012. As with the ANPR, EO Determinations issued an internal memorandum following the proposed and final regulations instructing that determination letters be issued applying the respective standards.\textsuperscript{69}

Each of these memoranda make it clear that any organization issued a determination letter would be required to meet the standards in final regulations, but this, of course, does not mean they have. The most material changes occurred between 2007 and 2009, and it is unlikely that many letters were issued during this time. Moreover, it seems likely that an organization that met the 2007 standards would also meet the current ones.

In any event, Revenue Procedure 2011-33 permits grantees to rely on the IRS determination as to type of supporting organization included in the BMF except where it (1) had knowledge of the revocation of the ruling or determination letter classifying the organization as one described in § 509(a)(1), (2), or (3) (or specifying its supporting organization type) prior to the publication of the revocation; or (2) was in part responsible for, or was aware of, the act or the failure to act that gave rise to the revocation of the ruling or determination letter classifying the organization as one described in § 509(a)(1), (2), or (3) (or specifying its supporting organization type).

\section*{V. Reporting Public Support}

Organizations should regularly assess whether they are meeting the public support test. New organizations that apply to the IRS for 501(c)(3) exemption as public charities are provided with a five-year “advance ruling” period in which to develop public support, and their IRS determination letter will reflect the applicable public charity classification. If, at the end of the advance ruling period, an organization cannot demonstrate public support, it will be reclassified as a private foundation. The IRS uses the financial information provided on the organization’s Form 990 at the end of the organization’s five-year advance ruling period to determine whether it continues to qualify as a public charity.

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Organizations that have been in existence longer than five years will need to report the level of public support on Schedule A of the Form 990 each year. The Form 990 is a public document, and it’s important to keep in mind that outside individuals and organizations may review the organization’s level of public support. If it becomes clear that an organization should no longer be classified as a public charity under the applicable public support test set forth in its IRS determination letter, then the organization can apply for reclassification of foundation status or for a change in Type of a 509(a)(3) organization by submitting Form 8940.