GETTING PUBLIC CHARITY STATUS RIGHT BEFORE IT GOES WRONG

EDWARD T. CHANEY AND KIMBERLY ENEY

Private foundation status can be as important to an organization as its Section 501(c)(3) determination, but a surprising number of organizations treat Section 509(a) classification as a technical afterthought. In addition, the public support tests under Section 170(b)(1)(A)(vi) and Section 509(a)(2), and the rules for Section 509(a)(3) supporting organizations, can be deceptively intricate and can pose substantial challenges to public charities as well as their supporters. To avoid finding themselves tangled in a reclassification controversy or in some uncomfortable conversations with funders, public charities should ensure that public support remains a planning priority while taking into account specific pitfalls and complexities that may arise in their particular situations.

Introduction—A matter that matters.

At a fundamental level, Section 501(c)(3) organizations are presumed to be private foundations unless they are public charities described in Section 509(a)(1), (2), or (3).[1] 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.

The distinction is important. First, from an operational perspective, the Chapter 42 excise taxes significantly restrict the activities of private foundations but do not apply to public charities. For example, private foundations must exercise expenditure responsibility over grants to non-public charities.[2] They must follow IRS-approved individual grant procedures in order to make scholarships or similar grants to individuals.[3] They cannot engage in any lobbying or self-dealing transactions.[4] And their impact and mission investing activities can be subject to complicated and highly technical rules.[5] Public charities, on the other hand, do not face these same limitations or administrative burdens and have a much greater degree of flexibility in conducting activities.

Second, from a financing/fundraising perspective, public charities have some distinct advantages. Generally, individuals can take a deduction of up to 50% of adjusted gross income for cash contributions to public charities and up to 30% for long-term capital gain property.[6] Individual donors, however, can only deduct up to 30% of adjusted gross income for cash donations to private foundations and up to 20% for long-term capital gain property.[7] Moreover,

Failure to accurately calculate public support and report public charity classification could result in an adverse reclassification by the IRS when it is too late to engage in planning.

EDWARD T. CHANEY is an associate at Schell Bray PLLC in Chapel Hill, NC. KIMBERLY ENEY is an associate in the Washington DC office of Morgan, Lewis & Bockius LLP.

donors can only deduct their cost basis when making gifts of long-term capital gain property (other than certain gifts of publicly traded securities) to private foundations, but gifts of such property to public charities are deductible at fair market value.[8] Finally, public charities can easily receive grants from private foundations and donor-advised funds, but those same grantors must exercise expenditure responsibility over distributions to private foundations.[9] In addition, foundations can only count a grant to another private foundation as a qualifying distribution if the grant recipient pays out the grant in the following year.[10]

Obviously, with such high stakes, an organization wants to avoid an IRS challenge to its public charity status, but questions of classification can arise in other ways, too. A number of important transactions depend on Section 509(a) compliance, ranging from mergers and other strategic combinations, to program-related investments, to the most basic grant support of an organization. Sometimes a change in leadership, legal counsel, or accountant can cause a fresh look at things, uncovering uncertainty or a questionable position. In addition, information about an organization's public support is publicly available on Schedule A of Form 990. Section 509(a) status and public representations on Schedule A of Form 990 deserve careful attention from the organization on an ongoing basis.

Specific issues under Sections 509(a)(1) and 170(b)(1)(A)(vi)

Section 509(a)(1) organizations receive substantial donative support from the government and the general public. From a large public health organization that conducts a nationwide fundraising walk to the nonprofit recipient of a neighborhood canned-food drive, these are the organizations that most people think about when they hear the term "public charities."[11]

'Normally' receiving substantial public support. Section 509(a)(1) organizations "normally" receive substantial support from the government and the general public. In order to "normally" receive such support, the organization must meet one of two tests. First, the 33 1/3% support test requires that the organization normally receive 33 1/3% or more of its total support from public sources.[12] Second, the 10% "facts and circumstances" test requires, among other things, that the organization normally receive 10% or more of its total support from public sources.[13] An organization "normally" meets the test for a tax year and the immediately succeeding year if it meets the test on an aggregate basis for that year and the four preceding tax years.[14] An organization will be reclassified as a private foundation if it fails to meet either of these tests for two consecutive years.[15] The reclassification will be effective as of the first day of the second consecutive tax year for purposes of Sections 507, 4940, and 6033, and for all other purposes for succeeding years.[16]

Both the 33 1/3% test and the 10% "facts and circumstances" test 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, or 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 ex-

[1] Section 509(a)(4) also provides a narrow path for organizations organized and operated exclusively for testing for public safety.
[2] Section 4945(d)(4)(B).
[3] Section 4945(d)(3).
[4] Sections 4945(d)(2), 4941(a)-(b).
[5] See, e.g., Section 4944.
[6] Section 170(b)(1)(A), (C).
[7] Section 170(b)(1)(D), (B).
[8] Reg. 1.170A-1(c)(1); Section 170(e)(1)(B)(ii).
[9] Section 4945(d)(4), 4966(c)(1)(B).
[10] Section 4942(g)(1), (3).
[11] While a variety of organizations can qualify as public charities under Section 509(a)(1) based on the type of activities they conduct—including churches, colleges and universities, and hospitals—this article focuses on public charities described under Section 170(b)(1)(A)(vi) that are dependent on substantial support from the government and the general public.
[12] Reg. 1.170A-9(f)(2).
[13] Reg. 1.170A-9(f)(3).
[14] Reg. 1.170A-9(f)(4).
[15] Reg. 1.170A-9(f)(4)(vii).
[16] *Id.*.
[17] Section 509(d).
[18] Section 509(d); Reg. 1.170A-9(f)(6)(i), Reg. 1.170A-9(f)(7).
[19] Reg. 1.170A-9(f)(6)(i).
[20] Reg. 1.170A-9(f)(8)(ii).
[21] Reg. 1.170A-9(f)(6)(i).
[22] *Id.*.
[23] *Id.*.
[24] Reg. 1.170A-9(f)(3).
[25] Reg. 1.170A-9(f)(3)(ii).
[26] *Id.*.
[27] Reg. 1.170A-9(f)(3)(iii).
[28] Reg. 1.170A-9(f)(3)(iii).

pended 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.[17] 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; and unusual grants.[18]

Public support generally includes grants, contributions, and support from Section 170(c)(1) governmental units.[19] The regulations distinguish between governmental support for the direct benefit of the public—which counts fully as public support—and support that meets the direct and immediate needs of the government, which is excluded from the support test as exempt-function income.[20] 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.[21] Contributions by an individual, a trust, or a corporation also count as public support, but only to the extent of 2% of total support for the computation period.[22] In applying the 2% limitation, all contributions from the donor and related parties are treated as made by one person.[23]

The 10% 'facts and circumstances' test. The fact that an organization's public support represents less than 33 1/3% of its total support does not prevent the organization from qualifying as a public charity under Section 170(b)(1)(A)(vi) so long as it meets the 10% "facts and circumstances" test. This test permits an organization's percentage of public support to be as low as 10% if it can demonstrate that it is "organized and operated" to attract public support on a continuous basis and meets some additional "facts and circumstances."[24]

An organization is "organized and operated" to attract public support on a continuous basis if it maintains a continuous and bona fide fundraising program, or if it carries on activities designed to attract support from governmental units or other Section 509(a)(1) organizations.[25] Consideration will be given to whether the scope of the fundraising activities is reasonable in light of its charitable activities, and whether an organization, in its early years, limited its solicitation program to likely donors who would enable the start-up of its charitable operations.[26]

In addition, the regulations provide that the following facts and circumstances will be taken into account in determining whether an organization is publicly supported:

- The organization's percentage of public support exceeds 10% (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 a broad public interest (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 related to such donors.
- The organization's facilities and services are available to the public and/or the public participates in the organization's 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., community revitalization or developing employment opportunities).
- 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.[27]

The regulations make it clear that an organization does not need to meet every factor. Instead, the factors relevant to each case and the weight accorded to any one of them may differ depending on the nature and purpose of the organization and the length of time it has been in existence.[28]

If it appears that an organization will not meet the 33 1/3% public support test during a given year, then it should review whether it can alternatively meet the 10% "facts and circumstances" test. Some organizations that tend to qualify under the 33 1/3% 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.

Government funding. The Section 509(a)(1) public support test allows an organization to treat the full amount of grants and contributions from the government as public support, but there are a

couple of issues that emerge when evaluating what constitutes governmental support. One issue arises when an organization receives support from the government because of an arrangement with a third party. For example, some Section 501(c)(3) organizations conduct charitable and educational activities around the world that advance important governmental initiatives. The Section 501(c)(3) organization may receive governmental support in connection with its activities, but the support may arise as a result of the Section 501(c)(3) organization's contract with a third party. Nevertheless, in many circumstances, the Section 501(c)(3) organization can still count the funding as governmental support that is fully includible as public support under the Section 509(a)(1) test. In Ltr. Rul. 7932094, the IRS ruled that a Section 501(c)(3) organization could treat funds received from the United States Agency for International Development (USAID) as governmental support, even though the funds were paid pursuant to a contract with a third party, because USAID approved the underlying contract and therefore earmarked its funds to the Section 501(c)(3) organization.

A related issue arises when a Section 501(c)(3) organization receives funds from the government for providing a service or tool that meets a governmental need. The question then is whether such support constitutes support from a governmental unit and is includable in public support, or whether it is excludable altogether as exempt function income. For example, an organization develops software designed exclusively for state governments that will help teachers improve educational outcomes in schools, and governments paid the organization to use this software and train teachers. The organization could treat the governmental support as a contribution fully counted as public support if the purpose of the payment (i.e., the software) serves the direct benefit of the public. If, instead, the software serves the immediate needs of the government, the organization will need to treat the support as exempt function income. Furthermore, the organization will not meet the Section 509(a)(1) test if the organization's revenue primarily consists of these payments that are treated as exempt function income.[29] Instead, it will need to meet the Section 509(a)(2) public support test, described below. Examples of payments serving the direct benefit of the public are payments by the government for the maintenance of public library facilities, or to nursing homes or homes for the aged to provide care to residents under government programs.[30]

Contributions from partnerships. Partnerships occasionally create and often support Section 501(c)(3) organizations. If a partnership provides all or a substantial amount of funding, there is a question about whether to treat the contribution as being made by the partnership or the individual partners for purposes of satisfying the Section 509(a)(1) test. The answer has important consequences. If the organization treats the contribution as made by the partnership, the full amount of the contribution is subject to the 2% limitation, making it a challenge to meet the Section 509(a)(1) support test in the absence of a substantial number of other contributions, particularly those from publicly supported Section 509(a)(1) organizations.[31] If, however, the organization treats the grant as made from the individual partners, then it is less of a challenge to meet the Section 509(a)(1) support test, even though those contributions may be subject to the 2% limitation, provided that a substantial number of the donors do not stand in a relationship with one another that would require aggregation.

Although there is no explicit guidance on this point, Section 509(a)(1) organizations can treat support from partnerships as received from the individual partners rather than the partnership based in part on principles found in the Code and regulations. The regulations accompanying Section 170(b)(1)(A)(vi) provide that contributions by "an individual, trust, or corporation" are taken into account as public support.[32] The regulations do not include a reference to the treatment of contributions by partnerships for purposes of the Section 509(a)(1) public support test, but the partnership rules offer some guidance. Sections 702(a)(4) and 703(a)(2)(C) pro-

[29] See the discussion in "Specific issues under Section 509(a)(2)," below.

[30] Reg. 1.170A-9(f)(8).

[31] Reg. 1.170A-13(f)(15).

[32] Reg. 1.170A-9(f)(6)(i).

[33] Reg. 1.509(a)-2(a).

[34] 1975-2 CB 215.

[35] GCM 37001, 2/10/77; GCM 38327, 3/31/80.

[36] Advisory Committee on Tax-Exempt and Government Entities (ACT), *Report of Recommendations* (6/10/09), page 7, available at www.irs.gov/pub/irs-tege/tege_act_rpt8.pdf. Similarly, the Exempt Organizations Committee of the ABA Section of Taxation advocates such a position in connection with its recommended update of Rev. Proc. 92-94, 1992-2 CB 507.

[37] Rev. Rul. 74-229, 1974-1 CB 142.

vide 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 guidance provides a basis for an organization to treat the contributions from a partnership as made by the individual partners when calculating the public support test. However, see the discussion below on support from partnerships under the Section 509(a)(2) test.

Foreign charities and support from foreign governments. Many foreign organizations apply for Section 501(c)(3) exemption, and classification as a public charity can help facilitate receipt of grants from U.S. private foundations. In fact, the 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.[33]

Because public support includes the full amount of contributions received from governmental units described in Section 170(c)(1), a question often arises as to whether contributions from foreign governments (which are not described in Section 170(c)(1)) can also count fully toward public support. In Rev. Rul. 75-435,[34] the IRS ruled that contributions from a foreign government can count fully toward an organization's public support. The IRS issued subsequent guidance in GCM 37001 and GCM 38327 indicating that support from foreign governments should not be counted fully as public support.[35] The arguments were primarily based on the concept that, for domestic charities, there is a lower likelihood that a foreign government would supervise the affairs of an organization operating outside its jurisdiction. These memoranda did not, however, supersede Rev. Rul. 75-435, and so an organization can count payments from foreign governments fully as public support.

This position is consistent with Reg. 53.4945-5(a)(4)(iii), which provides that both foreign governments and U.S. governmental entities are the equivalent of Section 509(a)(1) organizations for purposes of the expenditure responsibility rules. It is also consistent with the 2009 recommendation of the Advisory Committee on Tax Exempt and Government Entities that the IRS publish guidance providing that grants from foreign governments (excluding foreign governments on the Office of Foreign Assets Control's list of sanctioned countries) should be treated in the same way as grants from Section 509(a)(1) organizations for purposes of the public support test.[36] This guidance is also relevant to Type I supporting organizations, which can support foreign charities.[37]

Endowments and large contributions. Organizations with large endowments can have trouble meeting the Section 509(a)(1) test for a couple of reasons. First, unless a contribution toward an endowment is made by another public charity, the contribution will be subject to the 2% limitation and not fully includible as public support. Second, any accompanying investment income will not be included as public support. One solution is to place the endowment in a Section 509(a)(3) supporting organization of the public charity. Supporting organizations are described below and are classified as public charities based on their relationship to one or more Section 509(a)(1) or (2) organizations. Placing an endowment in a supporting organization allows the Section 509(a)(1) organization to maximize contributions and growth of its endowment without an accompanying concern about the impact on public charity status, although, as discussed below, this may create issues for Section 509(a)(2) organizations and for Type III functionally integrated supporting organizations.

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% 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% limitation do not jeopardize the organization's public charity classification. As discussed further below, the grantors cannot earmark grants through another public charity as a work-around to this issue.

Specific issues under Section 509(a)(2)

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 gross receipts from related activities. Most often, Section 509(a)(2) organizations tend to depend substantially or primarily on gross receipts from related activities and do not otherwise qualify under Section 509(a)(1) based on the type of activities they conduct (such as by being a school or hospital). Common examples include health care-related organizations, like nursing homes, hospices, or home health care providers, but Sec-

tion 509(a)(2) is appropriate for a wide variety of service-providing nonprofits, including museums, community development corporations, and educational organizations.

Of course, Section 509(a)(2) organizations often receive donative support as well. In fact, some organizations that receive donative support may have no choice but to seek classification under Section 509(a)(2) if their program service revenue heavily outweighs donative support. Section 170(b)(1)(A)(vi) does not permit an organization to meet either the 33 1/3% support test or the 10% facts and circumstances test, if it receives almost all of its support from program services and it receives an insignificant amount of its support from governmental units and the general public.[38] On the other hand, for the reasons discussed below, Section 509(a)(2) may not be the most appropriate classification for an organization that receives most of its support from donative sources. Due to the mechanics of the public support tests under Sections 170(b)(1)(A)(vi) and 509(a)(2), there is a comfortable continuum between these two extremes, but trends in one direction or the other may indicate the need to plan.

An organization seeking classification under Section 509(a)(2) must qualify in two ways as measured by mechanical tests on the Form 990 Schedule A: (1) one-third of its total support must come from public sources[39] and (2) it cannot derive more than one-third of its total support from income from investments and unrelated business activities (post tax).[40] Like those of Section 170(b)(1)(A)(vi), these tests are calculated on a five-year rolling basis, and failure to meet either of these two tests for two consecutive years results in reclassification as a private foundation.[41]

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 differ in the definition of "public support."[42] 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").[43] For this purpose, Section 509 generally does not define the term "person," so the meaning of that term is governed by Section 7701(a)(1).[44] Under that provision, a person includes an "individual, a trust, estate, partnership, association, company or corporation."[45]

In addition, public support generally includes two distinct types of funds: (1) gifts, grants, contributions, and membership fees and (2) gross receipts from related activities.[46] These sources of support face very different treatment. For donative support, revenue from permitted sources (which, as discussed below, excludes substantial contributors) 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.[47] But when it comes to income from related activities, amounts from each permitted source are only includable to the extent of the greater of $5,000 or 1% of total support for the tax year.[48] As a result, there are two frontline questions in characterizing revenue for the purposes of Section 509(a)(2): (1) is it from a permitted source (which will determine whether it is included in public support), and (2) is it donative in nature or exempt function income (which will determine whether any included revenue is subject to the limitation). Sometimes, answering these questions is not so straightforward.

It is important to remember that Section 509(a)(2) is less forgiving than Section 170(b)(1)(A)(vi); the one-third public support requirement and the one-third investment income limitation are bright lines. For this reason, organizations that hover near or trend toward the one-third marks should take extra

38 Reg. 1.170A-9(f)(7)(iii).
39 Section 509(a)(2)(A).
40 Section 509(a)(2)(B).
41 Reg. 1.509(a)-3(c)(1)(i).
42 It follows that the definitions of "total support" vary as well; Section 509(a)(2) includes gross receipts from related activities.
43 Reg. 1.509(a)-3(a)(2)(ii).
44 See GCM 39104, 12/23/83.
45 Section 7701(a)(1).
46 Reg. 1.509(a)-3(a)(2)(i)-(ii).
47 Section 509(a)(2)(A) (flush language).
48 Reg. 1.509(a)-3(b)(1).
49 See Section 4946(a)(1) and corresponding regulations.
50 Section 4946(a)(2) (cross referencing Section 507(d)(2)).
51 Note that Section 509(a)(1) organizations and governmental units (which are also not "persons" under Section 7701(a)(1)) are permitted sources and their donative support is fully includable in public support. Reg. 1.509(a)-3(j)(1).
52 Section 507(d)(2)(A); Reg. 1.507-6(a)(1).
53 However, there are provisions to exclude unusual grants. See Reg. 1.509(a)-3(c)(3).
54 Section 507(d)(2)(C).
55 Reg. 1.509(a)-3(g)(1).
56 Reg. 1.509(a)-3(g)(2).
57 Reg. 1.170A-9(f)(8)(ii)(C).
58 Reg. 1.509(a)-3(g)(3), Example 6.

care in their planning. In addition, the lack of a safety net raises the stakes for appropriately characterizing income and accurately completing the tests. With this in mind, following is an examination of three general areas of common pitfalls and complexities with Section 509(a)(2) calculations.

(Mis)calculating donative support. The first area relates to how Section 509(a)(2) organizations account for their donative support. Because public support excludes any support from disqualified persons (including substantial contributors), 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), which offers the 10% facts and circumstances test. On the other hand, some Section 170(b)(1)(A)(vi) organizations will fail the Section 509(a)(2) test for lack of gross receipts from related activities or a sufficiently diverse donor base. Due to the complexities discussed below, donative organizations will sometimes misclassify themselves under Section 509(a)(2).

Identifying substantial contributors. Section 509(a)(2) requires organizations to identify disqualified persons and track their contributions over time. Depending on the circumstances, doing so can be critically important. Disqualified persons include officers, directors, or trustees of the organization, certain of their family members, and their 35% controlled entities.[49] 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.[50]

Generally, a substantial contributor is any person (within the meaning of Section 7701(a)(1))[51] 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.[52] Since this definition accounts for historic contributions, a donor can become a substantial contributor with a single gift or a series of gifts over time.[53] Generally, most major donors will meet this definition and will therefore be disqualified persons. Moreover, once obtained, the substantial contributor branding is all but impossible to wipe away.[54] 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 calculation of public support. For example, improperly including support from substantial contributors may mask real risks to an organization's Section 509(a)(2) status, and a potential donor, the IRS, or other external stakeholder may ferret out the issue before the organization does.

Grants versus gross receipts. Sometimes, it can be difficult to distinguish between a donative grant and a contract for services, but much can hinge on the distinction. Assuming that contract revenue would be treated as income from a related activity, 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 would result in the grant's exclusion altogether.

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.[55] The activities pursuant to a contract for services, on the other hand, 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.[56] These rules complement the rules that apply to Section 170(b)(1)(A)(vi) organizations regarding the distinction between donative government support and exempt function income from government contracts, discussed above.[57]

This analysis can be nuanced based on the purposes of the grant or contract as well as the nature of 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 based on the purpose of the payment. 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 for a direct governmental need. The payment is therefore characterized as a grant.[58] 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 dis-

posal plant and a recommendation for the best location based on cost.[59]

Another example shows how the analysis can become nuanced in other ways, particularly with payments from the government that involve individual beneficiaries. Rev. Rul. 83-153[60] holds that Medicare and Medicaid reimbursement payments from the government are treated as gross receipts from related activities as opposed to grant income. The IRS reached this conclusion on the basis that the patient is the consumer of health care, and that he or she controls when and to whom a reimbursement is made. With such control, the patient should be treated as the payor, and the government reimbursements considered simply made on their behalf. As a result, Medicare and Medicaid reimbursements do not qualify as government support that broadly benefits the public.

While this position is both understandable and supportable, so is the alternative position that such payments are grants that support a program of the grantee that benefits the broader public. In fact, the IRS struggled with this dichotomy internally before coming down in favor of the current guidance.[61] In addition to the issue of control discussed in Rev. Rul. 83-153, a couple of other related factors swayed the IRS, including drawing a distinction between the nature of a payment and its source, and with respect to the nature of a payment, determining whether a payment is "from" the performance of services (i.e., gross receipts) or support "for" the performance of these services (i.e., grant support).[62]

The outcome of Rev. Rul. 83-153 seems to be right, but other examples show where things can get confusing. For instance, federal housing assistance can come in many forms, such as Section 8 housing vouchers granted to individuals for use in the open market,[63] or project-based vouchers that subsidize a particular multi-family project or units therein in order to preserve or increase the stock of available affordable housing.[64] In the former, the voucher attaches to the individual or family and follows them as they move from unit to unit. In the latter, it attaches to the particular subsidized unit and stays with a unit as eligible renters come and go. Based on the factor of consumer control and the distinction between payments "from" and payments "for" the performance of services, it would seem that the two subsidies—which are subject to bulk payments from governmental units or their contractors—would receive different treatment for the purposes of public support. This would be an odd result, and in practice many affordable housing organizations treat all housing voucher support consistent with Rev. Rul. 83-153, although, understandably, there appears to be some variance.

Issues in determining gross receipts. A second issue relates to determining gross receipts from related activities. As noted above, gross receipts from each permitted source are only includable as public support to the extent of the greater of $5,000 or 1% of total support for the tax year. Thus, if an organization is completely dependent on program service revenue, it will need at least 34 distinct sources of income providing 1% of total support each, a fact that unfortunately comes as a surprise to organizations from time to time.

Permitted sources still subject to limit. In this regard, one common pitfall occurs in the different treatment of donative support and program service revenue. Despite the fact that 100% of donative support from permitted sources is includable in public support, gross receipts from related activities from each permitted source is subject to the 1% limitation—even if from Section 509(a)(1) public charities and governmental units. Helpfully, though, 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 generally refers to the highest operational unit under a policy or administrative level.[65] Sometimes, this analysis may not be obvious.

[59] Reg. 1.509(a)-3(g)(3), Example 7.
[60] 1983-2 CB 48.
[61] See GCM 39058, 11/21/83.
[62] *Id.*
[63] 42 U.S.C. section 1437f(o)(1).
[64] 42 U.S.C. section 1437f(o)(13).
[65] Reg. 1.509(a)-3(i)(1).
[66] See "Contributions from partnerships," above.
[67] See, e.g., the discussion in TAM 9651001 (regarding the disposition of a property subject to acquisition indebtedness).
[68] Kawecki and Friedlander, "Recent Developments in Housing Regarding Qualification Standards and Partnership Issues," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 1996* (1995), Part II.6.C.
[69] 1998-1 CB 718.
[70] Salina and Friedlander, "Update on Health Care Joint Venture Arrangements," *Exempt Organizations Continuing Professional Education Technical Instruction Program for FY 2000* (1999), Part 2.E.
[71] Rev. Rul. 83-153, 1983-2 CB 48.
[72] Rev. Rul. 75-387, 1975-2 CB 216.
[73] Reg. 1.509(a)-3(m)(2).
[74] Ltr. Rul. 200508018 (11/29/04).

Payments from partnerships/collected payments. As previously noted, fees from program services received from each person are subject to the 1% limit, and for this purpose, a person includes a partnership. As a result, unlike the treatment of contributions by partnerships under the Section 170(b)(1)(A)(vi) test, there may be less room to attribute a payment for services from an entity taxed as a partnership to the individual partners under Section 509(a)(2).[66] However, this limitation does not apply to partnership income received by a Section 509(a)(2) charity by virtue of its ownership of a partnership interest. Instead, pursuant to Section 702(b), a partner's share of income from a partnership is treated as if it were realized directly from the source. As a result, for instance, if a Section 509(a)(2) organization owns an interest in a partnership that directly owns a 100-unit affordable housing project, its rental income should be treated as coming from 100 different persons.

This is both the logical and sensible outcome, but it took the IRS some time to stand firmly behind it. Section 509(a)(2) is silent on the matter, and there can be times where a partnership is treated as a separate entity (or person) as opposed to an aggregate of its partners.[67] Notably, in a 1996 CPE, the IRS hedged whether rental income from a low-income housing tax credit project partnership would be attributable to the tenants or the partnership for the purposes of Section 509(a)(2).[68] The IRS cleared the air with Rev. Rul. 98-15,[69] which examines the tax consequence of a whole hospital joint venture between nonprofit and for-profit hospital operators. In a favorable example in that ruling, the nonprofit contributed its entire operating assets to a joint venture limited liability company in return for an ownership interest. Going forward, it would not conduct other hospital care activities in any other form, and it would begin making grants from the proceeds of the joint venture. Among other things, the IRS concluded that the joint venture's provision of hospital services would continue to be attributable to the nonprofit member of the limited liability company, and as a result, it would be described in Section 509(a)(1) and Section 170(b)(1)(A)(iii) (which describes a hospital). In a follow-up 2000 CPE, the IRS noted that this result would apply to Section 509(a)(2) organizations as well.[70]

In related analysis, there are times when a single payment from a governmental body or another entity that aggregates funds collected from—or paid on behalf of—a group of other persons may be attributable to the individual members of the group and not to the payor. If so, the payment is not aggregated for purposes of the 1% limitation. For instance, as noted above, the patients are treated as the payors of bulk Medicare or Medicaid payments made by a government agency.[71] Similarly, hospitals that collect and remit to a blood bank the fees collected from individual patients are not treated as payors for the purposes of Section 509(a)(2).[72]

One-third investment income limitation issues. A third set of issues arises with respect to the investment income limitation for Section 509(a)(2) organizations.

Program-related/impact investing—gross receipts or investment income? Many public charities are wading into the program-related/impact-investing waters and making investments primarily to further their exempt purposes. These investments can take many forms and can be made for many purposes, but the appropriate characterization of resulting revenue as either gross receipts from related activities or investment income might be a significant factor for Section 509(a)(2) compliance, 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 fees or loans to a particular class of persons, such as aged, sick or needy persons" will be considered gross receipts and not investment income to the extent the activities contribute importantly to the exempt organization's purposes.[73] However, this principle applies more broadly to charitable investment activities than the narrow framing in the regulations might suggest. In Ltr. Rul. 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 and ruled that the receipt of dividend and investment income was treated as gross receipts.[74] Notably, the basis for this organization's exemption was lessening the burdens of government and not serving a particular charitable class, such as the poor and distressed. This is consistent with the treatment of program-related investments under the private foundation rules.

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 constitute common purposes for supporting organizations, particularly with respect to Section 509(a)(1) organizations. However, the one-third investment limitation po-

tentially makes this a problematic strategy for Section 509(a)(2) organizations—such organizations approaching the limitation could simply transfer the investments in a supporting organization and avoid private foundation reclassification. To avoid this outcome, the investment income resulting from assets transferred to a supporting organization from a Section 509(a)(2) organization will be attributed to the Section 509(a)(2) organization.[75] Similarly, anti-abuse rules apply where the purpose of creating a supporting organization is to avoid failing the Section 509(a)(2) tests.[76]

Whether employer-provided lodging is located 'on the business premises' has generated substantial litigation.

Specific issues under Section 509(a)(3)

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 509(a)(1), (2), or (3) 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, and 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).[77] Specifically, provisions of the PPA made it more difficult for donors to avoid the consequences of private foundation classification by 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. It imposed restrictions on the latter, including a new payout requirement, applying the excess business holdings rules, and severely curtailing grants from private foundations and donor-advised funds.

The Treasury Department and the IRS followed the PPA with several administrative actions, ultimately issuing final and temporary regulations at the end of 2012[78] and additional guidance at the end of 2013 to provide interim answers to remaining questions.[79] Collectively, this guidance sets forth the tests for Type III supporting organizations to qualify as either functionally integrated or non-functionally integrated, delineates the payout requirement for non-functionally integrated Type III organizations, 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 a full treatment is beyond the scope of this article. However, a few common and outstanding issues are explored below.

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).[80] 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 organizations must monitor. Type I or III supporting organizations can no longer receive 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), the donor's family members, or the donor's 35% controlled entities.[81] 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.[82] As a result, both supporting organizations and funders need to be aware of these possible relationships, which may require aninternal disclosure process.

[75] Reg. 1.509(a)-5(a).
[76] Reg. 1.509(a)-5(b).
[77] P.L. 109-208, 8/17/06.
[78] TD 9605, 2013-11 IRB 587.
[79] Notice 2014-4, 2014-2 IRB 274.
[80] Section 509(a)(3)(C).
[81] Section 509(f)(2).
[82] Sections 4966(d)(4)(A)(ii)(I), 4945(d)(4)(A)(ii), 4942(g)(4)(A)(ii)(I).
[83] Section 509(f)(2)(B)(i).
[84] Section 509(a), flush language.
[85] Section 4958(c)(3)(C)(ii)(II).
[86] See AICPA, "Compendium of Tax Legislative Proposals—Simplification and Technical Proposals" (February 2013) at 49, available at www.aicpa.org/advocacy/tax/taxlegislationpolicy/downloadabledocuments/compendium%20of%20legislation%20proposals%20february%202013.pdf
[87] Reg. 1.509(a)-4(i)(1).

Potential uncertainty for Section 509(a)(1), (2), or (3) organizations. The rule in Section 509(f)(2) 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 described in Section 509(a)(1) or (2).[83] In other words, a public charity can control the supported organization (typically, another charity) and still contribute to the supporting organization. One might see such relationships in a complex family of social service organizations, for instance. However, Section 509(a)(1), (2), and (3) organizations often have affiliated charities and supporting organizations as well, and the question is whether they have the same treatment as public charities for purposes of Section 509(f)(2).

There is a good argument that they do. For purposes of Section 509(a)(3), organizations described in Section 509(a)(2) include Section 509(a)(1), (2), and (3) organizations if they pass the applicable public support test.[84] Section 509(f)(2) begins by declaring that its provisions are for the purposes of Section 509(a)(3)(B), and nothing in Section 509(f)(2) nullifies the application of the Section 509(a)(3) general rule regarding the treatment of Section 509(a)(1), (2), and (3) organizations. Thus, on its face, Section 509(f)(2) appears to treat Section 509(a)(1), (2), and (3) organizations as being described in Section 509(a)(2). This provides a basis for Section 509(a)(1), (2), and (3) organizations to make contributions to their Type I or III supporting organizations without violating Section 509(f)(2).

Notably, however, Congress made a technical fix to the PPA regarding a similar provision of Section 4958 to explicitly exclude non-charitable supported organizations from the application of certain automatic excess benefit transactions that attend to supporting organizations.[85] Due to the differences in statutory construction between Sections 509 and 4958, this fix appears to have been needed with respect to Section 4958, but the fact that Congress did not take the opportunity to also clear the air in Section 509(f)(2) has created some uncertainty. This uncertainty can be an issue in a complex family of organizations that are exempt on several bases, which is why some have advocated for a similar technical fix to Section 509(f)(2).[86]

Type III sub-classification. Under the current regulations, a Type III supporting organization must satisfy a notification requirement, a responsiveness test, and either of two integral part tests.[87]

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 will be classified as a private foundation unless it can qualify as a public charity on other grounds.

Integral part test; functionally integrated. A Type III supporting organization can qualify as functionally integrated in one of three ways: (1) through the but-for test, (2) through the parent test, and (3) by supporting a government entity.

But-for test. First, an organization can conduct activities, substantially all of which (as determined under the facts and circumstances) directly further the exempt purposes of its supported organizations.[88] For this purpose, such activities would, but for the involvement of the supporting organization, normally be performed or carried out by the supported organizations.[89]

Very importantly, for these purposes, certain activities commonly performed by supporting organizations are not considered to directly further the exempt purposes of supported organizations. These include fundraising, grantmaking (whether to the supported organization or to third parties), and investing and managing nonexempt use assets (e.g., market rate endowment investments).[90] 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.

Parent test. A Type III supporting organization can be considered functionally integrated if it is the parent entity of its supported organization.[91] For this purpose, a parent must appoint a majority of the 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.[92] This type of relationship is commonly seen in complex health care organizations, but it could be appropriate in other families of exempt organizations managed by a central exempt coordinating entity, such as affordable housing or charter school management organizations. Oftentimes, these organizations may be conducting what might not otherwise qualify as charitable activities, and must meet the threshold requirements of Section 501(c)(3) under what is known (a bit confusingly) as the "integral part doctrine." As the name suggests, this ends up being 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.

Supporting a government entity. The final way in which a Type III supporting organization can qualify as functionally integrated is by supporting a government entity.[93] The 2012 regulations failed to provide guidance on the contours of this test, instead reserving the regulation for future action.[94] The 2013 interim guidance, however, provides a temporary definition on which supporting organizations and their funders may rely.[95] Until final regulations are published, a Type III supporting organization will be considered to meet this functionally integrated test if (1) it supports one or more supported organizations that are governmental entities 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

[88] Reg. 1.509(a)-4(i)(4)(i)(A).
[89] Reg. 1.509(a)-4(i)(4)(ii)(A)(2).
[90] Reg. 1.509(a)-4(i)(4)(ii)(C).
[91] Reg. 1.509(a)-4(i)(4)(i)(B).
[92] Reg. 1.509(a)-4(i)(4)(iii).
[93] Reg. 1.509(a)-4(i)(4)(i)(C).
[94] Reg. 1.509(a)-4(i)(4)(iv).
[95] Notice 2014-4, 2014-2 IRB 274.
[96] Reg. 1.509(a)-4(i)(5)(i).
[97] Reg. 1.509(a)-4T(i)(5)(ii)(B)-(C).
[98] Reg. 1.509(a)-4(i)(6).
[99] Reg. 1.509(a)-4(i)(5)(iii)(A).
[100] Reg. 1.509(a)-4(i)(5)(iii)(B).
[101] Reg. 1.509(a)-4(i)(5)(iii)(C).
[102] Sections 4945(d)(4), 4966(c)(2)(A).
[103] Regs. 1.170A-9(f)(5)(ii), 1.509(a)-3(e)(2)(i).
[104] Regs. 1.170A-9(f)(5)(ii), 1.509(a)-3(e)(2)(i).
[105] Sections 4966(d)(4)(A)(i), 4945(d)(4)(A)(ii), 4942(g)(4)(A)(i).
[106] Rev. Proc. 2011-33, IRB 2011-25.
[107] 2006-2 CB 1121.
[108] 2014-2 IRB 274.
[109] Payout Requirements for Type III Supporting Organizations that Are Not Functionally Integrated, 72 Fed. Reg. 42335 (2007).

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 change.

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.[96] 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 or 3.5% of the fair market value of its non-exempt assets from the prior year.[97] Appropriate distributions include, but may not be limited to: (1) amounts paid to a supported organization to accomplish its exempt purposes; (2) amounts paid to perform functions that directly further the exempt purposes of its supported organizations (defined in reference to the corollary rules for functionally integrated organizations), to the extent that such expenses exceed revenue from such activities; (3) reasonable and necessary administrative expenses; (4) amounts to acquire certain exempt-use assets; and (5) set-asides.[98]

The attentiveness requirement ensures that at least one-third of such distributions are directed toward one or more supported organizations that are attentive to the supported organization's operations and to which the supporting organization is responsive.[99] A supported organization will be considered attentive to the supported organization if (1) the supporting organization provides to the supported organization at least 10% of the supported organization's total support for the prior year, (2) the supporting organization's support is necessary to avoid the interruption of a substantial program or activity of the supported organization, or (3) a determination may be made under the facts and circumstances based on the consideration of all pertinent factors.[100] Distributions from the supporting organization to a donor-advised fund held by the supported organization will be disregarded for the purposes of the attentiveness test.[101]

Grantor reliance and earmarking

Public support test compliance issues do not end with the public charities themselves; they also present donors and grantors with a number of concerns. Private foundations and donor-advised funds, in particular, need to know the public charity status of their grantees,[102] and cannot be responsible for or aware of a grantee's failure of the applicable public support test.[103] Grantors can rely on an organization's public charity classification as specified in its determination letter until the date of a contrary notice in Publication 78,[104] though as described below, determination letters and IRS records may not contain pertinent information if the grantee is a supporting organization.

Determining supporting organization type. Excise taxes restrict grants from private foundations and donor-advised funds to Type III non-functionally integrated supporting organizations.[105] The issue, of course, is how a grantor can determine the classification of such a grantee to ensure that it complies with the applicable restrictions. For this purpose, Rev. Proc. 2011-33[106] provides that grantors may rely on a supporting organization's classification contained in the IRS Business Master File. However, the IRS did not start classifying types of supporting organizations until after the PPA, and there are a multitude of supporting organizations that have not sought IRS determination as to type. To provide guidance to grantors with respect to these organizations, the IRS issued procedures that grantors could follow in Notice 2006-109,[107] which were reinforced by Notice 2014-4[108] following the issuance of final regulations. These procedures permit a grantor to rely on a written opinion of counsel or certain representations and documents provided by a grantee supporting organization as to its type.

A number of important transactions depend on Section 509(a) compliance.

Critically though, Notice 2006-109 permitted functionally integrated Type IIIs to meet a pre-PPA "but-for" standard that is broader than the current standard set forth in the updated regulations. As discussed above, the current standards explicitly disfavor fundraising, grantmaking, and investment management, so organizations that were appropriate grantees under Notice 2006-109 may no longer be under Notice 2014-4. Accordingly, grantors should make sure that the documentation on which they intend to rely applies the standards set forth in Notice 2014-4. Unfortunately, however, many Type III supporting organizations may not be aware of the current standards, which can put grantors in the unenvi-

able position of educating grantees on tax compliance.

To further complicate things, the IRS may have issued determination letters classifying organizations as Type III 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 (ANPR) on 8/2/07.[109] This ANPR contemplated rules for Type III classification analogous to private operating foundations. The IRS received significant pushback on these standards, however, and issued proposed regulations in 2009 that looked very different.[110] After several years, the IRS tweaked things even further when final regulations were issued in 2012.

Following each of these three administrative actions, EO Determinations issued an internal memorandum authorizing the issuance of determination letters indicating Type III functionally integrated status based on each respective standard.[111] 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 that they have met those standards. The most significant changes occurred between 2007 and 2009, and it is unlikely that many letters were issued during that time. Moreover, it is certainly possible that an organization that met the 2007 standards would also meet the current ones.

In any event, a grantor is not obligated to look behind the veil. Rev. Proc. 2011-33 permits a grantor to rely on the IRS determination as to type of supporting organization included in the Business Master File except where it (1) had knowledge of the revocation of the ruling or determination letter classifying the organization as one described in Section 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 Section 509(a)(1), (2), or (3) (or specifying its supporting organization type). Nonetheless, additional scrutiny may be in order for some potential grantees.

Earmarking.

In general, the regulations "look through" certain payments to ensure that any funds paid by a donor to an organization that are earmarked for another organization are treated as paid to the ultimate recipient. As noted above, grants from Section 170(b)(1)(A)(vi) organizations are includable in full as public support under both the Section 509(a)(1) and (2) tests. However, under the Section 509(a)(1) test, contributions from a Section 170(b)(1)(A)(vi) organization that are expressly or impliedly earmarked by a donor as being for, or for the benefit of, another organization are subject to the 2% limitation.[112] In addition, an anti-abuse provision prohibits disqualified persons of a Section 509(a)(2) organization from expressly or impliedly earmarking a donation to the Section 509(a)(1) organization 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.[113] For these purposes, earmarking is not defined, but the examples illustrate that earmarking requires that the donor impose conditions or restrictions that remove the discretion and control in the grantee's use of the funds or in the selection of secondary grantees.[114] This is generally consistent with the earmarking rules applicable to private foundations for the purposes of determining a taxable expenditure under Section 4945(d)(4).[115]

Accordingly, a grant from a donor-advised fund that is properly organized and maintained by its sponsoring organization should

[110] REG-155929-06, 2013-11 IRB 650.

[111] Memorandum to Manager, EO Determinations from Robert Choi, Director, EO Rulings and Agreements, Regarding "Supporting Organizations IRC 509(a)(3)," dated 9/24/07, available at www.irs.gov/pub/irs-tege/509a3guidesheetchoimemo.pdf; memorandum to Manager, EO Determinations from Robert Choi, Director, EO Rulings and Agreements, regarding "Supporting Organizations IRC 509(a)(3)," dated 9/25/09, available at www.irs.gov/pub/foia/ig/tege/tege-07-0909-02.pdf; memorandum to Manager, EO Determinations from Holly Paz, Director, EO Rulings and Agreements, regarding " Type III Supporting Organizations," dated 2/4/13, available at www.irs.gov/pub/irs-tege/TypeIII_SupportingOrg_2013_Regs.pdf.

[112] Reg. 1.170A-9(f)(6)(v).

[113] Reg. 1.509(a)-3(j)(2).

[114] Reg. 1.509(a)-3(j)(3), Examples 1-3.

[115] Reg. 53.4945-5(a)(6).

[116] Sections 4966(d)(2)(A)(ii)-(iii); Staff of the Joint Committee on Taxation, "Technical Explanation of H.R. 4, the 'Pension Protection Act of 2006,' as Passed by the House on July 28, 2006, and as Considered by the Senate on Aug. 3, 2006 (JCX-38-06), 343 (Aug. 3, 2006)."

[117] Reg. 170A-9(f)(11)(v)(B)(1).

not be considered earmarked by the donor advisor. Under the definition of a "donor-advised fund," the fund must be owned and controlled by its sponsoring charity, and the corresponding advisory privileges cannot have the force of a legal right or obligation.[116] Similarly, a gift or grant to an agency or designated fund at a community foundation should be subject to the community foundation's unilateral variance power and ultimate discretion (although terms and practices may vary among community foundations, and donors and organizations would be wise to review the fund documentation).[117] However, to avoid the perception or potential for abuse, many community foundations and donor-advised fund sponsors have policies that prohibit or apply limits to grants where support from a fund makes up a substantial portion of the organization's public support.

Conclusion

Public charity classification matters. All too often, however, the various nuances associated with each of the tests get lost. Through complexity or carelessness, organizations can sometimes misrepresent their public charity classification and sources of support for several years. Failure to accurately calculate public support and report public charity classification on Schedule A of Form 990 could result in an adverse reclassification by the IRS when it is too late for the organization to engage in planning. While the various nuances associated with the tests can seem overwhelming, there is good news. The complexities associated with the public support tests present a number of opportunities to ensure continued classification as a public charity by modifying fundraising practices or revising governance relationships, thereby allowing a Section 501(c)(3) organization to get its public charity status right before it goes wrong. ■