Complex Public Support Issues

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Overview

- Why Do We Care?
- 509(a)(1) Complexities
- 509(a)(2) Complexities
- 509(a)(3) Complexities
- Reporting Requirements
- Reclassifying Public Charity Classification
Why Do We Care?

- Private foundation excise taxes
- Deductibility of contributions by donors
- Private foundation expenditure responsibility requirements
- What you need to monitor varies, depending on public charity classification
Overview of Section 509(a)(1)

- Public support: grants, contributions, support from 170(c)(1) governmental units
  - Full amount of contributions from other 170(b)(1)(A)(vi) charities
  - Contributions by individuals, trusts, or corporations to the extent they don’t exceed 2% of total support
Overview of Section 509(a)(1) (Continued)

- Total support: gifts, grants, contributions, membership fees, net UBI, gross investment income, tax revenues, value of government services or facilities provided without charge

- Does not include contributions of services, exempt function income, value of exemptions, capital gains, loan repayments, and unusual grants
Overview of Section 509(a)(1) (Continued)

- 33-1/3% support test
- 10% “facts and circumstances” test
- Definition of “normally”
“Facts and Circumstances”
- Public support percentage exceeds 10%
- Support received from a representative number of persons rather than members of a single family
- Governing body is representative of broad public interest rather than personal and private interests of a limited number of donors or related persons
- Availability of facilities and services to the public and/or public participation in services and programs
“Facts and Circumstances”

- Members of public with special knowledge or expertise, public officials, and civic or community leaders participate in or sponsor programs
- Organization maintains a definitive program to accomplish its charitable work in the community
- 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
509(a)(1): Funds from the Government

- Exempt function income versus public support
  - Direct and immediate needs of government vs. service or facility for the direct benefit of the public
- Government subcontractor as payor of funds
  - PLR 79320924: USAID earmarked funds to a 501(c)(3) by virtue of its approval of the organization’s contract regarding the work
509(a)(1): Contributions from Partnerships

- Contributions by “an individual, trust, or corporation”

- Under Section 702(a)(4), a partner can take into account his or her distributive share of the partnership’s charitable contributions
509(a)(1): Support from Foreign Governments

- Section 170(c)(1): A state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia

- Revenue Ruling 75-435: contributions from a foreign government count fully toward public support
509(a)(1): Large Contributions and Endowments

- Endowments
  - Investment income is not public support
  - Use of supporting organizations

- Large Grants and Contributions
509(a)(1): Multi-Year Grants

- Compute public support based on the organization’s normal method of accounting

- Accrual-method organizations can sometimes face challenges with multi-year grants
509(a)(2) - Overview

Path for organizations that generally draw support from a combination of donative sources and exempt function income

- Two prong test:
  - One third of total support must come from public sources
  - No more than one third of total support can be derived from investments and unrelated business activities
509(a)(2) – Public Support

- Includes only support from governmental units, Section 509(a)(1) organizations, and other persons who are not disqualified persons (permitted sources)

- Two buckets of revenue
  - Gifts, grants, contributions, and membership fees:
    - Not subject to any limitation – 100% included
    - BUT – substantial contributors excluded
  - Gross receipts from exempt function activities
    - Includable only to the extent of the greater of $5,000 and 1% of total support for the taxable year
Two key questions for characterizing revenue:

- Is it from a permitted source (which determines whether it is includable)?
- Is it donative in nature or exempt function income (which determines whether it will be subject to limitation)?
Identifying substantial contributors – and excluding their support

- Any person (other than a permitted source) who has contributed more than $5,000 to the organizations if that amount is greater than 2% of total contributions since inception
- Historic record that must be tracked and maintained
- 509(a)(2) not really appropriate for organizations that have been or will be primarily donative in nature
Section 509(a)(1)
- 100% of gifts, grants or membership dues from Section 509(a)(1) organizations are includable
- But no earmarking by donors

Grants versus gross receipts
- Grants includable without limit (unless the grant makes the grantor a disqualified person)
- Contracts limited to 1%
- Can be a nuanced determination
509(a)(2) – Determining Gross Receipts

- Permitted sources still subject to limit
  - Even 509(a)(1) organizations and governmental units
  - Each governmental bureau or agency is treated as a separate person

- Collected Payments on Behalf of Others
  - A single payment from an entity that collects funds from a group of persons is not aggregated for the purposes of the 1% limitation
  - A question of agency; might get fuzzy in certain circumstances
509(a)(2) – Investment Income Limitation

- Social/Impact Investing: Gross receipts or investment income?
  - Treas. Reg. § 1.509(a)-3(m)(2): rental or loan income from a charitable class considered gross receipts and not investment income
  - PLR 200508018: income from loans and equity interests in various businesses pursuant to a federally funded development initiative characterized as gross receipts
- Notably, the basis for exemption: lessening the burdens of government
Section 509(a)(3): What isn’t complex?

“Why, yes, we are a Section 501(c)(3) organization classified as a Type III functionally integrated Section 509(a)(3) supporting organization!”
Section 509(a)(3): Keeping up with the Jones

- Supporting organizations cannot be controlled by their disqualified persons
- Type I and III supporting organizations cannot receive contributions from a donor who controls the supported organization, his or her family members and 35% controlled entities
- DAFs and private foundations cannot make grants to supporting organizations where the donor advisor or disqualified persons control the supported organizations
- Automatic excess benefit transactions
Section 509(a)(3) – Type III Sub-Classification

- Functionally Integrated Versus Non-Functionally Integrated
  - Vital distinction
  - Non-Functionally Integrated Type III organizations subject to a payout requirement and generally cannot receive DAF and private foundation grant support
Section 509(a)(3) – Integral Part Test

- Three ways to qualify as integrally related
  - But For Test: conducts activities substantially all of which directly further the exempt purposes of its supported organization and but for the involvement of the supporting organization, the supported organization would normally carry them out
  - Fundraising, grantmaking, and investment management of nonexempt use assets do not directly further exempt purposes
Section 509(a)(3) – Integral Part Test (cont’d)

- Three ways to qualify as integrally related (cont’d)
  - Parent Test: The supporting organization can be the parent of its supported organizations
    - Must appoint a majority of the governing bodies and exercise a substantial degree of direction
    - Often times, this type of entity qualifies as exempt under the broader “integral part doctrine”
  - Supporting a Government Entity:
    - Interim guidance under 2014-4, 2014-2 IRB 274
Section 509(a)(3) – Integral Part Test

- Non-Functionally Integrated Type IIIs must fulfill two requirements:
  - Distribution (or payout) requirement: currently, the greater of 85% of the organization’s adjusted net income and 3.5% of the FMV of non-exempt assets
  - Attentiveness requirement: at least one third of required distributions are directed to one or more supported organizations that are attentive to the supported organization
Section 509(a)(3) – Integral Part Test

- A supported organization will be deemed to be attentive if:
  - The supporting organization provides at least 10% of the supported organization’s total support;
  - The supporting organization’s support is necessary to avoid the interruption of a substantial program or activity of the supported organization; or
  - Under the facts and circumstances
Section 509(a)(3) – Grantor Reliance

- Most supporting organizations have not been classified by IRS with respect to type
- Grantors may rely on following certain procedures first set forth in Notice 2006-109 and reinforced in Notice 2014-4
- Notice 2014-4 applies the standards established in the final regulations – grantors need current documentation
- Grantmaking, fundraising, and investment management may be an issue
About those determination letters...

- IRS announced its intention to propose regulations in 2007, issued proposed regulations in 2009 (very different than what was originally contemplated), and final regulations in 2012
- Began issuing determination letters as to type in 2007 based on the then current guidance, which has been somewhat fluid
Section 509(a)(3) – Form 990 Changes

- Schedule A underwent a significant revision to reflect the various tests for supporting organizations
- Could result in a spate of determinations or reclassifications
Reporting Public Support

- Five Year Advance Ruling Period
- Schedule A of the Form 990
Reclassifying Public Charity Status

- Form 8940

- Written request plus supporting documentation, depending on the type of classification requested