23rd Annual Health Sciences Tax Conference

Supporting organizations — Section 509(a)(3) and public charity status

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Supporting organizations — Section 509(a)(3)
Agenda

- Why is public charity status important?
- Types of public charities
- Supporting organizations
- Type III supporting organizations — new regulations
- Special rules affecting supporting organizations
- Changing public charity status
- Form 990 reporting requirements
Why is public charity status important?
Why is public charity status important?

► All Internal Revenue Code (IRC) Section 501(c)(3) organizations are classified as either a public charity or a private foundation (PF).

► Private foundations are subject to the following:
  ► Excise tax (1% or 2%) on net investment income, including capital gains
  ► Prohibition on self-dealing
  ► Annual 5% charitable distribution requirement
  ► Prohibition on excess business holdings
  ► Prohibition on jeopardizing investments
  ► Prohibition on expenditures for nonexempt purposes
  ► Termination tax
Why is public charity status important?

- Deductions for charitable contributions to certain private foundations (private nonoperating foundations) are subject to more restrictions.
  - Lower annual limits on amount deductible by individuals
- Failure to qualify as a public charity prevents a §501(c)(3) organization from being exempt under a group ruling.
- Public charities not required to submit detailed info required of PFs (Form 990-PF).
Types of public charities
Types of public charities

Section 509(a) lists four broad types of public charities:

- §509(a)(1) — includes organizations described in §170(b)(1)(A):
  - Churches or conventions or associations of churches
  - Educational organizations
  - Hospitals and medical research organizations
  - Certain endowment funds operated in connection with state and municipal colleges and universities
  - Governmental units
  - Publicly supported organizations supported by contributions from the general public and/or governmental units
- §509(a)(2) — publicly supported organizations that typically are supported by gross receipts from an exempt function activity
- §509(a)(3) — supporting organizations
- §509(a)(4) — testing for public safety
Publicly supported organizations — §170(b)(1)(A)(vi)

- §509(a)(1) — organizations described in §170(b)(1)(A)(vi)
  - Must normally receive more than 1/3 of support from gifts, grants and contributions from the general public and/or governmental units (or meet an alternative 10% facts and circumstances test)

- Public support test
  - Numerator is public support; denominator is total support
  - Five-year computation period — current year and previous four years
  - If test is met, organization considered a public charity for the current year and subsequent year

- Two-percent limitation on public support: to the extent a single donor’s contributions exceed 2% of the organization’s total support over the testing period, excess not considered public support
  - Does not apply to contributions/grants from other §170(b)(1)(A)(vi) public charities or governmental units
§509(a)(2)

- §509(a)(2) — publicly supported organization typically supported by gross receipts from an activity that is related to its exempt function
  - Examples: opera, symphony, museum, hospital that sells substantially all of its assets
- Two-part support test:
  - First, the organization must normally receive more than one-third of its support from any combination of:
    - Gifts, grants, contributions and membership fees
    - Gross receipts from admission fees, sales of merchandise, performance of services — to the extent the activities do not constitute unrelated trades or businesses
  - Second, the organization must normally receive not more than one-third of its support from the sum of:
    - Gross investment income
    - The excess, if any, of the amount of its Unrelated Business Taxable Income (UBTI) over the amount of tax imposed on that UBTI
Supporting organizations — §509(a)(3)

- §509(a)(3) — supporting organizations
  - Derive public charity status from organizational and operational relationship to one or more other types of public charities under §509(a)(1) or (a)(2)
  - Three types of supporting organizations (Type I, Type II and Type III)

Note: Supporting organizations are explained in more detail in the next section.
Qualifying for more than one public charity classification

- Treas. Reg. §1.509(a)-6 provides, in part, that “if an organization is described in 509(a)(1) and also in another paragraph of 509(a), it will be treated as described in 509(a)(1).”

- Therefore, if a fund-raising organization qualifies as both a §509(a)(1)/§170(b)(1)(A)(vi) organization and a §509(a)(3) supporting organization, technically it should be treated as a public charity under §509(a)(1) and not §509(a)(3).
Supporting organizations
Four tests for qualifying as a supporting organization (SO) — IRC 509(a)(3)

- Organizational test — governance documents
- Operational test — permissible beneficiaries and activities
- Control test — disqualified persons
- Relationship test (must meet one)
  - Type I
  - Type II
  - Type III
    - Functionally integrated
    - Nonfunctionally integrated
Organizational test

An SO’s articles of incorporation (governing instrument) must generally:

- Limit its purposes to one or more purposes set forth in IRC §509(a)(3)(A)
- Not expressly empower it to engage in activities that do not further those purposes
- State the specified public charities on behalf of which it is to be operated
- Not expressly empower it to support or benefit any organization other than the one(s) specified

Purposes

- General rule: the governing instrument should indicate that the organization is organized “for the benefit of, to perform the functions of, or to carry out the purposes of” one or more specified public supported organizations.
Organizational test

Specified organizations

- The specified supported organization must be a public charity under IRC §509(a)(1) or (a)(2) and, generally, must be designated by name in the articles of incorporation.

Type I and Type II SOs

- Instead of identifying the supported organization(s) by name, the governing instrument may designate the supported organization(s) by class or purpose.

Type III: generally must identify by name

Exception for Type I, Type II and Type III SOs

- Identifying the supported organization(s) by name is not required if there has been a “historic and continuing relationship” between the SO and the supported organization and, by reason of such relationship, there has developed a “substantial identity of interests” between such organizations.

Facts and circumstances test
Operational test

- An SO must engage solely in activities that support or benefit its specified supported organization(s).
- Other permissible beneficiaries:
  - Another SO that supports the specified supported organization(s)
  - Members of the charitable class benefited by the specified supported organization(s)
  - State colleges and universities that are governmental instrumentalities — §511(a)(2)(B)
- Permissible activities include but are not limited to:
  - Providing funding directly to permissible beneficiaries
  - Providing services directly to permissible beneficiaries
  - Carrying on an independent program that supports or benefits the specified supported organization
Control test — disqualified persons

- An SO must not be controlled, directly or indirectly, by “disqualified persons” (as defined by §4946) other than foundation managers.

- Disqualified persons include:
  - Substantial contributor
  - Creator of trust that is a substantial contributor
  - Owner of more than 20% of the combined voting power of a corporation, profits interest of a partnership, or beneficial interest of a trust or unincorporated enterprise, any of which is a substantial contributor to an SO
  - A family member of one or the above persons
  - A corporation, partnership or trust in which one of the above persons owns more than 35% of the combined voting power, profits interest or beneficial interest
Special rule pertaining to SOs and §501(c)(4), (5) or (6) organizations

- A §501(c)(3) organization can qualify as an SO and support a §501(c)(4), (5) or (6) tax-exempt organization.

- Requirements:
  - The §501(c)(4), (5) or (6) organization must meet the public support tests of IRC §509(a)(2).
  - The SO must meet the organizational test, operational test, control test and relationship test.
Relationship test

- Type I SO: “Operated, supervised or controlled by” one or more public charities
  - Similar to a parent-subsidiary relationship
- Type II SO: “Supervised or controlled in connection with” one or more public charities
  - Similar to a brother-sister relationship
- Type III SO: “Operated in connection with” one or more public charities
  - No direct control by the supported organization
  - Most restrictive requirements
  - Regulations issued December 2012
Relationship test — Type I SO
“Operated, supervised or controlled by”

- Relationship involves a substantial degree of direction by one or more supported organizations over the policies, programs and activities of the SO.
- Relationship is comparable to a parent-subsidiary relationship.
- Relationship is generally established by providing the supported organization(s) with the power to appoint/elect a majority of the directors/officers of the SO.
Type I SO

“Operated, supervised or controlled by”

Majority of officers and board directors of SO are appointed by supported organization’s governing body.
Relationship test — Type II SO
“Supervised or controlled in connection with”

- Presence of common supervision or control by the persons supervising or controlling both the SO and the supported organization(s) ensures that the SO will be responsive to the needs and requirements of the supported organization(s).
- Relationship is comparable to a brother-sister relationship.
- Control or management of the SO must be by the same individuals who control or manage the supported organization(s).
  - Usually, majority overlap consists of directors/trustees.
  - Majority overlap may also consist of principal officers.
Type II SO

1) Parent (SO) 
   Hospital

2) Parent
   Hospital
   SO

“Supervised or controlled in connection with”

Common supervision or control by the persons supervising or controlling both the SO and the supported organization (i.e., majority board overlap) is present.
Type III SOs — new regulations
Relationship test — Type III SO
“Operated in connection with”

➤ Background

➤ On December 28, 2012, the U.S. Treasury and Internal Revenue Service (IRS) issued final and temporary regulations regarding the requirements to qualify as a Type III SO.

➤ The regulations reflect changes to the law made by the Pension Protection Act of 2006.

➤ Proposed regulations had been issued in 2009.
Relationship test — Type III SO
“Operated in connection with”

- A Type III SO must be responsive to and significantly involved in the operations of the supported organization(s).
- A Type III SO must meet three requirements:
  - Notification requirement
  - “Responsiveness” test
    - To ensure that the SO is responsive to the needs of the supported organization(s) by requiring the supported organization to have the ability to influence the activities of the SO
  - “Integral part” test
    - To ensure that the SO maintains a significant involvement in the operations of one or more supported organization(s) and that the supported organization(s) are dependent on the SO for the type of support it provides
Type III SO

1) Parent (SO)
   Hospital

2) Hospital
   SO

“Operated in connection with”

SO must meet a responsiveness test and an integral part test.
Relationship test — Type III SO
“Operated in connection with”

- Notification requirement
  - SO must provide annually to each supported organization:
    - Written notice to a principal officer of each supported organization describing the amount and type of support the SO provided to the supported organization
    - Copy of the SO’s Form 990 most recently filed as of the notification date (may redact the name and address of any contributor)
    - Copy of the SO’s governing documents, as most recently amended, to the extent not previously provided
When are notification documents due?

- Notification documents must be **postmarked** or **electronically transmitted** by the last day of the fifth month following the close of the SO’s taxable year.
  - For calendar year taxpayers, notification documents are due by May 31.

- Transition rule: For the first year (i.e., the tax year that includes 12/28/12), the notification requirement must be met by the due date of Form 990, including extensions.
Relationship test — Type III SO
“Operated in connection with”

▶ Responsiveness test
  ▶ One or more officers, directors or trustees of the SO are elected or appointed by the supported organization
    Or
  ▶ One or more members of the supported organization’s governing body are also officers, directors or trustees of the SO
    Or
  ▶ The officers, directors or trustees of the SO maintain a close continuous working relationship with the officers, directors or trustees of the supported organization
  ▶ Because of one of the above, the officers, directors or trustees of the supported organization have a significant voice in the SO’s:
    ▶ Investment policies
    ▶ Timing of grants
    ▶ Manner of making grants
    ▶ Selection of grant recipients
Relationship test — Type III SO
“Operated in connection with”

- Regulations contain both a “good” and “bad” example of responsiveness.
- The good example describes a bank discretionary trustee of a testamentary trust supporting a private university:
  - Representatives of the bank and the university have quarterly face-to-face or telephonic meetings whereby they discuss projected needs and ways in which the university would like the bank to use the trust’s income and invest its assets.
  - The bank communicates regularly with the university officer regarding the trust’s investments and plans for distributions.
  - The bank provides to the university officer quarterly investment statements, notification required by the 2012 regulations and an annual accounting statement.
- Bad example:
  - The bank trustee of a trust supporting three supported organizations sends annual cash payments, the notification required by the 2012 regulations and an accounting statement.
Relationship test — Type III SO
“Operated in connection with”

- Integral part test
  - Functionally integrated (FI)
  - Nonfunctionally integrated (NFI)

- Key distinction
  - An NFI Type III SO must:
    - Make annual minimum distributions to its supported organization(s)
    - Meet an “attentiveness” requirement
Relationship test — Type III SO
“Operated in connection with”

- Integral part test — FI Type III SO
  - Three types of Type III SOs meet the integral part test because they are considered FI:
    - SO engages in activities, substantially all of which directly further the exempt purposes of the supported organization.
    - SO is a parent organization of the supported organization.
    - SO supports a governmental entity.*

* Note: IRS is to issue additional proposed regulations in the near future regarding how SOs can qualify as FI by supporting a governmental entity.
Relationship test — Type III SO
“Operated in connection with”

Substantially all activities: SO engages in activities, substantially all (based on all pertinent facts and circumstances) of which:

- Directly further the exempt purposes of the supported organization(s) (“direct furtherance” activities) by performing the functions, or carrying out the purposes, of these supported organization(s)

- But for the involvement of the SO, would normally have been performed by the supported organization(s)
Relationship test — Type III SO
“Operated in connection with”

► Examples of activities that do not directly further the exempt purposes of the supported organization:
  ► Fund raising
  ► Making grants
  ► Investing and managing nonexempt-use assets

► Example of activities that directly further the exempt purposes of the supported organization:
  ► Holding title to and managing exempt-use assets

► Making or awarding grants, scholarships or other payments to individuals who are members of the charitable class benefited by the supported organization count as direct furtherance activities under certain circumstances.
Relationship test — Type III SO “Operated in connection with”

- Parent organization of each supported organization:
  - SO (parent) must exercise a substantial degree of direction over the policies, programs and activities of the supported organization.
  - Majority of the officers or directors of the supported organization must be appointed by the SO (parent).

For example: Parent organization of a health care system
Relationship test — Type III SO
“Operated in connection with”

- Integral part test — NFI Type III SO
  - Must comply with:
    - Distribution requirement
    - Attentiveness requirement

- Distribution requirement:
  - SO is required to distribute, with respect to each taxable year, on or before the last day of each taxable year, amounts equaling or exceeding the SO’s distributable amount.
  - These distributions must be made to, or for the use of, one or more supported organizations.
Relationship test — Type III SO
“Operated in connection with”

- Distributable amount (as defined in temporary regulations)*
  - Equal to the greater of:
    - Eighty-five percent of the SO’s adjusted net income for the immediately preceding taxable year
    - Three and one-half percent of the fair market value of the SO’s nonexempt-use assets for the immediately preceding taxable year

- Distributions in excess of the annual distributable amount may be carried over for five subsequent years.

* Note: These regulations were issued as temporary to provide taxpayers with an opportunity to comment.
Relationship test — Type III SO
“Operated in connection with”

- Distributions that count toward distribution requirement
  - Determined based on cash method and include:
    - Amounts paid to a supported organization
    - Net amounts paid to perform a direct activity
    - Reasonable and necessary administrative expenses of the supported organization, other than investment-related expenses
    - Costs to acquire exempt-use assets
    - Set asides that meet certain requirements
      - Set asides permitted under rules similar to those applying to private foundations under §4942(g)(2)(B)(i)
        - Receipt of advance IRS approval, five-year limit, perjury statement from supported organization that the set aside is better than immediate payment of funds
Relationship test — Type III SO
“Operated in connection with”

► One-year grace period to meet distribution requirement
  ► For the first taxable year an organization is treated as an NFI Type III SO, it has no distributable amount

► Reasonable cause exception for organizations that fail to satisfy the distribution requirement
  ► Applies if the organization establishes that:
    ► Failure was due solely to unforeseen events/circumstances that are beyond the organization’s control, a clerical error or an incorrect valuation of assets.
    ► The failure was due to reasonable cause and not to willful neglect.
    ► The failure is corrected within 180 days of discovery of the error or of resolution of the unforeseen event.
Relationship test — Type III SO
“Operated in connection with”

- Attentiveness requirement
  - An NFI Type III SO must distribute at least one-third of its annual distributable amount to one or more of its supported organizations that are attentive to the operations of the SO and to which the SO is responsive.
To establish that a supported organization is attentive, the SO must provide one of the following:

- At least 10% of the supported organization’s total support received during its previous taxable year
- Support necessary to avoid the interruption of the carrying on of a substantial function or activity of the supported organization
- An amount of support that, based on “all the pertinent factors,” is a sufficient part of the supported organization’s total support
  - Pertinent factors: the number of supported organizations, length and nature of the relationship between the supported organization and SO, and the purpose toward which the funds are put
Relationship test — Type III SO
“Operated in connection with”

Transition rules

- For organizations in existence on December 28, 2012:
  - One-year grace period: beginning in the second taxable year beginning after December 28, 2012 (and in all succeeding years), all Type III SOs must meet the integral part test for FI or NFI under the new regulations.
    - Examples:
      - December 31 year end: must satisfy integral part test by the end of day, December 31, 2014
      - June 30 year end: must satisfy integral part test by end of day, June 30, 2015
    - A Type III SO that meets the but for integral part test requirement of the former regulations will continue to be treated as an FI Type III SO until the first day of the organization’s second taxable year beginning after December 28, 2012.
    - A Type III SO that meets the “payout” integral part test requirement of the former regulations will continue to be treated as an NFI Type III SO until the first day of the organization’s second taxable year beginning after December 28, 2012.
Special rules affecting SOs
Special rules affecting SOs

- A Type I or Type III SO cannot:
  - Accept any gift or contribution from a person (other than from a public charity but not including an SO) who, either alone or in conjunction with certain related parties, directly or indirectly controls the governing body of any of its supported organization(s)
    - Related parties include family members and 35%-controlled entities
    - IRS has indicated that it will issue regulatory guidance in the near future as to the definition of “control.”

- Type III SO cannot support a foreign organization.
Other rules affecting all SOs

- **Automatic excess benefit transactions**
  - Grants, loans, payments of compensation or other similar payment (such as an expense reimbursement) from an SO to a substantial contributor (or related person) is treated as an automatic excess benefit transaction.
    - Treatment is not applicable to payments made under a bona fide sale or lease of property.

- A “substantial contributor” is any person who contributes or bequeathes an aggregate amount of more than $5,000 to the organization, if such amount is more than 2% of the total contributions received by the organization from inception to the end of the year.
Other rules affecting all SOs

- Any loan provided by an SO to a disqualified person is treated as an excess benefit transaction, and the entire amount of the loan is treated as an excess benefit under §4958.
  - For this purpose, a disqualified person does not include a public charity (other than an SO).
  - A disqualified person of an SO is also treated as a disqualified person of the supported organization.

- Generally, a disqualified person under §4958 is one of the following:
  - A person in a position to exercise substantial influence over the affairs of the organization at any time during a five-year period ending on the date of the transaction
  - A family member of a disqualified person
  - A 35%-controlled entity of a disqualified person
Rules affecting Type III SOs

- Excess business holdings
  - Excess business holdings rules of IRC §4943 apply to Type III SOs (other than FI Type III SOs).

- Nonoperating private foundations may not count as a qualifying distribution under §4942 any amount paid to:
  - A Type III SO that is not FI
  - Any other SO if a disqualified person with respect to the foundation directly or indirectly controls the SO or a supported organization of such SO

Note: Any amount not treated as a qualifying distribution is treated as a taxable expenditure, unless the foundation exercises expenditure responsibility.
Changing public charity status
Changing public charity status

Form 990, Schedule A, Part I

- Organization is required to indicate the reason it is a public charity for the tax year.
- Reason can be the same as stated in the organization’s IRS determination letter, or it can be different.
- IRS does not update its records (i.e., the IRS Master File) on public charity status based on changes the organization makes on Schedule A.
Changing public charity status

To update the IRS Master File and/or receive an updated IRS determination letter, complete and submit Form 8940, *Request for Miscellaneous Determination*

- Used to request certain determinations from the IRS, including:
  - Change in (or initial determination of) type of Section 509(a)(3) SO
  - Reclassification of public charity status (i.e., changing from 509(a)(3) to 509(a)(1))
- User fee of $400
Form 990 requirements
2012 Schedule A (Form 990 or 990-EZ) instructions: public charity status

► Indicate the type of SO (Type I, Type II, FI Type III or NFI Type III)
► Indicate whether the organization received an IRS determination letter identifying its type
► Certify that the organization is not controlled by disqualified persons (other than foundation managers or organizations described in Section 509(a)(1) or (2))
► Indicate whether the organization has, subsequent to August 16, 2006, accepted a gift or contribution from a person (other than a Section 509(a)(1) or (2) organization) who directly or indirectly (alone or with certain related persons) controls its governing body
Provide the following information about each of the organization’s supported organizations:

- Name and Employee Identification Number
- Type of public charity status
- Indication of whether each supported organization is specifically named as a supported organization in the organization’s articles of incorporation or other governing documents
2012 Schedule A (Form 990 or 990-EZ) instructions: public charity status

- Type III organizations: indication of whether each supported organization was notified of support
- Type III organizations: indication of whether each supported organization is organized in the United States
- Total amount of monetary support paid to, or for the benefit of, each supported organization during the year

Note: The organization should describe in Part IV any services, facilities or goods that the organization provided to, or purchased for the benefit of, the supported organization during the year.
2012 Schedule R (Form 990) instructions: related organizations

- An organization is a related organization to the filing organization if at any time during the organization’s tax year:
  - It is an SO of the filing organization if the filing organization is a supported organization.
  - It is a supported organization if the filing organization is an SO.