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INTERNAL REVENUE SERVICE

NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

E.O. Exams Programs and Review
Internal Revenue Service
1100 Commerce Street
MC 4900 DAL
Dallas, TX 75242

April 10, 2008

UIL Code: 509.02-02, 4946.01-00

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Tax Years Involved:

Date of Conference:

Legend:

Q =
R =
S =
T =

W =
Y =

A =
B =
C =
D =

F =
G =
H =
J =

Date 1 =
Date 2 =
Date 3 =
Date 4 =

Date 5 =

Year =
State =

PLR 1 =
PLR 2 =

x =

ISSUES:

1. Is T properly classified as a supporting organization to Y under section 509(a)(3) of the Code?

2. Should T be reclassified as a private foundation if it does not meet the requirements under section 509(a)(3) of the Code as a supporting organization?

3. If T is reclassified as a private foundation, are A, B, and D disqualified persons to T, as defined by section 4946 of the Code?

4. Are Q and T disqualified persons to each other as defined by section 4946 of the Code?

FACTS:

T was incorporated on Date 1 as an endowment for Y. Per the articles of incorporation, the organization's purpose is to operate as a section 501(c)(3) organization and to support Y. Y is exempt under section 501(c)(3) of the Code and is not a private foundation because it is an organization described in sections 170(b)(1)(A)(iii) and 509(a)(1). The initial board of directors consisted of eight persons, including A. T received a determination letter on Date 2 indicating that it is exempt under section 501(c)(3) and that it is not a private foundation because it is an organization described in section 509(a)(3).

T began its activities in Year after receiving a building and land from its supported organization, Y. The building and land was used to provide residential housing and food services to the clients who received services from Y. T also received part of its initial funding from Q. The articles also state that the initial board of directors will be the same as the board of Y. In addition, the articles of incorporation provided that A would serve as a life director until his death.

T's primary investment asset is securities. T holds approximately 0.029% of W. The majority shareholders of W are Q and S. In addition, T holds 15% of R, a closely held corporation, which is also owned by Q and S. The voting proxy for these assets is held by A.

Q is a charitable trust that was created as a result of contributions from F and G. Q is exempt from Federal income tax as an organization described in section 501(c)(3) of the Code. Q is a private foundation as described in section 509(a). Q is the primary source of public support for Y. The three current trustees of Q are: A, a direct descendant of F and G, who established Q and were substantial contributors under section 4946(a)(1)(A); C, his son; and H, who is A's mother. A's daughter D is the Executive Director of Q.

The majority of Q's income comes from S. S is a trust created by F's will and is described in section 4947(a)(2) of the Code. One of the principal assets held by S is shares (37.575%) of stock in W. It is the largest block of W stock held by a single entity. The next largest block is held by Q, shares (23.695%).

From the date of its incorporation until Date 3, T had a six member Board of Directors. This board was comprised of persons that were also members of the Board of Directors of Y. During that time, A was the only director of Y that was also a disqualified person to Q. In 1991, T's articles of incorporation were restated to provide the purpose of the corporation as operating as a "supporting organization" within the meaning of section 509(a)(3) to the class of organization including, but not limited to, Y. The purposes in the articles include conducting clinical programs and studies, research, treatment, as well as providing social services and informational programs. In addition, the restated articles changed the board of directors from six members to three members and included a name change. The three individuals named were A, his son B and his daughter D. Both B and D serve for five year terms and if A ceases to serve as lifetime director, he will be replaced first by D and then by B. A, B and D are all disqualified persons to Q due to familial relationship under section 4946(a)(1)(D) of the Code.

T requested a ruling that the proposed transactions would not affect T's status as an organization described in section 501(c)(3) of the Code or its classification as a supporting organization within the meaning of section 509(a)(3). The proposed transaction involved an amendment to its articles of incorporation to change the purpose clause to allow the support of, in addition to Y, other exempt charitable organizations of the class or purpose of Y, and to reduce the total number of directors and to modify the selection process so Y would be able to control T by appointing the majority of directors. In addition, Y indicated that it planned to transfer funds to T for the purposes of increasing T's endowment.

In PLR 1, the Service ruled that the proposed transaction would not affect T's status as an organization described in section 501(c)(3) of the Code or its classification as a supporting organization within the meaning of section 509(a)(3). The ruling held that the "purpose" clause would continue to designate a "specified" organization within the meaning of section 1.509(a)-4(d) of the regulations and would not fail the organizational test under section 509(a)(3) of the Code. In addition, the amended Articles of Incorporation modifying the board of directors, continued to satisfy the "operated, supervised, or controlled by" test of section 1.509(a)-4(g) of the regulations. The Service further stated that in light of the above amendments, it found that by continuing to hold title to and operate a residential facility, which housed persons utilizing Y, T would continue to operate for the benefit of Y, its supported organization. Furthermore, given Y's authority to appoint all of T's board of directors, the fact that T would support organizations of the same class or purpose of Y would not have any affect on either the exempt purpose status or the non-private foundation status of Y. In addition, the Service held that A was not a disqualified person within the meaning of section 4946 of the Code.

The Service issued another ruling, PLR 2 that superseded the prior ruling, PLR 1. The rulings were identical except for the paragraph on disqualified persons. The ruling stated that the organization represented that A, B, and D were not disqualified persons with respect to T (other than by virtue of being foundation managers) because they were not "substantial contributors" to T within the meaning of section 507(d)(2) of the Code. Additionally, since such persons were not disqualified persons with respect to T, T was not controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and Y as permitted by section 509(a)(3)(c). The ruling further held that the proposed transactions would not affect T's status as an organization described in section 501(c)(3) or its classification as a supporting organization within the meaning of section 509(a)(3).

During the fiscal year ending Date 4, T received approximately $x in gross revenue, which included quarterly grants from Q, revenue from Y, interest, dividends and capital gain from the sale of securities and assets, and income from services performed for clients of Y. However, in 2001, the residential housing activity and client services were transferred to another corporation and are no longer being performed by T.

On Date 5, T's board voted to amend its articles of incorporation and bylaws to:

1. increase the number of directors from three to five;
2. give Y the right to appoint directors to each of the additional seats, giving Y four seats which it will approve annually; and
3. provide that disqualified persons to Q and employees of disqualified persons to Q may hold no more than a minority of board seats.

LAW:

Section 509(a)(3) of the Code defines a supporting organization to be an organization that is:

a. organized and operated exclusively for the benefit of, to perform the function of, or to carry out the purposes of one or more specified qualified supported organizations described in sections 509(a)(1) or (2);
b. operated, supervised, or controlled by or in connection with one or more organizations described in section 509(a)(1) or (2); and
c. not controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one more organizations described in section 509(a)(1) or (2).

Section 1.509(a)-4(j)(1) of the Income Tax Regulations provides that under the provisions of section 509(a)(3)(C) a supporting organization may not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations. If a person who is a disqualified person with respect to a supporting organization, such as a substantial contributor to the supporting organization, is appointed or designated as a foundation manager of the supporting organization by a publicly supported beneficiary organization to serve as the representative of such publicly supported organization, then for purposes of this paragraph such person will be regarded as a disqualified person, rather than as a representative of the publicly supported organization. An organization will be considered "controlled," for purposes of section 509(a)(3)(C), if the disqualified persons, by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operation or may prevent such organization from performing such act. This includes, but is not limited to, the right of any substantial contributor or his spouse to designate annually the recipients, from among the publicly supported organizations of the income attributable to his contribution to the supporting organization. Except as provided in subparagraph (2) of this paragraph, a supporting organization will be considered to be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. Thus, if the governing body of a foundation is composed of five trustees, none of whom has a veto power over the actions of the foundation, and no more than two trustees are at any time disqualified persons, such foundation will not be considered to be controlled directly or indirectly by one or more disqualified persons by reason of this fact alone. However, all pertinent facts and circumstances including the nature, diversity, and income yield of an organization's holdings, the length of time particular stocks, securities, or other assets are retained, and its manner of exercising its voting rights with respect to stocks in which members of its governing body also have some interest, will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

Section 1.509(a)-4(j)(2) of the regulations states that notwithstanding subparagraph (1) of this paragraph, an organization shall be permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it. For example, in the case of a religious organization operated in connection with a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization will not disqualify the organization under section 509(a)(3)(C) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

Section 4946(a)(1)(H) of the Code includes in the definition of "disqualified person," for purposes of section 4943, a private foundation which is effectively controlled (directly or indirectly) by the same person or persons who control the private foundation in question, or substantially all of the contributions to which were made (directly or indirectly) by the same person or persons described in subparagraph (A)[1], (B)[2], or (C)[3], or members of their families (within the meaning of subsection (d)[4]), who made (directly or indirectly) substantially all of the contributions to the private foundation.

RATIONALE:

Issue 1: The question we focus on here is whether T meets the test under section 509(a)(3)(C) of not being controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and section 509(a)(1) or (2) organizations. Under the facts presented, we find that T is properly classified as a supporting organization within the meaning of section 509(a)(3) of the Code.

We considered whether the fact that the foundation managers here were all family members of foundation managers leads to the conclusion of control by disqualified persons (family members of foundation managers). While family members of foundation managers are not expressly excluded from disqualified person status as foundation managers are under sections 509(a)(3)(C) and 1.509(a)-(4)(j)(1), we think it implicit in the statutory and regulatory scheme that they should be excluded (assuming that they are not disqualified persons in other respects). If foundation managers are not disqualified persons, then their family members should not be either.

We also considered the fact that the foundation managers in issue are disqualified

1 IRC 4946(a)(1)(A) a substantial contributor to the Foundation
2 IRC 4946(a)(1)(B) a foundation manager (within the meaning of subsection (b)(1)
3 IRC 4946(a)(1)(C)an owner of more than 20 percent of: (i) the total combined voting power of a corporation, (ii) the profits interest of a partnership, or (iii) the beneficial interest of a trust or unincorporated enterprise.
4 IRC 4946(d) for purposes of subsection (a)(1), the family of any individual includes his spouse, ancestors, children, grandchildren, great grandchildren, and the spouses of the preceding.

persons with respect to Q, a substantial contributor to T. We think the disqualified person control test does not prohibit a supporting organization from being controlled by individuals who are disqualified persons with respect to a private foundation that is a substantial contributor to the supporting organization, if the individuals themselves do not qualify as disqualified persons with respect to the supporting organization. T modified its board to reduce the influence of disqualified persons with respect to Q, after the tax years in issue.

Accordingly, T qualifies as a section 509(a)(3) supporting organization[5].

Issue 2: As T meets the requirements of section 509(a)(3), T should not be reclassified as a private foundation.

Issue 3: As discussed above, A, B, and D are disqualified persons to with respect to the private foundation, but not with respect to T, as defined by section 4946(a)(1)(D) of the Code.

Issue 4: Q, as a substantial contributor to T, is a disqualified person with respect to T under section 4946(a)(1)(A). However, because Q is described in section 501(c)(3), it is not a disqualified person for purposes of section 4941. See section 53.4946-1(a)(8) of the regulations. Since T qualifies under section 509(a)(3), it therefore is not a disqualified person with respect to Q for chapter 42 purposes. See section 53.4946-1(a)(7).

CONCLUSION:

Based on the foregoing facts, we find that:

1. T is properly classified as a supporting organization to Y under section 509(a)(3) of the Code.
2. T should be not be reclassified as a private foundation.
3. A, B, and D are not disqualified persons as defined by section 4946 of the Code with respect to T.
4. Q and T are not disqualified person with respect to each other as defined by section 4946 of the Code.

A copy of this memorandum is to be given to T. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

-END-

5 We have not considered the impact, if any, of the provisions relating to supporting organizations enacted as part of the Pension Protection Act of 2006 may have on T's qualification as a supporting organization.