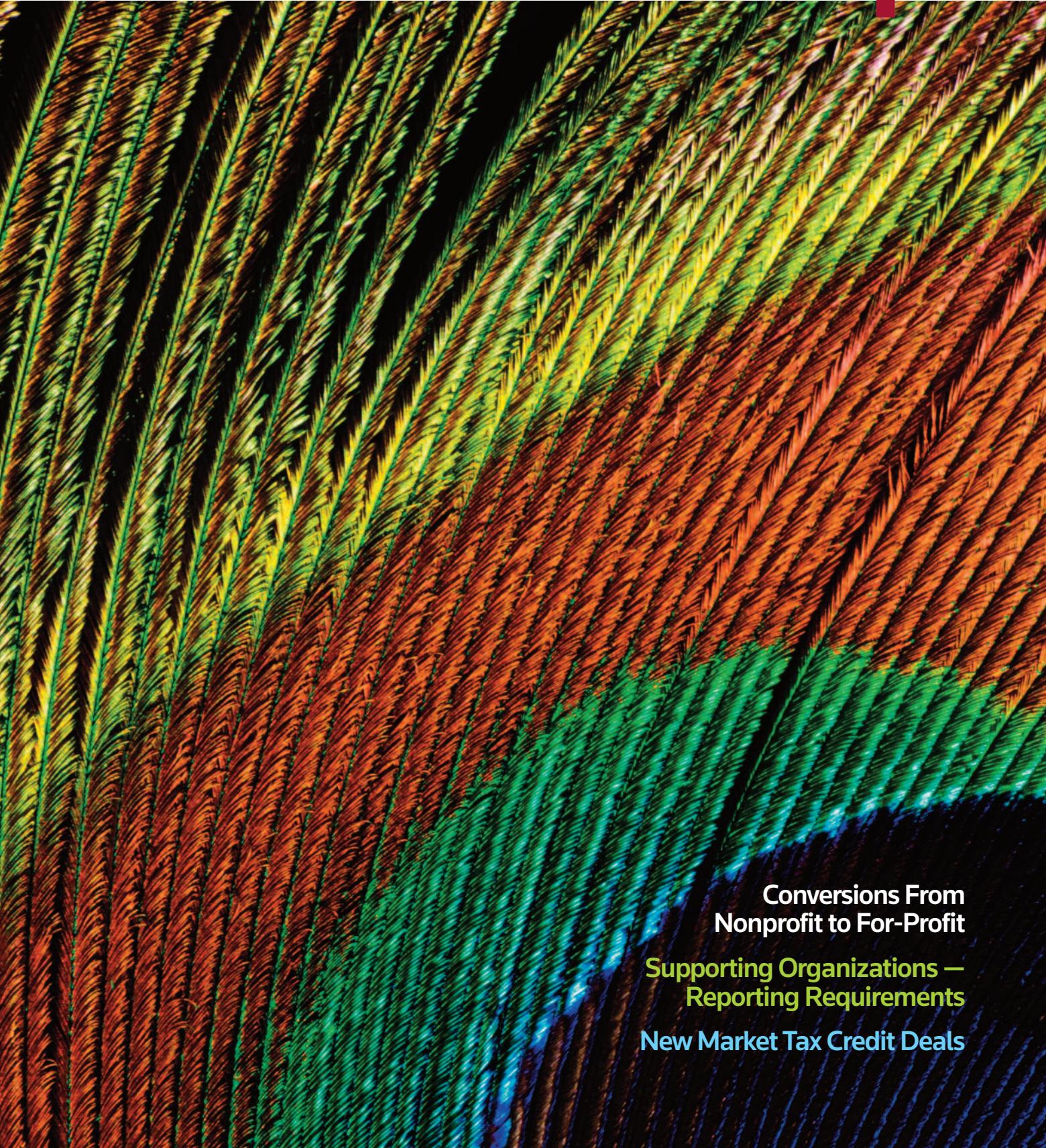


Taxation of Exempts



**Conversions From
Nonprofit to For-Profit**

**Supporting Organizations —
Reporting Requirements**

New Market Tax Credit Deals

SCHEDULE A REPORTING: SECTION 509(a)(3) SUPPORTING ORGANIZATIONS

JOHN V. WOODHULL AND JANICE M. SMITH

Supporting organizations historically have been viewed as operating within a very complex area of the tax law. The complexity arguably rose to a new level, however, with the 2014 introduction of an expanded Schedule A of Form 990—the form required for reporting public charity status and public support. Because of the expanded reporting requirements, supporting organization managers and tax practitioners have been forced to possess a deeper understanding of supporting organization tax law than required in the past.

If there is one area of tax law in which compliance can be amorphous, escaping even the most meticulous organizational and tax accounting professionals, it is the area of supporting organizations.¹ Not only are the tax rules complex, but, as discussed below, expanded tax reporting under the rules affects situations that were not even intended to be affected, thus forcing strained interpretations of the regulatory requirements.

The previous Schedule A

Until the 2014 Form 990 series was released, Schedule A of Form 990 was not much more than a pro forma checklist for charitable organizations' public

charity status. In most instances, charitable organizations simply checked the same box in Part I ("Reason for Public Charity Status") that they had checked in the previous year or years, and moved on to the next (and seemingly more important) schedules in Form 990. Public charity status seemingly had been relegated to one of the less important issues for tax exempt organizations to consider. If any effort was expended, it was focused primarily on Parts II and III of Schedule A (the support schedules) that numerically verified a charitable organization's public charity status under Section 509(a)(1)/Section 170(b)(1)(A)(vi) and Section 509(a)(2).

Schedule A previously had been revised in 2008 when the entire Form 990 was redesigned and expanded to 16 schedules. The primary changes that were introduced to Schedule A at that time related to the public support schedules, which were expanded from a four-year rolling average to a five-year rolling average. Prior to 2008, organizations applying for recognition of charitable exemption on Form 1023, "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code," were permitted to elect an "advance ruling" that required the organization to submit public support information on a separate schedule at the end of the five-year advance ruling period to confirm their public charity status under Section 509(a)(1)/Section 170(b)(1)(A)(vi). However, al-

Because of expanded reporting requirements, supporting organization managers and tax practitioners have been forced to possess a deeper understanding of supporting organization tax law than required in the past.

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though Question 6a in Part X (“Request for Advance Ruling”) remains in Form 1023, instructions on the form itself indicate that the advance ruling election is no longer available. This is another example of the difficulty the IRS has had in trying to update its publications and regulations to reflect the statutory changes enacted by Congress.

At present, once an initial determination has been made by the IRS regarding a charitable organization’s public charity status based on the financial information submitted with Form 1023, Schedule A is the only schedule that charitable organizations may use to demonstrate that they are maintaining their public charity status under Section 509(a)(1)/Section 170(b)(1)(A)(vi). If, at the end of five years, a charitable organization does not meet the one-third test or the 10% facts-and-circumstances test—the mathematical tests that demonstrate that an organization

threshold (as the case may be) in Part IV-A of Schedule A could continue to file as publicly supported organizations, albeit incorrectly, unless either the IRS audited the organization and directed it to begin filing a Form 990-PF or the organization itself stopped filing the Form 990. There was no automatic default to private foundation status in Part IV-A of the pre-2008 Form 990.

The winds of change hit the regulations ... and Schedule A

Notwithstanding the changes to Parts II and III of Schedule A, Schedule A reporting issues did not really come into focus until the Section 509(a)(3) regulations were finalized in 2012 and Parts IV, V, and VI were added to Schedule A beginning with the 2014 tax year.² Prior to 2006 and the changes enacted to Section 509(a)(3), Section 509(a)(3) often was used as a default public charity status, available for charitable organizations that were unable to effectively solicit charitable contributions or charge admissions for exempt activities and satisfy the public support tests of Sections 509(a)(1)/Section 170(b)(1)(A)(vi) and Section 509(a)(2). Although the relationship tests are the most difficult part of the 509(a)(3) regulations to satisfy, many charitable organizations choose to be classified as supporting organizations, with only a limited understanding of the restrictions that Section 509(a)(3) impose on their abilities to act independently.

The ‘new’ Schedule A— Expanded reporting for supporting organizations

As most supporting organizations discovered upon completing their 2014 Form 990, the number and complexity of the questions in the expanded Schedule A can be confusing and overwhelming. The ex-

¹ Supporting organizations are described in Section 509(a)(3). It defines them as an organization that is organized, and at all times operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more publicly supported organizations (specifically, organizations described in Section 509(a)(1) or Section 509(a)(2)). A supporting organization is either “operated, supervised or controlled by” “supervised or controlled in connection with,” or “operated in connection with” one or more publicly supported organizations. Supporting organizations must not be controlled directly or indirectly by disqualified persons.

² Even though Form 990, Schedule A, has been updated to conform to the new supporting organization requirements, Form 1023, Schedule D, has not been similarly updated. Thus, Form 1023 supporting organization filers should include documentation (such as a narrative explanation) to demonstrate that the applicable supporting organization tests will be met.

³ P.L. 109-208, 120 Stat. 780, 3/23/06. According to IRS Notice 2006-109, 2006-51 IRB 1121: “The PPA incorporates the previously informal nomenclature used to distinguish among types of supporting

organizations into the statute.” Specifically, Type I supporting organizations are “operated, supervised, or controlled by” one or more Section 509(a)(1) or 509(a)(2) organizations; Type II supporting organizations are “supervised or controlled in connection with” one or more Section 509(a)(1) or 509(a)(2) organizations; and Type III supporting organizations are “operated in connection with” a Section 509(a)(1) or (2) organization.

⁴ In considering the supporting organization regulations, a district court judge commented that “the Internal Revenue Service has drafted fantastically intricate and detailed regulations to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while avoiding the imposition of taxes.” *Windsor Foundation*, 40 AFTR2d 77-6004 at 77-6005 (ED Va., 1977).

⁵ See, for example, Mitchell *et al.*, “Supporting Organizations in the Spotlight,” 27 Exempts 3, page 3 (Nov/Dec, 2015).

⁶ Throughout this article, the term “publicly supported organizations” refers to organizations that receive broad public support and are classified as Section 509(a)(1) or Section 509(a)(2) organizations.

expanded tax reporting requirements necessitate much closer analysis than before. Specifically, Schedule A of Form 990 was substantially revised in 2014 to address the new reporting requirements of the final regulations governing supporting organizations under Section 509(a)(3). Prior to 2014, Section 509(a)(3) supporting organizations had to provide only a minimum amount of information on Schedule A, none of which had to be verified or cross referenced. Supporting organizations were required to list only the names of the organizations that they were supporting and answer three or four very non-intrusive questions.

The 2014 Schedule A, however, dramatically changed and expanded this limited reporting. The revised Schedule A contains more than 60 questions and line items, many of which are focused on Section 509(a)(3) supporting organizations. Although no one organization must answer all of the questions on Schedule A, there is a substantial amount of additional information that supporting organizations now must provide. Many of the questions require supporting organizations to delve into their archives and review their articles of incorporation, bylaws, exemption application, and IRS determination letters, among other things, in order to properly answer the questions.

To assist practitioners with some of the common supporting organization tax reporting issues that have arisen under the expanded Form 990, Schedule A, a checklist is of the information that must be gathered and analyzed appears in Exhibit 1.

Expanded reporting requires a deeper understanding

Prior to the expansion of the Schedule A questions relating to supporting organizations, supporting organization questions on Form 990 were relatively straightforward and unobtrusive. Because the questions were relatively high-level and required no follow-up explanations, organizations inadvertently could answer the questions incorrectly, seemingly without consequence. Under the revised reporting requirements in Schedule A, however, organizations not only must thoroughly understand the new specific supporting organization designations—Type I, Type II, and Type III—that were added to the tax law by the Pension Protection Act of 2006 (PPA),³ but also try to understand the complex maze of Type III functionally integrated and nonfunctionally integrated regulations. The modifications to Schedule A are another example of the difficulty the IRS has in bringing statutory changes, in this case enacted in 2006, into its regulations. The changes in this case

were not finalized until the end of 2012 and were finally incorporated into the instructions and Schedule A in 2014.

Overview of supporting organization classifications

The supporting organization statutes and regulations are very complex. In fact, they are some of the most complex regulations in the Tax Code.⁴ This article is not intended to include a detailed discussion of those rules, as that topic has been frequently addressed in previous articles.⁵ Rather, this article is intended to focus on the expansion of federal tax reporting related to supporting organizations, especially in

Instructions on the form itself indicate that the advance ruling election is no longer available.

Schedule A. Nevertheless, for purposes of this article, a brief synopsis of the Section 509 public charity rules is included so that the multiple references to public charity classifications and supporting organization “Types” will not be presented in a vacuum.

Determining the proper classification. An organization’s “public charity classification” generally refers to whether a Section 501(c)(3) charitable organization is described in Section 509(a)(1), 170(b)(1)(A), 509(a)(2), or 509(a)(3). Section 501(c)(3) charitable organizations that are not described in any of those sections are private foundations.

The most important factor to consider when determining the proper public charity classification of an organization is its anticipated sources of support. Generally, if an organization anticipates receiving broad public support—many different donors who make relatively small contributions to the organization, or program service revenue—publicly supported status under Section 509(a)(1)/170(b)(1)(A)(vi) or Section 509(a)(2), respectively, is most likely appropriate and the one that should be relatively easy for the organization to maintain. On the other hand, if an organization anticipates receiving one or a few very large contributions (comprising most of the organization’s total support), supporting organization status under Section 509(a)(3) is most likely appropriate, assuming that the organization primarily supports one or a few publicly supported organizations and is willing to operate under the control of another charitable organization.⁶ When an organization receives substantial support for one or very few sources—like one wealthy individual or family—and

EXHIBIT 1

Checklist for Gathering Information for Schedule A Supporting Organization Questions

Item	What to look for ...
Federal tax classification per IRS determination letter	What is the public charity classification of the organization according to its original IRS determination letter?
Federal tax classification per IRS Exempt Organizations Business Master File	What is the federal tax classification of the organization according to the IRS Exempt Organizations Business Master File (EO BMF)? The EO BMF is accessible at https://www.irs.gov/charities-non-profits/exempt-organizations-business-master-file-extract-eo-bmf . According to the EO BMF Information Sheet, there is a “Foundation Code” for each type of publicly supported organization. As to supporting organizations, there is a code for 509(a)(3) organizations generally, and codes for Type I, Type II, Type III functionally-integrated and Type III non-functionally-integrated supporting organizations, respectively. The more specific supporting organization codes would only relate to supporting organization status that was obtained in more recent years—older organizations will only have the more general 509(a)(3) Foundation Code.
Federal tax classification per analysis of current operations	Based on the organization’s current operations, is publicly supported status possible (based on the organization’s sources of support), or must the organization qualify for supporting organization status (or otherwise be classified as a private foundation)?
Original IRS Form 1023, “Application for Recognition of Exemption”	In the organization’s original Form 1023, did it assert supporting organization status, and, if so, on what basis did it request such status? Are all of the facts set forth in the Form 1023 the same now as they were then—for instance, the same governing document provisions and the same amount of public support?
Any subsequent communications with the IRS regarding public charity classification	Did the organization ever seek formal reclassification from the IRS of its public charity status? If so, on what basis, and what was the result?
Rationale for filing inconsistent with tax classification per IRS Determination Letter or EO BMF	Does the organization have an explanation for any inconsistencies between its tax classification and historical tax filings? This may involve changes in operations, changes in sources of support, misinterpretation of the tax rules, erroneous tax filings, etc.
Federal tax classified per analysis of anticipated operations	Based on the organization’s anticipated operations, is publicly supported status possible, or would the organization have to qualify for supporting organization status (or otherwise it would be classified as a private foundation)?
Tax filing history	How has the organization been filing its tax return—specifically, what public charity classification has it used? Practitioners might want to look back at least three years for this information.
Articles of incorporation	Is supporting organization status referenced in the purpose clause? A typical supporting organization purpose clause would state that the supporting organization is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more supported organizations.
Articles of incorporation	Is the supported organization named as a supported organization in the purpose clause?
Articles of incorporation	Is the supported organization named by class or purpose in the purpose clause?
Bylaws	Does the supported organization have control over the election of directors of the supporting organization?
Bylaws	Does the supported organization have the ability to appoint any board members of the supporting organization?
Board overlap	Notwithstanding any required board overlap per the Bylaws, what is the actual board overlap (whether inadvertent or required) between the supporting and supported organization?
Working relationship	If there is no board overlap, what is the working relationship between the officers, directors, or trustees of supporting and supported organizations?

prefers to not operate under the control of another charitable organization, it is most likely classified as a private foundation.

Publicly supported organizations. Publicly supported organizations classified under Section 509(a)(1)/Section 170(b)(1)(A)(vi) generally must receive a substantial part of their support in the form of contributions from other publicly supported organizations, government units, or the general public.

One way of qualifying as a publicly supported organization is to satisfy a mathematical public support

zation in order for it to determine whether it could, in fact, meet the public support test.

'Types' of supporting organizations. In the past, if an organization anticipated that it would not be able to generate a broad base of contributions or develop significant exempt function income, and it would support the activities of only one or a few specific publicly supported organizations, it made sense to seek classification from the IRS as a Section 509(a)(3) supporting organization. Selecting 509(a)(3) status seemed like a relatively easier default alternative to establishing and maintaining

The revised Schedule A automatically defaults organizations that fail the mathematical public support tests to private foundation status.

test (sometimes called the "one-third public support test"). Generally, the total amount of support that the organization normally receives from other publicly supported organizations, government units, or the general public must equal or exceed one-third of the total support that the organization normally receives. This test is calculated using a five-year moving average, as noted earlier in the discussion of Part II of Schedule A.⁷

To perform the test, a support fraction is calculated by including qualified government and public support in the numerator of the support fraction, and including all of the organization's support from almost all sources (including investment income) in the denominator of the fraction. All gifts, grants, and contributions are includable in full in the denominator, but they are included in the numerator only to the extent they do not exceed 2% of the organization's total support included in the denominator. Generally, grants from government units and other publicly supported charities are not subject to the 2% limitation.

Even if an organization did not calculate this public support test on its tax return (because it had been filing, not as a publicly supported organization, but rather as a supporting organization), a mockup of the public support test can be completed by the organi-

public charity status through contributions or exempt function income. As will be discussed later, Section 509(a)(3) status is no longer such an easy and uncomplicated alternative.

Generally, a supporting organization must either be controlled by a supported organization (a Type I supporting organization), have common management with the supported organization (a Type II supporting organization), or engage in activities that further charitable purposes of the supported organization and provide certain notices to the supported organization (a Type III functionally-integrated supporting organization).

There are additional complexities in determining and meeting supporting organization status when the supported organization is not a charitable organization under Section 501(c)(3).⁸ Those additional complexities would apply if the supported organization, for example, is classified as a Section 501(c)(6) trade association rather than a charitable organization. Thus, the trade association essentially would have to prove on an ongoing basis that it has broad public support, as if it were subject to the aforementioned one-third public support test itself. In addition, because a supporting organization is required to list the organization it supports, the supporting organization would have to list the Section 501(c)(6) organization in Part I, Line g(i) of Schedule A. However, in Line g(iii), the supporting organization would have to enter "9" (which is the number for Section 509(a)(2) organizations) for the Section 501(c)(6) organization, further reflecting the public charity status that the Section 501(c)(6) organization is required to maintain. Interestingly, there are no instructions in Schedule A to advise supporting organizations that it should be reported in this manner.

⁷ Organizations that fail to meet the one-third public support test may still qualify as a publicly supported organization by passing a 10% "facts and circumstances" test. Further discussion of this test, however, is beyond the scope of this article.

⁸ According to Section 509(a)(3), a supported organization may include an organization described in Section 501(c)(4) (social welfare organizations), Section 501(c)(5) (labor, agricultural, or horticultural organizations), or Section 501(c)(6) (business leagues or trade associations), as long as such organization would pass the applicable public support test if it were an organization described in Section 501(c)(3).

The regulations generally describe the nature of the relationships required between a supporting organization and the publicly supported organization under Section 509(a)(3)(B).⁹ According to the regulations, a supporting organization must meet one of three different types of relationships in order to meet the requirements of Section 509(a)(3).¹⁰ Thus, a supporting organization may be:

Type I. Operated, supervised, or controlled by—a parent/subsidiary corporation relationship.¹¹ Me-

along with a copy of the supporting organization's Form 990 and the supporting organization's governing documents (unless such documents had previously been provided).¹⁴ This requirement ensures that the supported organization is fully aware of the activities conducted by the supporting organization in support of the supported organization.

The responsiveness test¹⁵ assures that a supporting organization is responsive to the needs or demands of a supported organization. There are two

Although no one organization must answer all of the questions on Schedule A, supporting organizations must provide a substantial amount of additional information.

chanically, a Type I relationship is the easiest to establish, but politically it is not as easy. A majority of the officers, directors, or trustees of the supporting organization must be appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations. As a result of the obvious control exercised by the supported organization, there are correspondingly fewer questions in Schedule A regarding Type I relationships.

Type II. Supervised or controlled in connection with—a brother/sister corporation relationship.¹² The control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.

Type III. Operated in connection with.¹³ This involves complex rules reflecting the lack of operational control that exists with Type I and Type II relationships. Both functionally integrated and nonfunctionally integrated supporting organizations must meet a notification requirement, and satisfy the responsiveness test and integral part test. The responsiveness test is the same for both functionally integrated and nonfunctionally integrated organizations, while the nature of the integral part test depends on whether the organization is functionally integrated or nonfunctionally integrated. Given the multiple levels of reporting and documentation that now is required in the regulations and in Schedule A, it would not be surprising to see more Type III supporting organizations move to a Type I or a Type II relationship.

The notification requirement involves the supporting organization annually providing—by the last day of the fifth calendar month following the close of the tax year—a written notice to a principal officer of the supported organization describing the type and amount of support provided during the tax year,

components to the responsiveness test—one involving the relationship of officers, directors, or trustees,¹⁶ and one involving the supported organization having a significant voice in the investment policies of the supporting organization, grant-making, and the use of income or assets of the supporting organization.¹⁷

As stated earlier, the integral part test depends on whether an organization is functionally integrated or nonfunctionally integrated. For functionally integrated organizations, the integral part test is met if the supporting organization (1) engages in some charitable activity that actually supports the supported organization (rather than simply fundraising or holding investment assets); (2) is the parent of the supported organizations; or (3) supports a governmental organization.¹⁸ For nonfunctionally integrated organization, the integral part test generally is met by adhering to an annual distribution requirement.

As might be expected, there are many nuances to these rules—and the rules are continuing to evolve. As will be discussed in the remainder of this article, however, the revised Schedule A questions attempt to gauge compliance with the regulations published in 2012.

A walk through the expanded reporting requirements

The expanded Schedule A questions now require tax-exempt practitioners to analyze more closely various aspects of the relationships between the supporting and supported organizations that are listed in Schedule A. For the 2014 tax year, the expanded and more detailed questions caught most organizations off guard and left them not only trying to determine how to respond to the new questions, but also trying to figure out whether their prior tax report-

ing related to their supporting organizations was accurate, and if not, how they would correct any errors or inconsistencies.

A more serious issue raised by the new and expanded line of questions is whether the supporting organizations still qualify as supporting organizations and thus, as public charities. Specifically, would the organization's failure to meet every aspect of the complex supporting organization rules highlighted by the questions in Schedule A cause the IRS to deem the organization to be a private foundation—the tax classification that a charitable organization would have if it no longer qualified as a public charity.

This section explores the expanded Schedule A reporting requirements in the new Parts IV, V, and VI, which have brought to light various issues related to the public charity classification of organizations.

Part IV, Section A, applies to all supporting organizations and contains a series of 11 narrative questions requiring “yes” or “no” responses, with both “yes” and “no” responses requiring follow-up explanations. For example, the first question asks whether all of the organization's supported organizations are listed by name in the organization's governing documents. If the organization responds “no” to the question, then it must describe in Part VI (“Supplemental Information”) how the supported organizations are designated—for example, whether they are designated by class or purpose, or whether there is a historic and continuing relationship between the organizations. While completing the expanded Schedule A, quite a few organizations were surprised upon reviewing their governing documents to find out that the supported organization was not listed by name in the governing documents. Some of those organizations were required to delve into historical details of the organization in order to sufficiently articulate the existence of a historic and continuing relationship in a narrative response. The authors' experience with this type of relationship suggests that most supporting organizations were not tracking whether the supported (c)(4), (5) or (6) organizations satisfied the Section 509(a)(2) public support test.

Part IV, Section A, Line 3 relates to supporting organizations of Section 501(c)(4), (5), or (6) organ-

izations. Part (b) of the question asks whether the supporting organization confirmed that each supported organization qualified under Section 501(c)(4), (5), or (6) and satisfied the public support tests under Section 509(a)(2). If an organization responds “yes” to that question, it must then describe in narrative form when and how the organization made the determination. For example, did it complete a pro forma public support schedule to confirm that the public support tests under Section 509(a)(2) were met? Part (c) of the question asks whether the organization ensured that all support to such organizations was used exclusively for charitable purposes. If the organization responds “yes” to that question, it must then describe in narrative form what controls the organization put in place to ensure such use. For example, did it require formal reporting from the supported organization? Such questions demonstrate the depth of the responses required on the expanded Schedule A—as well as the fact that there are numerous planning opportunities identified throughout the questions in the form of policies and practices that should be put into place during the tax year in order to be able to appropriately respond to inquiries.

Part IV, Section B, relates specifically to Type I supporting organizations. As stated earlier, Type I supporting organization relationships arguably are the easiest to mechanically and operationally establish. The primary question in Section B asks whether the directors, trustees, or membership of one or more supported organizations have the power to regularly appoint or elect at least a majority of the supporting organization's directors or trustees at all times during the tax year. One complexity that sometimes arises with regard to this question concerns the allocation of the power to appoint and/or remove directors or trustees when there are multiple supported organizations and each one is able to appoint some, but not a majority, of the supporting organization's directors. Organizations might have to consider whether a “no” response is more appropriate for this question when multiple supported organizations are present, and, if so, how to articulate in narrative form the manner in which the supported organizations effectively

⁹ Reg. 1.509(a)-4(f)(2).

¹⁰ *Id.*

¹¹ Reg. 1.509(a)-4(g).

¹² Reg. 1.509(a)-4(h).

¹³ Reg. 1.509(a)-4(i).

¹⁴ Reg. 1.509(a)-4(i)(2).

¹⁵ Reg. 1.509(a)-4(i)(3).

¹⁶ Reg. 1.509(a)-4(i)(3)(ii). Perhaps the leadership of the supporting organization is appointed by the leadership of the supported organization, or there is common leadership, or, at a minimum, a “close and continuous working relationship” among the leaders in both organizations.

¹⁷ Reg. 1.509(a)-4(i)(3)(iii).

¹⁸ Reg. 1.509(a)-4(i)(4).

operated, supervised, or controlled the organization's activities.

Part IV, Section C, relates specifically to Type II supporting organizations. When a Type II relationship exists, this question frequently is answered in the affirmative—even when multiple supported organizations are involved. The specific question in Part C asks whether a majority of the organization's directors or trustees during the tax year were also a majority of the directors or trustees of each of the organization's supported organization(s) (emphasis added). Keep in mind, however, that when there are multiple supported organizations, an affirmative response to this question would require nearly identical boards. Responders often erroneously believe that if there is some degree of board overlap between the supporting and supported organizations (even if less than majority overlap), then the question may properly be answered "yes" and the responder may move on to the next section of the return. If majority overlap is not present with regard

ing foundations encounter considerable difficulty in responding to the integral part test questions. These two scenarios are described in the following sections.

Parent organizations

It is very common for parent organizations—especially in a health care system setting—to be Type III supporting organizations. Most parent organizations have been correctly reporting their public charity classification on their tax returns as Type III functionally integrated supporting organizations. However, the follow-up questions that were developed for Type III functionally integrated and nonfunctionally integrated supporting organizations have proven very difficult to answer with a simple "yes" or "no." No matter whether the answer was "yes" or "no," each question begged for a detailed explanation to explain why it was not really "yes" or "no."

Three specific questions that "all Type III supporting organizations" must answer are set forth in Schedule A, Part IV, Section D. These questions address the notification requirement and the responsiveness test.

The questions listed in Section D are designed to cover all Type III supporting organizations, including functionally integrated as well as nonfunctionally integrated supporting organizations. Unlike a Type I supporting organization, in which the supported organization appoints a majority of the supporting organization's board of directors, or a Type II supporting organization, in which there is a majority overlap of board members at both supported and supporting organizations, Type III supporting organizations generally are less connected via governance to their supported organizations and therefore are required to satisfy more procedural requirements under the regulations and answer many more questions on Schedule A.

The questions of Section D primarily are designed to address such less-connected scenarios so a supporting organization can demonstrate that some connection with its supported organization exists. Questions 1, 2, and 3 of Section D (as discussed below) normally would constitute very relevant and pertinent questions in establishing the necessary relationships required of Type III supporting organizations. However, for parent supporting organizations, the questions (and the underlying regulations, as well), almost seem irrelevant to some extent and, at best, result in some unusual responses.

Consider, for example, the operational structure of a parent organization in a large integrated health care system. One would expect that a par-

The modifications to Schedule A are another example of the difficulty the IRS has in bringing statutory changes into its regulations.

to each supported organization, however, the proper response to the question seemingly is "no," and a narrative explanation is required to explain how control or management of the supporting organization is vested in the same persons that control or manage the supported organization(s). For example, is there a common management team that leads the supporting and supported organizations? Especially in the situation of multiple supported organizations, organizations should maintain some type of internal documentation to show the actual board (or management) overlap to support the response to this question. Furthermore, if sufficient board (or management) overlap is not specifically required by the organizational bylaws, organizations might want to consider making necessary amendments to the governing documents to require such overlap.

Part IV, Section D relates to all Type III supporting organizations, and Section E relates to Type III functionally-integrated supporting organizations. Arguably the most difficult questions that arise in these sections involve parent organizations in tax exempt health care systems. In particular, the questions related to the notification requirement and the responsiveness test tend to produce somewhat contorted responses. Additionally, support-

ent organization of a large healthcare system already has access to all of the tax returns of its affiliated entities simply as a function of its position as the parent organization. One also would assume that a parent of a large healthcare system typically has some level of control (usually fairly strong control) over appointing the governing bodies of the affiliated entities. The stated purpose in most Form 1023 exemption applications for creating a parent organization in a large health care system is to have one coordinating body that oversees the governance and all activities of the entire system—including investment activities and oversight of the use of income and assets systemwide. Thus, as will be discussed below, the responses to the revised Schedule A questions can produce very strained and sometimes misleading answers for parent organizations.

However, for Type III supporting organizations that are not parent organizations and that operate outside of an integrated health system, the amount of involvement and overlap with their supported organization is usually much less. Thus, there is a need for standards and requirements to ensure that the supporting organization has the attention of the supported organization to maintain the required relationships of Section 509(a)(3). In this scenario, the Schedule A questions make more sense.

The following is a more detailed discussion and analysis of the Section D questions that parent organizations must answer, along with some considerations as to how the questions may relate to a parent supporting organization situation.

1. Did the organization provide to each of its supported organizations, by the last day of the fifth month of the organization's tax year, (i) a written notice describing the type and amount of support provided during the prior tax year, (ii) a copy of the Form 990 that was most recently filed as of the date of notification, and (iii) copies of the organization's governing documents in effect on the date of notification, to the extent not previously provided?

Given that a majority of parent supporting organizations extend their Form 990 filings for the maximum six months that are allowed, many of these organizations are faced with answering this question long after the tax year has ended, and long after the written notice and documentation should have been provided to the supported organizations within their systems. Thus, parent supporting organizations might want to consider whether the corporate cost allocations information that flows back and forth from the parent supporting organization to all of its supported affiliates is sufficient to qualify as a written notice of the type and

amount of support provided by the supporting organization for purposes of the Schedule A questions. Not only is it more than one notice, it accrues on the books throughout the year. Furthermore, could regular corporate communications among the parent organization and its affiliates meet the notification requirement—such as board or committee minutes? Or would the fact that all of the corporate governing documents in most health care systems are located in one place in the corporate office, accessible to anyone in the system who needs them, meet the requirement on providing governing documents to the supported organizations? Finally, if all of the current and prior Form 990s of all the affiliated organizations are in a tax preparation software package and available to most of the senior executives of all the affiliated organizations, could the answer to this question be "yes," since there would be no need to deliver a copy of the Form 990?

Seemingly, the normal operations of an integrated healthcare system would assure that tax returns and

The most important factor to consider when determining the proper public charity classification of an organization is its anticipated sources of support.

governing documents are accessible to all entities within the system, and the type and amount of support would be obvious based on the day-to-day operations of the parent organization. Latitude in responding to this question, however, is not apparent in the instructions.

2. Were any of the organization's officers, directors, or trustees either (i) appointed or elected by the supported organization(s) or (ii) serving on the governing body of a supported organization? If "No," explain in Part VI how the organization maintained a close and continuous working relationship with the supported organization(s).

This question is odd in the context of a parent organization, because it typically would be the parent organization appointing the board of each supported organization, rather than the other way around. In fact, under the integral part test, Type III parent supporting organizations must appoint the boards of the respective supported organizations. There very well could be some common officers or directors, however, and that would be the type of information that would be presented in the response to this question. Absent any overlap, the existence of a close and continuous working relationship would have to be explained in narrative form.

3. By reason of the relationship described in (2), did the organization's supported organizations have a significant voice in the organization's investment policies and in directing the use of the organization's income or assets at all times during the tax year? If "Yes," describe in Part VI the role the organization's supported organizations played in this regard.

The presence of common board members and officers can ensure that the supported organizations have a significant voice in the supporting organization's investment policies and use of its assets. Furthermore, if one entity controls all affiliate organizations in a health care system—or, in the case of a religiously affiliated system, if control is held by one or more individual religious leaders—the significant voice test may be met by virtue of the fact that the one entity, group of individuals, or single individual holds certain reserved powers over each entity in the affiliated system and, thus, is able to assure that all supported organizations have a significant voice in the investment policies and in directing the use of the supporting organization's income or assets for the benefit of the supported organizations.

Two additional questions faced by parent organizations are located in Schedule A, Part IV, Section E, relating to Type III functionally integrated supporting organizations. These questions go to the integral part test of the supporting organization regulations. Each of these questions, if answered in the affirmative, requires a narrative response.

3a. Did the organization have the power to regularly appoint or elect a majority of the officers, directors, or trustees of each of the supported organizations?

In most parent organization situations, this question would be answered in the affirmative. Generally, the parent organization is the sole corporate member of the supported organizations, and the governing documents of each supported organization would provide for election of its board by the sole corporate member. Unlike the questions in Section D that are focused on whether the parent supporting organization satisfies the notification and responsiveness test, which cannot be answered with a straight "yes" or "no", the questions in Section E, 3(a) and (b) are focused solely on parent supporting organizations and thus can be answered "yes" with no further explanation needed.

3b. Did the organization exercise a substantial degree of direction over the policies, programs, and activities of each of its supported organizations.

In a typical health care system, the parent organization holds certain reserved powers over each entity in the system. By enumerating some of those reserved powers in the narrative response—e.g., the ability to approve amendments to governing documents, to approve the incurrence of significant debt, to approve capital budgets, to appoint the board, and to approve certain fundamental corporate changes—the parent organization undoubtedly can exercise a substantial degree of direction over the

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policies, programs, and activities of each supported organization.

As discussed above, parent supporting organizations have a difficult time in responding to the three questions in Section D, which are focused on the notification and responsiveness tests. Intuitively, it would seem that a parent organization would meet both tests since it is the parent organization, and thus by its very position has the attention and involvement of its supported organizations. Yet, the manner in which the questions are structured in Section D requires parent supporting organizations to develop rather involved explanations in answering how they satisfy both tests even though a “yes” cannot be given. It also brings into play the fact that the IRS could assert that parent supporting organizations must meet the strict requirements listed in Section D or not qualify as Type III, functionally integrated supporting organizations.

Supporting foundations

Many organizations (from hospitals to colleges and universities to other operating charitable organizations that are publicly supported in their own right) have Type III supporting foundations. Such organizations fundraise on behalf of, or perhaps even hold investment assets for, the supported public charity. Their board members, however, are not appointed by the boards of the supported organization and a majority of the board members do not overlap with the supported organization’s board. Often, the names of these organizations mirror the names of the supported organizations—such as XYZ Memorial Foundation, supporting XYZ Memorial Hospital. Typically, these organizations conduct no direct charitable activity of their own apart from fundraising and investment activities. Such organizations have considerable difficulty in addressing the integral part questions on the expanded Schedule A and raise a very real question as to whether they qualify as Type III, functionally integrated supporting organizations.

Many of these organizations were formed as supporting organizations a long time ago and obtained recognition of exempt status from the IRS as supporting organizations upon formation. For purposes of this article, these organizations are referred to as “supporting foundations.”

A considerable number of these supporting foundations that existed when the PPA was enacted sought reclassification of public charity status because, under the PPA, the supporting organization rules became more onerous. At that time, if a supporting organization was able to prove that it

had sufficient public support on its own, seeking reclassification of public charity status under Section 509(a)(1)/Section 170(b)(1)(A)(vi) or Section 509(a)(2) made a lot of sense—especially for supporting organizations in a Type III relationship to the supported organization or organizations. For example, private foundations and donor-advised funds, under the then-new rules, became subject to

Organizations have found facts over the years that have caused the organization’s operations and its tax reporting to diverge.

limitations, and in some cases penalties, for making grants to supporting organizations, thus cutting off these supporting organizations from possible contributors. As a result, supporting organizations performed the mathematical calculation to determine whether they would meet the one-third or 10% facts-and-circumstances test. Many of the supporting organizations that met the public support test sought formal reclassification of public charity status from the IRS. In fact, the IRS had instituted a special reclassification process for such organizations. Those supporting foundations that did not take advantage of such process likely either did not know about it (or understand it), didn’t think that they could independently meet the public support test, or simply chose to maintain the status quo and not to do anything at the time for whatever reason.

Whatever the reasons, there are thousands of supporting organizations that exist today that are simply supporting foundations—performing no charitable activity of their own other than raising funds, holding investment assets for a publicly supported organization, or both. These organizations now must deal not only with the revised regulations but also with the expanded Schedule A reporting requirements that will highlight their deficiencies. And many of these organizations have been indicating for years for federal tax reporting purposes that they are Type III functionally integrated supporting organizations.

A Type III functionally integrated supporting organization must meet the integral part test in one of three ways. It can (1) engage in activities substantially all of which directly further the exempt purpose of the supported organization, (2) be the parent of its supported organization, or (3) support a government-supported organization, which under proposed regulations also will have to be actively engaged in charitable activities. The only one of these three tests potentially applicable to most Type III

functionally integrated supporting organizations is the first one—engaging in activities substantially all of which further the exempt purpose of the supported organization (the “activities test”).

In order to meet the activities test, the supporting organization must directly further the exempt purposes of the supported organization. The supporting organization regulations provide that activities directly further the exempt purposes of one or more supported organizations only if they are conducted by the supporting organization itself. Holding title to and managing exempt-use assets are activities that directly further the exempt purposes of the supported organization. In addition, the Treas-

The following are some initial questions to ask to assess the feasibility of qualifying as a Type II supporting organization:

- Do the governing documents of the supporting organization require any officer or director overlap with the supported organization’s officers and directors?
- Notwithstanding the response to the previous question, is there any “inadvertent” officer or director overlap with the supported organization (“inadvertent” meaning that, although not required by the governing documents, there are common officers or directors among the two organizations in any given year).
- What is the working relationship between the two organizations?

By analyzing the facts gathered in response to these questions, it is possible that a supporting foundation can meet the Type II supporting organization requirements. A common scenario encountered in practice is that there are at least a few common officers or directors, although there may not be majority governance overlap between the organizations, which is technically what the regulations call for. In certain instances, such as a situation in which the overlapping officers or directors are high-level officials at both the supporting and supported organizations, this fact pattern may be sufficient to demonstrate that there is “common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations to insure that the supporting organization will be responsive to the needs and requirements of the publicly supported organizations.”

Organizations must deal not only with the revised regulations but also with the expanded Schedule A reporting requirements that will highlight their deficiencies.

ury Regulations specifically provide that assets held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not being used (or held for use) to carry out the foundation’s exempt purpose, even though the income from such assets is used to carry out such exempt purpose.

This situation has left many traditional supporting foundations searching for answers and wondering whether they continue to qualify as supporting organizations, how to answer the specific questions of Schedule A, and whether amended Form 990s need to be filed since they might have incorrectly reported themselves as Type III functionally integrated supporting organizations. The bottom line is that, if they are not conducting any charitable activity, they do not qualify as a Type III functionally integrated supporting organization—as so vividly brought to light by the expanded Schedule A reporting. Unless their supported organization appoints their board (an easy enough option on paper, but much more difficult politically within the organizations since it requires the board of the supporting organization to relinquish real control to the supported organization), then Type I supporting organization status is not an option either. Type III nonfunctionally integrated status generally is not desirable, because that status has a number of private foundation requirements including a mandatory annual distribution requirement. So by default, that leaves Type II supporting organization status as a possible option.

Organizations experiencing a change in public charity status over time

In order to answer the new questions in Schedule A, organizations have been forced to review their governing documents (typically articles of incorporation and by-laws) as well as their IRS determination letters. As organizations have gathered the necessary documents and information to work through the expanded Schedule A reporting and underlying analysis, a considerable number of organizations have found surprises—changed facts over the years that have caused the organization’s operations and its tax reporting to diverge. For example, it is not uncommon for an organization that files its tax return as a supporting organization to discover that its IRS determination letter indicates Section 509(a)(1)/Section 170(b)(1)(A)(vi) status

instead. The following is a common scenario in this regard.

Example. Suppose a supporting organization, from inception, was intended to be an independently controlled and operated organization, supporting primarily the charitable causes of one organization (and perhaps even possessing a name similar to the supported organization), although retaining a high degree of independence, including the ability to support other causes, too. When the organization was formed, it anticipated broad public support. Over the years, however, the sources of support dwindled and became very limited, such that meeting the public support test on a going forward basis became difficult. An example of this might be a hospital or a university that formed a charitable foundation to solicit contributions from the general public, but in later years, primarily only received contributions from the hospital or university itself. In response to the lack of charitable contributions, the charitable foundation simply begins reporting its tax status as a supporting organization, rather than seeking formal reclassification from the IRS. Although the instructions to Schedule A permit charitable organizations to check a public charity different from the status stated in the exemption or determination letter, the original public charity status remains unchanged in the IRS records. The only way the public charity status can be officially changed is if the organization submits a Form 8940, "Request for Miscellaneous Determination." The authors suspect that many charitable organizations simply make the change on the Form 990, leaving the original public charity status unchanged.

Fast forward to current times when the organization has to complete the expanded Schedule A—and some inconsistencies start to come to light. The organization now has some fact-finding to conduct, and some choices to make.

- It can try to increase the public support it is receiving.
- It can amend its governing documents such that it is controlled by the supported organization, in which case it will have to seek formal reclassification of public charity status by the IRS.
- It can become a private foundation.

This scenario is not uncommon because, as time goes on, organizations change, their funding sources change, and their relationships with other organizations change. If there is one good thing that has arisen from the expanded Schedule A questions, it is that organizations can take this opportunity to assess the supporting organization relationships and reform the relationships, if necessary, to fit current times.

Conclusion

Practitioners should realize that, with regard to supporting organizations, the law and regulations are so complex and detailed that trying to respond to the expanded Schedule A questions without a thorough understanding of the rules is not advised. Inaccurate responses can not only create issues relating to the organization's tax exemption, potentially causing the IRS to deem that the organization has defaulted to private foundation status, but at the very least can make the organization look bad to potential funders, regulators, the media, and others, as Form 990 is a public document.

Organizations might want to take advantage of the opportunity created by the expanded Schedule A questions to take a closer look at their supporting organizations to confirm that their public charity classification is accurately reflected from an IRS perspective, that their governing documents reflect the requisite relationship between the supporting and supported organizations, and that public support is still as it was anticipated when the organization was formed (or, if it has changed, that it still makes sense for the organization). ■