

**J. BASIC DETERMINATION RULES
FOR
PUBLICLY SUPPORTED ORGANIZATIONS
AND SUPPORTING ORGANIZATIONS**

by
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1. Introduction

To a great extent, the Tax Reform Act of 1969 is based on the distinction between private foundations and public charities. Private foundations are subject to the excise taxes imposed by IRC Chapter 42, while public charities are not. It is, therefore, most advantageous for an IRC 501(c)(3) organization to be classified as a public charity rather than as a private foundation.

IRC 509 makes the statutory distinction between private foundations and public charities -- it provides that all organizations, foreign and domestic, described in IRC 501(c)(3) are private foundations except the types of organizations set forth in IRC 509(a)(1), (2), (3), or (4). "Public charities" is the generic term given to the excepted organizations.

Essentially, the types of organizations that qualify as public charities can be categorized as follows:

Type A. Organizations That Engage in Inherently Public Activity (IRC 509(a)(1) and IRC 170(b)(1)(A)(i)-(v)).

- (1) Churches (IRC 509(a)(1) and 170(b)(1)(A)(i)). (2) Educational Institutions (IRC 509(a)(1) and 170(b)(1)(A)(ii)).
- (2) Hospitals and Medical Research Organizations (IRC 509(a)(1) and 170(b)(1)(A)(iii)).
- (3) Certain Organizations Related to Colleges and Universities (IRC 509(a)(1) and 170(b)(1)(A)(iv)).
- (4) Governmental Units (IRC 509(a)(1) and 170(b)(1)(A)(v)).

Type B. Publicly Supported Organizations (IRC 509(a)(1) and 170(b)(1)(A)(vi); IRC 509(a)(2))

- (1) Organizations Receiving Substantial Support from a Governmental Unit or from the General Public (IRC 509(a)(1) and 170(b)(1)(A)(vi)).
- (2) Organizations Supported by Exempt Function Income (IRC 509(a)(2)).

Type C. Supporting Organizations (IRC 509(a)(3)).

Type D. Organizations That Test for Public Safety (IRC 509(a)(4)).

In determining private foundation classification under IRC 509, problems are encountered most frequently in the Type B. and Type C. areas. Whether an organization qualifies either as a publicly supported organization or as a supporting organization may involve the application of some very arcane rules. The Tax Court has characterized the IRC 170(b)(1)(a)(vi) regulations as "almost frighteningly complex and difficult" (Friends of the Society of Servants of God v. Commissioner, 75 T.C. 209, 213 (1980)), while a district court, in considering the IRC 509(a)(3) regulations, 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 v. United States, 77-2 U.S. Tax Cas. (CCH) (par.) 9709 (E.D. Va. 1977).

This article is not intended to deal with all questions regarding classification under IRC 509(a)(1)/170(b)(1)(A)(vi), 509(a)(2), and 509(a)(3) -- there are nuances left undiscussed and some subjects, such as community trusts, are omitted entirely. Rather, its purpose is to outline the classification schemes of those subparagraphs and to give the basic rules for determining whether an organization qualifies for the requested classification.

2. IRC 509(a)(1)/170(b)(1)(A)(vi) Organizations

A. Outline of Basic Requirements

Organizations described in IRC 170(b)(1)(A)(vi) are charities that normally receive a substantial part of their support from governmental units and/or from

direct or indirect contributions from the general public. The "substantial part of support" requirement is met by satisfying a 33 1/3 percent support test or, alternatively, a "facts and circumstances" 10 percent test. The cash basis of accounting must be used.

The percentages are calculated by using total support as the denominator and public support as the numerator. Both the 33 1/3 percent support test and the 10 percent "facts and circumstances" test generally measure an organization's public support over a four-year period; new organizations, however, have a shorter period of measurement. These measuring periods are intended to test whether an organization "normally" receives public support. Therefore, the steps to be taken in determining whether an organization qualifies for classification as an organization described in IRC 509(a)(1)/170(b)(1)(A)(vi) are as follows:

- (1) Know what is included in total support (the denominator);
- (2) Know what is included in public support (the numerator);
- (3) Know what is the proper measuring period to determine whether the organization "normally" receives public support; and
- (4) Make the calculation -- if the organization does not receive 33 1/3 percent public support, determine whether the "facts and circumstances" of the 10 percent test are satisfied.

B. The Determining Steps

1. The Elements of Total Support (The Denominator) for IRC 509(a)(1)/170(b)(1)(A)(vi) Organizations

Total support includes:

- (a) Gifts, grants (including governmental), contributions (except for contributions of services for which a deduction is not allowable), and those membership fees whose basic purpose is to provide support for the organization rather than to purchase admissions, merchandise, services, or the use of facilities;

Total support does not include

- (a) Contributions of services for which a deduction is not allowable;

- (b) Net income from unrelated business activities, whether or not such activities are carried on regularly or as a trade or business;
- (c) Gross investment income (as defined in IRC 509(e));
- (d) Tax revenues levied for the benefit of an organization and paid to or expended on behalf of the organization; and
- (e) The value of services or facilities (exclusive of services or facilities furnished to the public without charge) furnished by a governmental unit to the organization without charge.
- (b) Amounts received from the exercise or performance by the organization of its charitable, educational, or other IRC 501(c)(3) purpose constituting the basis for its exemption (e.g., amounts received for admissions to the theater of an exempt performing arts organization are excludable from total support);
- (c) The value of exemption from any federal, state, or local tax or any similar
- (d) Capital gains;
- (e) Loan repayments; and
- (f) "Unusual grants" (discussed below).

The exclusion of "unusual grants" from the calculation of total support (and, as noted below, from public support as well) generally is intended to apply to substantial contributions or bequests from disinterested parties that are attracted by reason of the publicly supported nature of the organizations, are unusual or unexpected with respect to the amount thereof, and would adversely affect the status of the organization as normally being publicly supported by reason of the size of the contribution. Reg. 1.170A-9(e)(6)(ii) and (iii). In order to determine whether a contribution qualifies as a "unusual grant," and therefore is excluded from total support, the following factors (none of which is necessarily determinative) are taken into consideration:

Favorable Factors

- (a) Contribution was made by a person with no connection to the organization.
- (b) Contribution was a bequest.
- (c) Contribution was in cash, readily marketable securities, or assets that further the exempt purposes of an organization, such as a gift of a painting to a museum.
- (d) The organization, prior to receipt of the particular contribution, has carried on an actual program of public solicitation and has been able to attract a significant amount of public support.
- (e) The organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution.
- (f) The organization, prior to the year in which the particular contribution was received, met the 33 1/3 support test without the benefit of any exclusions for unusual grants.
- (g) The organization has a representative (broadly based) governing body.
- (h) No material restrictions are imposed in connection with the grant.

Unfavorable Factors

- (a) Contribution was made by a person who (1) created the organization, (2) previously contributed a substantial part of its support or endowment, or (3) stood in a position of authority, such as being a foundation manager (within the meaning of IRC 4946(b)), with respect to the organization. (If such a person continues directly or indirectly to exercise control over the organization, it is an especially unfavorable factor.)
- (b) Contribution was an inter vivos transfer.
- (c) Less liquid (or less pertinent) assets that the organization may find difficult to dispose and do not contribute to the organization's exempt purpose.
- (d) No program of public solicitation or the public solicitation program has been unsuccessful.
- (e) Continued reliance on unusual grants. (May be evidence that the organization cannot reasonably be expected to attract future support from the general public.)
- (f) Organization, in year prior to receiving grant, did not meet the 33 1/3 percent support test, or only met the test because unusual grants were excluded.
- (g) Organization's governing body is not broadly based.
- (h) Material restrictions are imposed on the grant.

There are also special rules for support from a governmental unit, which are set forth in Reg. 1.170A-9(e)(8)(ii). If the amounts received in connection with a contract entered into with a governmental unit constitute amounts received from the exercise or performance of the organization's exempt function, they are not includible in total support. However, if the purpose of the payment is primarily to

provide a service to, or to maintain a facility for, the direct benefit of the public (as opposed to the government), the payment would be included in total support. Examples where the public is considered the direct beneficiary are (1) amounts paid for the maintenance of library facilities that are open to the public, (2) amounts paid to nursing homes or homes for the aged to provide health care or domiciliary services to residents of such facilities, (3) amounts paid to child placement or child guidance organizations, and (4) amounts paid by the Department of Health and Human Services to a Professional Standards Review Organization (PSRO) to carry out its functions. (For the last example, see G.C.M. 38489 (Aug. 29, 1980).

Finally, it must be noted that if an organization receives almost all support from gross receipts from related activities and only an insignificant amount of qualifying support from governmental units and contributions made directly or indirectly from the general public, it may not qualify for classification as an IRC 509(a)(1)/170(b)(1)(A)(vi) organization. Reg. 1.170A-9(e)(7)(ii).

2. The Elements of Public Support (The Numerator)

The two basic components of "public support" are support from governmental units and contributions from the general public. In this context, "contributions" include grants, as well as membership dues for which there is no consideration. More specifically, the elements to be taken into consideration in computing public support are as follows:

- (1) Support from governmental units (except for amounts received from the exercise or performance of the organization's exempt function, as discussed in the previous paragraph);
- (2) Contributions from IRC 170(b)(1)(A)(vi) organizations, and from other IRC 170(b)(1)(A) organizations, such as a church, that could also qualify for classification as an IRC 170(b)(1)(A)(vi) organization;
- (3) Contributions from any source not listed in (1) or (2) above, but only to the extent that the total amount of contributions from that donor during the computation period does not exceed two percent of the organization's total support for that period; and
- (4) All support from the sources listed in (1) and (2) above qualifies as public support, unless the support represents an amount that was expressly or impliedly earmarked by a donor to the governmental unit or publicly supported organization as being for the benefit of the organization asserting

that it should be classified as an IRC 170(b)(1)(A)(vi) organization. In a case of earmarking, the two percent limitation applies to support from that donor.

3. The Proper Measuring Period

a. The Meaning of "Normally"

Reg. 1.170A-9(e)(4) provides for a four-year computation period to determine whether an organization is "normally" publicly supported within the meaning of IRC 170(b)(1)(A)(vi). If the organization satisfies the 33 1/3 percent support test or the 10 percent facts and circumstances test on an aggregate basis for the four preceding taxable years, the organization will then qualify as "normally" publicly supported for the current year and the immediately succeeding taxable year. For example, an organization meeting the 33 1/3 percent support test on an aggregate basis for the years 1988, 1989, 1990, and 1991 will be considered "normally" publicly supported for the years 1992 and 1993. Note, however, that a private foundation cannot be reclassified as a public charity on this basis; instead, it must terminate its private foundation status in accordance with IRC 507(b)(1)(B)(i).

b. Exception for Material Changes in Sources of Support

In a current tax year, substantial and material changes may occur in an organization's sources of support other than changes arising from unusual grants. (For example, an organization may receive an unusually large contribution or bequest that does not qualify as an unusual grant.) In such a case, the four year computation period applicable to that year, either as an immediately succeeding tax year or as a current tax year, will not apply for purposes of determining whether the organization satisfies the 33 1/3 percent support test or the 10 percent facts and circumstances test on an aggregate basis. Instead of the four year computation period, a computation period of five years will apply. The five year period consists of the current tax year and the four years immediately preceding that year.

For example, if substantial and material changes occur in an organization's sources of support for the 1991 tax year, then, even though the organization meets the requirements of the 33 1/3 percent support test or the 10 percent facts and circumstances test based on a computation period of tax years 1986-1989 or 1987-1990, such an organization will not meet either of those tests unless it meets the requirements for a computation period consisting of the tax years 1987-1991.

c. Measuring Periods for Applicant Organizations

An organization applying for recognition of exemption as an organization described in IRC 501(c)(3) and classification as an organization described in IRC 509(a)(1)/170(B)(1)(a)(vi) or IRC 509(a)(2) may receive either a definitive or advance ruling on the classification issue. The following rules apply:

- (1) Definitive rulings may only be issued to organizations that have completed their first tax year, and that tax year must have consisted of at least eight months.
- (2) If a newly created organization can reasonably be expected to meet the requirements of IRC 170(b)(1)(A)(vi) (or IRC 509(a)(2)), it may request non-private foundation treatment for an advance ruling period consisting of its first five years. During that period, the organization will be treated as a publicly supported organization; however, at the end of that period, the Service will determine whether the organization has met the tests for publicly supported organizations during the advance ruling period. If the organization does not meet these tests at the end of the advance ruling period, it will be liable for the excise tax on investment income under IRC 4940 for the period covered by its advance ruling. (Note that if an organization requests an advance ruling, it must file Form 872-C, Consent Fixing Period of Limitation Upon Assessment of Tax Under IRC 4940. The consent extends the period of limitations for assessment of IRC 4940 tax of all tax years until one year beyond the normal expiration date of the last tax year within the advance ruling period.)
- (3) Prior tax years may only be taken into consideration, if the applicant organization was described in IRC 501(c)(3) during those years. Therefore, in certain situations, an organization may have existed for some time, but nevertheless has to be considered a newly created organization for purposes of classification as a newly supported organization. Such situations include: (1) an organization precluded from retroactive recognition of exemption under IRC 501(c)(3) because of IRC 508 and (2) an organization that changed its operations to qualify under IRC 501(c)(3). On the other hand, if a previously unincorporated organization had no change in operations or activities other than its act of incorporation, the period of time its predecessor operated could be taken into consideration. Rev. Rul. 77-116, 1977-1 C.B. 155.

4. Making the Calculation

a. A Support Test Worksheet for IRC 509(a)(1)/
170(b)(1)(A)(vi) Organizations

[Worksheet not shown]

b. The 10 Percent Facts and Circumstances Test

The facts and circumstances test, beyond its threshold requirement of 10 percent public support, requires that the organization be so organized and operated so as to attract new and additional public or governmental support on a continuous basis. In addition, it must demonstrate that it meets enough of the additional "facts and circumstances" listed in Reg. 1.170A-9(e)(3) to indicate that it is publicly supported. These additional factors are set forth below.

Favorable Factors

- (a) Public support well in excess of 10 percent. The higher the percentage of public support, the lesser will be the burden of establishing the publicly supported nature of the organization. (Even here, the regulation adds a qualifying factor: If the percentage of the support from public or governmental sources is low because the organization receives a high percentage of total support from investment income on its endowment funds, evidence in favor of meeting the facts and circumstances test would exist if the funds originally were contributed by a governmental unit or the general public.)
- (b) Does the organization receive support from a representative number of persons rather than from members of a single family? In determining what is a "representative number of persons," consideration will be given to the type of organization, the length of time of its existence, and whether it limits its activities to a particular community or region or to a special field of interest only to a limited number of persons.

Unfavorable Factors

- (a) A percentage of public support, close to 10 percent. The closer the percentage of public support is to 10, the greater will be the burden of establishing that the organization is publicly supported.
- (b) Lack of evidence of broad based support.

- (c) Does the organization have a governing body representative of the broad interests of the public (e.g., public officials, community leaders, or persons elected by a broadly based membership)?
- (d) (d) Are the facilities of the organization available to the public on a continuing basis? The regulations give as examples libraries and museums open to the public, symphony orchestras that give public performances, or an old age home providing bed care and nursing services to the public.
- (e) If the organization is a educational or research institution that regularly publishes scholarly journals, are its studies widely used by members of the [missing]
- (f) Do members of the public that have special knowledge or expertise, public officials, or civic or community leaders, participate in, or sponsor, programs of the organization?
- (g) Does the organization maintain a definitive program to accomplish its charitable work in the community (e.g., slum clearance or developing employment opportunities)?
- (h) Does the organization receive a significant part of its funds from a public charity or a governmental agency to which it is in some way accountable?
- (i) With respect to membership organizations, are its solicitations designed to enroll a substantial number of members in the community? Are dues for individual (as opposed to institutional) members fixed at rates designed to make membership available to a broad cross-section of the general public? Are its activities likely to appeal to persons having some broad common interest or purpose?
- (c) Governing body represents the private interests of a limited number of persons.
- (f) No participation in, or sponsorship of, organization's programs by public officials, or civic and community leaders.
- (g) No definitive program of community work.
- (h) No arrangements with public charities or governmental agencies, involving receipt of funds and accountability to such entities.
- (i) No attempt to enroll broad-based membership. Activities not likely to appeal to persons having some broad common interest or purpose.

3. IRC 509(a)(2) Organizations

A. Outline of Basic Requirements

Organizations classified under IRC 509(a)(1)/170(b)(1)(A)(vi) and under IRC 509(a)(2) have a similar basis for public charity status in that both receive support from "public" sources. In addition, many of the factors already discussed with respect to IRC 509(a)(1)/170(b)(1)(A)(vi) public charities apply to IRC 509(a)(2) public charities as well -- the definition of "normally," the measuring periods for applicant organizations, the treatment of "unusual grants," and the use of the cash basis of accounting.

There are, however, two significant differences between IRC 509(a)(1)/170(b)(1)(A)(vi) and IRC 509(a)(2) organizations:

- (1) The public support of IRC 509(a)(1)/170(b)(1)(A)(vi) is derived from gifts, grants and contributions; the public support of IRC 509(a)(2) organizations more typically consists of gross receipts derived from an activity that is related to the organization's exempt function. This income is not included in meeting the support test for an IRC 509(a)(1)/170(b)(1)(A)(vi) organization.
- (2) IRC 509(a)(2) places a limit on the receipt of certain types of income -- the organization must receive less than 33 1/3 percent of its total support from gross investment income and net unrelated business income -- while IRC 509(a)(1)/170(b)(1)(A)(vi) contains no such limitation. Therefore, while organizations claiming IRC 509(a)(1)/170(b)(1)(vi) status only have to satisfy one test, organizations claiming IRC 509(a)(2) status must satisfy two tests:

**More Than 33 1/3 Percent
Support Test**

The organization must normally receives more than one-third of its total support in each taxable year from the from the sum of:

- a. Gifts, grants, contributions, membership fees; and and
- b. Gross receipts from admission fees, sales of merchandise, performance of services, or furnishing of facilities, in an activity that is not an unrelated trade or business within the meaning of IRC 513.

**Negative 33 1/3 Percent
Support Test**

An organization must normally not receive more than one-third of its total support from the sum of:

- a. Gross investment income, and
- b. Unrelated business taxable income less the tax imposed on that income.

B. Total Support for IRC 509(a)(2) Organizations

Total support includes:

Total support does not include:

- | | |
|--|--|
| <ul style="list-style-type: none"> (1) Gifts, grants, contributions, and membership fees; (2) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity that is not a trade or business within the meaning of IRC 513; (3) Net income from unrelated trade or business activities, whether or not such activities are regularly carried on as a trade or business; (4) Gross investment income (as defined in IRC 509(e)); (5) Tax revenues levied for the benefit of an organization and either paid to or expended on behalf of the organization; and (6) The value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit to the organization without charge. | <ul style="list-style-type: none"> (1) The value of exemption from any federal, state or local tax or any similar benefit; (2) Capital gains; (3) Loan repayments; and (4) Unusual grants. |
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Note that contributions of services for which a deduction is not allowable and amounts received from the exercise or performance by the organization of its charitable, educational, or other IRC 501(c)(3) purpose constituting the basis for its exemption, which are excludable from the total support of IRC 509(a)(1)/170(b)(1)(a)(vi) organizations, are includible in the total support of IRC 509(a)(2) organizations. (As will be discussed immediately below, gross receipts from exempt purpose activities also are included in the public support of IRC 509(a)(2) organizations.)

C. The More Than 33 1/3 Percent Support Test

1. The General Rule

As noted more generally above, more than 33 1/3 percent of an IRC 509(a)(2) organization's total support must be derived from a total of:

- (a) Gifts, grants, contributions, or membership fees (IRC 509(a)(2)(A)(i)); and

- (b) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities, in a activity that is not an unrelated trade or business (within the meaning of IRC 513), not including such receipts from any person, or from any bureau or similar agency of a governmental unit (as described in IRC 170(c)(1)), in any taxable year to the extent that such receipts exceed the greater of \$5,000 or 1 percent of the organization's support (IRC 509(a)(2)(A)(ii)).

All receipts from disqualified person, as defined in IRC 4946 (substantial contributors, foundation managers, and certain persons and entities related to them) are completely excluded from public support, except that governmental units described in IRC 170(c)(1) and public charities described in IRC 509(a)(1) are not considered to be disqualified persons, regardless of the percentage of their grants and contributions to the organization's support.

As gifts and contributions, grants, and membership fees may be received in unlimited amounts for purposes of the public support test, whereas public support from gross receipts is limited to \$5,000/1 percent per person, it becomes important to distinguish gross receipts from the other items. The distinctions will be discussed below.

2. Gifts and Contributions Distinguished from Gross Receipts

Any payment of money or transfer of property without adequate consideration is considered a gift or contribution. The amount includible in computing support with respect to gifts, grants, or contributions of property or use of property is the fair market or rental value of the property at the date of the gift or contribution.

When payment is made or property is transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the status of the payment or transfer under IRC 170(c) determines whether and to what extent the payment or transfer constitutes a gift or contribution as distinguished from gross receipts from related items.

Where a payment is in part a gift and in part a payment for merchandise, admissions, services, or use of facilities, the payment is classified as a gift or contribution to the extent it exceeds the value of what is received, and the remainder is classified as support from gross receipts under IRC 509(a)(2)(A)(ii).

3. Grants Distinguished from Gross Receipts

Reg. 1.509(a)-3(g)(1) provides that a grant normally is made to encourage the grantee organization to carry on certain programs or activities in furtherance of its exempt purposes. Essentially, therefore, a grant is in the nature of a restricted gift or contribution for specified purposes, and includes instances where the grantee performs a service or produces a work product that incidentally benefits the grantor.

The term "gross receipts," on the other hand, means amounts received from an activity that is not an unrelated trade or business if a specific service, facility, or product is provided to serve the direct and intermediate needs of the payor rather than primarily to confer a direct benefit on the general public. Reg. 1.509(a)-3(g)(2). Availability of comparable services from a profit making organization is evidence that the payments are gross receipts rather than grants. Payments for research leading to the development of tangible products usually will be classified as gross receipts, while payments for basic research and studies carried on in physical or social sciences generally will be classified as grants. See Reg. 1.509(a)-3(g)(3) for examples of the distinction between gross receipts and grants.

It should be noted that Medicare and Medicaid payments constitute gross receipts from the exercise or performance of an exempt function. The individual patient, not a governmental unit, actually controls the ultimate recipient of these payments by his or her choice of a health care organization to perform the services. Therefore, Medicare and Medicaid receipts for services provided each patient are included as gross receipts to the extent that they do not exceed the greater of \$5,000 or 1 percent of the organization's total support for that year. See Rev. Rul. 83-153, 1983-2 C.B. 48. State agency payments for each youth in a care facility would fall into the same category.

4. Membership Dues Distinguished from Gross Receipts

The fact that a membership organization provides services, admissions, facilities, or merchandise to its members as part of its overall activities will not, in itself, result in the classification of fees received from members as gross receipts subject to the \$5,000 or 1 percent limit, rather than as membership fees. However, if an organization uses membership fees as a means of selling admissions, merchandise, services, or the use of facilities to members of the general public who have no common goal or interest (other than a desire to purchase such admissions, merchandise, services, or facilities), the payments do not constitute membership fees; instead, they are gross receipts.

On the other hand, to the extent that the basic purpose for making the payment is to provide support for the organization, rather than to purchase admissions, merchandise, services, or the use of facilities, the income received from the payment constitutes membership fees.

D. The Limit on Gross Investment Income and Unrelated Business Taxable Income

As noted above, for an organization to be classified under IRC 509(a)(2), in addition to meeting the 33 1/3 percent support test, it must also meet the gross investment income and unrelated business taxable income tests set forth in IRC 509(a)(2)(B). An organization will meet the IRC 509(a)(2)(B) test only if it normally receives not more than 33 1/3 of its total support in each taxable year from gross investment income (as defined in IRC 509(e)), and from the excess of unrelated business taxable income over the tax imposed on that income.

With respect to the gross investment income test, IRC 509(e) provides that the term "gross investment income" means the gross amounts of income from interest, dividends, payments with respect to securities loans, rents, and royalties, but not including any such income if it is subject to unrelated business income tax.

Unrelated business taxable income, as defined in IRC 512, includes gross income derived from any trade or business that is not substantially related to the exercise or performance by an organization of its exempt purpose or function normally constituting the basis for its exemption. For purposes of IRC 509(a)(2)(B), unrelated business taxable income is taken into consideration only if it is derived from a trade or business acquired after June 30, 1975.

In certain situations, it may be important to distinguish gross receipts from a related activity from gross investment income or unrelated business taxable income. For example, when the charitable purpose of an IRC 501(c)(3) organization is accomplished through furnishing facilities for a rental fee or loans to a particular class of persons, such as aged, sick, or needy persons, the support received from those persons will be considered gross receipts from a related exempt activity rather than from gross investment income or unrelated business taxable activity. However, if the organization also furnishes facilities or loans to persons who are not members of a particular class and the furnishing of facilities does not contribute importantly to accomplishing the organization's exempt purpose, the support received from furnishing the facilities or funds will be

considered rents or interest and will be treated as gross investment income or unrelated business taxable income.

E. A Support Test Worksheet for IRC 509(a)(2) Organizations

[Worksheet not shown]

4. IRC 509(a)(3) Organizations

A. Outline of Basic Requirements

Unlike the other non-private foundations denominated in IRC 509, IRC 509(a)(3) organizations neither have broadly based support nor do they engage in an inherently public or charitable activity. Instead, IRC 509(a)(3) excludes organizations from private foundation classification by reason of their close relationship to those public charities classified as IRC 509(a)(1) or (a)(2) organizations.

The theory supporting IRC 509(a)(3) is that the public charity's control or involvement with the organization will render unlikely the potential for manipulation to private ends present in private foundations. The statute requires, therefore, that the organization meet all three of the following tests:

1. Organizational and Operational Tests under IRC 509(a)(3)(A). The organization must be organized and at all times operated for the benefit of, and to perform the function of, the specified organizations described in IRC 509(a)(1) and (2);
2. Nature of Relationship Test under IRC 509(a)(3)(B). The organization must be operated, supervised, or controlled by, or in connection with, one or more organizations described in IRC 509(a)(1) and (2); and
3. Lack of Outside Control Test under IRC 509(A)(3)(C). The organization must not be controlled directly or indirectly by one or more disqualified persons (as defined in IRC 4946) other than foundation managers and other than one or more organizations described in IRC 509(a)(1) or (2).

Overall, these tests seek to define the extent of control or involvement by the IRC 509(a)(1) or (2) "supported" organization and the lack of control or involvement of others.¹

B. Basic Steps in Making an IRC 509(a)(3) Determination

Of the tests set forth in the statute, the relationship test of IRC 509(a)(3)(B) is the most important. Therefore, whether there is a proper relationship between the organizations should be determined first. The order in which one should proceed in making a determination under IRC 509(a)(3) is as follows:

[Flow chart not shown]

1. General Observations

As set forth in Reg. 1.509(a)-4(f)(2), a supporting organization can meet the relationship test if it has one of the following relationships with one or more IRC 509(a)(1) or (a)(2) organizations: (a) operated, supervised, or controlled by; (b) supervised or controlled in connection with; or (c) operated in connection with.

The relationships "operated, supervised, or controlled by" and "supervised or controlled in connection with" rest, as their names indicate, on a finding of supervision or control. "Operated in connection with" is a more amorphous standard, with more complicated rules.

2. The "Operated, Supervised, or Controlled by" Relationship (Reg. 1.509(a)-4(g))

This relationship requires a substantial degree of direction over the policies, programs, and activities of a supporting organization by one or more publicly supported organizations -- a relationship similar to parent and subsidiary. Such a relationship is established by the fact that a majority of the members of the

¹ The statute also covers charitable organizations established by membership-based IRC 501(c)(4), (c)(5), and (c)(6) organizations. Having created an organization recognized as exempt under IRC 501(c)(3), the membership-based organization may also have the charity avoid private foundation status if the supported organization could qualify under IRC 509(a)(2) if it were an IRC 501(c)(3) organization. Since most unions and professional organizations are supported by dues, charities established by them may be eligible for IRC 509(a)(3) status.

controlling body of the supporting organization (its officers, directors, or trustees) are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity or membership of one or more publicly supported organizations. Reg. 1.509(a)-4(g)(1).

The following are examples of the "operated, supervised, or controlled by" relationship:

[Diagram not shown]

It should be noted Reg. 1.509(a)-4(g)(2) provides that an organization may establish the "operated, supervised, or controlled by" relationship even if it is controlled by one or more publicly supported organizations, but operated for the benefit of other publicly supported organizations, provided the purposes of the controlling publicly supported organizations are carried out by benefiting the other publicly supported organizations.

3. The "Supervised or Controlled in Connection with" Relationship (Reg. 1.509(a)-4(h))

As "organized, supervised, or controlled by" involves a parent-subsidiary relationship, "supervised or controlled in connection with" involves a brother-sister relationship. This relationship requires common supervision and control by the persons supervising or controlling both the supporting organization and the publicly supported organization or organizations. Therefore, as Reg. 1.509(a)-4(h)(1) provides, "in order to meet such requirement, the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations."²

Claims to "supervised or controlled in connection with" relationships rarely were encountered until perhaps a dozen years ago, when hospitals reorganized to

² A significant distinction between the "supervised and controlled in connection with" relationship and the "operated in connection with" relationship is that an organization will not be considered as being "supervised or controlled in connection with" a publicly supported organization solely by reason of its making payments to the publicly supported organization, even if the publicly supported organization has enforceable rights under state law. See Reg. 1.509(a)-4(h)(2) and Example 2, Reg. 1.509(a)-4(h)(3).

become multi-entity systems. A typical, although somewhat simple, hospital reorganization is set forth below.³

[Diagram not shown]

At issue here is the IRC 509 status of the holding company, which functions as the parent and sole corporate member of the subsidiaries. Typically described as an entity that provides overall direction to the system and coordinates policy making and long range planning, it neither has broadly based support nor engages in an inherently public or charitable activity. Consequently, it can only escape private foundation classification by establishing that it is described in IRC 509(a)(3). Here the entity's key problem is establishing a requisite relationship. It cannot establish that it is "operated, supervised, or controlled by" a publicly supported organization, because, as the parent, it cannot argue that it is operated, supervised, or controlled by its subsidiaries. It may establish that it has an "operated in connection with" relationship with its publicly supported subsidiaries; however, since this relationship requires that each of the beneficiary organizations be specifically named (a matter that will be discussed further below), many parent holding companies found this too troublesome, especially when considering that the systems would continue to reorganize and continue to add new publicly supported subsidiaries. Consequently, many of these holding companies decided to claim the "supervised or controlled in connection with" relationship.

In testing whether the parent holding company is "supervised or controlled in connection with" the publicly supported subsidiaries that it supports or benefits, the Service must determine whether control or management of the supporting organization (the parent holding company) is, in the words of Reg. 1.509(a)-4(h)(1), "vested in the same persons" that perform such functions for each publicly supported organization (in the above example, the hospital, the fund raising unit, and the blood bank). The key document that discusses this situation is G.C.M. 39508 (May 27, 1986). The rule of thumb developed in the G.C.M. is that no less than a majority of the persons who control or manage the supporting organization

³ It should be noted that the reorganized hospital system depicted has no taxable subsidiaries. In G.C.M. 39508, May 27, 1986, Chief Counsel specifically noted that it had not decided the question of the effect of a taxable subsidiary on a parent holding company's IRC 501(c)(3) status. The practice, to this point, has been to determine both the IRC 501(c)(3) status and the IRC 509(a)(3) status of a parent holding company without reference to the existence of a taxable subsidiary. The issue has not been ultimately resolved, however.

have the "requisite commonality" with the persons performing the same functions for each an every publicly supported organization that is supported or benefited.

In this context, what do "vested in the same persons" and "requisite commonality" mean? G.C.M. 39508 is quite definite in stating that "same persons" does not mean representatives or appointees. On the other hand, "same persons" does not necessarily mean that directors of the supporting organization must have the identical position (i.e., be also directors), in each and every publicly supported organization. Therefore, if the chief operating officer of the hospital sat on the board of the holding company, that person would be considered a person vested with control or management of both organizations even though he or she held different positions in each.⁴

Whether the "rule of thumb" is satisfied may be determined, as a practical matter, by looking at the supporting organization's governing instruments. For example, the "rule of thumb" would be satisfied if the articles of incorporation or bylaws of the supporting organization (parent holding company) require that a majority of persons who control it must perform the same functions for each publicly supported organization that it supports or benefits. On the other hand, a mere present identity of individuals, without any documentary evidence that such identity will continue for the life of the relationship of the organizations, would be insufficient.

Where less than a majority is involved, other facts and circumstances, such as the purpose of the reorganization, the number of publicly supported organizations being supported or benefited, all agreements among all organizations, and the nature of the activities of the supporting organization and each of the publicly supported organizations, must be considered. These facts and circumstances, together with the number of persons who control or manage the

⁴ This is consistent with Example 3 of Reg. 1.509(a)-4(h)(3), which gives an example of a charitable trust established for the benefit of a church. All original named trustees are members of the church, leaders of the church, and hold important offices in one or more of the churches' related institutions. Successor trustees are by the terms of the trust instrument to be chosen by the remaining trustees and also to be members of the church; in addition, all the original trustees have represented that any successor trustee will be a leader in the church and hold an important office in one or more of the church's related institutions. The example states that, under these circumstances, the supervised or controlled in connection with relationship is satisfied.

supporting organization and the publicly supported organizations, must clearly demonstrate that the supporting organization can and will be responsive to the needs or demands of each publicly supported organization and can and will be an integral part of, or maintain a significant involvement in, the operations of each supported organization it seeks to serve. Reg. 1.509(a)-4(f)(3)(i) and (ii). In practical terms, this means where the "rule of thumb" is not satisfied, particularly where there are many publicly supported organizations being served, it may not be reasonable to conclude that the requirements of Reg. 1.509(a)-4(f)(3)(i) and (ii) can be satisfied because the supporting organizations' influence or control over the supporting organization will be too diluted.

4. The "Operated in Connection with" Relationship (Reg. 1.509(a)-4(i))

a. General Principles

The "operated in connection with" relationship rests upon findings of responsiveness to the needs of the publicly supported organization and an integral or significant involvement in the affairs of the publicly supported organization or organizations. This relationship is satisfied where the supporting organization meets both the "responsiveness" and "integral part" tests.

b. The "Responsiveness" Test (Reg. 1.509(a)-4(i)(2))

An organization will meet this test if it is responsive to the needs or demands of the publicly supported organization or organizations. To meet this test, either of the following tests must be satisfied.

Responsiveness test #1 (Reg. 1.509(a)-4(i)(2)(ii))

The publicly supported organization must elect, appoint, or maintain a close working relationship with the officers, directors, or trustees of the supporting organization. (Consequently, the officers, directors, or trustees of the publicly supported organization have a significant voice in the investment policies of the supporting organization the timing of grants and the manner of making them, the selection of recipients, and generally the use of the income or assets of the supporting organization. However, a mere working relationship between representatives of the organizations that involves only the selection of grantees would not satisfy this test because the publicly supported organizations does not have a significant voice in directing the use of the supporting organization's income or assets. Rev. Rul 75-437, 1975-2 C.B. 217.)

Responsiveness test #2 (Reg.1.509(a)-4(i)(2)(iii))

The supporting organization is (1) a charitable trust under state law, (2) each specified publicly supported organization is a named beneficiary under the trust's governing instrument, and (3) the beneficiary organization has the power to enforce the trust and compel an accounting under state law. (In cases where there are named beneficiaries receiving fixed shares of the trust's income, it will be assumed that the beneficiary organizations have the power, under state law, to enforce the trust and compel an accounting. In all other cases, however, the supporting organization must produce authority under state law that the beneficiary organizations have such powers.)

For an organization that was supporting or benefitting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the above responsiveness tests.⁵

c. The "Integral Part" Test (Reg. 1.509(a)-4(i)(3))

An organization claiming the "operated in connection with" relationship will meet this test if it maintains a significant involvement in the operations of one or more publicly supported organizations and these organizations, in turn, are dependent upon the supporting organization for the type of support it provides. To meet this test, either of the following tests must be satisfied (unless the special rules, set forth in Reg. 1.509(a)-4(i)(4) and discussed in the next subdivision of this article, apply.

⁵The Tax Court, in Nellie Callahan Scholarship Fund v. Commissioner, 73 T.C. 626 (1980), held that the "named beneficiary" requirement of responsiveness test #2 was satisfied even though the governing instrument referred only to pupils at a community high school. The court found that, under the instrument, it was clear that the municipality, of which the community high school was an integral part, was the beneficiary organization. The Service does not acquiesce in this decision. See 1980-2 C.B. 2.

Integral part test #2 (Reg. 1.509(a)-4(i)(3)(iii))

The supporting organization (1) pays substantially all of its income to or for the use of one or more publicly supported organizations (Rev. Rul. 76-208, 1976-1 C.B. 161, holds that "substantially all," in this context, means at least 85 percent of the organization's income); (2) the amount of support received by one or more of the publicly supported organizations must be sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the "attentiveness requirement"); and (3) a significant amount of the total support of the supporting organization must go to those publicly supported organizations that meet the "attentiveness requirement."

Integral part test #1 (Reg. 1.509(a)-4(i)(3)(ii))

The activities engaged in for or on behalf of the publicly supported organization are activities that perform the functions of, or carry out the purposes of, such organizations, and these activities, but for the involvement of the supporting organizations, would normally be engaged in by the publicly supported organizations themselves. (This test only applies in situation where the supporting organization actually engages in activities that benefit the supporting organizations (e.g., performing publishing and printing functions for a college), as opposed to simply making grants to support the publicly supported organizations.)

Satisfaction of integral part test #2 creates greater difficulty -- the particular problem involves meeting the attentiveness requirement. Reg. 1.509(a)-4(i)(3)(iii)(a), (b), and (d), respectively, provide three alternative ways of meeting this requirement.

1. Amount of total support provided. Compare the amount of support provided to total support. "Total support" refers to all of the publicly supported organization's support unless the supported organization is a university, hospital, church, etc., and the support is provided to a particular school or department of the larger entity (in which case, the support provided is compared to the total support of the department, school, etc.) Rule of thumb: a grant of less than 10 percent of total support would be insufficient to insure attentiveness. G.C.M. 36379 (Aug. 15, 1975). By its terms, this way applies only to grant-making programs and is inapplicable to organizations that engage in their own independent program.
2. Support earmarked for a particular program or activity of the supported organization. The test is whether the publicly supported organization will be attentive to the operations of the supporting organization in order to avoid the interruption of the particular earmarked program or activity. Examples: an organization that underwrites a chamber music series at a museum, and an organization that endows a chair at a

school. In these examples, there are three common factors: (a) the supporting organization pays over all its income; (b) the supporting organization provides all its funds; and (c) the expense of conducting the program is substantial.

3. Facts and circumstances. Factors include the number of beneficiaries; the length and nature of the relationship of the organizations; the purpose to which the funds are put; and "acceptable evidence of actual attentiveness," such as a requirement that the supporting organization furnish its financial statements so that the beneficiary organization can assure itself of the investment and operational practices of the supporting organization. None of the above factors are considered determinative; however, certain combinations of facts and circumstances will enable the supporting organization to satisfy the "attentiveness requirement." In one example, the supporting organization provided \$ 100,000 annually to a city museum over a number of years, an amount that was minimal when compared to the museum's total support. However, (1) the museum was the only beneficiary of the supporting organization; (2) the amount provided represented substantially all of the supporting organization's income; (3) the supporting organization was the only nongovernmental organization that supported the museum; (4) the supporting organization furnished annual reports to the museum's director who furnished a statement that he reviewed the upon receipt; and (5) the museum's director was authorized to approve or veto the supporting organization's expenditures. Here the size of the grant and the continuing nature of the relationship were the critical factors. In a second example, an organization earmarked income to support a substantial program of a publicly supported organization. Here the facts and circumstances were (1) the funds constituted 50 percent of the organizations total support, and (2) the organizations exchanged financial reports and regularly corresponded regarding the program's details. The combination of the earmarking of funds, the size of the grant, the percentage of support and the frequency and nature of the correspondence would meet the requirements of the facts and circumstances test. Note, however, Reg. 1.509(a)-4(i)(3)(iii)(e) specifically provides that a beneficiary organization's enforceable rights under state law will not satisfy the integral part test.

d. Special "Integral Part" Test Rules for Special Situations

There are special integral part test rules for two special situations. The first involves an organization that meets the integral part test for a specified number of years, but no longer can do so under the general rules because the supported organization has expanded to the extent that the support is no longer sufficiently substantial. In this situation, the integral part test is considered satisfied if:

- (a) The test was satisfied for a five year period;
- (b) The failure to satisfy the test for the current taxable year is attributable to the fact that the provided support is no longer sufficiently substantial; and

- (c) Between the five year period and the taxable year there has been an historic and continuing relationship between the two organizations. Reg. 1.509(a)-4(i)(1)(iii).

The second special rule, the "transitional rule" of Reg. 1.509(a)-4(i)(4), involves older trusts. Under this rule, the trust will be considered to meet the integral part test if, for taxable years beginning after October 16, 1972, written annual reports are provided to each public charity and the trust met all of the five following requirements on November 20, 1970, and all years thereafter:

- (a) All its interests are devoted to the purposes set forth in IRC 170(c)(1) or IRC 170(c)(2)(B), and a charitable deduction was allowed for those interests;
- (b) The trust was created before November 20, 1970, and did not receive any gift, grant, contribution, or bequest after that date;
- (c) The trust is required to distribute all of its net income currently to the designated public charities;
- (d) The trust has no discretion to vary the amounts payable to any beneficiary; and
- (e) None of the trustees would be treated as disqualified persons (other than by reason of being foundation managers) with respect to the trust if the trust were a private foundation.

D. The Organizational Test

1. The Organizational Test in General (Regs. 1.509(a)-4(c) and (d))

To qualify for classification under IRC 509(a)(3), an organization's governing instrument must meet the following requirements:

- (a) Limit the purposes of the organization to one or more of the purposes set forth in IRC 509(a)(3)(A);
- (b) Not expressly empower the organization to engage in activities that are not in furtherance of such purposes;
- (c) State the specified publicly supported organizations on whose behalf the organization is to be operated; and

- (d) Do not expressly empower the organization to support or benefit any organization other than the specified publicly supported organizations.

2. The Organizational Test's Requirements for Supporting Organizations Whose Relationship Is "Operated, Supervised, or Controlled by" or "Supervised or Controlled in Connection with"

An organization whose relationship is "operated, supervised, or controlled by" or "supervised or controlled in connection with" should not have much difficulty meeting the organizational requirements. With respect to purposes, the organization meets this requirement if the purposes set forth in its governing instrument are similar to, but no broader than, the purposes set forth in the governing instruments of its controlling IRC 509(a)(1) or (a)(2) organization. Reg. 1.509(a)-4(c)(2).⁶

With respect to specifying publicly supported organizations in the governing instrument, an organization having either the "operated, supervised, or controlled by" or the "supervised or controlled in connection with" relationship satisfies this requirement even if it designates the supported organizations by class or purpose rather than by name, e.g., institutions of higher learning in the state of X. Reg. 1.509(a)-4(d)(2). Furthermore, in such cases, it is permissible for the supporting organization's governing instrument to permit: (1) the substitution of one publicly supported organization within the same class or a different class designated in the articles; (2) the supporting organization to operate for the benefit of new or additional publicly supported organizations of the same class designated in the articles; or (3) the supporting organization to vary the amount of its support among different publicly supported organizations within the class or classes of organizations designated in the articles. Reg. 1.509(a)-4(d)(3). Therefore, by meeting such minimal requirements, a supporting organization that is "operated, supervised, or controlled by" or "supervised or controlled in connection with" will satisfy the organizational test unless it expressly empowers itself to engage in

⁶ Organizations that are "operated, supervised, or controlled by" or "supervised or controlled in connection with" a publicly supported IRC 501(c)(4), (5), or (6) organization deemed to be an IRC 509(a)(1) or (2) organization for purposes of IRC 509(a)(3) merely must have articles that require it to carry on charitable activities within the meaning of IRC 170(c)(2). For a discussion of the involvement of a publicly supported non-IRC 501(c)(3) organization, see Rev. Rul. 76-401, 1976-2 C.B. 175.

activities not in furtherance of IRC 509(a)(3)(A) purposes, or expressly empowers itself to support or benefit a non-publicly supported organization.⁷

3. The Organizational Test's Requirements for Supporting Organizations Whose Relationship Is "Operated in Connection with"

Where a supporting organization is "operated in connection with" one or more publicly supported organizations, there may be problems in satisfying the organizational test. First, with respect to purposes, Reg. 1.509(a)-4(c)(2) provides that the articles of the supporting organization must state that it is formed "for the benefit of," or "to carry out the purposes of" one or more publicly supported organizations. Although the regulation does not require that such exact words be used, there must be at least some statement committing the supporting organization to support or benefit the publicly supported organizations. See Rev. Rul. 75-437, 1975-2 C.B. 218.⁸

A second problem for organizations with an "operated in connection with" relationship arises from the requirement of Reg. 1.509(a)-4(c)(2) that they must state, by name, the specified publicly supported organizations on whose behalf the organization is to be operated. However, in situations where there has been an historic relationship between the supporting organization and the publicly supported organization and where, by reason of such relationship, a substantial

⁷ One court case that may conflict with the Service's interpretation of the organizational test (and the operational test discussed later in this article), is Change-All Souls Housing Corp. v. United States, 671 F.2d 463 (Ct. Cl. 1982). In that case, the organization was affiliated with a public charity and a private foundation. The court held that the plaintiff was organized and operated for the benefit of the public charity. The fact that the plaintiff benefited a private foundation (which had the same purposes as the public charity) did not preclude it from private foundation status.

⁸ Therefore, a statement in a trust instrument that the trust income is to be used "for the purpose of paying for ... the education ... at Yale College of such graduates of Duxbury, Massachusetts High School or bona fide resident of Duxbury" would fail to satisfy the requirement because it fails to include a statement that the trust was created to benefit the publicly supported organization (Yale); rather, the instrument states that the purpose of the trust is to benefit students. In the case where the above provision appeared, however, (Goodspeed Scholarship Fund v. Commissioner, 70 T.C. 515 (1978), the court ruled otherwise and stated: "We see no use in requiring language more specific than that which Mrs. Goodspeed used." The Service does not acquiesce in this decision (1981-1 C.B. 2).

identity of interest has been developed between the organizations, the identity of the supporting organization need be made only as specifically as is required for organizations "operated, supervised, or controlled by" or supervised or controlled in connection with." Reg. 1.509(a)-4(d)(2)(iv).

Substitution of other entities for the designated publicly supported organization may create problems. The basic rule is that if the supporting organization does designate the specified publicly supported organization by name, it will not fail to meet the organizational test because its articles permit the substitution of another publicly supported organization, designated by class or purpose rather than by name, but only if such substitution is conditioned upon an event beyond the control of the supporting organization, such as loss of exemption, substantial failure or abandonment of operations, or dissolution of the publicly supported organization designated in the articles. Whether the condition is truly based upon an event outside the control of the supporting organization has been the subject of litigation. See Quarrie Charitable Fund v. Commissioner, 603 F.2d 1274 (7th. Cir. 1979); aff'g 70 T.C. 182 (1978), where the Seventh Circuit concluded that the nature of the events contemplated in the plaintiff's governing instrument combined with the trustee's exercise of judgment brought these events within the trustee's control for all practical purposes; therefore, the instrument's provision regarding substitution caused the organization to fail to meet the organizational test under IRC 509(a)(3)(A) and Reg. 1.509(a)-4(d).

Failure to meet the organizational test also will not occur solely because the supporting organization's articles permit it to operate for the benefit of a non-publicly supported organization that is designated by name or by class or purpose, but only if (1) a publicly supported organization is currently being supported and (2) the possibility of operating for the benefit of other than a publicly supported organization is a remote contingency, conditioned on events outside the publicly supported organization's control. If an organization that is not publicly supported eventually becomes the beneficiary, the supporting organization will fail the operational test described below but would not fail the organizational test, unless it was specifically named in the governing instrument, in which case the supporting organization will fail both the organizational and operational tests. See Reg. 1.509(a)-4(c)(3) and 1.509(a)-4(d)(4).

E. The Operational Test

The operational test, which is set forth in Reg. 1.509(a)-4(e), is concerned with permissible beneficiaries and permissible activities. Essentially, it provides that a supporting organization will be operated exclusively to support one or more specified organizations only if it engages in activities that support or benefit the publicly supported organizations. Such activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the specified publicly supported organization or organizations. Pursuant to Reg. 1.509(a)-4(e)(1), payments may be made to organizations other than the specified publicly supported organization only under the following circumstances:

1. The payment constitutes a grant to an individual who is a member of the charitable class benefited by the specified publicly supported organization rather than a grant to the organization receiving it (applicable rules are set forth in Reg. 53.4945-4(a)(4));
2. The payment is made to an organization that is operated, supervised, or controlled by; supervised or controlled in connection with; or operated in connection with the publicly supported organization; or
3. The payment is made to an organization described in IRC 511(a)(3)(B) (colleges and universities that are government agencies or instrumentalities).

A supporting organization is not required to pay over its income to supported organizations but may carry on its own independent programs designed to support or benefit the specified publicly supported organization. However, all such support must be limited to the permissible beneficiaries that are set forth in the preceding paragraph. Reg. 1.509(a)-4(e)(3) furnishes examples of independent programs that are permissible. These include an alumni association that uses its income to conduct a program of educational activities for the university's alumni faculty and students, and an organization formed and supported by a church to conduct educational lectures on religious subjects. Supporting organizations also may engage in fund raising activities, such as solicitations, fund raising dinners and unrelated trade or business to raise funds for the publicly supported organizations or their permissible beneficiaries.

Independent programs designed to support an organization that is "supervised or controlled in connection with" or "operated in connection" with publicly supported organizations is not infrequently encountered in hospital reorganizations -- often there is a newly created subsidiary seeking IRC 509(a)(3)

status on the basis that its program, while immediately of assistance to its IRC 509(a)(3) parent, ultimately benefits the IRC 509(a)(1) or (a)(2) entities within the system. In this situation, the subsidiary seeking IRC 509(a)(3) status satisfies the operational test.

F. The Disqualified Person Control Test

Under IRC 509(a)(3)(C) a supporting organization may not be controlled, directly or indirectly, by disqualified persons. The question of control by disqualified persons arises most frequently with organizations that purport to be "operated in connection with" publicly supported organizations.

It is necessary to look to whether disqualified persons may, by aggregating their votes or positions of authority, require the supporting organization to engage, or decline to engage, in an act that significantly affects the operations of the supporting organization. Under Reg. 1.509(a)-4(j)(1), the general rule is that control will be found where the disqualified persons have either 50 percent of the voting power or a veto power over the supporting organization's activities. Pursuant to Reg. 1.509(a)-4(j)(2), however, the 50 percent test may be rebutted by a showing that, in fact, some other person or group has control. (For example, in the case of a religious organization operated by a church, the fact that the majority of the organization's governing body is composed of lay persons who are substantial contributors (and thus disqualified persons under IRC 4946) will not disqualify the organization under IRC 509(a)(3)(C) if a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.)

For purposes of the control test, a foundation manager who is a disqualified person for some other independent reason, such as being a substantial contributor, will be treated as a disqualified person even if appointed or designated as a foundation manager by the publicly supported beneficiary organization.

IRC 509(a)(3)(C) not only forbids "direct control;" it also forbids "indirect control." Reg. 1.509(a)-4(j)(1) provides that all pertinent facts and circumstances will be taken into consideration in determining whether a disqualified person does in fact indirectly control an organization, including the nature, diversity, and income yield of the organization's holdings, the length of time particular stocks, securities and other assets are retained, and the manner of exercising its voting rights with respect to stocks in which members of its governing body have some

interest. See Rev. Rul. 80-207, 1980-2 C.B. 193, for an example of indirect control that disqualified an organization from IRC 509(a)(3) classification.