

Supporting Organizations Guide Sheet Explanation

Type I and Type II

March 13, 2008

This Guide Sheet Explanation is designed to provide an overview of exempt organization tax law rules applicable to supporting organizations and to assist in preparation of the IRC 509(a)(3) Supporting Organizations Guide Sheet Type I and Type II. A separate explanation and guide sheet is available Type III supporting organizations.

OVERVIEW

Background

Every organization described in IRC 501(c)(3) is further classified under IRC 509(a) as either 1) a private foundation, or 2) other than a private foundation if it qualifies under IRC 509(a)(1), (2), (3), or (4).

Private foundations typically have a single major source of funding (usually gifts from one family or corporation rather than funding from many sources). Organizations that are qualified under IRC 509(a)(1) include churches, hospitals, qualified medical research organizations affiliated with hospitals, schools, colleges and universities, and organizations that have an active program of fundraising and receive contributions from many sources, including the general public, governmental agencies, corporations, private foundations or other public charities. Organizations qualified under IRC 509(a)(2) receive income from the conduct of activities in furtherance of the organization's exempt purposes. Organizations qualified under IRC 509(a)(3) actively function in a supporting relationship to one or more IRC 509(a)(1) or (2) organizations.

An organization may request IRC 509(a)(3) status either 1) when it initially files a Form 1023 application for IRC 501(c)(3) exemption, or 2) subsequently, by requesting a determination letter that changes its existing foundation status. A nonexempt charitable trust described in IRC 4947(a)(1) may also request a determination that it is described in IRC 509(a)(3), even though it is has not been recognized as an IRC 501(c)(3) organization, pursuant to Revenue Procedure 72-50, 1972-2 I.R.B. 830. For information about Rev. Proc. 72-50, see FY 1980 Continuing Professional Education text entitled *General Explanation of Trusts Subject to Section 4947 of the Internal Revenue Code*.

The Pension Protection Act of 2006 (PPA of 2006) modified the statutory scheme applicable to supporting organizations to address concerns that some supporting organizations were being used to inappropriately benefit private interests. This guide sheet inquires about supporting organization arrangements that lend themselves to private benefit abuses, including situations where a supporting organization makes loans, grants, or compensation payments to or for the benefit of donors or donors' families and businesses. The guide sheet also inquires about situations where the supporting organization is a recipient of closely held stock, personal residences, partnership interests,

sole proprietorships, or insurance policies, as these asset types may be manipulated for the benefit of donors or donors' families and businesses. In these circumstances, one needs to consider possible denial of IRC 501(c)(3) exemption, or possible denial of IRC 509(a)(3) supporting organization status.

Types

In general, supporting organizations have been identified by the type of relationship they have with their supported IRC 509(a)(1) or (2) organizations. Under the PPA of 2006, supporting organizations are classified into Type I, Type II, or Type III supporting organizations. The names are new, but they merely reflect the existing three relationships with supported organizations described in the current regulations. Type I supporting organizations are operated, supervised, or controlled by one or more IRC 509(a)(1) or (2) organizations. Type II supporting organizations are supervised or controlled in connection with one or more IRC 509(a)(1) or (2) organizations. Type III supporting organizations are operated in connection with one or more IRC 509(a)(1) or (2) organizations. The PPA of 2006 classifies Type III supporting organizations into the following two categories: Type III supporting organizations that are not functionally integrated or functionally integrated Type III supporting organizations.

Type III supporting organizations that are not functionally integrated are subject to excess business holding rules under IRC 4943 and must meet annual payout requirements. Further, private foundations are prohibited from treating grants made to Type III supporting organizations that are not functionally integrated as qualifying distributions under IRC 4942.

Functionally integrated Type III supporting organizations are not subject to excess business holding rules of IRC 4943, are not subject to annual payout requirements, and private foundations may treat grants to functionally integrated Type III supporting organizations as qualifying distributions under IRC 4942.

Until final guidance is issued that defines functionally integrated Type III supporting organizations as described in IRC 509(d) and 4943(f)(5)(B), the IRS is generally suspending the issuance of determination letters to this category of Type III organizations other than organizations that choose to meet the advance notice of proposed rulemaking. [See Advance Notice of Proposed Rulemaking (ANPRM), 72 Fed. Reg. 42335 (Aug. 2, 2007). This ANPRM is available from the IRS website at www.irs.gov under Charities and Nonprofits.]

The ANPRM sets forth criteria for qualifying as a functionally integrated Type III supporting organization. If a Type III supporting organization chooses to meet the ANPRM, IRS may issue a determination letter that classifies it as a functionally integrated Type III supporting organization. Of course, the organization would have to comply with the regulations that define functionally integrated Type III supporting organizations when they are finalized. If an organization chooses not to agree to comply with the ANPRM, it can qualify for a determination letter that classifies it as a Type III

supporting organization without determining whether it is or is not functionally integrated. In this case, Notice 2006-109, 2006-51 I.R.B. 1121, provides rules on which private foundations can rely to ensure they are not making grants to Type III supporting organizations that are not functionally integrated. Finally, Announcement 2006-93, 2006-48 I.R.B.1017, provides for an expedited process whereby organizations that are classified as IRC 509(a)(3) supporting organizations may, if they qualify for the status, obtain a determination letter that modifies their foundation classification to IRC 509(a)(1) or (2).

A supporting organization must meet an organizational test that requires it to contain provisions in its organizational document (e.g. articles of incorporation, trust instrument, articles of association, or articles of organization) that limit its purposes to operate exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more IRC 509(a)(1) or (2) organizations. A supporting organization must also meet an operational test that requires it to engage solely in activities that support one or more publicly supported organizations. A supporting organization may not be controlled directly or indirectly by a disqualified person. Effective August 17, 2006 the PPA of 2006 provides that neither a Type I nor Type III supporting organization qualifies as a supporting organization if it accepts gifts from a person (other than a IRC 509(a)(1), (2), or (4) organization) that directly or indirectly controls (alone, or together with family members and 35 percent controlled organizations) the governing body of a supported organization.

A Type I supporting organization must be operated, supervised, or controlled by one or more publicly supported organizations. The relationship between the supported organization and the supporting organization is like a parent-subsidiary relationship. This relationship exists where one or more supported organizations (by their governing bodies, members of the governing bodies, officers acting in their official capacities, or their membership) elect or appoint a majority of the organization's officers, directors, or trustees.

A Type II supporting organization must be supervised or controlled in connection with one or more publicly supported organizations. A Type II relationship is like a brother sister relationship. In a Type II relationship, the same persons control or manage both the supporting organization and the supported organization.

SPECIFIC EXPLANATION KEYED TO GUIDE SHEET

PART I: ORGANIZATIONAL TEST UNDER IRC 509(a)(3)(A)

An organization must meet the organizational test to qualify under IRC 509(a)(3). If a supporting organization does not meet the Organizational Test, it is not qualified under IRC 509(a)(3). Special organizational test rules pertain to supporting organization that support IRC 501(c)(4), (5) or (6) organizations. Therefore, complete Section II below instead of Section I to demonstrate that an organization meets the organizational test

where it seeks to qualify under 509(a)(3) because it is supporting an IRC 501(c)(4), (5) or (6) organization.

Section I – Organizational Test for an organization supporting IRC 509(a)(1) or 509(a)(2) public charities

A. Is the supporting organization requesting classification as a Type I or II supporting organization? If "No", refer case to 509(a)(3) Type III reserved inventory. If "Yes", to satisfy the organizational test there must be a "Yes" answer to one of the questions B, C or D below. In addition, all three components of question E must be met.

A Type I or II supporting organization's organizing document must limit its purposes to supporting one or more IRC 509(a)(1) or (2) organizations. Although the organizing document may accomplish this limitation in a variety of ways, the organizing document may not contain any provisions that are inconsistent with its stated purpose of supporting the specified organization(s). For purposes of this guide sheet, the term "organizing document" means a trust instrument, corporate charter, articles of incorporation, articles of association, or other written instrument by which the organization is created under state law.

B through D - A supporting organization seeking to qualify as a Type I supporting organization (operated, supervised or controlled by relationship), or Type II supporting organization (supervised or controlled in connection with relationship) has three methods by which it may specify the publicly supported organization on whose behalf the organization is to be operated.

One method is to designate the supported organization by name in its organizing document. For example, X is an organization described in section 501(c)(3) which operates for the benefit of Y, an institution of higher learning that controls X and is a section 509(a)(1) organization. X's articles will meet the organizational test if they provide for the giving of scholarships to enable students to attend Y.

Another method is to designate the supported organization by class or purpose instead of by name. For example, M is an organization described in section 501(c)(3) which was organized and operated by representatives of N church to run a home for the aged. M is controlled by N church, a section 509(a)(1) organization. Care of the sick and aged are long-standing temporal functions and purposes of organized religion. By operating a home for the aged, M is operating to support or benefit N church in carrying out one of its temporal purposes. Thus M's articles will meet the organizational test if they require M to care for the aged since M is operating to support one of N church's purposes (without designating N church by name). See section 1.509(a)-4(d) of the Income Tax Regulations.

The third method is by showing the existence of a historic and continuing relationship and, by reason of such relationship, there has developed a substantial identity of interests

between such organizations. A disqualified person cannot have authority or discretion to designate beneficiaries other than those specified by name, class, or purpose in the organizing document. See Quarrie v. Commissioner, 70 T.C. 182 (1978).

B. Does the supporting organization’s organizing document specify by name the IRC 509(a)(1) or (2) organization(s) it supports? If “Yes,” skip to E below.

C. Does the supporting organization’s organizing document identify the IRC 509(a)(1) or (2) organization(s) it supports by class or purpose? If “Yes,” skip to E below.

D. Do the supporting organization and the supported organization(s) have a historic and continuing relationship such that there is a substantial identity of interests between the two organizations?

E. To meet the organizational test, there must be a “Yes” answer to E (1) and a “No” answer to E(2) and E(3).

E(1) through E(3) - A Type I (operated, supervised or controlled by) or Type II (supervised or controlled in connection with) supporting organization must contain provisions in its organizing document that limit its purposes to one or more purposes that are similar to, but no broader than, the purposes set forth in the governing instruments of its controlling IRC 509(a)(1) or (a)(2) organizations. In addition, the organizing document may not contain provisions that expressly empower it to (1) engage in activities that do not support its supported organizations, or (2) support organizations that are not specified by name, purpose, or class.

E(1) Does the organization’s organizing document limit its purposes to provide that it 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 one or more specified 509(a)(1) or (a)(2) organizations?

E(2) Does the organization’s organizing document expressly empower it to engage in activities which are not in furtherance of the purposes stated in (E)(1) above?

E(3) Does the organization’s organizing document expressly empower it to operate to support or benefit any organization not specified by name, purpose, or class in its organizing document?

Section II – Organizations Operating in Conjunction With Certain IRC 501(c)(4), (5) or (6) organizations

Special organizational test rules pertain to supporting organizations that support IRC 501(c)(4), (5) or (6) organizations. Therefore, complete this Section II rather than Section I to demonstrate that an organization meets the organizational test where it seeks to qualify under IRC 509(a)(3) because it is supporting an IRC 501(c)(4), (5) or (6)

organization. For purposes of this guide sheet, the term “organizing document” means a trust instrument, corporate charter, articles of incorporation, articles of association, or other written instrument by which the organization is created under state law.

A Does the supporting organization claim to support an IRC 501(c)(4), (5) or (6) organization? If “Yes,” proceed to questions B through E.

Questions A through D are directed to whether the supporting organization meets the IRC 509(a)(3) requirements where its supported organization is an IRC 501(c)(4), (5) or (6) organization. See Reg. 1.509(a)-4(c)(1).

B Does the IRC 501(c)(4), (5) or (6) organization meet the public support tests of IRC 509(a)(2)?

A supporting organization may support an IRC 501(c)(4), (5) or (6) organization if such organization would be classified as an IRC 509(a)(2) public charity. In other words, if the IRC 501(c)(4), (5) or (6) organization was uprooted and transplanted in IRC 501(c)(3) soil, would it qualify under IRC 509(a)(2). Therefore, the IRC 501(c)(4), (5) or (6) organization must meet the support tests of 509(a)(2), namely that (1) more than one third of its support is derived from gifts, grants, contributions, or membership fees, or gross receipts from permitted sources, and (2) not more than one-third of its support is derived from the sum of its gross investment income and unrelated business taxable income less IRC 511 income taxes.

C Does the supporting organization meet the organizational test by stating in its organizing document that it will carry on exclusively charitable purposes, which can include religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals within the meaning of IRC 170(c)(2)?

A supporting organization can not state in its organizing document that it is organized and operated exclusively to support a named IRC 501(c)(4), (5) or (6) organization because this would fail the 501(c)(3) organizational test. In this circumstance, the supporting organization will meet the IRC 509(a)(3) organizational test by stating in its organizing document that it will carry on exclusively charitable purposes. These purposes can include one or more of the following purposes: religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals within the meaning of section 170(c)(2). This rule is further explained in Rev. Rul. 76-401, 1976-2 C. B. 175.

D Does the supporting organization meet the Type I or II relationship requirement?

Because a supporting organization that is supporting an IRC 501(c)(4), (5) or (6) organization can not name the organization that it is supporting in its organizing document, it cannot qualify as a Type III under the “operated in connection with” relationship. Therefore, the supporting organization must meet the Type I or Type II

relationships by demonstrating either that the members of its governing board are appointed by the IRC 501(c)(4), (5) or (6) organization (Type I), or that a majority of its board are also members of the IRC 501(c)(4), (5) or (6) organization (Type II). This rule is also further explained in Rev. Rul. 76-401.

E Does the supporting organization have sufficient safeguards to ensure its support is used exclusively for charitable purposes?

Question E is directed to whether the supporting organization meets the IRC 501(c)(3) requirement that it retain control and discretion over the use of its funds for its exempt purposes. Rev. Rul. 68-489, 1968-2 C.B. 210 discusses the control and discretion requirement when a charity distributes funds to an organization that is not qualified under IRC 501(c)(3).

For example, does the supporting have safeguards in place to ensure that any payments made to an IRC 501(c)(4), (5) or (6) organization are used exclusively in furtherance of the supporting organization's charitable purposes? IRC 501(c)(4), (5) or (6) organizations, by their very nature, are not organized and operated for purposes that are exclusively charitable. Therefore, it is incumbent upon the supporting organization to ensure that payments given to IRC 501(c)(4), (5) or (6) organizations are used in furtherance of the supporting organization's charitable purposes.

- The payment cannot be used for political intervention and any payment made to the supported organization for lobbying expenditures must be attributed to the supporting organization's lobbying limitation.
- A supporting organization can help to ensure that payments made to an IRC 501(c)(4), (5) or (6) organization are used exclusively for charitable purposes by, for example, making restricted use grants limited to charitable purposes when distributing funds directly to an organization that does not qualify under IRC 501(c)(3).
- Therefore, it would be appropriate to inquire about what restrictions are placed on funds expended by an IRC 509(a)(3) organization that is organized and operated to support an IRC 501(c)(4), (5) or (6) organization, including (1) restrictions on the use of grants for exclusively charitable purposes, (2) reports regarding the use of grants, and (3) conditions on the use of funds that are not expended for the stated charitable purposes for which the grant was made.

PART 2: OPERATIONAL TEST UNDER IRC 509(a)(3)(A)

An organization must meet the operational test to qualify under IRC 509(a)(3). If an organization does not meet requirements of either A or B below or a combination of A and B below, it does not meet the operational test.

A. Does the organization make payments to or for the use of the specified IRC 509(a)(1) or (2) organization(s)? To meet the operational test under this section, there must be a “Yes” answer to A(1), A(2), A(3), or A(4) below. If “No,” the organization must meet B below to meet the operational test.

The specified IRC 509(a)(1) or (2) organizations are those organizations that the supporting organization is organized and operated to support.

A(1) Does the organization make payments only to or for the use of one or more specified IRC 509(a)(1) or (2) organizations?

A(2) Does the organization make payments to or for the use of individual members of the charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s)?

A(3) Does the organization make payments indirectly through another unrelated organization to or for the use of a member of a charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s), but only if the payment constitutes a grant to an individual rather than a grant to an organization?

A(4) Does the organization make payments to or for the use of another supporting organization that also supports or benefits the specified IRC 509(a)(1) or (2) organization(s)?

The organization may also make payments to or for the use of a college or university described in IRC 511(a)(2)(B).

B. Does the organization provide services or facilities to or for the use of the specified IRC 509(a)(1) or (2) organization(s)? To meet the operational test under this section, there must be a “Yes” answer to B(1), B(2), or B(3) below. If “no,” the organization must meet A above to meet the operational test.

B(1) Does the organization provide services or facilities only to or for the use of one or more specified IRC 509(a)(1) or (2) organizations?

B(2) Does the organization provide services or facilities to or for the use of individual members of the charitable class benefited by the specified IRC 509(a)(1) or (2) organization(s)?

B(3) Does the organization provide services or facilities to or for the use of another supporting organization that also supports or benefits the specified IRC 509(a)(1) or (2) organization(s)?

The organization may also provide services or facilities to or for the use of a college or

university described in IRC 511(a)(2)(B).

PART 3: CONTROL TEST UNDER IRC 509(a)(3)(C)

An IRC 509(a)(3) organization cannot be controlled by disqualified persons (other than foundation managers). Questions A through F require a “No” answer. Questions G through L are facts and circumstances questions that require additional scrutiny if answered “Yes.”

Persons who are in a position of serving on the governing board of the supported organization may also be directors, trustees or officers of the supporting organization in order to improve the supporting organization’s operations and exercise appropriate supervision and control.

Disqualified persons may also serve on the governing board of the supporting organization. Disqualified persons consist of all the disqualified persons defined in IRC 4946, except foundation managers who are disqualified persons solely because of their status as foundation managers. Disqualified persons include (1) a substantial contributor; (2) foundation managers (officers, directors, trustees, and persons with similar powers); (3) an individual with 20% or more voting power of a corporation (or profits interest in a partnership or beneficial interest in a trust) that is a substantial contributor; (4) a lineal descendent or ancestor of a family member of the individuals above; or (5) a corporation, partnership, or trust in which persons described in 1-4 above own more than 35% of the profit interests. IRC 509(a)(1) or (2) organizations and foundation managers who are disqualified persons only as a result of being foundation managers are not treated as disqualified persons.

The presence of any disqualified persons (with the exceptions noted above) on a supporting organization’s governing body is cause for close examination of whether prohibited control is present. Although control is generally present where a disqualified person can aggregate a majority of the voting power, veto power also constitutes control. In addition, control by disqualified persons may be present even in the absence of a majority of the voting power or veto power if disqualified persons control decisions based on all of the facts and circumstances. See Reg. 1.509(a)-4(j) for rules regarding control by disqualified persons.

A Is the organization controlled directly or indirectly by disqualified persons because disqualified persons on the governing board can potentially aggregate their votes together to control the operations of the supporting organization?

One example of impermissible control is where the board of directors consists of five directors, two are disqualified persons, two are appointed by the supported charity, and the final director is a so-called “independent” director appointed by the disqualified persons. Appointment of the fifth director by disqualified persons represents “indirect” control by disqualified persons.

B Is the organization controlled directly or indirectly by disqualified persons because disqualified persons on the governing board can potentially aggregate their votes together with other board members who provide personal services to the disqualified persons, such as legal, accounting, or investment advice, to control the operations of the supporting organization?

An example of indirect control described in Rev. Rul. 80-207, 1980-2 C.B. 113 involves an IRC 501(c)(3) organization whose purpose is to make distributions to a university described in IRC 509(a)(1) and 170(b)(1)(A)(ii). The organization is controlled by a four member board of directors. One of these directors is a substantial contributor to the organization. Two other directors are employees of a business corporation of which more than 35 percent of the voting power is owned by the substantial contributor. The remaining director is chosen by the university. None of the directors has a veto power over the organization's actions. Reg. 1.509(a)-4(j) provides that all pertinent facts and circumstances will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization. One circumstance to be considered is whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons. In this example, employees of a disqualified person are considered to be subject to the influence of a disqualified person in determining whether one or more disqualified persons control 50 percent or more of the voting power of an organization's governing body. Since the organization was controlled by a disqualified person and the employees of a disqualified person, it was determined not to qualify as a supporting organization.

An analogous example of control is a four person board of directors made up of one disqualified person, two persons appointed by the supported charity, and a fifth director who is paid by the disqualified persons for accounting, legal, or investment advice apart from the affairs of the supporting organization. Since the disqualified person is in a position to influence the decisions of the fifth director, this factor would need to be taken into consideration as evidence of indirect control by the disqualified person.

C Do disqualified persons have the right to appoint the nominating committee or successor governing board members?

Another way that control may be exercised indirectly by disqualified persons is where two disqualified persons on a five member board of directors are authorized to select all nominees for the fifth so-called "independent" director position. Even if the two charity appointed directors then appoint the fifth director from among the list of selected nominees, control over the board resides with the disqualified persons.

D Is the organization controlled directly by disqualified persons because the disqualified persons either have 50% of the voting power on the governing board or a veto power over the supporting organization's activities?

Voting power may also be maintained through voting rights. For example, a publicly supported organization may be entitled to appoint four out of five of the members of the

board of directors. The fifth director must be a disqualified person. If the disqualified person has an 80 percent vote on all major decisions of the organization, voting power is retained through voting rights regardless of representation on the board of directors.

E Is the organization controlled directly or indirectly by disqualified persons because disqualified persons have veto power over the supporting organization's activities?

Reg. 1.509(a)-4(j) provides that a supporting organization will be considered to be controlled by one or more disqualified persons if a disqualified person has the right to exercise veto power over the action of the organization. A veto situation is also deemed to exist where a two member board of directors of a supporting organization is made up of one disqualified person board member and one appointed by the supported organization.

F Is the organization controlled directly because the disqualified persons control the primary assets of the supporting organization?

If a disqualified person does not control the board but continues to control the supporting organization's assets after the assets are transferred to the supporting organization, the disqualified person virtually controls the organization by control of the assets. This position is suggested in Reg. 1.509(a)-4(j). The following items G through K relate to various forms of control of the supporting organization's assets by a disqualified person.

G Does a disqualified person own a general partnership interest in a limited partnership in which the supporting organization owns an interest?

The general partner of a limited partnership generally is responsible for the management of the partnership and usually the general partner makes most or all important decisions for the partnership, including the distribution of income to partners. If a disqualified person holds a 1 percent general partnership interest and the supported organization holds a 99 percent limited partnership interest (in most cases received from the disqualified person), the disqualified person is able to control the partnership and thus control the supporting organization's only or primary asset.

H Does a disqualified person own an interest of 51% or more of the voting stock of a corporation in which the supporting organization is a stockholder?

If a disqualified person holds 85 percent of the stock of a closely-held corporation and transfers 5 percent of such stock to the supporting organization which constitutes the supporting organization's only or primary asset, the 80 percent ownership of the corporation allows the disqualified person to effectively influence the economic rights associated with ownership of a minority interest in the corporation such as the five percent stock held by the supporting organization.

I Does a disqualified person hold 51% or more control of a corporation through a

voting trust or other voting arrangement in which the supporting organization is a stockholder?

Control of a closely held corporation may also be maintained through a voting trust or voting rights. Thus, if the supporting organization owns 90 percent of the stock of a closely held corporation and the disqualified person holds only five percent of the stock, the disqualified person may still be entitled to maintain voting control of such corporation through a voting trust arrangement or other voting rights.

J Does a disqualified person have a controlling interest in a limited liability corporation (LLC) in which the supporting organization has an interest?

Control of a limited liability company may be maintained by a disqualified person in a manner similar to the corporate and partnership examples described above.

K Does a disqualified person have an ownership interest in assets such as real estate, insurance, art work, collectibles, intellectual property, promissory notes, or other assets in which the supporting organization also has an interest?

A disqualified person may also maintain control of real property or tangible or intangible personal property through joint ownership arrangements. For real or tangible personal property, the control may also be facilitated by the possession of the property by the disqualified person through lease or custody arrangements. The real or personal property may also be used in the business of the disqualified person.

Also, consider a situation where the disqualified person donated a valuable collection of antique automobiles to a supporting organization, the collection is maintained in a warehouse at the country residence of the disqualified person, and the warehouse is leased to the supporting organization. In this situation, the disqualified person still controls the collection by controlling access.

L Do donors or their family members have the right to provide advice to the supporting organization regarding investments or grant making?

(a) Consider what safeguards are in place to ensure that disqualified persons are not in control of investment or grant making decisions of the supporting organization.

(b) For example, determine if there is an “advisory committee” or similar arrangement created in the trust agreement or other organizing documents conferring on the donor or members of the family the right to select grant recipients which must be accepted by the supporting organization.

M Taking into account all of the facts and circumstances, including information described in questions G through L, are disqualified persons in a position to directly or indirectly control the decisions made by the supporting organization?

Consider any number of ways that the disqualified person may control the use or enjoyment of assets transferred to and held by the supporting organization.

PART 4: RELATIONSHIP REQUIREMENT UNDER IRC 509(a)(3)(B)

An organization must meet either Section I below to qualify as a Type I Supporting Organization or Section II below to qualify as a Type II Supporting Organization. The specific requirement for a Type I Supporting organization is contained in Reg. 1.509(a)-4(g). The specific requirement for a Type II Supporting Organization is contained in Reg. 1.509(a)-4(h).

Section I – Type I “Operated, Supervised or Controlled By”

A. Is the supporting organization seeking to meet the “operated, supervised or controlled by” relationship test with respect to one or more IRC 509(a)(1) or (2) organizations? If “No,” see Section II below or refer the case to 509(a)(3) Type III reserve inventory.

A Type I supporting organization is operated, supervised, or controlled by one or more public charities (supported organizations) described in IRC 509(a)(1) or (2). IRC 509(a)(3)(B)(i).

B. Are a majority of the supporting organization’s officers, directors, or trustees appointed or elected by a supported organization’s officers, directors, trustees or membership?

A supporting organization is operated, supervised, or controlled by an IRC 509(a)(1) or (2) organization if a majority of the supporting organization’s officers, directors or trustees are appointed or elected by a supported organization’s officers, directors, trustees or membership. This is similar to a parent/subsidiary relationship. IRC 509(a)(3)(B)(i) and Reg. 1.509(a)-4(g). These persons who are in a position of serving on the governing board of the supporting organization may also be directors, trustees or officers of the supported organization in order to improve the supporting organization’s operations and exercise appropriate supervision and control.

C. Does the supporting organization accept gifts or contributions from any person (other than a public charity described in IRC 509(a)(1), (2), or (4)) who directly or indirectly controls the governing body of a supported organization (alone, or together with family members or a 35% controlled organization)? If “No,” proceed to the next question. If “Yes,” the organization does not meet this requirement.

A supporting organization will fail to qualify as a Type 1 supporting organization if a donor to the supporting organization controls directly or indirectly an IRC 509(a)(1) or (2) supported organization that the Type 1 supporting organization supports. It will also fail to qualify if the organization accepts a gift or contribution from a member of that

donor's family (as defined in IRC 4958(f)(4)) or from the donor's 35% controlled entity. Direct or indirect control of a supported organization is determined through any combination of the donor, the donor's family members, and the donor's 35% controlled entity. See IRC 509(f)(2)(A)(i) and (f)(2)(B). This rule does not apply to donors that are themselves IRC 509(a)(1), (2) or (4) organizations.

D. Does the supporting organization support organizations that are not organized in the United States? If "No," skip D(1), D(2), and D(3). If "Yes," proceed to these questions. There must be a "Yes" answer to either D(1) or D(2), and a "Yes" to D3 for the organization to qualify under IRC 509(a)(3).

D(1) Is the foreign supported organization recognized by the IRS as exempt under IRC 501(c)(3) and a public charity under section 509(a)(1) or (2)? OR

D(2) Is the foreign supported organization described in IRC 501(c)(3) and a public charity described under IRC 509(a)(1) or (2)?

D(3) Does the organization retain control and discretion over the funds distributed to the foreign organization? See Rev. Ruls. 74-229 and 66-79 for more information regarding qualification and deductibility.

A Type I or Type II supporting organization is not specifically precluded from supporting a foreign charity unlike the way in which section 509(f)(1)(B) prohibits a Type III supporting organization from supporting foreign charities. However, all supporting organizations are limited to supporting only section 509(a)(1) or (2) public charities. If the foreign supported charity has received exemption from the Service under section 501(c)(3) as a 509(a)(1) or (2) public charity then such charity may be supported by a Type I or Type II supporting organization. Similarly, Rev. Rul. 74-229, 1974-1 C.B. 142 provides another avenue for a Type I or Type II supporting organization to support a foreign charity. Under Rev. Rul. 74-229, a Type I or Type II supporting organization may support a foreign charity if such charity is described in (but not exempt under) section 501(c)(3) and would meet the requirements of section 509(a)(1) or 509(a)(2) if it applied. In this circumstance, the supporting organization should be asked for information sufficient to demonstrate that the foreign charity would qualify under IRC 501(c)(3) and IRC 509(a)(1) or (2). Rev. Rul. 66-79 provides information regarding charitable contribution deductions when a domestic charitable organization is supporting a foreign charity. Also, see PLR 9651031 for an example of this situation.

Section II - Type II "Supervised or Controlled in Connection With"

A Is the organization seeking to meet the "supervised or controlled in connection with" relationship test with respect to one or more IRC 509(a)(1) or (2) organizations? If "Yes," continue. If "No," see Section I above or refer case to 509(a)(3) Type III reserve inventory.

A Type II supporting organization is supervised or controlled in connection with one or

more public charities (supported organizations) described in IRC 509(a)(1) or (2). IRC 509(a)(3)(B)(ii).

B. Is control or management of the supporting organization placed with the same persons that control or manage the supported organization?

A supporting organization is supervised or controlled in connection with an IRC 509(a)(1) or (2) organization if control or management of the supporting organization is placed with the same persons that control or manage the supported organization. An example is the presence of the same directors seated on the boards of both organizations. This is similar to a brother/sister relationship. IRC 509(A)(3)(B)(ii) and Reg. 1.509(a)-4(h).

C. Does the supporting organization support organizations that are not organized in the United States? If “No,” skip C(1), C(2), and C(3). If “Yes,” proceed to these questions. There must be a “Yes” answer to either C(1) or C(2), and a “Yes” to C(3) for the organization to qualify under IRC 509(a)(3).

C(1) Is the foreign supported organization recognized by the IRS as exempt under IRC 501(c)(3) and a public charity under section 509(a)(1) or (2)? OR

C(2) Is the foreign supported organization described in IRC 501(c)(3) and a public charity described under IRC 509(a)(1) or (2)?

C(3) Does the organization retain control and discretion over the funds distributed to the foreign organization? See Rev. Ruls. 74-229 and 66-79 for more information regarding qualification and deductibility.

A Type I or Type II supporting organization is not specifically precluded from supporting a foreign charity unlike the way in which section 509(f)(1)(B) prohibits a Type III supporting organization from supporting foreign charities. However, all supporting organizations are limited to supporting only section 509(a)(1) or (2) public charities. If the foreign supported charity has received exemption from the Service under section 501(c)(3) as a 509(a)(1) or (2) public charity then such charity may be supported by a Type I or Type II supporting organization. Similarly, Rev. Rul. 74-229, 1974-1 C.B. 142 provides another avenue for a Type I or Type II supporting organization to support a foreign charity. Under Rev. Rul. 74-229, a Type I or Type II supporting organization may support a foreign charity if such charity is described in (but not exempt under) section 501(c)(3) and would meet the requirements of section 509(a)(1) or 509(a)(2) if it applied. In this circumstance, the supporting organization should be asked for information sufficient to demonstrate that the foreign charity would qualify under IRC 501(c)(3) and IRC 509(a)(1) or (2). Rev. Rul. 66-79 provides information regarding charitable contribution deductions when a domestic charitable organization is supporting a foreign charity. Also, see PLR 9651031 for an example of this situation.

PART 5: ORGANIZATION REQUIRING HEIGHTENED SCRUTINY

This PART 5 is designed to identify transactions, assets, and other situations that raise red flags because of concern that a supporting organization may be used to overly benefit private interests. The presence of one or more of the listed factors is not determinative. All facts and circumstances must be considered in determining whether an organization meets the requirements for tax exemption and/or supporting organization status.

Potential Red Flags

The following examples illustrate the types of transactions requiring heightened scrutiny.

1. A donor contributes cash to a supporting organization. The supporting organization “loans” the money back to the donor’s for-profit business. The supporting organization receives an unsecured promissory note for the loan and the donor takes a deduction for a contribution to the supporting organization.

In this example, there is no collateral on the loan other than a promise to pay which places the supported organization’s assets at risk. In addition, the donor is receiving impermissible private benefit that also amounts to inurement since the donor is an insider and because the loan is made to a for-profit business that is owned by the donor. **Much of the abuse in the supported organization area relates to unreasonable compensation and loans to disqualified persons, their family members, and their businesses.** Control is an important factor in determining whether an organization operates for the benefit of private interests. If disqualified persons have some position of substantial influence over the supporting organization, unreasonable compensation or loan activity may be present. See *Best Lock Corporation v. Commissioner*, 31 T.C. 620 (1959); *Orange County Agricultural Society, Inc. v. Commissioner*, 893 F.2d 529, 534 (2d Cir. 1990); and *Lowry Hospital Association v. Commissioner*, 66 T.C. 850 (1976).

2. A donor contributes cash to the supporting organization. No payments are scheduled or made to or on behalf of any publicly supported organizations.

In this situation, the supporting organization has not demonstrated that it operates for IRC 501(c)(3) purposes or meets the IRC 509(a)(3) operational test. In addition, the donor may be in a position to exercise control over the supporting organization because after having taken a charitable contribution deduction, no distributions have either been made or are scheduled to be made to any supported organizations.

3. A donor contributes cash to the supporting organization. The supporting organization uses its assets to pay college tuition in the form of a “scholarship” to the donor’s child. In this situation, the donor receives a private benefit/inurement because the supporting organization’s assets are used to pay the school tuition of the donor’s child.

4. The donor makes a “contribution” of a historic façade easement to a supporting organization and takes a deduction.

In this situation, careful scrutiny is required to ensure that an inappropriate contribution deduction was obtained where local historic preservation laws already prohibit alteration of the home's façade. In this situation, the contributed easement is superfluous to achieving a charitable purpose. Even if the façade could be altered, the deduction claimed for the easement contribution may far exceed the easement's impact on the value of the property. (See IRM 7.20.6.2.1)

5. A donor contributes an interest in a partnership, or limited liability company, closely held business, real estate, intellectual property, art work, or conservation easements to a supporting organization.

In this situation, the assets may not be geared to generate significant income. Therefore, the payout by the Type III supporting organization that is not functionally integrated may not be sufficient to ensure attentiveness by the supported organization to the operations of the supporting organization(s). Thus, the supporting organization may fail the integral part test unless other facts and circumstances evidence attentiveness by the supported organization.

Further, a situation in which donor(s) contribute nonproductive assets to a Type III supporting organization that is not functionally integrated may raise concerns under IRC 501(3) regarding whether an organization is operated for a substantial nonexempt purpose as well as an issue under IRC 509(a)(3) regarding whether there is indirect control of the supporting organization by disqualified persons.

Most supporting organizations further legitimate charitable purposes. However, some taxpayers may seek to shield assets inappropriately through supporting organizations. This has resulted in the need for heightened scrutiny of supporting organizations generally to screen for those where there is a significant potential for abuse. The typical Type I or II supporting organization that supports a hospital, university, or other large charitable institution generally does not raise the private benefit concerns that require heightened scrutiny. The questions below are aimed at identifying situations that raise potential for impermissible private benefit. Additional questions needed to develop an issue should be tailored to the organization's specific situation.

Section I – Potential Promoters

For purposes of completing this guide sheet, the term “promoter” refers to a person who organizes or assists in the organization of a partnership, trust, investment plan, or any other entity or arrangement that is to be sold to a third party. The concern is that the partnership, trust, etc., is designed to be used or is actually used by that third party to obtain tax benefits not allowable by the Internal Revenue Code.

A Are any promoters identified with the establishment or operation of the supporting organization?

B Does the supporting organization benefit a list of more than five supported organizations?

II Unreasonable Compensation /Loans

A Are goods, services, or cash provided to donors or their family members or persons with whom they have business relationships?

B Are the goods, services, or cash provided to donors or their family members or persons with whom they have business relationships part of reasonable compensation arrangements?

C Are goods, services, or cash provided to officers, directors, or trustees?

D Are the goods, services, or cash provided to officers, directors, or trustees part of reasonable compensation arrangements?

E Are the goods, services or cash provided to the five highest compensated employees or independent contractors part of reasonable compensation arrangements?

F Is there evidence of any loan activity?

G Are loans made to donors or their family members or persons with whom they have a business relationship, to officers, directors, or trustees, or to the five highest compensated employees or independent contractors?

H Are the loans made to donors or their family members or persons with whom they have a business relationship, to officers, directors, or trustees, or to the five highest compensated employees or independent contractors part of reasonable compensation arrangements?

Section III - Closely Held Stock/Non-liquid Investments/Assets That Do Not Produce Current Income

A Does the supporting organization hold closely held stock?

B Does the supporting organization hold an interest in a partnership or limited liability company in which the donor retains an interest as a general partner or member?

C Does the supporting organization own significant other investments (\$100,000 or more) that are not explained in detail?

D Does the supporting organization own significant land (\$100,000 or more).

E Does the supporting organization own significant other property (\$100,000 or more) that does not produce current income?

F Does the supporting organization own life insurance on the donor's life or the life of the donor's family member?

G Does the supporting organization own more than 20% of the stock of a corporation, partnership interest, or beneficial interest of an estate?