
**Public Charity or Private Foundation Status
Issues under IRC 509(a)(1)-(4), 4942(j)(3), and 507**

By Virginia G. Richardson and John Francis Reilly

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Overview

Purpose This article presents an overview of the issues confronted when dealing with whether an organization is a public charity or a private foundation, whether it is a private operating foundation, and what are the rules regarding termination of private foundation status.

**Introduction:
Public
Charity/Private
Foundation
Distinction** 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.

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Overview, Continued

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| Introduction | <p>Organizations described in IRC 501(c)(3) fall into two categories, private foundations and public charities. IRC 509 makes the statutory distinction between private foundations and public charities.</p> <ul style="list-style-type: none">• IRC 509 does not define "private foundation"; instead, 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. |
| Distinction Includes Foreign Organizations | <p>The private foundation/public charity distinction applies to both foreign and domestic organizations.</p> |
| Importance of the Distinction | <p>The distinction between private foundation and public charity classification is critical; public charity status is by far the more advantageous category. The principal reason is that private foundations are subject to the provisions of IRC chapter 42. They must:</p> <ul style="list-style-type: none">• Refrain from acts of self-dealing (IRC 4941),• Meet minimum distribution requirements (IRC 4942),• Abstain from "excess business holdings" (IRC 4943) and "jeopardizing investments" (IRC 4944), and• Refrain from making certain expenditures (IRC 4945) - while public charities are not subject to the provisions of IRC chapter 42. Public charities are, however, subject to IRC 4958. |

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Overview, Continued

Importance of the Distinction, continued

Additional advantages flowing from public charity classification involve:

- Exemption from the IRC 4940 tax on net investment income to which most private foundations are subject,
- Less burdensome reporting requirements (the annual information return that private foundations must complete, Form 990-PF, is more complex than the information returns filed by public charities (Forms 990 and Form 990-EZ)),
- Exemption, in the case of certain public charities, from various federal excise taxes, and
- Additional fundraising opportunities.

Fundraising Advantages

The fundraising advantages take several forms.

- Higher dollar limitations apply to contributions made by individuals and corporations to public charities.
- Under IRC 642(c), organizations classified under IRC 509(a)(1) may establish and maintain pooled income funds; other organizations described in IRC 501(c)(3) may not.
- The expenditure responsibility rules of IRC 4945(d)(4) make it far more likely that a public charity will receive grants from private foundations.

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Overview, Continued

Types of Organizations that Qualify as Public Charities

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))

- Churches or conventions or associations of churches (IRC 509(a)(1) and 170(b)(1)(A)(i))
- Educational organizations that normally maintain a regular faculty and curriculum and normally have a regularly enrolled body of students in attendance at the place where their educational activities are regularly carried on (IRC 509(a)(1) and 170(b)(1)(A)(ii))
- Hospitals and medical research organizations (IRC 509(a)(1) and 170(b)(1)(A)(iii))
- Organizations that provide support for a state college or university (IRC 509(a)(1) and 170(b)(1)(A)(iv))
- Governmental units of the United States (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))

- Organizations that receive substantial support from a governmental unit or from the general public (IRC 509(a)(1) and 170(b)(1)(A)(vi))
- 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))***

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Overview, Continued

Determining Private Foundation Classification under IRC 509

Determining private foundation classification under IRC 509 is not always a simple matter. Whether an organization qualifies as one that engages in an inherently public activity, 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 IRS 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) & 9709 (E.D. Va. 1977)

Types of Private Foundations

Private foundations are also subdivided into the categories of private operating foundations and private nonoperating foundations.

- Private operating foundations are private foundations whose income or assets are used, to a substantial extent, for operations that directly benefit the public, rather than for grant-making purposes.

This article also deals with the tests for qualification as a private operating foundation.

Terminations

The final topic of this article concerns termination of private foundation status under IRC 507. All organizations that have private foundation status are subject to the IRC chapter 42 provisions and to the supervision that results from the enforcement of those sanctions. Only by demonstrating that this supervision is no longer necessary can a private foundation terminate that status.

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Overview, Continued

Terminations, continued

- The only way an organization can terminate its private foundation status is to comply with the requirements of IRC 507, that is, by showing that its assets are subject to public supervision, either through transfer of its assets to a publicly supported organization, by operation as a publicly supported organization, or by following the rules of IRC 507(a)(1) relating to voluntary terminations.

This article will discuss those termination rules as well as the rules relating to the situation where a private foundation transfers its assets to another private foundation.

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

**IRC
170(b)(1)(A)(i)
Exclusion-
Church or
Convention or
Association of
Churches**

The IRC 170(b)(1)(A)(i) exclusion covers "a church or a convention or association of churches."

**Meaning of
"Convention or
Association of
Churches"**

The term "convention or association of churches" generally refers to the central association or convention of a group of churches or to an organization of churches of differing denominations.

- Thus, an organization having a membership comprised of churches of various denominations in a geographic area for the purpose of developing the spirit of Christian fellowship and cooperative mission among the local churches and of promoting the spiritual, moral, social, and civil welfare of the area qualifies as an "association of churches" within the meaning of IRC 170(b)(1)(A)(i). Rev. Rul. 74-224, 1974-1 C.B. 61.

**Relationship of
IRC
170(b)(1)(A)(i)
to IRC
501(c)(3) -
Religious
Purposes**

Churches are a subset of IRC 501(c)(3) organizations organized and operated for religious purposes. An organization that does not qualify as a church may still qualify for IRC 501(c)(3) status and for public charity status.

**Relationship of
IRC
170(b)(1)(A)(i)
to IRC
501(c)(3)
Requirements**

Churches are not exempt from the substantive requirements for exemption under IRC 501(c)(3). Therefore, a church's activities may not result in:

- Inurement. *Western Catholic Church v. Commissioner*, 73 T.C. 196 (1979) (primary activity was investment of fund of founder, who controlled organization); *Church of Scientology of California v. Commissioner*, 83 T.C. 381 (1984), *aff'd* 823 F.2d 1310 (9th Cir. 1987), *cert. denied*, 486 U.S. 1015 (1988) and *Founding Church of Scientology v. United States*, 412 F.2d 1197 (Ct. Cl. 1969), *cert. denied*, 397 U.S. 1009 (1970) (net earnings inured to founder and founder's family); *Synanon Church v. United States*, 820 F.2d 421 (D.C. Cir. 1987) (inurement and use of organization to promote violence).

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

Relationship of IRC 170(b)(1)(A)(i) to IRC 501(c)(3) Requirements, continued

- Private benefit or other furtherance of substantial nonexempt purposes. Rev. Rul. 81-94, 1981-1 C.B. 330 (enunciates Service position regarding mail order churches); *First Libertarian Church v. Commissioner*, 74 T.C. 396 (1980) (organization engaged in substantial social and political activities); *The Ecclesiastical Order of the Ism of Am, Inc. v. Commissioner*, 80 T.C. 833 (1983), *aff'd* 740 F.2d 967 (6th Cir. 1984), *cert. denied*, 471 U.S. 1015 (1985) (organization recruited new members by emphasizing to a great extent the tax benefits of becoming a member).
- Political campaign intervention or substantial lobbying. *Christian Echoes National Ministry v. United States*, 470 F.2d 849 (10th Cir. 1972), *cert. denied* 414 U.S. 864; *Branch Ministries v. Rossotti*, 211 F.3d 137 (D.C. Cir. 2000).

Churches are also subject to the unrelated business income tax provisions contained in IRC 511 to 515.

Consequences of Church Status

Whether an organization is classified as a "church or convention or association of churches" is significant because these organizations are treated differently from other organizations.

- The requirements under IRC 508(a) and 508(b) that an organization give notice to the Service that it is applying for recognition of IRC 501(c)(3) status and that it is not a private foundation do not apply to churches.
- Churches do not have to file annual information returns because IRC 6033(a)(2)(A) excuses them.
- IRC 7611 imposes restrictions on church tax inquiries and examinations.

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

**Lack of
Definition – 14
Points**

Congress has not given guidance to the meaning of "church." (The issue of the meaning of "church" for federal tax purposes is exhaustively discussed in Whelan, "'Church' in the Internal Revenue Code: The Definitional Problems," 45 Fordham L. Rev. 885 (1977).)

The current IRC 170 regulations do not define "church."

- The Service considers all facts and circumstances in determining whether an organization is a "church," including whether the organization has the following characteristics:
 1. A distinct legal existence
 2. A recognized creed and form of worship
 3. A definite and distinct ecclesiastical government
 4. A formal code of doctrine and discipline
 5. A distinct religious history
 6. A membership not associated with any other church or denomination
 7. Ordained ministers ministering to its congregations
 8. Ordained ministers selected after completing prescribed studies
 9. A literature of its own
 10. Established places of worship
 11. Regular congregations
 12. Regular religious services
 13. Sunday schools for religious instruction of the young
 14. Schools for the preparation of its ministers

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

Lack of Definition – 14 Points, continued

- These criteria were first announced by then-Commissioner Jerome Kurtz at the PLI seventh Biennial Conference on Tax Planning, Jan. 9, 1978, and then published by the Service in 1978 as a news release, IR-1930.
- The criteria are not exclusive - any other facts and circumstances that may bear upon the organization's claim for church status may also be considered.
- Furthermore, the promulgation of the 14 criteria is not an attempt to quantify the factual circumstances required for recognition as a church. Determinations are not made simply on the basis of the number of characteristics the organization possesses. Given the variety of religious practices, a determination of what constitutes a church is inherently unquantifiable.

Judicial Decisions Helpful in Determining Whether an Organization Is a "Church"

There are a number of judicial decisions that are helpful in determining whether an organization qualifies as a church. Two early cases are *De La Salle* and *Chapman*.

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

An Early Case: *De La Salle* In *De La Salle Institute v. United States*, 195 F. Supp. 891 (N.D. Cal., 1961), the court held that a corporation organized under the auspices of the Roman Catholic Church, whose members were the members of a religious order, was not a church. The corporation operated (1) a novitiate that trained men for the order, (2) Catholic schools for youth, (3) homes for members of the order and (4) a winery and distillery, in addition to chapels at the schools and novitiate.

- *De La Salle* has been cited especially for two of the court's observations: "the tail cannot be permitted to wag the dog" (*Id.* at 901) and Congress left the definition of church to the "common meaning and usage of the word" (*Id.* At 903). (Later court decisions have noted, however, that the "common meaning and usage" approach must take into consideration the diversity of religious beliefs and the First Amendment's religious protection clauses. See *Foundation of Human Understanding v. Commissioner*, 88 T.C. 1341, 1356-7 (1987).)
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An Early Case: *Chapman* In *Chapman v. Commissioner*, 48 T.C. 358 (1967), the Tax Court declared that Congress used "church" more in the sense of a denomination or sect than in a generic or universal sense and added that it did not intend to imply that to be considered a church a group must have an organizational hierarchy or maintain church buildings.

The court then concluded that a group of missionary workers drawn from many Christian churches could not be said to be a church. The group was interdenominational and independent of any connection with the churches with which its members were affiliated. It did not seek converts other than to the principles of Christianity generally and if successful urged those converts to establish their own native churches. It was merely a religious organization comprised of individual members who were already affiliated with various churches.

The concurring opinion by Judge Tannenwald is especially noteworthy because he stressed the importance of a congregational component when determining whether an organization is a "church." He stated that religious purposes:

. . . may be accomplished individually and privately in the sense that oral manifestation is not necessary, but it may not be accomplished in physical solitude. A man may, of course, pray alone, but, in such a case, though his house may be a castle, it is not a church. Similarly, an organization engaged in an evangelical activity exclusively through the mails would not be a church. *Id.* at 367.

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

**Cases Decided
After
Publication of
the 14 Points**

- The first case that applied the 14 criteria was *American Guidance Foundation, Inc. v. United States*, 490 F. Supp. 304 (D.D.C. 1980), *aff'd* in an unpublished opinion (D.C. Cir. 1981). In *American Guidance*, the court set forth the following conclusions:
 - At a minimum, a church includes a body of believers that assemble regularly in order to worship.
 - It must also be reasonably available to the public in its conduct of worship, in its educational instruction, and in its promulgation of doctrine.
 - Superficially responsive documentation purporting to show that the 14 criteria have been satisfied is not sufficient to establish church status.
 - An IRC 501(c)(3) religious organization comprised of a few family members who attend worship services at a relative's apartment and made no real effort to extend its membership beyond the family was not a church for purposes of IRC 170(b)(1)(A)(i).
- In *Church of the Visible Intelligence That Governs the Universe v. United States*, 14 Ct. Cl. 55 (1983), the Court of Claims held that the organization was not a church because it satisfied few of the 14 criteria, had only three members, provided no information on sacerdotal functions or doctrine pertaining to them, and provided no information on charitable activities typically associated with a church.
- In *Universal Bible Church, Inc. v. Commissioner*, T.C.M. 1986-170, the Tax Court concluded that the organization was not a church because it failed to establish that it had a distinct religious history, a membership beyond the trustees (2-50 people attended services, which were held in the homes of the trustees), or religious instruction for children and because its primary means for promoting its beliefs was to be through radio, television, and other media.

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

Cases Decided After Publication of the 14 Points, continued

- In *Church of Eternal Life and Liberty, Inc. v. Commissioner*, 86 T.C. 916 (1986), the Tax Court found that an organization with only two members that had not increased in size since its inception and, in fact, had made no attempts to attract new members was not a church since it failed to serve any associational role for purposes of worship. In this respect, the court stated:

[w]hile incipient churches may have only two or three gathered together, a church membership will grow well beyond those small numbers given the vitality of its associational role. Petitioner, by contrast, seems to have intentionally pursued a policy that discouraged membership for reasons, we believe, that served the private purposes of its founder. *Id.* at 924-925.

- In *First Church in Theo v. Commissioner*, T.C.M. 1989-16, the Tax Court held that the organization was not a church because its principal activity was publishing religious literature and it had no plans for membership (although it conducted some religious services), no formal creed (other than the Bible and a belief that God dwells in all people), no sacerdotal functions, no membership unassociated with other churches, no regular congregations or services, no established place of worship, no organized ministry for ministering to congregations, and no youth instruction.
- In *Spiritual Outreach Society v. Commissioner*, 927 F.2d 335 (8th Cir. 1991), the court concluded that an organization that held bi-monthly outdoor gospel music events and retreats with people of different religions for purposes of meditation and study was not a church where it had no congregation of members who claimed the organization as their church, no ministers other than guest ministers from other churches, and no religious education of the young.
- In *VIA v. Commissioner*, T.C.M. 1994-349, the organization was formed to promote the "wellness" and spiritual growth of its members through use of the latest discoveries in exercise, nutrition, and stress management. It held meetings, which involved group meditation, exchange of information on wellness, monitoring of members' physical fitness, and designing of individual wellness programs, in members' houses. Also, it trained mentors to conduct such activities, published a newsletter sold at grocery stores, sold a nutritional supplement and planned to broadcast a wellness news program. The Tax Court found that the organization was not a church, reasoning that it did not meet any of the criteria other than a distinct legal existence and a literature of its own, and that its meetings, even if viewed as a form of worship, were incidental to other activities.

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

**An
Organization
Held to Be a
Church -
*Purnell v.
Commissioner,*
T.C.M. 1992-
349**

In *Purnell*, the organization had a creed, form of worship, code of doctrine and discipline, a literature of its own, established places of worship, regular congregations, and regular religious services. It qualified as a church for purposes of IRC 170(b)(1)(A)(i) even though it had no definite and distinct ecclesiastical government, no organization of ordained ministers and no schools for the preparation of its ministers.

**Evangelistic
Organizations/
Media
Ministries**

Traditionally, the Service has classified evangelistic organizations as publicly supported organizations under IRC 170(b)(1)(A)(vi) rather than churches under 170(b)(1)(A)(i) because the organizations engaged in short-term revivals or crusades intended to supplement and reinforce, not replace, the activities of local churches. An evangelistic organization usually did not maintain a regular and continuing program in the localities it visited.

- Recent years have seen a change in the classification of some evangelistic organizations. This change has been caused not by any change in Service position, but by changes that have evolved in the structure and activities of these organizations. Once purely "itinerant" organizations have built permanent churches from which they now broadcast their services. Many of these organizations have developed an established congregation that attends regular religious services.

Media evangelism once was merely an extension of a church or religious organization and did not serve to change the character of the organization.

- Recent years have seen the growth of organizations whose primary purpose is broadcasting religious programs. This situation raises the issue of whether "church" classification is dependent upon a congregation being physically present.
- As the Tax Court has noted in *Church of Eternal Life and Liberty, Inc. v. Commissioner*, 86 T.C. 916, 924 (1986), an organization seeking church classification must demonstrate that the principal means by which it accomplishes its religious purposes is to assemble regularly a group of individuals related by common worship and faith.

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

**Evangelistic Organizations/
Media Ministries,
continued**

- In *Foundation for Human Understanding v. Commissioner*, 88 T.C. 1341 (1987), the Tax Court considered an organization that initially spread its religious teachings through broadcasts that eventually drew a regular listening audience of 30,000 with a potential audience of 2,000,000 and through a publication that had 5,200 subscribers with an estimated readership of 15,000.
- The organization later conducted regular religious services for congregations of 50-350 people at two locations, in addition to the broadcasting and publishing.
- The court, while troubled by the amount of broadcasting activities conducted by the organization, concluded that a congregation of 50-350 persons could not be considered incidental. Therefore, despite the broadcasting activities, it held that the organization was a church.
- In dissent, Judge Chabot, citing *Church of Eternal Life and Liberty*, wrote that because the principal means of spreading the organization's beliefs was through broadcasting activities, it was not entitled to church status. *Id.* At 1373-1374.

The Service disagreed with the Tax Court's application of the facts to the law and, therefore, acquiesced in result only. A.O.D., *Foundation of Human Understanding*, 1987-2 C.B. 1.

IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations

General

Educational organizations described in IRC 170(b)(1)(A)(ii) represent the second general category of organizations excepted from private foundation classification under IRC 509(a)(1).

An IRC 170(b)(1)(A)(ii) organization must:

- Present formal instruction as its primary function,
- Normally maintain a regular faculty and curriculum, and
- Normally have a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

Included in this exception are such organizations as private and public primary, secondary, preparatory or high schools, colleges, universities, and various other instructional institutions.

Related Code Sections

IRC 170(b)(1)(A)(ii) is cross referenced in various excise tax sections that exempt sales to nonprofit educational organizations from such excise taxes as those imposed on diesel fuel and special motor fuels (IRC 4041(g)(4)), various manufactured articles listed in chapter 32 (IRC 4221(d)(5)), and certain communication services (IRC 4253(j)).

- The excise tax exemption provisions operate somewhat differently in that they extend not only to an IRC 170(b)(1)(A)(ii) organization but also to a school operated as an activity of an IRC 501(c)(3) organization, even if the school activity is not the organization's primary activity.

Example

A nonprofit organization established to operate a museum which, as part of its program, offers accredited seminar and degree programs with a regular faculty and curriculum to qualified students of a local university and provides a lecture series open to students and the general public is not an IRC 170(b)(1)(A)(ii) organization since its primary function is operating a museum and not providing formal instruction. Rev. Rul. 76-167, 1976-1 C.B. 329. However, a sale to the museum's school of an article otherwise subject to a manufacturers excise tax would be exempt from such tax.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

Related Code Sections, continued

Notwithstanding this difference, precedents relating to the excise tax exemptions are useful in making determinations under IRC 170(b)(1)(A)(ii).

Primary Function Requirement

Reg. 1.170A-9(b)(1) provides that the primary function of an IRC 170(b)(1)(A)(ii) organization is the presentation of formal instruction. While an IRC 170(b)(1)(A)(ii) organization may engage in other activities, it must have as its primary function the operation of a school.

Examples

- An organization organized for the primary purpose of engaging in medical research and that, as a secondary activity, offers formal instruction to professionals and graduate students does not qualify as an educational organization under IRC 170(b)(1)(A)(ii). Rev. Rul. 56-262, 1956-1, C.B. 131.
- An organization whose principal purpose and functions are devoted to the collection and preservation of coins and medals, and which, as a secondary activity, provided formal instruction to graduate and post-graduate students is not an educational organization within the meaning of IRC 170(b)(1)(A)(ii). Rev. Rul. 58-433, 1958-2 C.B. 102.
- An organization that was established to train, educate, and rehabilitate mentally handicapped children and that meets the prescribed requirements concerning formal instruction, faculty, curriculum, and student body enrollment comes within the scope of the term "nonprofit educational organization" for excise tax purposes. However, another organization operated primarily as a residential facility for handicapped children does not come within the scope of the term "nonprofit educational organization." Rev. Rul. 62-6, 1962-1 C.B. 198.
- However, an organization whose primary activity is providing specialized instruction by correspondence cannot qualify as a school under IRC 170(b)(1)(A)(ii) because its primary function is not the presentation of formal instruction. Rev. Rul. 75-492, 1975-2 C.B. 80.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

**Primary
Function
Requirement,
continued**

- An organization established to operate a museum which, as part of its program, offers accredited seminar and degree programs with a regular faculty and curriculum to qualified students of a local university and provides a lecture series open to students and the general public is not an IRC 170(b)(1)(A)(ii) organization since its primary function is operating a museum and not providing formal instruction. Rev. Rul. 76-167, 1976-1 C.B. 329.
- An exempt organization whose primary function is conducting guided tours, during which the participants are instructed in the skills and crafts of the area in which they are touring, does not qualify as a nonprofit educational organization within the meaning of IRC 170(b)(1)(A)(ii). Rev. Rul. 76-237, 1976-1 C.B. 330.
- An organization that operates a tutoring service for students on a one-to-one basis in their homes, maintains a small center to test students to determine their need for individual tutoring, and employs tutors on a part-time basis is not an educational organization described in IRC 170(b)(1)(A)(ii). Rev. Rul. 76-384, 1976-2 C.B. 57.
- An organization that conducts an internship program placing college and university students with cooperating government agencies for a semester, is not engaging in the presentation of formal instruction and does not have a curriculum. Therefore, it is not an educational organization described in IRC 170(b)(1)(A)(ii). Rev. Rul. 76-417, 1976-2 C.B. 58.
- An organization whose primary activity is operating an improvisational repertory theater, does not qualify as an IRC 170(b)(1)(A)(ii) organization. Rev. Rul. 77-211, 1977-1 C.B. 312.
- A community center corporation that offers classes in subjects such as art, cooking dance, photography, swimming, languages, gymnastics, and mechanics in connection with its primary activity of carrying on social, cultural, and recreational programs is not described in IRC 170(b)(1)(A)(ii). Rev. Rul. 79-167, 1979-1 C.B. 335.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

**Primary
Function
Requirement,
continued**

- A residential treatment center for emotionally disturbed children is an organization described in IRC 170(b)(1)(A)(ii) as it conducts a school program that operates five hours a day, five days a week, on a year-round basis; the school enrolls children who are not part of the residential program, provides an educational treatment plan for each child, and provides one staff member for every two children and one teacher, who has a credential to teach severely emotionally disturbed children. Rev. Rul. 79-403, 1979-2 C.B. 362.
- A corporation that operates a vocational rehabilitation center for handicapped individuals that provides classroom training, on the job training and employment in its sheltered workshops and retail stores, and related services is not an organization described in IRC 170(b)(1)(A)(ii), since its primary activity is not the providing of formal instruction. Rev. Rul. 80-20, 1980-1 C.B. 231. Rev. Rul. 64-264 clarified and superseded.

**"Primary
Function" and
Organizations
Operating As
an Integral
Part of a School**

An organization that operates as an integral part of a school may qualify as an organization described in IRC 501(c)(3).

- Even if it operates as an integral part of a school classified under IRC 170(b)(1)(A)(ii), an organization may not itself qualify itself for IRC 170(b)(1)(A)(ii) status unless its primary function is the presentation of formal instruction.

Examples

- A university endowment association organized to receive and hold property for the university's use is not an IRC 170(b)(1)(A)(ii) organization. Rev. Rul. 60-110, 1960-1 C.B. 121.
- Associations of universities formed to solicit contributions or to promote the athletic programs of member universities are not nonprofit educational institutions for excise tax purposes. Rev. Rul. 63-15, 1963-1 C.B. 189.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations, Continued

Recreational and Camping Organizations Ordinarily Do Not Qualify for IRC 170(b)(1)(A)(ii) Classification

Examples

- An organization that primarily operates a summer camp involving both recreational and educational activities and also conducts a training program for camp counselors does not qualify as a nonprofit educational organization. Rev. Rul. 74-366, 1974-2 C.B. 345. *See also* Rev. Rul. 68-659, 1968-2 C.B. 489 (Girl Scouts of America and local councils are not nonprofit educational institutions for excise tax purposes.)
- Compare, however, the survival school described in Rev. Rul. 73-434, 1973-2 C.B. 71. An organization that has full-time instructors who regularly conduct a 26-day survival course, mostly out-of-doors, to teach young people how to survive in a natural environment, is an educational organization within the meaning of IRC 170(b)(1)(A)(ii) and qualifies for IRC 170(b)(1)(A)(ii) classification. Also, the organization described in Rev. Rul. 83-140, 1983-2 C.B. 185 -- a wilderness camping program for troubled adolescents -- qualifies for IRC 170(b)(1)(A)(ii) classification.

Curriculum and Faculty

To qualify as an IRC 170(b)(1)(A)(ii) educational organization a school must normally maintain a regular curriculum and faculty.

Curriculum Requirement Places No Limitation on Subject Matter

The curriculum requirement for IRC 170(b)(1)(A)(ii) status does not mean that a school must present courses in traditional academic subjects. While many, if not most, schools will satisfy the curriculum requirement by offering these types of courses, other types of curriculums may be offered.

Examples

- A ballet school that offers a formal college preparatory program of instruction and maintains a regular faculty, curriculum, and enrollment of students at the place where its educational activities are carried on is an educational organization within the meaning of IRC 170(b)(1)(A)(ii). Rev. Rul. 67-447, 1967-2 C.B. 121.
- An organization created as a result of collective bargaining agreements to train individuals desiring to acquire skills and crafts required in a particular industry is an educational organization described in IRC 170(b)(1)(A)(ii). Rev. Rul. 72-101, 1972-1 C.B. 144.

Continued on next page

IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

Curriculum Requirement Places No Limitation on Subject Matter, continued

- An organization that teaches survival techniques in a natural environment to young people was held to be an educational organization within the meaning of IRC 170(b)(1)(A)(ii). Rev. Rul. 73-434, 1973-2 C.B. 71.
- A training center established to instruct the blind to properly function with the aid of guide dogs meets the requirements relating to faculty, curriculum, and enrolled student body, and qualifies under IRC 170(b)(1)(A)(ii). Rev. Rul. 73-456, 1973-2 C.B. 342. (Note, however, that an organization that conducts a dog obedience school will not qualify for recognition of exemption under IRC 501(c)(3) since the dog rather than the owner is the primary object of training. Rev. Rul. 71-421, 1971-2 C.B. 229; *Ann Arbor Training Club, Inc. v. Commissioner*, 74 T.C. 207 (1980).)
- An organization established to educate persons in a particular method of natural childbirth that as its primary activity operates a school offering two courses to educate prospective parents and train medical professionals, and that meets the requirements relating to faculty, curriculum, and enrolled student body, qualifies as a nonprofit educational organization for purposes of the exemption from the retailers, manufacturers, and communication taxes. Rev. Rul. 73-543, 1973-2 C.B. 343.
- An organization whose primary activity consists of providing courses of study in one of the martial arts consisting of regularly scheduled participatory exercises and theoretical discussions taught by a faculty of qualified instructors to a regularly enrolled student body, is an educational organization within the meaning of IRC 170(b)(1)(A)(ii). Rev. Rul. 78-309, 1978-2 C.B. 123.

Examinations or Grades Are Not Essential

Examinations or grades are not essential to satisfaction of the curriculum requirement.

Example

- A religious school operating as a center for adults and combining a personal, group, and subject approach to learning has a regular faculty and a regular enrollment of students in attendance at the place where its educational activities are carried out. Regardless of the fact that no examinations or grades are given, it is an educational organization under IRC 170(b)(1)(A)(ii). Rev. Rul. 68-175, 1968-1 C.B. 83.
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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

**Classroom
Setting Not
Required**

The instruction need not be carried on in a classroom setting.

Examples

- An organization maintaining a regular staff of paid instructors who conduct field study courses related to sociological and physical sciences for a regularly enrolled body of college and secondary school students supplementing their formal classroom studies is described in IRC 170(b)(1)(A)(ii). Rev. Rul. 75-215, 1975-1 C.B. 335. *See also* Rev. Rul. 73-434, 1973-2 C.B. 71 (survival course) and Rev. Rul. 83-140, 1983-2 C.B. 185 (wilderness camping program).
- Compare, however, Rev. Rul. 76-237, 1976-1 C.B. 331 (organization that conducts guided tours does not qualify for IRC 170(b)(1)(A)(ii) status).

**Nursery
Schools/Day
Care Centers**

Preschool children's nursery schools or day-care centers may meet the regular curriculum requirement.

Examples

- Nursery school that maintains a faculty and curriculum and has an enrolled body of students is an educational institution exempt from federal admissions tax. Rev. Rul. 54-472, 1954-2 C.B. 381.
- Preschool day-care center that meets the requirements relating to faculty, curriculum and enrolled student body is a nonprofit educational institution for purposes of federal excise taxes. Rev. Rul. 73-430, 1973-2 C.B. 362.
- Compare, however, a day-care center that primarily provides care for children in homes of staff members is not an organization described in IRC 170(b)(1)(A)(ii) as it is providing primarily a custodial service and not formal instruction. Rev. Rul. 78-446, 1978-2 C.B. 257.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

Individualized Instruction

Individualized instruction may satisfy the curriculum requirement, depending upon the circumstances.

Examples

- An organization that provides an elementary education for children meets the curriculum requirement, even though it has no formal course program or formal classroom instruction, where it provides an individualized course of study for each child, based on the child's interests and aptitudes. Rev. Rul. 72-430, 1972-2 C.B. 105.
- Compare, however, Rev. Rul. 76-384, 1976-2 C.B. 57 (organization operating a tutoring service for students on a one-on-one basis in their homes does not qualify for IRC 170(b)(1)(A)(ii) classification).

A Series of Unrelated Lectures or Conferences Will Not Meet the "Regular Curriculum" Requirement

An IRC 170(b)(1)(A)(ii) organization must normally maintain a regular curriculum, although a formal course program or formal classroom instruction is not necessarily required. This means a school's course or courses of study, and its curriculum, must be offered on a recurrent basis. Therefore, if an organization merely offers a series of unrelated lectures or conferences, it will not meet the regular curriculum requirement and cannot qualify as an IRC 170(b)(1)(A)(ii) organization.

Examples

- An organization that accomplishes its exempt educational purposes by holding conferences, discussions, and seminars to which prominent men and women from all fields of endeavor are invited to attend and participate is not an organization described in IRC 170(b)(1)(A)(ii) since it does not maintain a regular faculty and curriculum and does not have a regularly enrolled body of pupils or students in attendance. Rev. Rul. 64-128, 1964-1 (Part 1) C.B. 191.
- An organization that offers a variety of lectures, workshops, and short courses on oriental philosophies and psychic phenomena, led by various invited authorities and noted personalities in these fields and open to the general public as well as members who wish to attend, is not an educational organization under IRC 170(b)(1)(A)(ii) because the subject matter neither is organized into an interrelated curriculum so as to constitute formal instruction nor is offered on a regular basis. Rev. Rul. 78-82, 1978-1 C.B. 70.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

**Regular
Faculty
Requirement**

A school described in IRC 170(b)(1)(A)(ii) also must normally maintain a regular faculty. Generally, this requirement will be met if its classes, seminars, or other means of instruction are conducted by teachers, instructors, or other qualified persons who perform their duties on a recurrent basis.

- On the other hand, an organization such as the one described in Rev. Rul. 64-128 (1964-1 (Part 1) C.B.191), which engaged in research and held a series of unrelated conferences and lectures, each of which was directed by a separately chosen group of persons who were authorities in their fields, would not be considered to have a regular faculty.

**Regularly
Enrolled
Students in
Attendance**

IRC 170(b)(1)(A)(ii) also requires that schools described therein have a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on.

- The requirement that students be "regularly enrolled" was considered in Rev. Rul. 64-128, 1964-1 C.B. 191. That ruling held that prominent men and women who were invited to attend a single conference or lecture program were not "regularly enrolled" students.

**"Place"
Requirement**

IRC 170(b)(1)(A)(ii) requires that a school's students be in attendance at the place where its educational activities are regularly carried on. A school may have its own facility or periodically use the facilities of other organizations or persons.

- In Rev. Rul. 69-492, 1969-2 C.B. 36, for example, the Service held that an organization which operated a school at another school's campus over the summer was an IRC 170(b)(1)(A)(ii) organization.

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations,
Continued

Brevity of Course Is Not a Disqualifying Factor So Long As the Curriculum Is Regularly Carried on and There Is a Regularly Enrolled Body of Students

A curriculum may be of several weeks duration so long as it is regularly carried on.

Examples

- An organization whose only function is to conduct classes for eight weeks each summer during which it maintains a regular faculty and curriculum with regularly enrolled students qualifies as an IRC 170(b)(1)(A)(ii) organization. Rev. Rul. 69-492, 1969-2 C.B. 36.
- *See also* Rev. Rul. 72-101, 1972-1 C.B. 144 (eight week vocational program); Rev. Rul. 73-434, 1973-2 C.B. 71 (26 day survival course); Rev. Rul. 73-456, 1973-2 C.B. 342 (four-week course training the blind to function with guide dogs); Rev. Rul. 73-543 (six-week natural childbirth course).

However, where the curriculum is of a brief duration, the "regularly enrolled body of students" requirement may not be met.

Examples

- An organization that conducts (1) a regularly scheduled eight week course in yoga that is taught by a regular faculty once a week to registered students, and (2) regularly scheduled single-session classes and irregularly scheduled classes, lectures, seminars, discussions open to the public on an unregistered walk-in basis is not a nonprofit educational organization for excise tax purposes, although the eight week course program constitutes a school activity. Rev. Rul. 79-130, 1979-1 C.B. 332.
- *See also* Rev. Rul. 64-128, 1964-1 C.B. 191 (organization that invited students to conferences and seminars did not have a regularly enrolled body of students); Rev. Rul. 74-46, 1974-1 C.B. 304 (traveling theater company lacked an enrolled body of students).

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IRC 170(b)(1)(A)(ii) Exclusion - Certain Educational Organizations, Continued

**Racially
Nondiscrimin-
atory Policy**

A private school must have adopted and operate in accordance with a racially nondiscriminatory policy to qualify as an organization described in IRC 501(c)(3) and IRC 170.

- Rul. 71-447, 1971-2 C.B. 230, holds that a private school that does not have a racially nondiscriminatory policy as to students does not qualify for exemption as an organization described in IRC 501(c)(3). A "racially nondiscriminatory policy as to students" is defined as meaning the school admits students of any race to all rights, privileges, programs, and activities generally accorded or made available to students at that school and the school does not discriminate on the basis of race in administration of its educational policies, admissions policies, scholarship and loan programs, and athletic and other school-administered programs.
 - Rev. Rul. 75-231, 1985-1 C.B. 158, holds that organizations, including churches, that conduct schools with a policy of refusing to accept children from certain racial and ethnic groups will not be recognized as tax-exempt charities under sections 170 and 501(c)(3) of the Code.
 - In *Bob Jones University v. United States*, 461 U.S. 574 (1983), the Supreme Court of the United States upheld the scope and exercise of the Service's authority to deny tax exempt status to private schools maintaining a racially discriminatory policy. The Court held that the school, which prescribes and enforces racially discriminatory standards on the basis of religious doctrine, does not qualify for exemption under IRC 501(c)(3). The Court concluded that racially discriminatory private schools violate a fundamental public policy and cannot be viewed as conferring a public benefit within the common law standards of charity and congressional intent underlying IRC 501(c)(3).
 - Rev. Proc. 75-50, 1975-2 C.B. 587, sets forth guidelines and record keeping requirements for determining whether private schools that are applying for recognition of exemption from federal income tax under IRC 501(c)(3) of the Code, or are presently recognized as exempt from tax, have a racially nondiscriminatory policy as to students.
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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations

Introduction

IRC 170(b)(1)(A)(iii) and Reg. 1.170(A)-9(c) refer to two distinct types of organizations:

- (1) An organization whose principal purpose or function involves the providing of medical or hospital care or medical education or medical research ("IRC 170(b)(1)(A)(iii) hospital").
 - (2) A medical research organization whose principal purpose or function is the providing of medical research and which is directly engaged in the continuing active conduct of medical research in conjunction with a hospital ("IRC 170(b)(1)(A)(iii) medical research organization").
-

IRC 170(b)(1)(A)(iii) Hospital –

An organization qualifies as an IRC 170(b)(1)(A)(iii) hospital under Reg. 1.170A-9(c)(1) if:

Medical or Hospital Care Is of the Essence

- (a) It is a hospital, and
- (b) Its principal purpose or function is the providing of medical or hospital care or medical education or research.

Reg. 1.170A-9(c)(1) also provides that if the principal purpose of an organization is the providing of medical education or research it will not be considered a "hospital" for purposes of IRC 170(b)(1)(A)(iii) unless it is also actively engaged in providing medical or hospital care to patients on its premises or in its facilities on an inpatient or outpatient basis, as an integral part of its medical education or research functions.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Meaning of "Medical Care"

The term "medical care" includes the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided the cost of such treatment is deductible under IRC 213 by the person treated. Reg. 1.170(b)(1)(A)(iii).

- The medical care provided must be for human beings; therefore, an organization that maintains a free clinic for animals does not qualify as a hospital nor as an organization that provides medical or hospital care within the meaning of IRC 170(b)(1)(A)(iii). Rev. Rul. 74-572, 1974-2 C.B. 82.

Related Code Sections

IRC 4253(h), which cross references IRC 170(b)(1)(A)(iii), exempts sales to nonprofit hospitals. Revenue rulings under this section are helpful in illustrating the meaning of "hospital" under IRC 170(b)(1)(A)(iii).

Rulings issued under former IRC 503(b)(5) and its predecessors are also helpful in ascertaining the meaning of "medical care."

Certain Other Establishments May Qualify as an IRC 170(b)(1)(A)(iii) Hospital

A rehabilitation institution, outpatient clinic, or community mental health or drug treatment center may qualify as a hospital for purposes of IRC 170(b)(1)(A)(iii) if its principal purpose or function is providing medical care. Reg. 1.170(b)(1)(A)(iii).

- An organization, all the accommodations of which qualify as an "extended care facility" within the meaning of 42 U.S.C. §1395x(j), may qualify as a hospital if its principal purpose or function is providing hospital or medical care. The type of organization contemplated under 42 U.S.C. §1395x(j) is one that provides skilled nursing services under the supervision of physicians and registered professional nurses to inpatient injured, disabled or sick persons transferred from hospitals.
- "Hospital" does not, however, include convalescent homes, or homes for children or the aged, nor does the term include institutions whose principal purpose or function is to train handicapped individuals to pursue some vocation.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Medical Education or Research As a Principal Function of an IRC 170(b)(1)(A)(iii) Hospital

A hospital's principal purpose or function need not be medical or hospital care to qualify under IRC 170(b)(1)(A)(iii).

- While medical or hospital care may be the principal purpose or function of most hospitals, an organization may qualify as an IRC 170(b)(1)(A)(iii) hospital even if its principal purpose or function is medical education or medical research, but only if it is actively engaged in providing medical or hospital care to patients on its premises or in its facilities, on an inpatient or outpatient basis, as an integral part of its medical education or medical research purposes. Reg. 1.170A-9(c)(1).

Other Organizations

Organizations that do not provide medical or hospital care or medical education or medical research cannot qualify as organizations described in IRC 170(b)(1)(A)(iii) no matter how health-related their services may be.

Examples

- An organization whose activities include conducting religious services, vocational instruction for the mentally retarded, and rehabilitation services for the handicapped is not an IRC 170(b)(1)(A)(iii) organization, even though it has some characteristics of a hospital, because its principal purpose or function is not that of a hospital. Rev. Rul. 56-262, 1956-2 C.B. 131.
- An organization that has as its primary function, raising funds needed by hospitals and public agencies for the care of crippled children and also operates a medical treatment center, is not an IRC 170(b)(1)(A)(iii) organization since its primary activity is raising funds. Rev. Rul. 59-27, 1959-1 C.B. 57.
- A Planned Parenthood Center that (1) maintains a clinic to which local doctors provide services for medical examinations and consultations, (2) provides informational classes and distributes literature on planned parenthood practices, and (3) cooperates with pharmaceutical companies in medical research as to the effectiveness of various birth control pills is not a nonprofit hospital for purposes of IRC 4253(h) as it is not engaged in providing hospital care or operating a hospital for the sick. Rev. Rul. 67-465, 1967-2 C.B. 381.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Other Organizations, continued

- A home for the aged whose principal purpose was to provide domiciliary and custodial care for 120 residents and also maintained a 15-bed infirmary for treatment of minor illnesses was not a hospital under former IRC 503(b)(5) since medical or hospital care was not its principal purpose or function. Rev. Rul. 69-401, 1969-2 C.B.128.
- An organization conducting programs of research, public information and education, and professional education and training with respect to a specific disease, but not for the principal purpose of providing medical or hospital care, does not qualify for exemption from communications tax provided by IRC 4253(h) because the organization is not described in IRC 170(b)(1)(A)(iii). Rev. Rul. 75-295, 1975-2 C.B. 437.
- A residential center for the aged and indigent and their families was not a nonprofit hospital under IRC 4253(h) since its medical care function, although extensive, was secondary to its primary purpose of operating a home for the aged and indigent. Rev. Rul. 76-9, 1976-1 C.B. 348.

Treatment of Outpatients

The general principle is that an outpatient clinic qualifies as a hospital under Reg. 1.170A-9(c)(1) if its principal purpose or function is the providing of medical care.

Examples

A community health care center that provides outpatient medical, dental, and general health care is a nonprofit hospital for purposes of the excise tax under IRC 4253(h), which cross references IRC 170(b)(1)(A)(iii). Rev. Rul. 73-131, 1973-1 C.B. 446.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Treatment of Outpatients, continued

- An organization that operates mobile clinics to provide free medical care in certain foreign countries where patients are unable to travel to hospitals is a nonprofit hospital under IRC 4253(h) because the mobile medical clinics provide hospital or medical care, much the same as outpatient clinics. Rev. Rul. 74-619, 1974-2 C.B. 367.
- Compare, however, an exempt organization that primarily provides health services to sick persons in their own homes under the direction of their private physicians and provides only incidental patient treatment at the organization's office, which is not equipped to serve as an outpatient facility on a continuing basis, does not qualify as a hospital as defined in IRC 170(b)(1)(A)(iii). Rev. Rul. 76-452, 1976-2 C.B. 60.

Cooperative Hospital Service Organizations and IRC 170(b)(1)(A)(iii) Status

The term "hospital," for purposes of IRC 170(b)(1)(A)(iii), embraces cooperative hospital service organizations that meet the requirements of IRC 501(e) and Reg. 1.501(e)-1. Reg. 1.170A-9(c)(1).

Instrumentalities and IRC 170(b)(1)(A)(iii) Status

The term "hospital" includes: (a) federal hospitals and (B) state, county, and municipal hospitals that are instrumentalities of governmental units referred to in IRC 170(c)(1) and otherwise come within the definition. Reg. 1.170A-9(c)(1).

Joint Ventures and IRC 170(b)(1)(A)(iii) Status

A hospital organization described in IRC 170(b)(1)(A)(iii) that contributes its assets to a joint venture will continue to qualify under IRC 170(b)(1)(A)(iii) as long as the organization's principal activity remains the provision of health care, regarding the activities of the joint venture proportionately as the activities of the partners. Rev. Rul. 98-15, 1998-1 C.B. 718.

Dual Classification

A hospital described in IRC 170(b)(1)(A)(iii) is not prevented by Reg. 1.170A-9(e)(1) from qualifying as a publicly supported organization under IRC 170(b)(1)(A)(vi). Rev. Rul. 76-416, 1976-2 C.B. 57.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Medical Research Organizations - General

A medical research organization is described in IRC 170(b)(1)(A)(iii) if

- (1) the principal purpose or functions of the organization are medical research, and
- (2) it is directly engaged in the continuous active conduct of medical research in conjunction with a hospital described in IRC 501(c)(3), a federal hospital, or in conjunction with an instrumentality of a government unit referred to in IRC 170(c)(1). Reg. 1.170A-9(c)(2)(ii).

A medical research organization that operates in conjunction with a hospital operated for profit does not qualify as an organization described in IRC 170(b)(1)(A)(iii). Rev. Rul. 66-245, 1966-2 C.B. 71.

Definition of Medical Research

Medical research means the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments of mankind. Reg. 1.170A-9(c)(2)(iii).

Under Reg. 1.170A-9(c)(2)(iii), medical research encompasses the associated disciplines spanning the biological, social and behavioral sciences including

- (1) Chemistry (biochemistry, physical chemistry, bio-organic chemistry, etc);
 - (2) Behavioral sciences (psychiatry, physiological psychology, neurophysiology, neurology, neurobiology, social psychology, etc.);
 - (3) Biomedical engineering (applied biophysics, medical physics and medical electronics, e.g., developing pacemakers and other medically related electrical equipment); and
 - (4) Virology, immunology, biophysics, cell biology, molecular biology, pharmacology, toxicology, genetics, pathology, physiology, microbiology, parasitology, endocrinology, bacteriology, and epidemiology.
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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Principal Purpose or Functions

The "principal purpose or functions" test for IRC 170(b)(1)(A)(iii) medical research organizations is both an organizational test and an operational test.

- An organization must be organized for the principal purpose of engaging primarily in the conduct of medical research and must be actually engaged primarily in the conduct of medical research.
- However, an organization that otherwise meets all of the requirements of this paragraph to qualify as a medical research organization will not fail to qualify solely because its governing instrument does not specifically state that its principal purpose is to conduct medical research. Reg. 1.170A-9(c)(2)(iv).

Disbursing Funds -- Not Directly Engaged

Engaging directly in the continuous active conduct of medical research does not include the disbursing of funds to other organizations for the conduct of research by them or the extending of grants or scholarships to others.

- Therefore, if an organization's primary purpose is to make such disbursements, it is not primarily engaged in the continuous active conduct of medical research. Reg. 1.170A-9(c)(2)(v)(c).
- Similarly, inactive medical research organizations do not qualify. Reg. 1.170A-9(c)(2)(i).

Primarily Engaged Directly in the Continuous Active Conduct of Medical Research - General Rules

In order for an organization to be primarily engaged directly in the continuous active conduct of medical research, the organization must either devote a substantial part of its assets to, or expend a significant percentage of its endowment for, such purposes, or both.

- Whether an organization devotes a substantial part of its assets to, or makes significant expenditures for, such continuous active conduct depends upon the facts and circumstances existing in each case. Reg. 1.170A-9(c)(2)(v)(a).
- An organization will be treated as devoting a substantial part of its assets to such purposes if it devotes more than one half of its assets to the continuous active conduct of medical research. Reg. 1.170A-9(c)(2)(v)(b).

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Primarily Engaged Directly in the Continuous Active Conduct of Medical Research - General Rules, continued

- An organization will be treated as expending a significant percentage of its endowment for such purposes if it expends funds equaling 3.5 percent or more of the fair market value of its endowment. Reg. 1.170A-9(c)(2)(v)(b); Reg. 1.170A-9(c)(2)(x), *Example (1)*.

Failing to Meet the Assets/Expenditures Tests -- Facts and Circumstances Control

In evaluating facts and circumstances, the factor given most weight is the margin by which the organization failed to meet such tests. Reg. 1.170A-9(c)(2)(v)(x), *Example (3)*.

- Reg. 1.170A-9(c)(2)(v)(a) lists some facts and circumstances favoring the organization as well as those failing to satisfy the tests:
 - The organization fails to satisfy the tests because it failed to properly value its assets or endowment and, upon discovery of the improper valuation it devotes additional assets to, or makes additional expenditures for, such purposes, so that it satisfies such tests for a prior year in addition to satisfying such tests for the current year.
 - The organization acquires new assets or has a significant increase in the value of its securities after it had developed a budget in a prior year based on the assets it then owned and their prior values.
 - The organization fails to make expenditures in any given year because of the interrelated aspects of its budget and long-term planning requirements, for example, where an organization prematurely terminates an unsuccessful program and because of long-term planning requirements it will not be able to establish a fully operational replacement program immediately.
 - The organization has an objective to spend less than a significant percentage in a particular year but make up the difference in the subsequent few years, or to budget a greater percentage in an earlier year and a lower percentage in a later year.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Failing to Meet the Assets/Expenditures Tests -- Facts and Circumstances Control, continued

- An adaptation of Reg. 1.170A-9(c)(2)(x), *Example (2)* demonstrates a practical application of these facts and circumstances:

O, an IRC 501(c)(3) organization, was created to promote knowledge within the field of medical research and medical education. All of O's assets consist of a diversified portfolio of stocks and bonds. O's endowment earns 3.5 percent annually, which O expends in the conduct of various medical research programs in conjunction with certain hospitals. However, in 1999, O receives a substantial bequest of additional stocks and bonds. O's budget for 1999 does not take into account the bequest and as a result O expends only 3.1 percent of its endowment in 1999. However, O establishes that it will expend at least 3.5 percent of its endowment for the active conduct of medical research for taxable years 2000 through 2003. O, therefore, is directly engaged in the continuous active conduct of medical research in conjunction with a hospital for taxable year 2000.

Primarily Engaged Directly in the Continuous Active Conduct of Medical Research - Special Rules

In determining whether a substantial part of an organization's assets are devoted to, or its endowment is expended for, the continuous active conduct of medical research activities the following rules apply:

- An organization may satisfy the assets or expenditures tests by meeting the tests either for a computation period consisting of the immediately preceding taxable year, or for the computation period consisting of the immediately preceding four taxable years.
 - In applying the tests for a four-year computation period, although the organization's expenditures for the entire four-year period shall be aggregated, the fair market value of its endowment for each year shall be aggregated or summed, even though, in the case of an asset held throughout the four-year period, the fair market value of such an asset will be counted four times. Reg. 1.170A-9(c)(2)(vi)(a).
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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Primarily Engaged Directly in the Continuous Active Conduct of Medical Research - Special Rules, continued

- Similarly, the fair market value of an organization's assets for each year of a four-year computation period shall be aggregated or summed. Reg. 1.170A-9(c)(2)(vi)(a).
- Any property substantially all the use of which is "substantially related" (within the meaning of IRC 514(b)(1)(A)) to the exercise or performance of the organization's medical research activities will not be treated as part of its endowment. Reg. 1.170A-9(c)(2)(vi)(b).
- Reg. 1.170A-9(c)(2)(vi)(c) sets forth the following valuation guidelines:
 - The valuation of assets must be made with commonly accepted methods of valuation. A method of valuation made in accordance with the principles stated in the regulations under IRC 2031 constitutes an acceptable method of valuation.
 - Assets may be valued as of any day in the organization's taxable year to which the valuation applies, provided the organization follows a consistent practice of valuing the asset as of such date in all taxable years.
 - An asset held by the organization for part of a taxable year shall be taken into account by multiplying the fair market value of the asset by a fraction, the numerator is the number of days in the taxable year that the foundation held the asset and the denominator of which is the number of days in the taxable year.

Medical Research in Conjunction with a Hospital

To be considered primarily engaged in the continuous active conduct of medical research, in conjunction with a hospital, the organization need not be formally affiliated with a hospital, but there must be a joint effort on the part of the research organization and the hospital pursuant to an understanding that the two organizations will maintain continuing close cooperation in the active conduct of medical research. Reg. 1.170A-9(c)(2)(vii).

Continued on next page

IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Medical Research in Conjunction with a Hospital, continued

For example, the necessary joint effort will normally be found to exist under Reg. 1.170A-9(c)(2)(vii) if all of the following circumstances exist:

- The activities of the medical research organization are carried on in space located within or adjacent to a hospital,
- The organization is permitted to utilize the facilities (including equipment, case studies, etc.) of the hospital on a continuing basis, and
- There is substantial evidence of the close cooperation of the members of the staff of the research organization and members of the staff of the particular hospital.

Reg. 1.170A-9(c)(2)(vii) also provides as follows:

- Active participation by hospital staff members in research conducted by the organization is evidence of such cooperation and
- In instances where medical research may involve substantial investigation, experimentation, and study not immediately connected with hospital and medical care, the required joint effort will also normally be found to exist if there is an established relationship between the medical research organization and the hospital, under which the cooperation of appropriate personnel and the use of hospital facilities are required whenever they would aid research conducted by the medical research organization.

Reg. 1.170A-9(c)(2)(x) sets forth the following favorable example:

An IRC 501(c)(3) organization, N, was created to promote human knowledge within the field of medical research and medical education. All of N's assets were contributed to it by A and consist of a diversified portfolio of stocks and bonds. N's endowment earns 3.5 percent annually, which N expends in the conduct of various medical research programs in conjunction with Y hospital. N is located adjacent to Y hospital, makes substantial use of Y's facilities and there is close cooperation between the staffs of Y and N. N is directly engaged in the continuous active conduct of medical research in conjunction with a hospital.

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IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Commitment to Spend Contributions

In order for a contributor to have the maximum deduction allowance provided for in IRC 170(b)(1)(A) (currently 50 percent) during the calendar year in which the contribution is made, a medical research organization must be committed to spend the contribution for research before January 1 of the fifth calendar year that begins after the date the contribution is made. IRC 170(b)(1)(A)(iii); *Fox v. Commissioner*, T.C.M. 1968-205.

- The five year period is ignored for purposes of determining whether a medical research organization is a public charity under IRC 509(a)(1). Reg. 1.509(a)-2(b).
- An organization need not receive contributions deductible under IRC 170 to qualify as a medical research organization and the organization need not be committed to spend amounts to which the limitation of IRC 170(b)(1)(A) does not apply. Reg. 1.170A-9(c)(2)(i).
- Reg. 1.170A-9(c)(2)(viii) sets forth the following rules concerning "commitment":
 - The organization's commitment that the contribution will be spent within the prescribed time for the prescribed purposes must be legally enforceable.
 - A promise in writing to the donor in consideration of making a contribution that a contribution will be spent within the prescribed time will constitute a commitment.
 - A medical research organization will be presumed to have made the commitment required under this subdivision with respect to any contribution if its governing instrument or by-laws require that every contribution be spent for medical research before January 1 of the fifth year which begins after the date the contribution is made.

Continued on next page

IRC 170(b)(1)(A)(iii) Exclusion - Hospitals and Medical Research Organizations, Continued

Commitment to Spend Contributions, continued

- The expenditure of contributions received for plant, facilities, or equipment, used solely for medical research purposes shall ordinarily be considered to be an expenditure for medical research. Reg. 1.170A-9(c)(2)(viii).
 - If a contribution is made in other than money, it shall be considered spent for medical research if the funds are spent by the organization within the five-year period for medical research; or, if property is used on a continuing basis directly in connection with research, it shall be considered spent for medical research in the year in which it is first so used. Reg. 1.170A-9(c)(2)(viii).
-

Organizational Period for New Organizations

A newly created organization shall be considered to be primarily engaged directly in the continuous active conduct of medical research in conjunction with a hospital if it establishes to the satisfaction of the Service that it reasonably can be expected to be so engaged by the end of its organizational period. Reg. 1.170A-9(c)(2)(ix).

- The necessary information to be submitted must include:
 - Detailed plans showing the proposed initial medical research program,
 - Architectural drawings for the erection of buildings and facilities to be used for medical research in accordance with such plans,
 - Plans to assemble a professional staff, and
 - Detailed projections showing the timetable for the expected accomplishment of the foregoing. Reg. 1.170A-9(c)(2)(ix).
 - The "organizational" period shall be that period which is appropriate to implement the proposed plans, giving effect to the proposed amounts involved and the magnitude and complexity of the projected medical research program, but not exceeding three years from organization. Reg. 1.170A-9(c)(2)(ix).
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IRC 170(b)(1)(A)(iv) Exclusion - Endowment Funds Organized and Operated in Connection with State and Municipal Colleges and Universities

IRC 170(b)(1)(A)(iv) Exclusion-- Organizations for the Benefit of Certain State and Municipal Colleges and Universities

Organizations described in IRC 170(b)(1)(A)(iv) are endowment funds organized and operated in connection with State and municipal colleges and universities.

Reason for Enactment of IRC 170(b)(1)(A)(iv)

Congress recognized that in many instances state law prevents state-owned colleges or universities from receiving certain gifts or bequests for particular purposes because their states require that gifts made directly to a State institution be placed in the general state treasury from which funds are appropriated by the legislature for state institutions.

- In order to encourage gift giving for the use of state colleges and universities, the deduction benefit available to donors to private colleges and universities was extended to certain funds organized and operated for state universities and colleges. S. Rep. No. 585, 87th Cong., 1st Sess. 4 (1961).

Statutory Requirements

An organization is described in IRC 170(b)(1)(A)(iv) if:

- It normally receives a substantial part of its support from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public,
- It is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university that is referred to in IRC 170(b)(1)(A)(ii), and
- The benefited college or university is an agency or instrumentality of a State or political subdivision thereof or is owned or operated by an agency or instrumentality of one or more states or political subdivisions.

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IRC 170(b)(1)(A)(iv) Exclusion, Continued

**Explanation of
Statutory
Terms**

"Support" does not include income received in the exercise or performance of the organization's exempt function. Further, in determining the amount of support received by the organization with respect to a contribution of property that is subject to reduction under IRC 170(e), the fair market value of the property shall be taken into account. Reg. 1.170A-9(b)(2)(i).

An example of "indirect contributions from the general public" is the receipt by the organization of its share of the proceeds of an annual collection campaign of a community chest, community fund, or united fund. Reg. 1.170A-9(b)(2)(i).

"Expenditures to or for the benefit of a college or university" includes expenditures for any one or more of the normal functions of colleges and universities such as:

- The acquisition and maintenance of real property comprising part of the campus area,
- The erection of, or participation in the erection of, college or university buildings,
- The acquisition and maintenance of equipment and furnishings used for or in conjunction with, normal functions of colleges and universities, or
- Expenditures for scholarships, libraries and student loans. Reg. 1.170A-9(b)(2)(i).

**Distinctions
Between IRC
170(b)(1)(A)(iv)
and IRC
170(b)(1)(A)(vi)**

The requirement of Reg. 1.170A-9(e)(5)(i) that an organization must have been in existence for at least one taxable year consisting of at least eight months in order to obtain a ruling or determination letter that it is not a private foundation by virtue of being described in IRC 509(a)(1) and IRC 170(b)(1)(A)(vi) does not apply to IRC 170(b)(1)(A)(iv) organizations. Rev. Rul. 77-407, 1977-2 C.B. 77.

A distinction between public support for IRC 170(b)(1)(A)(iv) purposes and IRC 170(b)(1)(A)(vi) purposes is that the class of government entities referred to in IRC 170(b)(1)(A)(iv) is smaller. Rev. Rul. 82-132, 1982-2 C.B. 107.

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IRC 170(b)(1)(A)(iv) Exclusion, Continued

**Distinctions
Between IRC
170(b)(1)(A)(iv)
and IRC
170(b)(1)(A)(vi),
continued**

An organization that meets the public support test of IRC 170(b)(1)(A)(vi) will also satisfy the public support test of IRC 170(b)(1)(A)(iv); however, an organization that fails to meet the public support test of IRC 170(b)(1)(A)(vi) may still meet the public support test of IRC 170(b)(1)(A)(iv) and Reg. 1.170(A)-9(c)(2). Rev. Rul. 82-132, 1982-2 C.B. 107.

IRC 170(b)(1)(A)(v) Exclusions

**IRC
170(b)(1)(A)(v)
Exclusion-The
United States,
States and
Their
Subdivisions**

Organizations excluded from private foundation classification pursuant to IRC 170(b)(1)(A)(v) are governmental units referred to in IRC 170(c)(1).

- These are States, possessions of the United States, or any political subdivision thereof; the United States; or the District of Columbia.
 - Indian Tribal governments are also excluded pursuant to IRC 7871(a)(7)(B).
-

**"Political
Subdivision,"
the Purpose of
IRC
170(b)(1)(A)(v)
and How IRC
170(b)(1)(A)(v)
Fits Into the
General
Statutory
Scheme**

Although the IRC 170 regulations do not define "political subdivision," Reg. 1.103(b) provides that the term "denotes any division of any state or local governmental unit which is a municipal corporation or which has been delegated that right to exercise part of the sovereign power of the unit."

- A state or municipality itself would not qualify for exemption since its purposes and activities are not exclusively those described in IRC 501(c)(3). *Estate of John C. F. Slayton*, 3 B.T.A. 1343 (1926). Likewise a political subdivision, even if structurally independent, is not entitled to IRC 501(c)(3) status because it possesses sovereign powers.
- Thus, in Rev. Rul. 74-14, 1974-1 C.B. 125, a public housing authority incorporated under a state statute conferring upon it the power to conduct examinations and investigations, to administer oaths, issue subpoenas, and make its findings and recommendations available to appropriate agencies was held not to qualify under IRC 501(c)(3) since its powers were deemed to be regulatory or enforcement powers.

Why then does IRC 170(b)(1)(A)(v) exist since it has nothing to do with IRC 501(c)(3) status, much less private foundation status under IRC 509? (The statutory language of IRC 509 defines "private foundation" as an organization described in IRC 501(c)(3).) The answer; Congress enacted IRC 170(b)(1)(A)(v) to demonstrate that contributions to such governmental units qualify for the 50 percent contribution limitation. It was not done to exclude such governmental units from private foundation status.

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IRC 170(b)(1)(A)(v) Exclusion, Continued

Specific Cases:
Rev. Rul. 75-435 and *Texas Learning Technology Group*

Rev. Rul. 75-435, 1975-2 C.B. 79, concerns a voluntary association of counties, organized to perform research in the field of local government, train local officials with respect to their public duties, provide information to permit more efficient operation of county government and represent counties at the State legislature. The association's members consisted of county officials and others. Rev. Rul. 75-435 holds that the association is not a political subdivision for purposes of IRC 170(c)(1) since it was not delegated any of the sovereign powers of its member counties or the state, although it constituted a wholly-owned instrumentality.

In *Texas Learning Technology Group v. Commissioner*, 96 T.C. 686 (1991), the Tax Court concluded that an IRC 501(c)(3) organization, which was created to formulate, develop, and administer programs on behalf of member school districts in Texas, was not a governmental unit under IRC 170(b)(1)(A)(v) because it lacked the necessary sovereign power.

IRC 509(a)(4)

**Testing For
Public
Safety--IRC
509(a)(4)**

Another category of organizations excluded from classification as private foundations is described in IRC 509(a)(4). IRC 509(a)(4) organizations are those which qualify under IRC 501(c)(3) as organized and operated for the purpose of testing products for public safety.

- Organizations organized and operated for the purpose of testing products for public safety are exempt under IRC 501(c)(3). However, IRC 170, 2055, 2106, and 2522 make no provision for the deduction of contributions, bequests, or gifts to an organization formed for this purpose.
 - This provision was added to IRC 501(c)(3) to cover organizations that test consumer products to determine their acceptability for use by the general public. Sen. Rept. No. 1622, 83rd Cong., 2nd Sess., 310 (1954). Congress was responding to a court decision that held that a testing laboratory was not exempt under IRC 501(c)(3) on the ground that its purpose was, in substantial part, to serve the interests of the manufacturers of electrical equipment. *Underwriters Laboratories, Inc. v. Commissioner*, 135 F.2d 371 (7th Cir. 1943), *cert. denied*, 320 U.S. 756 (1943).
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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi)

Statute

An organization described in IRC 170(b)(1)(A)(vi) is one which:

- Is referred to in IRC 170(c)(2), and
- Normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under IRC 501(a)) from a governmental unit referred to in IRC 170(c)(1) or from direct or indirect contributions from the general public.

Certain Rules for Classifying Organizations Under IRC 170(b)(1)(A)(vi)

There is one circumstance where an organization may qualify as a "public charity" under IRC 509(a)(1) even though it does not satisfy IRC 170(c)(2). If it is created or organized under laws outside the United States or its possessions and it otherwise meets the requirements under IRC 170(b)(1)(A)(vi) it qualifies as a public charity. Reg. 1.509(a)(2)(a)(1) and (2).

- If an organization is described both in IRC 509(a)(1) and also in 509(a)(2) or 509(a)(3), the organization will be treated as described in 509(a)(1). Reg. 1.509(a)-6.

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.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Outline of Basic Requirements, continued

- 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:

- Know what is included in total support (the denominator);
- Know what is included in public support (the numerator);
- Know what is the proper measuring period to determine whether the organization "normally" receives public support; and
- 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.

Continued on next page

Figure 1

Elements of Total Support (The Denominator)

| Total support includes | Total support does not include |
|--|---|
| (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; | (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; | (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) Gross investment income (as defined in IRC 509(e)); | (c) The value of exemption from any federal, state, or local tax or any similar benefits; |
| (d) Tax revenues levied for the benefit of an organization and paid to or expended on behalf of the organization; and | (d) Capital gains; |
| (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. | (e) Loan repayments; and |
| | (f) "Unusual grants" (discussed below). |

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Exclusion of Unusual Grants

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 an "unusual grant," and therefore is excluded from total support, the following factors (none of which is necessarily determinative) are taken into consideration:
See Figure 2

Continued on next page

Figure 2

"Unusual Grant"

| Favorable Factors | Unfavorable Factors |
|---|--|
| (a) Contribution was made by a person with no connection to the organization. | (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 a bequest. | (b) Contribution was an inter vivos transfer. |
| (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. | (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) 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. | (d) No program of public solicitation or the public solicitation program has been unsuccessful. |
| (e) The organization may reasonably be expected to attract a significant amount of public support subsequent to the particular contribution. | (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) 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. | (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) The organization has a representative (broadly based) governing body. | (g) Organization's governing body is not broadly based. |
| (h) No material restrictions are imposed in connection with the grant. | (h) Material restrictions are imposed on the grant. |

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Support from Governmental Units

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, 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).

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

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:

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):

- 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;
- 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
- All support from the sources listed in the two bullets 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.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Old Age Homes and Public Support – Assigning Income is Not Public Support

In the past, there has been considerable litigation involving old age homes and public support. In *Williams Home, Inc. v. United States* and *Miller Home, Inc. v. United States*, 540 F. Supp. 310 (W.D. Va. 1982), the Williams Home operated a retirement home for women age 55 and older. The organization had been assessed a tax as a private foundation. The Williams Home contested its status as a private foundation, claiming it satisfied the facts and circumstances test and was a public charity. In order to be admitted to the home, all applicants were required to disclose and convey their assets in exchange for future care. The organization argued that these amounts represented support from the general public and could be considered in meeting the facts and circumstances test. The court found that the amounts were exempt function income, since the transfer of assets were due to the insistence of the home rather than any disinterested generosity from the applicants.

Williams Home cited *Home for Aged Men v. United States* No. 77-0019-W(H) (D.W. Va. 1980), in which the issue was the validity of Reg. 1.170a-9(e)(3)(i), the facts and circumstances test requiring that an organization receive at least 10 percent of its income from public contributions. Without the inclusion of monies collected from admittees to the home as membership fees, the home did not meet the 10 percent public support test. The court concluded that the regulations were valid, noting that, although the regulations were not contemporaneous with the enactment of IRC 170, they were contemporaneous with and necessary to the enactment and purposes of IRC 509. In *Williams Home*, the validity of the 10 percent facts and circumstances test was also upheld.

Investment Income is not Public Support

In *St. John's Orphanage, Inc. v. United States*, 16 Cl. Ct. 299 (Cl. Ct. 1989), the court held that a foundation failed to meet the 10 percent facts and circumstances test. The foundation operated an orphanage until 1951, when it was dissolved and its assets sold. The organization was established as a foundation to distribute trust funds to child welfare projects. The foundation derived a majority of its income from dividends and interest from the proceeds of the 1951 sale. It received only 5.6 percent of its income from public support.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

**An Example of
a Public
Support
Computation**

M, an organization described in IRC 170(c)(2), shows that it derived funds from the following sources during taxable years 1970 through 1973:

- (a) Interest and dividends--\$80,000
- (b) Net income from unrelated business activities--\$20,000
- (c) Gifts and contributions from the general public--\$200,000
- (d) Capital gains--\$5,000
- (e) Admission fees (amounts from the exercise of its exempt function under IRC 501(a))--\$5,000

In this situation, M's total support (denominator of the public support fraction) is \$300,000, the sum of items (a), (b), and (c); items (d) and (e) are excluded because capital gains and income related to exempt functions are not included in the definition of support for purposes of IRC 170(b)(1)(A)(vi). M organization's public support (numerator of the public support fraction) is \$200,000, since of the total support received only item (c), gifts and contributions, qualifies as public support. M's public support fraction is public support \$200,000 over total support \$300,000 or 66 2/3 percent public support.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

**Support from
the General
Public—2
Percent
Limitation**

Support from the general public means any direct or indirect contribution an organization derives from a donor. Thus, contributions from the general public are included in full in the numerator and denominator of the recipient organization's public support fraction except as provided below. Reg. 1.170A-9(e)(6)(i).

- The term "contribution" has the same meaning as it has under IRC section 170(c). Thus any payment of money or transfer of property without consideration will be treated as a contribution. The amount includible in computing support with respect to contributions of appreciated property shall be the fair market value of such property at the date of the contribution.
- To the extent that a donor's contribution exceeds 2 percent of an organization's total support, it is not considered public support and, therefore, is excluded from the numerator of the public support fraction. The entire amount of the contribution is included in the denominator of the fraction. Reg. 1.170A-9(e)(6)(i)
- The 2 percent limitation applies to any person or persons related to the donor in a manner described in IRC 4946(a)(1)(C) through (G) as if made by the donor. For example, a husband and wife would be treated as one person for purposes of the 2 percent limitation.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

**Support from
the General
Public—2
Percent
Limitation,
continued**

See *Example* (1) of Reg. 1.170A-9(e)(9)(1), which illustrates the application of the 2 percent test:

Example (1)

(a) M is an organization referred to in section 170(c)(2). For the years 1970 through 1973 (the applicable period with respect to the taxable year 1974 under subparagraph (4) of this paragraph), M received support (as defined in subparagraphs (6) through (8) of this paragraph) of \$600,000 from the following sources:

| | |
|---|----------------|
| Investment income | \$300,000 |
| City Y (a governmental unit referred to in section 170(c)(1) | 40,000 |
| United Fund (an organization referred to in section 170(b)(1)(A)(vi)..... | 40,000 |
| Contributions | <u>220,000</u> |
| Total support | \$600,000 |

(b) With respect to the taxable year 1974, M 'normally' received in excess of 33 1/3 percent of its support from a governmental unit referred to in section 170(c)(1) and from direct and indirect contributions from the general public (as defined in subparagraph (6) of this paragraph) computed as follows:

| | |
|---|---------------|
| 33 1/3 percent of total support | \$200,000 |
| Support from a governmental unit referred to in section 170(c)(1) ... | 40,000 |
| Indirect contributions from the general public (United Fund) | 40,000 |
| Contributions by various donors (no one having made contributions which total in excess of \$12,000—2 percent of total support) | 50,000 |
| Six contributions (each in excess of \$12,000--2 percent total support) 6 x \$12,000 | <u>72,000</u> |
| | \$202,000 |

(c) Since the amount of X's support from governmental units referred to in section 170(c)(1) and from direct and indirect contributions from the general public with respect to the taxable year 1974 'normally' exceeds 33 1/3 percent of M's total support for the applicable period (1970-73), X meets the 33 1/3 percent-of-support test under subparagraph (2) of this paragraph and is therefore treated as satisfying the requirements for classification as a 'publicly supported' organization under subparagraph (2) of this paragraph for the taxable years 1974 and 1975 (there being no substantial and material changes in the organization's character, purposes, methods of operation, or sources of support in these years).

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Support from the General Public—2 Percent Limitation, continued

As noted above, in most cases, the 2 percent limitation does not apply to support from other IRC 170(b)(1)(A)(vi) organizations or from governmental units referred to in IRC 170(c)(1). It is also not applicable to support from other organizations, which normally receive a substantial part of their support from direct or indirect contributions made by the general public. For example, the two percent limitation prescribed by Reg. 1.170A-9(e)(6)(i) does not apply to the support received by an exempt organization described in IRC 170(c)(2) from individual churches described in IRC 170(b)(1)(A)(i) that are publicly supported and entitled to IRC 170(b)(1)(A)(vi) status. Rev. Rul. 78-95, 1978-1 C.B. 71.

However, contributions made by an IRC 501(c)(6) business league to an IRC 501(c)(3) organization seeking to be classified as other than a private foundation under IRC 509(a)(1) because it is publicly supported under IRC 170(b)(1)(A)(vi) are subject to the two percent limitation imposed by Reg. 1.170A-9(e)(6). Rev. Rul. 77-255, 1977-2 C.B. 74.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Regulations under IRC 513(i)

The final regulations under IRC 513(i) (TD 8991, April 25, 2002) allow the full amount of qualified sponsorship payments (except for payments in the form of services) to be treated as contributions for purposes of the public support test under IRC 170(b)(1)(A)(vi) and 509(a)(2), without reduction for the amount of disregarded benefits. The 2 percent ceiling keeps the level of disregarded benefits low enough so that the entire amount of a qualified sponsorship payment may be treated as a contribution for public support purposes. Reg. 1.170A-9(e)(6)(i) – the term contributions includes qualified sponsorship payments (as defined in Reg. 1.513-4) in the form of money or property (but not services).

Reg. 1.509(a)(3)(f)(3) Examples:

- *Example 2.* Q, a performing arts center, enters into a contract with a large company to be the exclusive sponsor of the center's theatrical events. The company makes a payment of cash and products in the amount of \$100,000 to Q, and in return, Q agrees to make broadcast announcement thanking the company before each show and to provide \$2,000 of advertising in the show's program (2 percent of \$100,000 is \$2,000). The announcement constitutes use or acknowledgment pursuant to IRC 513(i)(2). Because the value of advertising does not exceed 2 percent of the total payment, the entire \$100,000 is a qualified sponsorship payment under IRC 513(i), and \$100,000 is treated as a contribution for purposes of IRC 509(a)(2)(A)(i).
- *Example 3.* R, a charity, enters into a contract with a law firm to be the exclusive sponsor of the charity's outreach program. Instead of making a cash payment, the law firm agrees to perform \$100,000 of legal services for the charity. In return, R agrees to acknowledge the law firm in all its informational materials. The total fair market value of the legal services, or \$100,000, is a qualified sponsorship payment under IRC 513(i), but no amount is treated as a contribution under IRC 509(a)(2)(A)(i) because the contribution is of services.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Special Rules For Earmarked Grants From Public Charities and Governmental Units

An exception to the special rule for grants from public charities and governmental units as described in the previous paragraph:

- Where a donor makes an indirect contribution (one which is expressly or impliedly earmarked as being for, or for the benefit of, a particular recipient) through an organization described in IRC 170(b)(1)(A)(vi) or a governmental unit for a particular organization claiming status under IRC 170(b)(1)(A)(vi), such contribution is subject to the 2 percent limitation. Reg. 1.170A-9(e)(6)(v). (For further details, *see* Reg. 1.509(a)-3(j).)
- In other words, the substance of a transaction will always govern, and if the publicly supported organization or governmental unit is merely a conduit for amounts which have been expressly or impliedly earmarked by a donor as being for the particular organization, the contributions will be treated as having been made by the original donor and the 2 percent limitation will apply.

Special Rules for Membership Fees

Membership fees are fully included (subject to the 2 percent limitation) in the numerator and denominator of the public support fraction if made for the recipient organization's support rather than to purchase admissions, merchandise, services, or the use of facilities. If made for any of the latter purposes, it is important to determine further whether such membership fees represent amounts derived from unrelated or related business activities because the treatment accorded each varies.

- Membership fees that represent income from business activities unrelated to the organization's exempt purposes under IRC 501(a) are included in the denominator, but excluded from the numerator, of the public support fraction. (*See* IRC 509(d)(3) and IRC 513 for a further discussion of unrelated business activities.)
- Membership fees that represent amounts received from business activities related to the organization's exempt purposes under IRC 501(c) are fully excluded from the numerator and denominator of the public support fraction. (This topic is further discussed in the next subsection of this article, regarding the special rules for gross receipts from unrelated business activities).

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Special Rules For Gross Receipts From Related Activities

In computing an organization's public support fraction, gross receipts derived from any trade or business activity the conduct of which is related to the organization's charitable, educational, or other purpose constituting the basis for its exemption under IRC 501(a) are excluded from the numerator and denominator. Rules for determining whether support is or is not related to an organization's exempt purpose are set forth in IRC 513 and Reg. 1.513-1(d).

If an organization is dependent for its support primarily on gross receipts from related activities, it is not considered publicly supported under IRC 170(b)(1)(A)(vi) regardless of any other factors. Reg. 1.170A-9(e)(7)(ii).

- An organization is considered to be dependent primarily on gross receipts from related activities if it derives almost all support from related activities and an insignificant amount from governmental units and direct or indirect contributions made by the general public.
- In the following example, drawn from Reg. 1.170A-9(e)(7)(ii), the organization is dependent primarily on gross receipts from activities related to its exempt purposes so that it cannot qualify as an IRC 170(b)(1)(A)(vi) organization:

X, an organization described in section 501(c)(3), is controlled by A, its president. X received \$500,000 during the 4 taxable years immediately preceding its current taxable year under a contract with the Department of Transportation, pursuant to which X has engaged in research to improve a particular vehicle used primarily by the Federal Government. During this same period, the only other support received by X consisted of \$5,000 in small contributions primarily from X's employees and business associates. The \$500,000 amount constitutes support under section 509(d)(2).

Note that Medicare and Medicaid payments constitute gross receipts derived from the exercise or performance of a health care organization's exempt activities for purposes of the support test of IRC 170(b)(1)(A)(vi) and IRC 509(a)(2). Rev. Rul. 83-153, 1983-2 C.B. 48.

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Special Rules Regarding Support From Governmental Units

Generally, governmental support is accorded favorable treatment when determining whether an organization qualifies under IRC 170(b)(1)(A)(vi). Any amount classified as support from a governmental unit is fully included in the numerator of an organization's public support fraction except for indirect contributions earmarked by individual donors as described above in the section regarding special rules for earmarked grants.

General Principles

- The term "governmental unit" means an entity described in IRC 170(c)(1).
- Governmental support means only contributions received from governmental units and certain other amounts received in connection with contracts entered into with governmental units that constitute amounts paid for the performance of services or in connection with a government research grant. Reg. 1.170A-9(e)(8)(i).
- One peculiar issue under IRC 170(b)(1)(A)(vi) and IRC 509(a)(2) relates to support from a foreign government. Rev. Rul. 75-435, 1975-2 C.B. 215, holds that support from a foreign government constitutes support from a government under IRC 170(c)(1) and, therefore, is not subject to the 2 percent limitation under IRC 170(b)(1)(A)(vi) and IRC 509(a)(2). Although G.C.M. 38327 (March 31, 1980) recommends the revocation of Rev. Rul. 75-435, the revenue ruling remains in force and effect.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Special Rules For Amounts Paid Under Government Contract

Amounts an organization receives from governmental contracts may be classified, depending on the particular facts, either as governmental support or support from activities related to the organization's exempt purposes. The classification is important since

- Amounts classified as governmental support will be included in the numerator of the public support fraction;
- Whereas, if the payments are classified as support from activities related to exempt purposes, they will be excluded from the numerator of the public support fraction unless the purpose is to permit the recipient organization to provide a facility or service for the direct benefit of the public rather than to serve the direct and immediate needs of the payor. Reg. 1.170A-9(e)(8)(ii).

If a payment is made by a governmental unit primarily to enable the recipient organization to provide a service or maintain a facility for the direct benefit of the public (as opposed to the government), it is considered governmental support includible in the numerator of an organization's public support fraction.

Examples of where the public is considered the direct beneficiary are:

- Amounts paid for the maintenance of library facilities that are open to the public;
- Amounts paid under government programs to nursing homes or homes for the aged in order to provide health care or domiciliary services to residents of such facilities;
- Amounts paid to child placement or child guidance organizations under government programs for services rendered to children in the community; and
- Amounts paid to the Department of Health and Human Services to a Professional Standards Review Organization (PSRO) to carry out its functions. The particulars of this situation are set forth in Rev. Rul. 81-276, 1981-2 C.B. 128, as follows:

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Special Rules For Amounts Paid Under Government Contract, continued

Example

A PSRO was established pursuant to section 249F of the Social Security Amendments of 1972, and was designated as a PSRO for a particular area by HHS. It derives all of its support from contracts with HHS that provide for payment for all reasonable and necessary expenses incurred by it in the performance of its functions. The organization is described in IRC 170(b)(1)(A)(vi). (For a discussion of the situation, see G.C.M. 38489 (Aug. 29, 1980).

In addition, similar rules applicable to amounts from governmental sources considered to provide direct public benefit are set forth in Reg. 1.509(a)-3(g).

Gross Receipts vs. Governmental/Public Support

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).

Nature of a Publicly Supported Organization That Does Not Meet the 33 1/3 Percent of Support Test

A mandatory consideration in determining whether an organization that does not normally meet the 33 1/3 percent of support test is nevertheless normally publicly supported is whether it is organized and operated to attract public and governmental support on a continuing basis. Factors the IRS would consider are:

- Is it organized and operated to attract new and additional public or governmental support on a continuous basis?
- What is the percentage of public and governmental support?
- Is public support broadly based?
- Does it have a representative governing body?
- Does it provide public facilities or services directly for the benefit of the public?

Reg. 1.170A-9(e)(3)(ii).

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Nature of a Publicly Supported Organization That Does Not Meet the 33 1/3 Percent of Support Test, continued

Underlying this approach are three considerations:

- Whether the scope of the organization's fund-raising activities is reasonable in light of its charitable activities;
- An awareness that a new organization may have limited sources or amounts of support before it can expand its solicitation program or activities; and
- An awareness that the facts and circumstances involving each case will vary and must be accorded consideration based upon the nature and purpose of the organization.

Example

Reg. 170A-9(e)(3)(iii) provides that a high support percentage of investment income from endowment funds will normally be treated as an adverse factor especially if such funds were originally contributed by a few individuals or members of their families. On the other hand, if such endowments were originally contributed by a governmental unit or by the general public, this would be favorable to a conclusion that the organization is publicly supported.

As indicated above, no one factor will fit all situations or be considered conclusive of an organization's publicly supported nature. Each factor is only meaningful in light of the type of organization involved. However, the regulations provide certain facts and circumstances which, taken as a whole, offer a guide for ascertaining whether an organization has a publicly supported nature. However, before the facts and circumstances test can be used, an organization must meet the 10 percent support requirement.

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Publicly Supported Under the 10 Percent Requirement

Where an organization receives at least 10 percent but less than 33 1/3 percent, of its total support from contributions made directly or indirectly by the general public or from governmental units, Reg. 1.170A-9(e)(3) provides that the Service will then look to the factors (described above) to determine whether the organization is in the nature of a publicly supported organization. An organization with at least 10 percent public support that also shows sufficient characteristics indicating it is in the nature of a publicly supported organization may qualify, as an organization described in IRC 170(b)(1)(A)(vi).

- The regulations make clear that the 10 percent requirement is minimal so that an organization without this minimal amount of public support is not described in IRC 170(b)(1)(A)(vi). Also, the higher an organization's public support above 10 percent, the lesser is its burden of establishing its publicly supported nature through other factors. Reg. 1.170A-9(e)(3)(iii). A discussion of these applicable factors is set out below.

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 in **Figure 3**.

Continued on next page

10 Percent Facts and Circumstances Test

| Favorable Factors | Unfavorable 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.) | (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) 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. | (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)? | (c) Governing body represents the private interests of a limited number of persons. |
| (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. | |

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10 Percent Facts and Circumstances Test, Continued

| Favorable Factors | Unfavorable Factors |
|--|---|
| (e) If the organization is an educational or research institution that regularly publishes scholarly journals, are its studies widely used by colleges and universities, or by members of the general public? | |
| (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? | (f) No participation in, or sponsorship of, organization's programs by public officials, or civic and community leaders. |
| (g) Does the organization maintain a definitive program to accomplish its charitable work in the community (e.g., slum clearance or developing employment opportunities)? | (g) No definitive program of community work. |
| (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? | (h) No arrangements with public charities or governmental agencies, involving receipt of funds and accountability to such entities. |
| (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? | (i) No attempt to enroll broad-based membership. Activities not likely to appeal to persons having some broad common interest or purpose. |

Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

The Proper Measuring Period

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.

Meaning of "Normally"

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). (See IRC 507, in this article.)

An Example of "Normally"

The following example from Reg. 1.170A-9(e)(4)(iv) illustrates an application of the four year normal support rule:

X, an organization described in section 170(c)(2), meets the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph in taxable year 1975 on the basis of support received during taxable years 1971, 1972, 1973, and 1974. It therefore "normally" meets the requirements of subparagraph (2) of this paragraph for 1975 and 1976, the taxable year immediately succeeding 1975 (the current taxable year). For the taxable year 1976, X is unable to meet the 33 1/3 percent-of-support test described in subparagraph (2) of this paragraph on the basis of support received during taxable years 1972, 1973, 1974, and 1975. If X can meet the requirements of subparagraph (3) of this paragraph on the basis of taxable years 1972, 1973, 1974, and 1975, X will meet the requirements of subparagraph (3) of this paragraph for 1977 (the taxable year immediately succeeding 1976, the current taxable year) under subdivision (ii) of this subparagraph. However, if on the basis of both the taxable years 1972 through 1975 and 1973 through 1976, X, fails to meet the requirements of both subparagraphs (2) and (3) of this paragraph, X will not be described in section 170(b)(1)(A)(vi) for 1977. However, X will not be

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

An Example of "Normally", continued

disqualified as a section 170(b)(1)(A)(vi) organization for taxable year 1976, because it "normally" met the requirements of subparagraph (2) of this paragraph on the basis of the taxable years 1971 through 1974, unless the provisions of subdivision (v) of this subparagraph become applicable.

Generally, after an organization is considered normally publicly supported, it must then be unable for two consecutive computation periods to satisfy the 33 1/3 percent public support test or the 10 percent public support requirement to fall short of being described in IRC 170(b)(1)(A)(vi). There is an exception to this general rule for material changes in sources of support as described below.

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.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

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:

- 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.
- Organizations that have been in existence for at least one taxable year consisting of at least eight months, but for less than five taxable years, can substitute the number of taxable years they have been in existence prior to their current taxable year to determine whether they meet the 33 1/3 percent test or the 10 percent facts and circumstances test. Again, note that there is an exception where there is a material change in sources of support.
- An organization that meets the "at least eight months" requirement has the option of requesting a five-year advance ruling period instead of a definitive ruling based on the support it has received to date. Organizations that do not meet the eight months requirement do not qualify for a definitive ruling and must request a five year advance ruling. (As stated in Rev. Rul. 74-487, 1974-2 C.B. 82, the term "eight months" means eight full months.)
- 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

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Measuring Periods for Applicant Organizations, continued

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.)

- 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:
 - an organization precluded from retroactive recognition of exemption under IRC 501(c)(3) because of IRC 508 and
 - 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.

Advance Rulings to Newly Created Organizations

General

Many newly created organizations cannot meet either the four year "normally" publicly supported provisions or the provisions for new organizations to qualify as "normally" publicly supported because they have not been in existence for a sufficient period of time. Nevertheless, a newly created organization may qualify for an advance ruling that it will be treated as an organization described in IRC 170(b)(1)(A)(vi) during an advance ruling period sufficient to enable it to develop an adequate support history on which to base an initial determination as to foundation status.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Advance Rulings to Newly Created Organizations

General, continued

Briefly, the type of newly created organization that would qualify for an advance ruling is one that can show that its organizational structure, proposed programs and activities, and intended method of operations are such as to attract the type of broadly based support from the general public, public charities, and governmental units necessary to meet the public support requirements under IRC 170(b)(1)(A)(vi).

- Initially, Reg. 1.170A-9(e)(5)(i) provided for an advance ruling period of two or three years depending on the length of the first tax year. Reg. 1.170-9(e)(5)(iv) provides for an extended advance ruling of an additional three years.
- Subsequently, Congress directed the Treasury Department to extend the advance ruling period for newly formed organizations to five years. H.R. 98-861 (Conf. Rep.), 98th Cong., 2nd Sess. 1090 (1984), *reprinted* in 1984-3 C.B. (Vol. 2) 344. The new five year period replaces both the two or three year advance ruling period and the extended advance ruling period for organizations applying on Form 1023.
- A newly created organization subject to the two or three year advance ruling period may request a ruling or determination letter that it will be treated as a 170(b)(1)(A)(vi) organization for its first five taxable years.
 - The request must be accompanied by a consent to extend the statute (Form 872-C) that, in effect, states the organization will be subject to IRC 4940 taxes if it fails to qualify as not a private foundation during the five year advance ruling period.
 - The organization's first tax year (regardless of length) shall count as the first year in the five year period.
 - The advance ruling period will end on the last day of the organization's fifth tax year.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Failure to Obtain Advance Ruling

If a newly created organization has not obtained an advance ruling or determination letter, it cannot rely upon the possibility that it will meet either the 33 1/3 percent test or the 10 percent facts and circumstances test. Therefore, in order to avoid the risk of being classified a private foundation, the organization may comply with the rules governing private foundations by paying any applicable chapter 42 taxes. Then, if the organization subsequently meets the public support requirements for either of the computation periods mentioned in Reg. 1.170A-9(e)(5)(v)(b) or (c), it will be treated as a 170(b)(1)(A)(vi) organization from its inception and any tax imposed under chapter 42 will be refunded.

Reliance By Grantors and Contributors

General

If an organization is not able to meet the public support requirements for its current taxable year or has its advance ruling or extended advance ruling period terminated prior to the expiration of such ruling period, grantors and contributors will ordinarily not be affected by such change of status until notice is given to the public by a means such as publication in the Internal Revenue Bulletin.

However, grantors and contributors will be affected if they were responsible for, or aware of, the act or failure to act that resulted in the organization's loss of IRC 170(b)(1)(A)(vi) status or acquired knowledge that the Service had given notice that the organization would be deleted from such classification. Reg. 1.170A-9(e)(4)(v)(b).

- In this respect, Reg. 1.170A-9(e)(4)(v)(c) and 1.170A-9(e)(6)(iv)(b), respectively, provide procedures by which potential grantors may obtain advance assurance that they will not be considered responsible for, or aware of, a substantial and material change in support or an unusual grant that is not excluded from the support computation which may result in a recipient organization's failure to meet the requirements of IRC 170(b)(1)(A)(vi).

Rev. Proc. 81-6, 1981-1 C.B. 620, and Rev. Proc. 89-23, 1989-1 C.B. 844, which amplifies Rev. Proc. 81-6, provide guidelines to determine whether a grantor or contributor will be considered responsible for a substantial and material change in support.

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Publicly Supported Organizations Described in IRC 509(a)(1) and 170(b)(1)(A)(vi), Continued

Grantee Ruling Requests on the Effect of Potential Grants

If a grantee organization is concerned that a potential grant may cause it to lose classification under IRC 170(b)(1)(A)(vi), it can request a ruling to determine the effect a particular contribution will have on its status. Such request must contain all the pertinent information necessary to make a determination. The issuance of such letter is at the discretion of the Service but if a favorable ruling is issued, affected grantors and contributors can rely on such ruling. Reg. 1.170A-9(e)(5)(iii)(C).

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

| Preceding Years ▶ | (a) 1 st | (b) 2 nd | (c) 3 rd | (d) 4 th | (e) Total |
|---|------------------------|------------------------|------------------------|------------------------|--------------|
| 1. Gifts, grants and contributions received (Do not include unusual grants)..... | | | | | |
| 2. Membership fees received..... | | | | | |
| 3. Gross income from interest, dividends, amounts received from payments on securities loans (IRC 512(a)(5)), rents, royalties and unrelated business taxable income (less IRC 511 taxes) from business acquired by the organization after June 30, 1975..... | | | | | |
| 4. Net income from unrelated business activities not included in line 3..... | | | | | |
| 5. Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf..... | | | | | |
| 6. The value of services of facilities furnished by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge..... | | | | | |
| 7. Other income. Do not include gain (or loss) from the sale of capital assets..... | | | | | |
| 8. Total of lines 1 through 7..... | | | | | |
| 9. Enter 2% of line 8(e)..... | | | | | |
| 10. Add lines 1(e), 2(e), 5(e), and 6(e) | | | | | |
| 11. Less: Contributions of individual donors in excess of 2% of aggregate total support (line 9) | | | | | |
| 12. Total public support (numerator)..... | | | | | |
| 13. Aggregate total support from line 8(e) (denominator)..... | | | | | |
| 14. Public Support percentage (line 12 divided by line 13)..... | | | | | |
| <p><i>If line 14 is 33 1/3 percent or more, the organization qualifies under IRC 509(a)(1) / 170(b)(1)(A)(vi). If line 14 is less than 33 1/3 percent, consider the facts & circumstances test.</i></p> | | | | | |

Community Trusts

General

A community trust (or community foundation) is an organization established to receive gifts or bequests from the public and to administer them for charitable purposes primarily in the community or area in which it is located.

- Although Reg. 1.170A-9(e)(11)(i), is entitled "community trusts," it specifically acknowledges that the rules apply whether the organization is in the form of a trust, corporation, association, or some combination thereof.
- A community trust is often established to attract large contributions of a capital or endowment nature for the benefit of a particular community or area, and often such contributions come initially from a small number of donors.
- While the community trust generally has a governing body comprised of representatives of the particular community or area, its contributions are often received and maintained in the form of separate trusts or funds, which are subject to varying degrees of control by the governing body.
- Usually, the separate trusts or funds are managed by banks or other corporate trustees.

Qualification Issues

To qualify as a publicly supported organization, a community trust:

- Must either meet the 33 1/3 percent support test, or,
- If it cannot meet the test, it must be organized and operated so as to attract new and additional public or governmental support on a continuous basis sufficient to meet the 10 percent facts and circumstances test.

Community trusts are generally able to satisfy the requirement of attraction of public support (as contained in the facts and circumstances test) if they seek gifts and bequests from a wide range of potential donors in the community or area served, through banks or trust companies, through attorneys or other professional persons, or in other appropriate ways that call attention to the community trust as a potential recipient of gifts and bequests made for the benefit of the community or area served.

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Community Trusts, Continued

Qualification Issues, continued

A community trust, however, is not required to engage in periodic, community-wide, fund-raising campaigns directed toward attracting a large number of small contributions in a manner similar to campaigns conducted by a community chest or a united fund. Reg. 1.170A-9(e)(10).

Community Trusts Under the IRC 170 Regulations – In General

When the Tax Reform Act of 1969 was enacted, a number of community trusts had already been established. (The earliest, the Cleveland Foundation, was created in 1914.) The regulations under IRC 170(b)(1)(A)(vi) prior to the Tax Reform Act of 1969 recognized this trend by containing an example describing a typical community trust. However, the regulations failed to address two major problems:

- The Entity Problem - whether an aggregation of trusts could be treated as a single entity for purposes of Subchapter F and related provisions, and
- The Support Problem - whether community trusts should be subject to the same support requirements as other IRC 170(b)(1)(A)(vi) organizations.

The current regulations, 1.170A-9(e)(10) - (14), create a fiction that treats the community trust as a single entity rather than a group of related private foundations.

Essentially, the regulations set forth two tests applicable only to community trusts:

- The "single entity" test of Reg. 1.170A-9(e)(11)(iii)-(vi), and
- The "component part" test of Reg. 1.170A-9(e)(11)(ii).

The single entity test determines whether the community foundation will be treated as a single entity for federal tax purposes. The component part test determines whether the individual trusts or funds can be treated as a single entity.

The single entity test must be applied before the component part test. G.C.M. 37818 (Jan. 11, 1979).

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Community Trusts, Continued

The Single Entity Test

In order to be treated as a "single entity", the current regulations provide that a community trust must satisfy the following requirements --

- Name. It must be commonly known as a community trust, fund, foundation or by other similar name and conveying the concept of a capital or endowment fund to support charitable activities in the community or area it serves. Reg. 1.170A-9(e)(11)(iii). (A name such as the Pleasantville Foundation fits this requirement.)
- Subject to a Common Instrument. All the funds of the organization must be subject to a common governing instrument or a master trust or agency agreement. Reg. 1.170A-9(e)(11)(iv).
- Common Governing Body. The organization must have a common governing body or distribution committee which either directs or, in the case of a fund designated for specified beneficiaries, monitors the distribution of all of the funds exclusively for charitable purposes. Reg. 1.170A-9(e)(11)(v)(A).
- Powers of Modification and Removal. The governing body must have the power to modify any restriction or condition on the distribution of funds for any specified charitable purposes or to specified organizations if, in its sole judgment and discretion, the restrictions become "unnecessary, incapable of fulfillment, or inconsistent with the charitable needs of the community." The community trust can satisfy this requirement if it adopts in its master trust agreement language similar to that provided in Rev. Rul. 77-333, 1977-2 C.B. 75. The phrase "in its sole discretion," joined with "inconsistent with the charitable needs of the community," gives the governing body great latitude to modify any fund restrictions, including the beneficiary of a designated fund. Reg. 1.170A-9(e)(11)(v)(B).
- The governing body must also have the unrestricted power to replace any participating trustee, custodian, or agent for breach of fiduciary duty under State law or for failure to produce a reasonable return of net income over a reasonable period of time. Reg. 1.170A-9(e)(11)(v)(B).

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Community Trusts, Continued

The Single Entity Test, continued

- Common Reports. The community trust must prepare periodic financial reports treating all of the funds that are held by the community trust, either directly or in component parts, as funds of the organization. Reg. 1.170A-9(e)(11)(vi).
- Exercise of Powers. The governing body must also (by resolution or otherwise) commit itself to exercise the powers of modification and removal (indicated in (d) above) in the interest of the community trust. Reg. 1.170A-9(e)(11)(v)(E).
- Commitment to Obtain Information, Etc. The governing body must also (by resolution or otherwise) commit itself to obtain information and take other appropriate steps to ensure that each trustee or custodian of its component parts:
 - Abides by the terms of the common governing instrument, and
 - Obtains a reasonable return of net income. Reg. 1.170A-9(e)(11)(v)(F).

These requirements may be satisfied by amendments to the governing instrument of the community trust and by the governing body's adoption of the appropriate resolutions. As noted above, sample governing instrument amendments and resolutions are contained in Rev. Rul. 77-333, 1977-2 C.B. 75, and Rev. Rul. 77-334, 1977-2 C.B. 77.

Component Part

There are also rules that deal with the issue of donor control. These rules complement the single entity test in that they provide guidelines for treatment of a trust or fund as a component part of the community trust. Reg. 1.170A-9(e)(11)(i) and (ii). To be treated as a component of a community trust, a trust or fund must meet the following requirements:

- It must be created by a gift, bequest, legacy, devise, or other transfer to a community trust which is treated as a "single entity;" and
 - It may not be directly or indirectly subjected by the transferor to any material restriction or condition (as defined in Reg. 1.507-2(a)(8)) with respect to the transferred assets.
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Community Trusts, Continued

Component Part, continued The community trust regulations also provide guidelines with respect to the treatment of trusts, not-for-profit corporations, and associations not included as component parts. *See* Reg. 1.170A-9(e)(14).

Material Restrictions Whether a material restriction or condition has been imposed must be determined from all the facts and circumstances of the transfer. Significant facts and circumstances include the following:

- Whether the transferee (including a participating trustee, custodian, or agent) is the owner in fee of the assets it receives;
- Whether such assets are to be held and administered by the transferee in a manner consistent with one or more of its exempt purposes;
- Whether the governing body of the transferee has the ultimate authority and control over such assets, and the income derived therefrom; and
- Whether, and to what extent, the governing body of the transferee is organized and operated so as to be independent from the transferor. Reg. 1.507-2(a)(8)(i).

Certain factors, however, will not adversely affect the determination:

- The fund may be given a name that memorializes the donor or his or her family and
- The income and assets of the transferred fund may be used for a purpose or a public charity designated in the transfer instrument.

The donor may designate, before or at the time of the creation of the fund, the specific IRC 509(a)(1), 509(a)(2), or 509(a)(3) public charity that may receive the income or assets of the fund. Note, however:

- The designation of a specific public charity as the recipient of the income or assets of a fund at the time of the fund's creation must be distinguished from the reservation of the right of the donor to direct the distribution of the income or assets following the gift or to offer advice concerning the distribution after completion of the gift.

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Community Trusts, Continued

Material Restrictions, continued

- The reservation of a power to direct or advise as to distribution is subject to the rules concerning advice, set forth below.

Example

The O Private Foundation transferred all of its net assets to X Bank as trustee for the P Community Trust. Under the terms of the transfer, X is to hold the assets in trust for P and is directed to distribute the income annually to the Y Church, a public charity described in Section 170(b)(1)(A)(i). The distribution of income to Y Church is consistent with P's exempt purposes. Accordingly, the transferred assets are not subject to a material restriction. Reg. 1.507-8(a)(v), *Example (3)*.

Transferred assets may be administered in an identifiable fund with restrictions on distributions of principal. The donor may require the transferee to retain the transferred property, so long as continued retention is important to the achievement of exempt purposes. Reg. 1.507-2(a)(8)(iii)(C) and (D).

Adverse factors include the following:

- The donor or the donor's designee reserves the right to name the distributees or direct the timing of distributions by the transferee (other than by designation in the transfer instrument);
- The transferee is required to take or withhold action with respect to the transferred assets which is not designed to further the transferee's exempt purposes, and if performed by the transferor would have constituted a violation of chapter 42;
- The transferee assumes the transferor's contractual obligations or takes the assets subject to such obligations, for purposes inconsistent with the purposes or best interests of the transferee;
- The transferee is required to retain transferred investment assets;
- The transferor retains a right of first refusal to the transferred assets; and
- The transferee is required to maintain relationships with respect to the management of transferred assets, such as continuing relationships with investment counselors.

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Community Trusts, Continued

**Rules
Concerning
Advice**

Where the only criterion considered by the transferee in making a distribution of income or principal from the transferred assets is advice offered by the transferor, the Service will conclude that a material restriction exists.

In all other instances, the issue is one of facts and circumstances. Under Reg. 1.507-2(a)(8)(iv)(A)(2), factors that will be favorably considered include the following:

- There has been an independent investigation by the staff of the transferee evaluating whether the donor's advice is consistent with specific charitable needs most deserving the transferee's support;
- The transferee has promulgated guidelines enumerating specific charitable needs consistent with its charitable purposes and the donor's advice is consistent with such guidelines;
- The transferee has instituted an educational program publicizing to donors and other persons the above guidelines;
- The transferee distributes funds in excess of amounts distributed from the donor's fund to the same or similar types of organizations or charitable needs as those recommended by the donor; and
- The transferee's solicitations for funds specifically state that it will not be bound by advice offered by the donor.

Under Reg. 1.507-2(a)(8)(iv)(A)(3), adverse factors include the following:

- The solicitations (written or oral) of funds by the transferee state or imply, or a pattern of conduct on the part of the transferee creates an expectation, that the donor's advice will be followed;
- The advice of a donor is limited to distributions of amounts from the donor's fund, and the independent investigation and guidelines described above are not present;
- Only the advice of the donor as to distributions of such donor's fund is solicited by the transferee and no procedure is provided for considering advice from persons other than the donor with respect to such fund; and
- For the taxable year and all prior taxable years the transferee follows the advice of all donors with respect to their funds substantially all of the time.

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Community Trusts, Continued

**Application of
the Criteria
Concerning
Material
Restrictions**

Reg. 1.507-2(a)(8)(v) sets forth the following examples of the application of the criteria concerning material restrictions:

Example (1)

- The M Private Foundation transferred all of its net assets to the V Community Trust. Prior to the transfer, M's activities consisted of making grants to hospitals and universities to further research into the causes of cancer. Under the terms of the transfer, V is required to keep M's assets in a separate fund and use the income and principal to further cancer research. Although the assets may be used only for a limited purpose, this purpose is consistent with and in furtherance of V's exempt purposes, and therefore does not subject the transferred assets to a material restriction.

Example (2)

- The N Private Foundation transferred all of its net assets to W Community Trust. Under the terms of the transfer, W is required to use the income and principal to endow a chair at a university to be known as the "John J. Doe Memorial Professorship", named after N's creator. Although the transferred assets are to be used for a specified purpose by W, this purpose is in furtherance of W's exempt educational purposes, and there are no conditions on investment or reinvestment of the principal or income. The use of the name of the foundation's creator for the chair is not a material restriction, which would prevent the transferred assets from being a component part of W Community Trust.

Example (3)

- The O Private Foundation transferred all of its net assets to X Bank as trustee for the P Community trust, a community trust which is a public charity described in section 170(b)(1)(A)(vi). Under the terms of the transfer, X is to hold the assets in trust for P and is directed to distribute the income annually to the Y Church, a public charity described in section 170(b)(1)(A)(i). The distribution of income to Y Church is consistent with P's exempt purposes. If the trust created by this transfer otherwise meets the requirements of Reg. 1.170A-9(e)(11) as a component part of P Community trust, the assets transferred by O to X will be treated as distributed to one or more public charities within the meaning of section 507(b)(1)(A). The direction to distribute the income to Y Church meets the conditions of Reg. 1.507-2(a)(8)(iii)(B) of this section and will therefore not disqualify the transfer under section 507(b)(1)(A).

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Community Trusts, Continued

**Application of
the Criteria
Concerning
Material
Restrictions,
continued**

Example (4)

- The U Private Foundation transferred all of its net assets to Z Bank as trustee for the R Community Trust. Under the terms of the transfer, Z is to hold the assets in trust for R and distribute the income to those public charities described in section 170(b)(1)(A) (i) through (vi) that are designated by B, the creator of U. R's governing body has no authority during B's lifetime to vary B's direction. Under the terms of the transfer, it is intended that Z retain the transferred assets in their present form for a period of 20 years, or until the date of B's death if it occurs before the expiration of such period. Upon the death of B, R will have the power to distribute the income to such public charities as it selects and may dispose of the corpus as it sees fit. The restrictions imposed are material, and accordingly the transfer will be treated as made to a separate trust rather than to a component part of R Community Trust.

**Transitional
Rules**

Since some established community trusts may have problems in satisfying traditional support requirements under IRC 170(b)(1)(A)(vi), the regulations provide for a 5-year transitional ruling period which was designed to give community trusts the time needed to attract new sources of support to enable them to meet the established support requirements under IRC 170(b)(1)(A)(vi). See Reg. 1.170A-9(e)(12) and (13).

Publicly Supported Organizations Described in IRC 509(a)(2)

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:

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.

- 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 as follows:

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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Two tests:

| More Than 33 1/3 Percent Support Test | Negative 33 1/3 Percent Support Test |
|---|---|
| <p>The organization must normally receive more than one-third of its total support in each taxable year from the sum of:</p> <ul style="list-style-type: none"> a. Gifts, grants, contributions, membership fees; 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. | <p>An organization must normally not receive more than one-third of its total support from the sum of:</p> <ul style="list-style-type: none"> a. Gross investment income, and b. Unrelated business taxable income less the tax imposed on that income. |

| Elements of Total Support for IRC 509(a)(2) Organizations | |
|---|---|
| Total support includes: | Total support does not include: |
| (1) Gifts, grants, contributions, and membership fees; | (1) The value of exemption from any federal, state or local tax or any similar benefit; |
| (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; | (2) Capital gains; |
| (3) Net income from unrelated trade or business activities, whether or not such activities are regularly carried on as a trade or business; | (3) Loan repayments; and |
| (4) Gross investment income (as defined in IRC 509(e)); | (4) Unusual grants. |
| (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. | |

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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Note on Certain Contributions of Service

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.)

More than 33 1/3 Percent Support Test - 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:

- Gifts, grants, contributions, or membership fees (IRC 509(a)(2)(A)(i)); and
 - 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 persons, 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.
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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

**Accounting
Method for
Purposes of
Support
Computation**

Reg. 1.509(a)-3(k) provides that in the computation of the 33 1/3 percent support test, support is determined solely on the cash receipts and disbursements method of accounting described in IRC 446(c)(1) so that, for example, a grant payable over a term of years is includible in the support fraction of the recipient organization only to the extent actually received.

**Examples of
Support
Computation**

The following example from Reg. 1.509(a)-3(b)(2) illustrate an application of the 33 1/3 percent support test. For purposes of the example:

The term “general public” is defined as persons other than disqualified persons and other than persons from whom the foundation receives gross receipts of the greater of \$5,000 or 1 percent of its support in any taxable year, and the term “gross receipts” is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

Example (2). For the taxable year 1970, Y, an organization described in section 501(c)(3), received support of \$600,000 from the following sources:

| | |
|---|----------------|
| Bureau O (gross receipts for services rendered)... | ...\$10,000 |
| Bureau P (gross receipts for services rendered)..... | 10,000 |
| General public (gross receipts for services rendered) | 150,000 |
| General public (contributions)..... | 40,000 |
| Gross investment income..... | 150,000 |
| Contributions from substantial contributors..... | <u>240,000</u> |
| Total support..... | ...\$600,000 |

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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Examples of Support Computation, continued

Since the \$10,000 received from each bureau amounts to more than the greater of \$6,000 or 1 percent of Y's support for 1970 (1 percent of \$600,000 = \$6,000), each amount is includible in the numerator of the one-third support fraction only to the extent of \$6,000. Thus, for the taxable year 1970, Y received support from sources required to meet the one-third support test of section 509(a)(2)(A) computed as follows:

| | |
|--------------------------------------|---------------|
| Bureau O..... | \$6,000 |
| Bureau P..... | 6,000 |
| General public (gross receipts)..... | 150,000 |
| General Public (contributions)..... | <u>40,000</u> |
| Total..... | \$202,000 |

- Therefore, in computing the support test set forth in IRC 509(a)(2)(A), \$202,000 is includible in the aggregate numerator and \$600,000 is includible in the aggregate denominator of the support fraction.

Gifts and Contributions

The terms "gifts" and "contributions," for purposes of the 33 1/3 percent support test, have the same meaning as they have under IRC 170(c), and also include bequests, legacies, devises, and transfers within the meaning of IRC 2055 or 2106(a)(2). Therefore, any payment of money or transfer of property without adequate consideration is considered a "gift" or "contribution." Where payment is made or property transferred as consideration for admissions, sales of merchandise, performance of services, or furnishing of facilities to the donor, the payment or transfer will not be considered a "gift" or "contribution" to the extent of the value of the quid pro quo. See Reg. 1.509(a)-3(f) and Rev. Rul. 67-246, 1967-2 C.B. 104.

The amount of the gift, grant, or contribution of property, or use of such property, that is includible in computing support is the property's fair market value or rental value at the date the gift is made. Reg. 1.509(a)-3(f)(2).

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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

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).

Grants Distinguished From Gross Receipts

Payments from permitted sources that are classified as grants are included in full in the numerator of the support fraction. If the payments are classified as gross receipts, they are included in the numerator only to the extent that the amount received from any person or governmental unit does not exceed the greater of \$5,000 or one percent of the organization's total support.

- A payment is normally considered a grant if paid to encourage the recipient organization to carry on programs or activities in furtherance of the recipient's exempt purposes even if the payee of the grant receives an incidental benefit. Terms and conditions may be imposed on the grant by the payor to insure that the funds will be used in a manner compatible with the payor's programs and result in public benefit. However, the imposition of terms and conditions and the possibility of benefits resulting to the grantor will sometimes make it difficult to distinguish a grant from other amounts received as gross receipts from the carrying on of exempt activities. Reg. 1.509(a)-3(g)(1).

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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Grants Distinguished From Gross Receipts, continued

- 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).
- Reg. 1.509(a)-3(g)(2) provides that if a payment requires the recipient organization to provide a specific service, facility, or product that serves the direct and immediate needs of the payor, such payment is considered gross receipts to the payee and not a grant. Furthermore, where the specific service, facility, or product received by the payor is one that is usually provided by a profit-making organization in its normal course of business, that fact is considered evidence that the payment constitutes gross receipts.
- Reg. 1.509(a)-3(g)(2) also provides that payments made for research leading to the development of tangible products for the use or benefit of the payor will generally be considered gross receipts, whereas payment for basic research in the physical or social sciences will generally be considered a grant.
 - 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.

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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Grants Distinguished From Gross Receipts, continued

- 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.
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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. Reg. 1.509(a)-3(h).
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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Gross Receipts
\$5,000 or 1
Percent
Limitation

IRC 509(a)(2)(A)(ii) provides that gross receipts from related activities (activities that are not unrelated trade or business within the general rule of IRC 513(a)) are includible in the numerator of the 33 1/3 percent support test of IRC 509(a)(2)(A) only to the extent that the amount received from any person or any bureau or similar agency of a governmental unit described in IRC 170(c)(1) does not exceed the greater of \$5,000 or one percent of the organization's total support in any taxable year.

The limitation is applied on a year-to-year basis and is not cumulative.

Earmarked
Funds From
IRC 509(a)(1)
Organizations

While a grant received from an organization that is a public charity described in IRC 509(a)(1) is fully includible in computing the numerator of the 33 1/3 percent support test of IRC 509(a)(2)(A), an indirect contribution (one that is expressly or impliedly earmarked by the donor as being for, or for the benefit of, a particular recipient) from one of the public charity's donors retains its character as a contribution from such donor. Therefore, if a donor who is a substantial contributor (as defined in IRC 507(d)(2)) with respect to the ultimate recipient makes an indirect contribution through a public charity, such amount is excluded from the numerator of the support fraction. Reg. 1.509(a)-3(j).

Example

N is a national foundation for the encouragement of art and is an organization described in section 170(b)(i)(A)(vi). Grants to N are permitted to be earmarked for particular purposes. O, which is an art workshop devoted to training young artists and claiming status under section 509(a)(2), persuades C, a private foundation, to make a grant of \$25,000 to N. C is a disqualified person with respect to O. C made the grant to N with the understanding that N would be bound to make a grant to O in the sum of \$25,000, in addition to a matching grant of N's funds to O in the sum of \$25,000. Only the \$25,000 received directly from N is considered a grant from N. The other \$25,000 is deemed an indirect contribution from C to O and is to be excluded from the numerator of O's support fraction." Reg. 1.509(a)-3(j)(3), Example (3).

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Gross Receipts from Thrift Shops

Gross receipts from IRC 513(a)(1), (2), or (3) activities are treated as gross receipts from related activities and, therefore, subject to the \$5,000 or one percent limitation. In general, such activities relate to thrift shops, university or hospital convenience shops, and businesses operated by charitable organizations where substantially all work is performed by volunteers. Reg. 1.509(a)-3(1).

Gross Receipts from a Governmental Unit's Bureau or Agency

Because the \$5,000 or one percent limitation under IRC 509(a)(2)(A)(ii) applies separately to the gross receipts an organization receives from each bureau or similar agency of a governmental unit, the definition of what constitutes a bureau or similar agency of a governmental unit is important.

- A governmental unit described in IRC 170(c)(1) includes a state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia.
- Under Reg. 1.509(a)-3(i)(1), the term "bureau" means a unit functioning at the operating as contrasted to the policymaking level of government. A bureau is descriptive of a subdivision of a department of government. The term would not usually include those levels of government which are basically policymaking or administrative, such as the office of the Secretary or Assistant Secretary of a department, but would consist of the highest operational level under such policymaking or administrative levels.
- The definition of "bureau" for purposes of the gross receipts limitation is illustrated by the following two examples from Reg. 1.509(a)-3(i)(2):
 - Example (2). The Bureau for Africa and the Bureau for Latin America are considered "bureaus" within the meaning of section 509(a)(2)(A)(ii). Both are separate operating units under the Administrator of the Agency for International Development, a policymaking official. If an organization received gross receipts from both of these bureaus, the amount of gross receipts received from each would be subject to the greater of \$5,000 or 1 percent limitation under section 509(a)(2)(A)(ii).

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(2), Continued

Gross Receipts from a Governmental Unit's Bureau or Agency, continued

- Example (4). The Department of Mental Health, a State agency which is an operational part of State X's Department of Public Health, is considered a "bureau." The Department of Public Health is basically an administrative agency and the Department of Mental Health is at the first operational level within it."
- Gross receipts received from a unit functioning at the policymaking or administrative level of a governmental unit are treated as received from one bureau of such unit and are aggregated when applying the \$5,000 or one percent limitation. Where an organization is receiving gross receipts from both a policymaking or administrative unit and an operational unit of a department of government it will be treated as receiving gross receipts from two "bureaus" within the meaning of IRC 509(a)(2)(A)(ii).

Payments Under CACFP

"Sponsoring organizations" under the United States Department of Agriculture's Child and Adult Care Food Program (CACFP) receive the following payments:

- Payment for meals (which they must pay over to sponsored providers) at a rate established by law;
- Administrative payments; and
- One-time start-up payments to develop or expand successful CACFP operations in day care homes.

All such payments under CACFP are support to the payee organization within the meaning of IRC 509(a)(2) (and "gross receipts" within the meaning of IRC 6033(a)(2)(A)(i)).

In determining if a sponsoring organization is other than a private foundation, meal payments are payments for the performance of the organization's exempt function, and counted as "public support" under IRC 509(a)(2), in a manner similar to the Medicare and Medicaid payments described above.

Administrative expense reimbursements and start-up payments are treated as government grants. *See* Reg. 1.509(a)-3(g)(2); Reg. 1.170A-9(e)(8).

Continued on next page

Publicly Supported Organizations Described in IRC 509(a)(2), Continued

**Gross
Investment
Income and
Unrelated
Business
Income Test**

The second part of the IRC 509(a)(2) exclusion is the requirement that less than 33 1/3 of the support be from investment or unrelated business income activities.

**33 1/3 Percent
Limit on Gross
Investment
Income and
Unrelated
Business
Taxable Income**

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 generated by a related activity from gross investment income or unrelated business taxable income.
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Publicly Supported Organizations Described in IRC 509(a)(2), Continued

33 1/3 Percent Limit on Gross Investment Income and Unrelated Business Taxable Income, continued

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.

Special Rule of Attribution

For purposes of the gross investment and unrelated business income test of IRC 509(a)(2)(B), certain portions of an organization's receipts from the following organizations will retain their character as gross investment income:

- Organization seeking IRC 509(a)(3) status based on the distributions given;
 - IRC 501(c)(3) organizations, IRC 4947(a)(1) non-exempt charitable trusts, and IRC 4947(a)(2) split-interest trusts, required to distribute (or which normally distribute) at least 25 percent of their adjusted net income (IRC 4947(f)) to the distributee, and having that distribution normally represent at least 5 percent of the distributee's net income. These receipts will retain their character to the extent they were gross investment income in the hands of the distributor or (if the distributor is an IRC 4947(a)(2) split-interest trust) to the extent that such amounts would be gross investment income attributable to transfers in trust after May 26, 1969, if the trust were a private foundation.
 - In applying these rules, all income characterized as gross investment income in the possession of the distributing organization is deemed to be distributed first by the distributing organization before the distributee organization may treat any of the amounts received as gifts or contributions from the organization described in above. Reg. 1.509(a)-5(a)(1).
-

The 33 1/3 Percent Good Support Test and the 33 1/3 percent limitation on Gross Investment Income and UBI

Normal Support

Both tests described above must be met on the basis of the organization's "normal" support.

Computation of Normal Support

Computation of Normal Support

Both the test prescribed under IRC 509(a)(2)(A) (requiring at least one-third of support from gifts, grants, contributions, membership fees and "gross receipts") and the test prescribed under IRC 509(a)(2)(B) (requiring that not more than one-third of support be derived from investment income and unrelated business taxable income) are to be computed on the basis of the organization's normal sources of support. *See* Reg. 1.509(a)-3(c)(6) for examples which illustrate application of the normal support rule.

Examples. The application of the principles set forth in this paragraph is illustrated by the examples set forth below. For purposes of these examples, the term 'general public' is defined as persons other than disqualified persons and other than persons from whom the foundation received gross receipts in excess of the greater of \$5,000 or 1 percent of its support in any taxable year, the term 'gross investment income' is as defined in section 509(e), and the term 'gross receipts' is limited to receipts from activities which are not unrelated trade or business (within the meaning of section 513).

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Computation of Normal Support, Continued

Computation of *Example (1)*

Normal Support, continued

For the years 1970 through 1973, X, an organization exempt under section 501(c)(3) which makes scholarship grants to needy students of a particular city, received support from the following sources:

1970
Gross receipts (general public) \$ 35,000
Contributions (substantial contributors) 36,000
Gross investment income 29,000

Total support \$100,000

1971
Gross receipts (general public) 34,000
Contributions (substantial contributors) 35,000
Gross investment income 31,000

Total support \$100,000

1972
Gross receipts (general public) 35,000
Contributions (substantial contributors) 30,000
Gross investment income 35,000

Total support \$100,000

1973
Gross receipts (general public) 30,000
Contributions (substantial contributors) 39,000
Gross investment income 31,000

Total support \$100,000

In applying section 509(a)(2) to the taxable year 1974 on the basis of subparagraph (1)(i) of this paragraph, the total amount of support from gross receipts from the general public (\$134,000) for the period 1970 through 1973 was more than one-third, and the total amount of support from gross investment income (\$126,000) was less than one-third, of its total support for the same period (\$400,000). For the taxable years 1974 and 1975, X is therefore considered 'normally' to receive more than one-third of its support from the public sources described in section 509(a)(2)(A) and less than one-third of its support from items described in section 509(a)(2)(B) since due to the pattern of X's support, there are no substantial and material changes in the sources of the organization's support in these years. The fact that X received less than one-third of its support from section 509(a)(2)(A) sources in 1973 and more than one-third of its support from items described in section 509(a)(2)(B) in 1972 does not affect its status since it met the 'normally' test over a 4-year period.

Continued on next page

Computation of Normal Support, Continued

Computation of Normal Support, continued

Example (2)

Assume the same facts as in example (1) except that in 1973 X also received an unexpected bequest of \$50,000 from A, an elderly widow who was interested in encouraging the work of X, but had no other relationship to it. Solely by reason of the bequest, A became a disqualified person. X used the bequest to create five new scholarships. Its operations otherwise remained the same. Under these circumstances X could not meet the 4-year support test since the total amount received from gross receipts from the general public (\$134,000) would not be more than one-third of its total support for the 4-year period (\$450,000). Since A is a disqualified person, her bequest cannot be included in the numerator of the one-third support test under section 509(a)(2)(A). However, based on the factors set forth in subparagraph (4) of this paragraph, A's bequest may be excluded as an unusual grant under subparagraph (3) of this paragraph. Therefore, X will be considered to have met the support test for the taxable years 1974 and 1975.

Example (3)

In 1970, Y, an organization described in section 501(c)(3), was created by A, the holder of all the common stock in M corporation, B, A's wife, and C, A's business associate. Each of the three creators made small cash contributions to Y to enable it to begin operations. The purpose of Y was to sponsor and equip athletic teams for underprivileged children in the community. Between 1970 and 1973, Y was able to raise small amounts of contributions through fund raising drives and selling admission to some of the sponsored sporting events. For its first year of operations, it was determined that Y was excluded from the definition of 'private foundation' under the provisions of section 509(a)(2). A made small contributions to Y from time to time. At all times, the operations of Y were carried out on a small scale, usually being restricted to the sponsorship of two to four baseball teams of underprivileged children. In 1974, M recapitalized and created a first and second class of 6 percent nonvoting preferred stock, most of which was held by A and B. A then contributed 49 percent of his common stock in M to Y. A, B, and C continued to be active participants in the affairs of Y from its creation through 1974. A's contribution of M's common stock was substantial and constituted 90 percent of Y's total support for 1974. Although Y could satisfy the one-third support test on the basis of the four taxable years prior to 1974, a combination of the facts and circumstances described in subparagraph (4) of this paragraph preclude A's contribution of M's common stock in 1974 from being excluded as an unusual grant under subparagraph (3) of this paragraph.

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Computation of Normal Support, Continued

Computation of Normal Support, continued

A's contribution in 1974 constituted a substantial and material change in Y's sources of support within the meaning of subparagraph (1)(ii) of this paragraph and on the basis of the 5-year period prescribed in subparagraph (1)(ii) of this paragraph (1970 to 1974), Y would not be considered as 'normally' meeting the one-third support test described in paragraph (a)(2) of this section for the taxable years 1974 (the current taxable year) and 1975 (the immediately succeeding taxable year).

Example (4)

M, an organization described in section 501(c)(3), was organized in 1971 to promote the appreciation of ballet in a particular region of the United States. Its principal activities will consist of erecting a theater for the performance of ballet and the organization and operation of a ballet company. The governing body of M consists of nine prominent unrelated citizens residing in the region who have either an expertise in ballet or a strong interest in encouraging appreciation of the art form. In order to provide sufficient capital for M to commence its activities, X, a private foundation, makes a grant of \$500,000 in cash to M. Although A, the creator of X, is one of the nine members of M's governing body, was one of M's original founders, and continues to lend his prestige to M's activities and fund raising efforts, A does not, directly or indirectly, exercise any control over M. By the close of its first taxable year, M has also received a significant amount of support from a number of smaller contributions and pledges from other members of the general public. Upon the opening of its first season of ballet performances, M expects to charge admission to the general public. Under the above circumstances, the grant by X to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2). Although A was a founder and member of the governing body of M, X's grant may be excluded.

Example (5)

Assume the same facts as example (4). In 1974, during M's third season of operations, B, a widow, passed away and bequeathed \$4 million to M. During 1971 through 1973, B had made small contributions to M, none exceeding \$10,000 in any year. During 1971 through 1974, M had received approximately \$550,000 from receipts for admissions and contributions from the general public. At the time of B's death, no person standing in a relationship to B described in section 4946(a)(1)(C) through (G)

Continued on next page

Computation of Normal Support, Continued

Computation of Normal Support, continued

was a member of M's governing body. B's bequest was in the form of cash and readily marketable securities. The only condition placed upon the bequest was that it be used by M to advance the art of ballet. Under the above circumstances, the bequest of B to M may be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether M meets the one-third support test under section 509(a)(2).

Example (6)

O is a research organization described in section 501(c)(3). O was created by A in 1971 for the purpose of carrying on economic studies primarily through persons receiving grants from O and engaging in the sale of economic publications. O's five-member governing body consists of A, A's sons, B, and C, and two unrelated economists. In 1971, A made a contribution to O of \$100,000 to help establish the organization. During 1971 through 1974 A made annual contributions to O averaging \$20,000 a year. During the same period, O received annual contributions from members of the general public averaging \$15,000 per year and receipts from the sale of its publications averaging \$50,000 per year. In 1974, B made an inter vivos contribution to O of \$600,000 in cash and readily marketable securities. Under the above circumstances, B's contribution cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether O meets the one-third support test.

Example (7)

P is an educational organization described in section 501(c)(3). P was created in 1971. The governing body of P has nine members, consisting of A, a prominent civic leader and eight other unrelated civic leaders and educators in the community, who also participated in the creation of P. During 1971 through 1974, the principal source of income for P has been receipts from the sale of its educational periodicals. These sales have amounted to \$200,000 for this period. Small contributions amounting to \$50,000 have also been received during the same period from members of the governing body, including A, as well as other members of the general public. In 1974 A contributed \$750,000 of the nonvoting stock of Y, a closely held corporation. A retained a substantial portion of the voting stock of Y. By a majority vote, the governing body decided to retain the Y stock for a period of at least five years. Under the above circumstances, A's contribution of the Y stock cannot be excluded as an unusual grant under subparagraph (3) of this paragraph for purposes of determining whether P meets the one-third support test.

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Computation of Normal Support, Continued

Computation of Normal Support, continued

- An organization will be considered as "normally" meeting these tests for its current taxable year and the taxable year immediately succeeding its current taxable year, if, for the four taxable years immediately preceding the current taxable year it meets both tests based on an aggregate of the results in the four year taxable period.
- Because an organization will be considered to be described under IRC 509(a)(2) for the two taxable years following a computation period in which it satisfies the support tests, it follows that after an organization once meets the support tests for a computation period it must thereafter fail these tests for two consecutive taxable years before it will fail qualification under IRC 509(a)(2).
- Where, for example, an organization meets the support tests of IRC 509(a)(2)(A) and (B) for a computation period of taxable years 1990 through 1993, it would be considered to be described under IRC 509(a)(2) for taxable years 1994 and 1995. It will continue to be described under IRC 509(a)(2) for taxable year 1995 even if it fails to meet the tests of IRC 509(a)(2)(A) and (B) for a computation period of taxable years 1991 through 1994.
- Generally, an organization's applicable computation period consists of the four taxable years immediately preceding its current taxable year. However, different rules are applied for new organizations and for organizations which have experienced material changes in their sources of support.

Special Normal Support Rule for New Organizations

An organization that has not completed four taxable years may, if it has completed at least one taxable year consisting of eight months, substitute the taxable years it has been in existence for the four year period described in the table above to compute whether the support received in that abbreviated period satisfies the one-third support and one-third gross investment and unrelated business income tests of IRC 509(a)(2). If, by substituting in this fashion, a new organization can satisfy these tests then, even though it has not completed four taxable years, it will be considered an organization that normally meets such tests and, therefore, described in IRC 509(a)(2) beginning with its first taxable year. *See* Reg. 1.509(a)-3(c)(1)(iv).

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Computation of Normal Support, Continued

Special Normal Support Rule for New Organizations, continued

- An organization that has completed at least one taxable year consisting of eight months may, alternatively, choose to apply for an advance determination of foundation status as a newly created organization under the rules set forth later in this article on page 2-108.

Special Rules for Material Changes in Support

Because the 509(a)(2) exclusion focuses on a "normal" support test, special rules exist for situations where there are material changes in an organization's sources of support.

Reliance Period for Organizations

A determination that an organization is described in IRC 509(a)(2) because it is considered to have normally met the one-third support, and gross investment and unrelated business income tests of IRC 509(a)(2)(A) and (B) is effective for each taxable year of the computation period plus the two taxable years immediately succeeding the computation period. An exception to this pattern occurs if for the current taxable year there are "substantial and material" changes in the organization's sources of support (other than a change arising from an unusual grant as described in text on 170(b)(1)(A)(vi) and 509(a)(1)).

- In the year in which a substantial and material change occurs, the organization's satisfaction of its normal support rule is determined on the basis of a new computation period consisting of the taxable year of the substantial and material change and the four immediately preceding taxable years. *See* Reg. 1.509(a)-3(c)(1)(ii).
- In the case of a new organization, one with fewer than five completed taxable years, the computation period encompasses the year of the substantial and material change and, in lieu of the four immediately preceding taxable years, all of the organization's prior years of existence. *See* Reg. 1.509(a)-3(c)(1)(iv).
- An example of a substantial and material change is the receipt of an unusually large contribution or bequest which is not excluded from support as an unusual grant under Reg. 1.509(a)-3(c)(3).

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Computation of Normal Support, Continued

**Reliance Period
for
Organizations,
continued**

Example: if there are substantial and material changes in an organization's sources of support for taxable year 1976, then even though such organization meets the one-third support and gross investment and unrelated business income tests based on a computation period of taxable years 1971 through 1974 or 1972 through 1975, the organization will not meet the requirements of IRC 509(a)(2) for taxable year 1976 unless it meets the one-third support, and gross investment and unrelated business income tests for a computation period of the taxable years 1972 through 1976.

**Reliance Period
for Grantors
and
Contributors**

- Reg. 1.509(a)-3(c)(1)(iii)(a) provides that where an organization ceases to be described in IRC 509(a)(2) because of a substantial and material change in its sources of support, the organization's status with respect to grantors and contributors will not be affected for purposes of IRC sections 170, 507, 545(b)(2), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522 until notice of change of status under IRC 509(a)(2) is made public (public notice is usually set forth in the Internal Revenue Bulletin) unless:
 - The grantor or contributor was responsible for, or was aware of, the substantial and material change; or
 - The grantor or contributor acquired knowledge that the Service had given notice to such organization that it would be deleted from classification as an organization described in IRC 509(a)(2).
 - If, prior to making a grant or contribution, a grantor obtains a written statement signed by a responsible officer of the recipient organization that such grant will not result in a substantial and material change leading to loss of the organization's status under IRC 509(a)(2), the grantor will not be considered responsible for, or aware of, any substantial or material change. The written statement must include information, including pertinent financial data for the four preceding years, to assure a reasonably prudent person that the grant or contribution will not result in loss of status under IRC 509(a)(2). Reg. 1.509(a)-3(c)(1)(iii)(b).
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Computation of Normal Support, Continued

Reliance Period for Grantors and Contributors, continued

- However, this provision does not apply if a reasonable doubt exists as to the effect of a grant on the organization's support or if the grantor is a founder, creator, or foundation manager. In such cases, the recipient organization may apply to the Service for a ruling (under conditions set forth in Reg. 1.509(a)-3(c)(5)(ii)) as to the effect a particular grant will have on its status under IRC 509(a)(2), thereby, if the ruling is favorable, protecting the grantor.
 - Rev. Proc. 81-6, 1981-1 C.B. 620, provides guidelines to determine whether a grantor or contributor will be considered responsible for a substantial and material change in support. This Rev. Proc. was amplified by Rev. Proc. 89-23, 1989-1C.B. 844.
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Exclusion of Unusual Grants

- An unusual grant might also cause a material change in support, but might qualify for total exclusion from the support test rather than being tested under the procedure discussed above.
 - As previously discussed, an organization is described in IRC 509(a)(2) if it meets both the one-third support test set forth in IRC 509(a)(2)(A) and the one-third gross investment and unrelated business income test set forth in IRC 509(a)(2)(B). However, an organization that cannot meet the one-third support test because of one or more large and unusual contributions may, under certain conditions, entirely exclude such contributions in computing whether it satisfies the one-third support test.
 - Where an organization excludes an unusual grant in computing the one-third support test, that grant must also be excluded in computing whether it satisfies the gross investment and unrelated business income test.
 - The provision for excluding unusual grants contemplates a situation where a disinterested party is attracted to support an organization based on its publicly supported nature but the amount given in support would adversely affect the organization's ability to meet the IRC 509(a)(2) tests.
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Unusual Grants See exhibit on unusual grants in the 509(a)(1) and 170(b)(1)(A)(vi) portion of this article (page 2-50).

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Computation of Normal Support, Continued

Newly Created Organizations Because new organizations may be unsure of their sources of support, special rules are available for an organization's first five years.

- The support tests set forth in IRC 509(a)(2) are computed on the basis of an organization's "normal" sources of support. It may take several years for newly created organizations to establish their "normal" sources of support. Often the type of financial support that an organization receives during its formative years differs significantly from the type of support received after it has been established and operated for a while.
- For example, it may take a newly created symphony orchestra several years before it gains acceptance in the community in which it performs and receives the broad, public support anticipated. During those early years the orchestra may be dependent on a limited group whose financial support does not satisfy the support tests of IRC 509(a)(2).
- Similarly, a newly created community chest may engage in several fund raising drives before it attracts broad public support.
- In view of this, the regulations provide for a two or three year period to allow a newly created organization time to establish that it meets the support tests of IRC 509(a)(2). This is referred to as the organization's advance ruling period. In the Deficit Reduction Act of 1984, Congress directed the Treasury Department to extend the advance ruling period for newly created organizations to five years. H.R. Rep. 98-861 (Conf. Rep.), 98th Cong., 2nd Sess. 1090 (1984), *reprinted in* 1984-3 C.B. (Vol. 2) 344. If a newly created organization can reasonably be expected to meet the support tests by the end of its advance ruling period, the Service may issue it an advance ruling or determination letter. An advance ruling or determination permits an organization to be "treated as" an IRC 509(a)(2) organization for its advance ruling period, as explained below.
- An advance ruling or determination is not a ruling that an organization, in fact, will meet the requirements of IRC 509(a)(2) during its advance ruling period. Thus, organizations that receive an advance ruling or determination letter, must, at the expiration of the advance ruling period, establish their status under IRC 509(a)(2) for the years covered by the advance ruling or they will be presumed to be private foundations under IRC 508(b). The length of advance ruling periods and the establishment of private foundation status at the expiration of the advance ruling period are discussed in the next section.

Continued on next page

Computation of Normal Support, Continued

Advance Ruling Period and Determinations of Foundation Status

Reg. 1.509(a)-3(d)(1) provides for an advance ruling period of two or three years depending on the length of the first tax year. Reg. 1.509(a)-4(i) provide for an extended advance ruling of an additional three years. A new five year period replaces both the two or three year advance ruling period and the extended advance ruling period for organizations applying on Form 1023.

- A newly created organization subject to the five year advance ruling period may request a ruling or determination letter that it will be treated as a 509(a)(2) organization for its first five taxable years. This request must be filed with a consent to extend the statute (Form 872-C) that in effect states the organization will be subject to IRC section 4940 taxes if it fails to qualify as not a private foundation during the five year advance ruling period.
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Reasonable Expectation Factors

Several factors will be used to determine whether there is a reasonable expectation that the organization will meet the public support test at the end of its advance ruling period.

- Reg. 1.509(a)-3(d)(2) provides that in determining whether an organization can reasonably be expected to meet the one-third support and gross investment and unrelated business income tests so as to qualify for an advance ruling or determination letter:

[T]he basic consideration is whether its organizational structure, proposed programs or activities, and intended method of operation are such as to attract the type of broadly based support from the general public, public charities, and governmental units which is necessary to meet such tests. While the factors which are relevant to this determination, and the weight accorded to each of them, may differ from case to case, depending on the nature and functions of the organization, a favorable determination will not be made where the facts indicate that an organization is likely during its advance or extended advance ruling period to receive less than one-third of its support from permitted sources (subject to the limitations of paragraph (b) of this section) or to receive more than one-third of its support from gross investment income.

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Computation of Normal Support, Continued

Specific Factors Reg. 1.509(a)-3(d)(3) also lists the following as some of the pertinent factors to be considered:

- Whether the organization has or will have a governing body which is comprised of public officials, or individuals chosen by public officials acting in their capacity as such, of persons having special knowledge in the particular field or discipline in which the organization is operating, of community leaders, such as elected officials, clergymen, and educators, or, in the case of a membership organization, of individuals elected pursuant to the organization's governing instrument or bylaws by a broadly based membership. This characteristic does not exist if the membership of the organization's governing body is such as to indicate that it represents the personal or private interests of disqualified persons, rather than the interests of the community or the general public.
- Whether a substantial portion of the organization's initial funding is to be provided by the general public, by public charities, or by government grants, rather than by a limited number of grantors or contributors who are disqualified persons with respect to the organization. The fact that the organization plans to limit its activities to a particular community or region or to a special field which can be expected to appeal to a limited number of persons will be taken into consideration in determining whether those persons providing the initial support for the organization are representative of the general public. On the other hand, the subsequent sources of funding which the organization can reasonably expect to receive after it has become established and fully operational will also be taken into account.
- Whether a substantial proportion of the organization's initial funds are placed, or will remain, in an endowment, and whether the investment of such funds is unlikely to result in more than one-third of its total support being received from gross investment income.
- In the case of an organization which carries on fund-raising activities, whether the organization has developed a concrete plan for solicitation of funds from the general public on a community or area-wide basis; whether any steps have been taken to implement such plan; whether any firm commitments of financial or other support have been made to the

Continued on next page

Computation of Normal Support, Continued

**Specific
Factors,
continued**

organization by civic, religious, charitable, or similar groups within the community; and whether the organization has made any commitments to, or established any working relationships with, those organizations or classes of persons intended as the future recipients of its funds.

- In the case of an organization which carries on community services, such as slum clearance and employment opportunities, whether the organization has a concrete program to carry out its work in the community; whether any steps have been taken to implement that program; whether it will receive any part of its funds from a public charity or governmental agency to which it is in some way held accountable as a condition of the grant or contribution; and whether it has enlisted the sponsorship or support of other civic or community leaders involved in community service programs similar to those of the organization.
- In the case of an organization which carries on educational or other exempt activities for, or on behalf of, members, whether the solicitation for dues-paying members is designed to enroll a substantial number of persons in the community, area, profession, or field of special interest (depending on the size of the area and the nature of the organization's activities); whether membership dues for individual (rather than institutional) members have been fixed at rates designed to make membership available to a broad cross-section of the public rather than to restrict membership to a limited number of persons; and whether the activities of the organization will be likely to appeal to persons having some broad common interest or purpose, such as educational activities in the case of alumni associations, musical activities in the case of symphony societies, or civic affairs in the case of parent-teacher associations.
- In the case of an organization which provides goods, services, or facilities, whether the organization is or will be required to make its services, facilities, performances, or products available (regardless of whether a fee is charged) to the general public, public charities, or governmental units, rather than to a limited number of persons or organizations; whether the organization will avoid executing contracts to perform services for a limited number of firms or governmental agencies or bureaus; and whether the service to be provided is one which can be expected to meet a special or general need among a substantial portion of the general public.

Continued on next page

Computation of Normal Support, Continued

"Treatment as" an IRC 509(a)(2) Organization An organization, and grantors, or contributors to the organization may generally rely on an advance determination letter or ruling that the organization will be "treated as" an organization described in IRC 509(a)(2) until 90 days after the advance ruling period ends. If information needed to establish the organization's IRC 509(a)(2) status is submitted within the 90 day period, reliance is extended until the Service issues a determination letter or ruling.

- Reg. 1.509(a)-3(e)(2) provides that an organization and its grantors and contributors may rely on an advance ruling for all purposes except IRC 507(d) and IRC 4940.
- This means that if it is subsequently determined that an organization was a private foundation from its inception, then the provisions of IRC 507(d), which defines "aggregate tax benefits" and "substantial contributors" with respect to private foundations, and IRC 4940, which imposes excise taxes on the net investment income of private foundations, are applicable from the organization's inception.

Reliance Rules for Advance Ruling or Determination Letters Reg. 1.509(a)-3(e)(3) provides that grantors and contributors may rely on an advance ruling or determination letter during the advance ruling period until the organization's new status is made public (usually by publication in the Internal Revenue Bulletin).

- This provision does not protect grantors or contributors that are responsible for, or aware of, an act or failure to act that results in an organization's failure to qualify under IRC 509(a)(2), or acquire knowledge that the Service has revoked the organization's advance ruling or determination letter.

The Proper Measuring Period See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (page 2-68). The law is identical for IRC 509(a)(2) organizations.

Meaning of "Normally" See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (page 2-68). The law is identical for IRC 509(a)(2) organizations.

Continued on next page

Computation of Normal Support, Continued

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|---------------------------------|--|
| An Example of "Normally" | See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (pages 2-68 to 2-69). The law is identical for IRC 509(a)(2) organizations. |
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|---|---|
| Exception for Material Changes in Sources of Support | See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (page 2-69). The law is identical for IRC 509(a)(2) organizations. |
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| Measuring Periods for Applicant Organizations | See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (pages 2-70 to 2-71). The law is identical for IRC 509(a)(2) organizations. |
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| Advance Rulings to Newly Created Organizations | See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (pages 2-71 to 2-72). The law is identical for IRC 509(a)(2) organizations. |
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General

| | |
|---|---|
| Failure to Obtain Advance Ruling | See this topic that was discussed previously in the IRC 509(a)(1) and 170(b)(1)(A)(vi) section (page 2-73). The law is identical for IRC 509(a)(2) organizations. |
|---|---|

Continued on next page

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

| Preceding Years | (a) | (b) | (c) | (d) | (e) |
|--|-----------------|-----------------|-----------------|-----------------|-------|
| | 1 st | 2 nd | 3 rd | 4 th | Total |
| 1. Gifts, grants and contributions received (Do not include unusual grants)..... | | | | | |
| 2. Membership fees received..... | | | | | |
| 3. Gross income from admissions, merchandise sold or services performed or furnishing of facilities in any activity that is not a business unrelated to the organization's charitable, etc., purposes... | | | | | |
| 4. Gross income from interest, dividends, amounts received from payments on securities loans (IRC 512(a)(5)), rents, royalties, and unrelated business taxable income (less IRC 511 taxes) from businesses acquired by the organization after June 30, 1975..... | | | | | |
| 5. Net income from unrelated business activities not included in line 4..... | | | | | |
| 6. Tax revenues levied for the organization's benefit and either paid to it or expended on its behalf..... | | | | | |
| 7. The value of services or facilities furnished by a governmental unit without charge. Do not include the value of services or facilities generally furnished to the public without charge..... | | | | | |
| 8. Other income. Do not include gain (or loss) from the sale of capital assets..... | | | | | |
| 9. Total of lines 1 through 8..... | | | | | |
| 10. Enter 1% of line 9..... | | | | | |
| 11. Add lines 1(e), 2(e), 3(e), 6(e) and 7(e) | | | | | |
| 12. Deduct: Income from disqualified persons | | | | | |
| Exempt function income exceeding \$5,000/1% limit | | | | | |
| 13. Line 11 less line 12 = public support (numerator) | | | | | |
| 14. Total support from line 9(e) (denominator) | | | | | |
| 15. Public support percentage (line 13 divided by line 14)..... | | | | | |
| If line 15 is 33 1/3 percent or more, the public support test is met. Go on to gross investment test. If line 15 is less than 33 1/3 percent, the organization will not qualify under IRC 509(a)(2). | | | | | |
| 16. Investment income from line 4(e)..... | | | | | |
| 17. Unrelated business income on line 5(e) less tax paid on that income..... | | | | | |
| 18. Total of lines 16 and 17 (numerator) | | | | | |
| 19. Total support from line 9(e) (denominator) | | | | | |
| 20. Gross investment percentage (line 18 divided by line 19)..... | | | | | |

If line 20 is less than 33 1/3 percent, the gross investment test is met. If line 20 is 33 1/3 percent or more, the organization will not qualify under IRC 509(a)(2).

Source of Support - IRC sections 509(a)(1) vs. 509(a)(2)

| IRC Sections 509(a)(1) & 170(b)(1)(A)(vi) | | Source of Support | IRC Section 509(a)(2) | |
|--|-------------|---|------------------------------|-------------|
| Numerator | Denominator | | Numerator | Denominator |
| Include ¹ | Include | Gifts, bequests and contributions from: Individual, trust, corporation | Include ² | Include |
| Include | Include | Governmental unit | Include | Include |
| Include ³ | Include | 170(b)(1)(A)(vi) organization | Include ³ | Include |
| Include | Include | Ordinary Grants | Include | Include |
| Exclude | Exclude | Unusual Grants (approved) | Exclude | Exclude |
| Exclude | Exclude | Membership Fees: to obtain merchandise, admissions, etc. | Include ^{2 & 4} | Include |
| Include | Include | to provide support | Include | Include |
| Exclude | Include | Dividends and Interest | Exclude | Exclude |
| Exclude | Exclude | Rents: related activity | Include ^{2 & 4} | Include |
| Exclude | Include | other | Include | Include |
| Exclude | Exclude | Gross receipts from related activity: Admissions, sale of merchandise, services rendered, fundraising not UBI (e.g., charitable gaming), facilities furnished, etc. | Include ^{2 & 4} | Include |
| Exclude | Include | Net income from unrelated activity | Exclude | Include |
| Include | Include | Value of services received from Governmental units without charge | Include | Include |
| Include | Include | Governmental units under contracts or grants: for services rendered for benefit of the Government | Include ^{2 & 4} | Include |
| Exclude | Exclude | for carrying out related activity | Include ^{2 & 4} | Include |
| Include | Include | for direct benefit of public | Include | Include |
| Include | Include | Taxes levied for benefit of organization | Include | Include |
| Exclude | Exclude | Capital gains | Exclude | Exclude |
| Exclude | Exclude | Contributions of non-deductible services | Exclude | Exclude |
| Exclude | Exclude | Amounts borrowed | Exclude | Exclude |

Continued on next page

Source of Support - IRC sections 509(a)(1) vs. 509(a)(2), Continued

- ¹ To the extent that the total amount of the contributions by any individual, trust, or corporation during the period involved does not exceed 2% of the organization's total support for each period.
- ² Does not include amounts received from disqualified persons. For purposes of this computation, IRC section 509(a)(2) and 509(a)(3) organizations may be considered disqualified persons. IRC 509(a)(1) organizations and 170(c) governmental units are not considered disqualified persons.
- ³ Does not include amounts received from donor to contributing organization if donor is a substantial contributor to recipient organization.
- ⁴ To the extent that receipts from any person, governmental bureau, or governmental agency do not exceed the greater of \$5,000 or 1% of the organization's support in any taxable year.
- ⁵ Subject to 2% limitation described in footnote ¹ above if contributions represent amounts that have been specifically earmarked for recipient organization.
-

Supporting Organizations Described in IRC 509(a)(3)

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:
 - 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);
 - 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
 - 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.

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

**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. While the relationship test is listed beneath the organizational and operational test in both statute and regulations, the particular relationship the supporting organization has may determine the ease or difficulty it will encounter in meeting the other tests. 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:

Continued on next page

REGULATIONS

1.509(a)-4(g)

1.509(a)-4(h)

1.509(a)-4(i)

I. RELATIONSHIP TEST

A. Operated, supervised or controlled by - (Parent-Subsidiary), or
 B. Supervised or controlled in connection with - (Brother-Sister), or
 C. Operated in connection with -
 (1) Responsiveness test
 (2) Integral part test

YES

NO

Organization fails to qualify under IRC 509(a)(3). Continue to gather additional reasons for denial.

1.509(a)-4(c) and (d)

II. ORGANIZATIONAL TEST

A. Limit the purposes to one or more of the purposes set forth in IRC 509(a)(3)(A), and
 B. Limit the activities to the above purposes, and
 C. State the specified publicly supported organizations on whose behalf this organization is operated, and
 D. Prohibit the organization from benefiting any organization other than those listed in C, above.

YES

NO

1.509(a)-4(e)(1)

1.509(a)-4(e)(2)

III. OPERATIONAL TEST

A. Make payments solely to permissible beneficiaries
or
 B. Conduct an independent activity or program in support of permissible beneficiaries.

YES

NO

1.509(a)-4(j)

CONTROL TEST

Whether supporting organization is controlled, directly or indirectly, by disqualified persons.

NO

YES

Organization fails to qualify under IRC 509(a)(3).

The organization qualifies for classification under IRC 509(a)(3).

Supporting Organizations Described in IRC 509(a)(3), Continued

The Relationship Test in General

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:

- Operated, supervised, or controlled by;
- Supervised or controlled in connection with; or
- 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. Where such relationships exist, we are dealing with, in the words of Senator Hugh Scott (then Senate minority leader) a situation where "(b)y virtue of this complete identity of control . . . there is in reality only one entity." 115 *Cong. Rec.* 37514 (1969). The "operated in connection with" relationship is not so concrete; its presence is established by such factors as "responsiveness" and "significant involvement." Reg. 1.509(a)-4(f)(4). Stating that there is in reality only a single entity is inappropriate here. Perhaps the court in *Windsor Foundation v. United States*, 77-2 U.S.T.C. 9709 (E.D. Va. 1977), in discussing whether an organization was "operated in connection with" described the situation best by stating "the IRS has drafted fantastically intricate and detailed regulations to thwart the fantastically intricate and detailed efforts of taxpayers to obtain private benefits from foundations while evading the imposition of taxes."

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. Reg. 1.509(a)-4(g)(1)(i).

- Such a relationship is established by the fact that a majority of the members of the 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)(i).
-

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

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

- It is not necessary for the governing bodies of both organizations to have the same persons. Reg. 1.509(a)-4(g)(1)(ii).
 - Reg. 1.509(a)-4(g)(1)(ii) 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 organization or organizations are carried out by benefiting the other publicly supported organizations.
-

Examples

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

1. A university press operated to perform a university's printing and publishing. It is controlled by a board of governors appointed by the university's board of trustees. Reg. 1.509(a)-4(g)(2), *Example (1)*.
 2. A scientific study council organized under the joint sponsorship of several independent, publicly supported organizations. Each of the sponsoring organizations elects members to the council's board. The remaining board members are the council's president and at-large members elected by the council's board. Reg. 1.509(a)-4(g)(2), *Example (2)*.
 3. A charitable trust, whose trustees are appointed by a university. The trust was organized and is operated to pay over all its income to designated IRC 170(b)(1)(A)(iii) hospitals that allow the university's faculty members to use the hospitals' research facilities. Reg. 1.509(a)-4(g)(2), *Example (3)*.
 4. A trust established to grant scholarships to student's graduating from a city's public high school that is trusteeed by members of the city council and managed by the city's treasurer. Rev. Rul. 75-436, 1975-2 C.B. 217.
 - Rev. Rul. 75-436 illustrates another principle: A governmental entity, such as the city described in the revenue ruling may qualify as a supporting organization because as a governmental unit referred to in IRC 170(c)(1) it qualifies as an IRC 509(a)(1)/170(b)(1)(A)(v) organization.
-

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

**Examples,
continued**

5. A community trust described in Reg. 1.170A-9(e)(11) that was created by a publicly supported community chest to hold permanently endowed charitable funds and to distribute income to local publicly supported charities. A majority of the community trust's trustees are appointed by the community chest's governing body. Rev. Rul. 81-43, 1981-2 C.B. 350.
-

**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."
- 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. Reg. 1.509(a)-4(h)(2)
- *Example 2*, Reg. 1.509(a)-4(h)(3), sets forth the following illustration of the distinction:

B, a philanthropist, created P, a charitable trust for the benefit of Z, a symphony orchestra described in section 509(a)(2). B transferred 100 shares of common stock to P. Under the terms of the trust instrument, the trustees (none of whom is under the control of B) were required to pay over all of the income produced by the trust assets to Z. The governing instrument of P contains certain provisions whose effect is described in section 508(e)(1)(A) and (B). Under applicable State law, Z can enforce the provisions of the trust instrument and compel payment to Z in a court of equity. There is no relationship

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

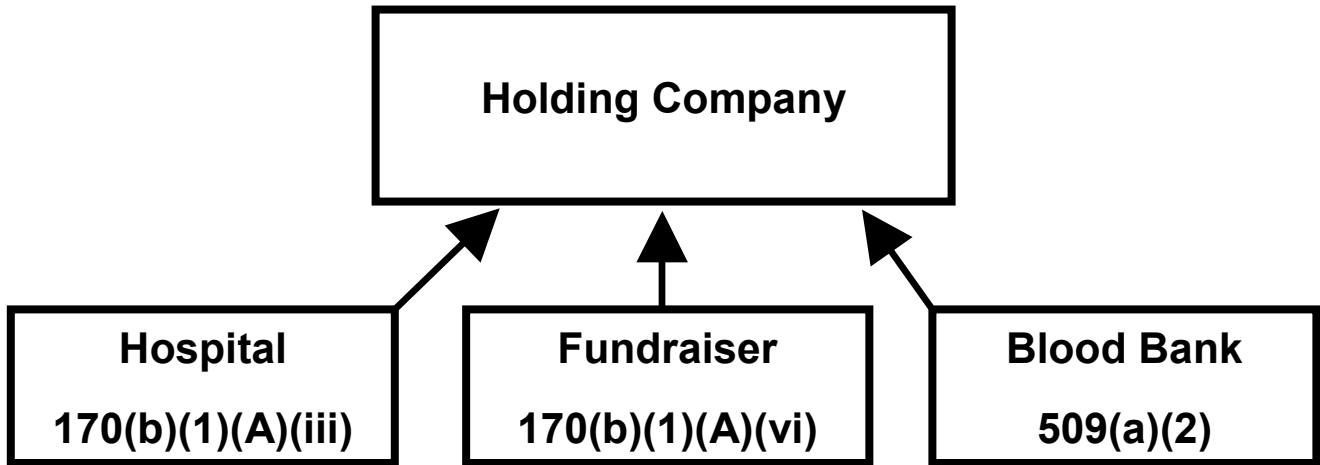
**The
"Supervised or
Controlled in
Connection
with"
Relationship
(Reg. 1.509(a)-
4(h)), continued**

between the trustees of P and the governing body of Z. Under these circumstances P is not supervised or controlled in connection with a publicly controlled organization. Because of the lack of any common supervision or control by the trustees of P and the governing body of Z, P is not supervised or controlled in connection with Z within the meaning of section 509(a)(3)(B).

- Claims to "supervised or controlled in connection with" relationships rarely were encountered until hospitals reorganized to become multi-entity systems. A typical, although somewhat simple, hospital reorganization is given on the following page.

Continued on next page

**The “Supervised or Controlled in Connection With” Relationship
Regulation 1.509(a)-4(h)**



Supporting Organizations Described in IRC 509(a)(3), Continued

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

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

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

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

- 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.
- 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.
- 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 documentation that is required by the governing instruments, would be insufficient to satisfy the "rule of thumb" as there would be no guarantee that such identity would continue for the life of the relationship of the organizations.

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

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

- 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 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.

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

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

The responsiveness test requires compliance with one of two alternative subparts, with additional facts and circumstances to be taken into account in the case of a relationship that antedates November 20, 1970.

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

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

Responsiveness test #1 is quite direct. It requires the supporting organization to demonstrate that one of the following arrangements exists:

- One or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the publicly supported organizations;
- One or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or
- The officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations.

Once the arrangement is shown, the organization faces an additional hurdle - it must demonstrate that, by reason of such arrangement, the officers, directors, or trustees of the publicly supported organizations have a significant voice in:

- The investment policies of the supporting organization,
- The timing of grants,
- The manner of making grants,
- The selection of recipients by the supporting organization, and
- In otherwise directing 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 organization 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.

Continued on next page

Supporting Organizations Described in IRC 509(a)(3), Continued

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

Responsiveness test # 2 requires that

- (1) The supporting organization be a charitable trust under state law,
 - (2) Each specified publicly supported organization be 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.
- Controversy has centered around the "named beneficiary" requirement. The 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.
 - With respect to the requirement that the beneficiary organization have the power to enforce the trust and compel an accounting, 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.
 - In *Roe Foundation Charitable Trust v. Commissioner*, 58 T.C.M. 402 (1989), the Tax Court found that the Trust failed to meet either of the two alternatives of the responsiveness test.
 - Under responsiveness test #1, although the Trust appointed the president-elect of the supported organization to the Trust's governing body, the president-elect had only one out of a possible four votes. The court found it questionable whether the lone member of the supported organization would have a significant voice in the Trust's activities, investment policies, or in directing the use of the Trust's income.

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Supporting Organizations Described in IRC 509(a)(3), Continued

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

The Trust also failed to satisfy responsiveness test #2. Although the Trust was a charitable trust under state law, it failed to include as a beneficiary any specified publicly supported organization. Additionally, under the State of Washington's law of charitable trusts, the Washington State Attorney General, not the beneficiary (even assuming it was specifically identified) has the power to enforce the Trust and compel an accounting.

Additional Facts and Circumstances

For an organization that was supporting or benefiting 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. Reg. 1.509(a)-4(i)(1)(ii).

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 transitional rules for organizations created before November 20, 1970, which are set forth in Reg. 1.509(a)-4(i)(4) and discussed in the next subdivision of this article) apply.
-

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

The supporting organization:

- 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);
 - 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
 - A significant amount of the total support of the supporting organization must go to those publicly supported organizations that meet the "attentiveness requirement."
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Supporting Organizations Described in IRC 509(a)(3), Continued

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

To satisfy this test, two requirements must be met:

1. The activities engaged in for or on behalf of the publicly supported organization must be activities that perform the functions of, or carry out the purposes of, such organizations; and
 2. These activities, but for the involvement of the supporting organizations, would normally be engaged in by the publicly supported organizations themselves.
- The general rule is that this test only applies in situations where the supporting organization actually engages in activities that benefit the supporting organizations, for example, performing publishing and printing functions for a college), as opposed to simply making grants to support the publicly supported organizations.
 - The one exception is where an organization makes grants to members of a charitable class benefited by the supported organization, a community trust described in Reg. 1.170A-9(e)(11). In such a case grant-making does not fall outside the scope of the term "activities" in Reg. 1.509(a)-4(i)(3)(ii). G.C.M. 38417 (June 20, 1980).
 - Nevertheless, it should be noted that the organization discussed in G.C.M. 38417 failed the integral part test because it could not satisfy the second prong of Reg. 1.509(a)(4)(i)(3)(ii). It could not demonstrate that the community trust's dependence on its activities was such that the trust would undertake those activities but for the organization's involvement. Instead, G.C.M. 38417 notes that the community trust would have engaged in grant-making activities regardless of, and not because of a dependence on, the grant-making activities of the organization.

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Supporting Organizations Described in IRC 509(a)(3), Continued

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

- One court case with which the Service does not agree is *Change-All Souls Housing Corp. v. United States*, 671 F.2d 463 (Ct. Cl. 1982). The case and the government's position of the case, are described in AOD 1244, (Mar. 22, 1984) as follows:
 - Change-All Souls Housing Corporation (Change-All) is an exempt organization, which was organized by the membership of two other nonprofit corporations, one a church, the other a private foundation. Change-All was organized to provide low and moderate income housing in Washington, D.C. The organization sought exemption as a 501(c)(3) organization, which it was granted, but it was classified as a private foundation because, although it supported [the church], it also supported a private foundation.
 - The court determined that Change-All satisfied the relationship test of section 509(a)(3) because it was "operated in connection with" the church, a 501(c)(3) organization. The court examined the statute and the regulations and found no support for the government's position that section 509(a)(3) requires a supporting organization to support exclusively those organizations which are described in section 509(a)(1) or (2). The court noted that Change-All's relationship to the church was sufficient to ensure the public responsiveness required of section 509(a)(3) organizations and this responsiveness was not diminished by Change-All's relationship with the private foundation.
 - We believe that this organization fails both the organizational and operational tests of section 509(a)(3)(A). We believe the court's determination to the contrary is incorrect. Further, we disagree with the court's finding that Change-All met the requirements of section 509(a)(3)(B) in that it was "operated in connection with" one or more publicly supported organizations.
 - There is no conflict in the circuits and the issue is not of sufficient demonstrable administrative importance as to warrant Supreme Court review. However, should the issue arise in other cases, technical advice should be sought.

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Supporting Organizations Described in IRC 509(a)(3), Continued

The Threshold Test: Substantially All of Its Income

Reg. 1.509(a)-4(i)(3)(i) provides that the supporting organization must make payments of substantially all of its income to or for the use of one or more publicly supported organizations.

- This "substantially all" requirement is a prerequisite to all parts of the integral part test under Reg. 1.509(a)-4(i)(3)(iii). G.C.M. 36523 (Dec. 18, 1975).
- Rev. Rul. 76-208, 1976-1 C.B. 161, defines "substantially all," for purposes of the integral part test as at least 85 percent and prohibits counting accumulated income even if it must be paid to the supported organization. Rev. Rul. 76-208 relies on Reg. 53.4942(b)-1(c) for the definition of "substantially all" as 85 percent. This does not mean that the "substantially all" requirement cannot be met when there are relatively minor payout delays. For example, in a case where income was accumulated for a limited period for a specific purpose at the request of the supported organization, G.C.M. 36523 (Dec. 18, 1975) concluded that the organization was not precluded from meeting the "substantially all" test.
- Long term capital gains may be excluded from income for purposes of the "substantially all" test, but short term gains may be included. Authority for this position is based on Reg. 53.4942(a)-2(d)(2)(ii), which includes long term capital gains, but excludes short term gains in the computation of "adjusted net income."

Integral part Test #2 (Reg. 1.509(a)-4(i)(3)(iii), continued: the "Attentiveness" Requirement

Satisfaction of integral part test #2 may create considerable 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.

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Supporting Organizations Described in IRC 509(a)(3), Continued

**Integral part
test #2**

1. Amount of total support provided (Reg. 1.509(a)-4(i)(3)(iii)(a)).

Under this test, the amount of support received by a publicly supported organization must represent a sufficient part of the organization's total support to assure attentiveness.

- 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.)
- The regulations do not specify what percentage of a supporting organization's support must be received from a supporting organization to meet this test. The requirement is that facts and circumstances show that the support is sufficient to ensure that the supported organization is attentive to the operations of the supporting organization. Rule of thumb: a grant of less than 10 percent of total support would be unlikely, by itself, 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. Earmarking (Reg. 1.509(a)-4(i)(3)(iii)(b)).

Under this test, a supporting organization can meet the attentiveness requirement, even if it does not provide a sufficient amount of the beneficiary's total support, if the support is earmarked for a particular program or activity of the supported organization. In such a situation, 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 function or activity for which the support is earmarked.

Reg. 1.509(a)-4(i)(3)(iii)(c) furnishes two examples of earmarked support that meet the attentiveness requirement: an organization that underwrites a chamber music series at a museum, and an organization that endows a chair at a law school.

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Supporting Organizations Described in IRC 509(a)(3), Continued

**Integral part
test #2,
continued**

In these examples, there are three common factors:

- The supporting organization pays over all its income,
- The supporting organization provides all the funds, and
- The expense of conducting the program is substantial.

3. Facts and circumstances (Reg. 1.509(a)-(i) (3)(iii)(d)).

The regulation notes: "All pertinent factors . . . will be considered in determining whether the amount of support received by a publicly supported beneficiary organization is sufficient to insure the attentiveness of such organization to the operations of the supporting organization. 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."

Example (1)

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.

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Supporting Organizations Described in IRC 509(a)(3), Continued

**Integral part
test #2,
continued**

Example (2)

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 organization's 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.

Example (3)

G.C.M. 36523 (Dec. 18, 1975) provides another example of "attentiveness" achieved under the "facts and circumstances" test. The organization described in the G.C.M. was making grants to a zoo, a part of the city government. The G.C.M. concluded that the percentage of support was insufficient to insure the zoo's attentiveness; thus, the organization could not qualify under the Reg. 1.509(a)-4(i)(iii)(a) attentiveness test. Nevertheless, G.C.M. 36523 concluded the organization could pass the facts and circumstances test of Reg. 1.509(a)-4(i)(3)(iii)(d). The G.C.M. noted that the zoo was historically a part of the city government and that the organization was only one of two nongovernmental organizations to support the zoo.

- Even where a supported organization is not dependent upon the supporting organization for a sufficient amount of support, the integral part test is not met merely because the supported organization has enforceable rights under state law. Reg. 1.509(a)-4(i)(3)(iii)(e).

**"Substantial
amount of
support"**

The attentiveness test also requires that a substantial amount of the total support of the supporting organization must go to those publicly supported organizations that meet the attentiveness requirement. In the only pronouncement that mentions this requirement in a given situation, G.C.M. 36326 (June 30, 1975) noted in a situation where the supported organization paid all of its income equally to three supported charities, the "substantial amount requirement" was met.

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Supporting Organizations Described in IRC 509(a)(3), Continued

**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 was supporting one or more publicly supported organizations before November 20, 1970, that met 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.

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Supporting Organizations Described in IRC 509(a)(3), Continued

The Organizational Test

The organizational test is described in Reg. 1.509(a)-4(c) and (d).

- Reg. 1.509(a)-4(c)(1) provides that 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.
- The limiting language must be contained in the supporting organization's governing instrument. Reg. 1.509(a)-4(c)(1). In one case, an organization did not meet the organizational test because the Tax Court concluded, due to lack of proof otherwise, that two of three possible beneficiaries designated in the trust's creating document were not IRC 509(a)(1) or (a)(2) organizations. Therefore, the court found that the trust instrument expressly empowered the trust to benefit organizations other than the "specified" publicly supported organizations. *Trust Under the Will of Bella Mabury v. Commissioner*, 80 T.C. 718 (1983).

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Supporting Organizations Described in IRC 509(a)(3), Continued

The Organizational Test's Requirements for Supporting Organizations Whose Relationship Is "operated, supervised, or controlled by" or "supervised or controlled in connection with"

Generally, 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).
- 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) must have articles that require it to carry on activities that are exclusively religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals 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.

Specifying Publicly Supported Organizations in the Governing Instrument

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).

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Supporting Organizations Described in IRC 509(a)(3), Continued

Specifying Publicly Supported Organizations in the Governing Instrument, continued

- There are, nevertheless, situations where the organizational test is not met. Rev. Rul. 79-197, 1979-1 C.B. 204, discusses a situation where the organizational document provides that the supporting organization will pay out its future income until a specific amount has been paid to specified publicly supported organizations that control it. After the specific amount has been paid, the organization will dissolve and will distribute its assets to publicly supported organizations that a contributor selects. Rev. Rul. 79-197 holds that the organization does not meet the organizational test because its articles do not require it to support organizations designated by name, class, or purpose after it has paid out the specific amount.

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.

Problems in satisfying the Organizational Test

First Problem

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.

- 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." Just as with a similar decision, *Nellie Callahan Scholarship Fund v. Commissioner*, 73 T.C. 626 (1980) *nonacq.* 1980-2 C.B., the Service does not agree with the *Goodspeed* decision (1981-1 C.B. 2).

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Supporting Organizations Described in IRC 509(a)(3), Continued

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

Second Problem

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 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).

In *Cockerline Memorial Fund v. Commissioner*, 86 T.C. 53 (1986), The Tax Court concluded that a trust to furnish scholarships for residents of Oregon who attend Oregon colleges and universities had maintained an historic and continuing relationship with the colleges and universities that resulted in an substantial identity of interest between the Fund and the IRC 509(a)(1) supported organizations.

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Supporting Organizations Described in IRC 509(a)(3), Continued

Another Problem - Substitution of Other Entities for the Designated Publicly Supported Organization

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 court concluded that 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...

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).

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Supporting Organizations Described in IRC 509(a)(3), Continued

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. According 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).

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Supporting Organizations Described in IRC 509(a)(3), Continued

A Supporting Organization May Carry on Its Own Independent Programs

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. 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 are 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.

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.

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Supporting Organizations Described in IRC 509(a)(3), Continued

The Disqualified Person Control Test, continued

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.

Example

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.

Foundation Manager Who is a Disqualified Person

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.

Indirect Control

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.

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Supporting Organizations Described in IRC 509(a)(3), Continued

Unusual situations: Non-exempt Charitable Trusts and IRC 509(a)(3)

Pursuant to Rev. Proc. 72-50, 1972-2 C.B. 830, as superseded in minor part by Rev. Proc. 76-34, 1976-2 C.B. 657, a trust classified as a non-exempt charitable trust under IRC 4947 may request a determination letter that that it meets the requirements of IRC 509(a)(3) even though it neither has obtained nor seeks exemption under IRC 501(c)(3).

Unusual Situations: Supported Organizations Described in IRC 501(c)(4), (5), or (6)

Under certain circumstances a supporting organization may support exempt organizations other than those described in IRC 501(c)(3). Reg. 1.509(a)-4(k) provides that the supported organization must meet the following standards:

- It must be described in IRC 501(c)(4), (5), or (6); and
 - It must satisfy the same public support requirements that IRC 509(a)(2) provides for IRC 501(c)(3) organizations.
-

Unusual Situations: Supported Organization is a Foreign Organization

Rev. Rul. 74-229, 1974-1 C.B. 142, holds that a domestic charitable organization, organized and operated in support of a foreign organization described in IRC 501(c)(3), qualifies as an IRC 509(a)(3) supporting organization.

- A domestic charity seeking IRC 509(a)(3) status on the basis of its support for a foreign organization may have a problem - the requirements for insuring IRC 170(c)(2) deductibility and satisfying the requirements of IRC 509(a)(3) are at cross-purposes. IRC 170(c)(2) deductibility is predicated upon a showing that the domestic charity has "control and discretion" over the use of the contributions it receives, whereas IRC 509(a)(3) requires that the foreign (supported) organization maintain sufficient authority over the domestic charity to satisfy one of the three relationships required to establish IRC 509(a)(3) qualification.
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IRC 4942(j)(3) – Private Operating Foundations

Background

Certain private foundations devote most of their earnings and much of their assets directly to the conduct of educational, charitable or religious purposes, as distinct from merely making grants to other organizations for these purposes.

The private foundations that directly conduct IRC 501(c)(3) activities are known as "private operating foundations" (or simply "operating foundations"). Private operating foundations, while subject to most of the rules pertaining to private foundations, are treated like public charities for certain purposes:

- Private operating foundations are excepted from the income distribution requirements and related excise taxes of IRC 4942 that are imposed on other private foundations. IRC 4942(a)(1). (On the other hand, private operating foundations, if they are to maintain their status, must regularly expend all of their adjusted net income directly for the active conduct of their exempt purposes.)
- Private operating foundations are eligible to receive qualifying distributions from other private foundations. (A private foundation generally can satisfy its IRC 4942 distribution requirement by making distributions directly for exempt functions or to private operating foundations or public charities, but not to another private "non-operating" foundation unless the private non-operating foundation makes a qualifying distribution of the grant within a certain period. IRC 4942(g)(1)(A) and (g)(3).)
- A donor generally may deduct a charitable contribution to a private operating foundation to the same extent as contributions to organizations described in IRC 509(a)(1), (2), or (3), for income tax purposes. IRC 170(b)(1)(A)(vii), 170(b)(1)(E)(i), 170(e)(1)(13)(ii), 170(e)(3)(A), and 170(e)(5)(C)(i).
- Private operating foundations are treated like organizations described in IRC 509(a)(1), (2), or (3) for estate and gift tax purposes with respect to certain transactions involving works of art. IRC 2055(e)(4) and 2503(g).
- Certain private operating foundations qualify as "exempt operating foundations" under IRC 4940(d). (Exempt operating foundations are exempt from excise tax under IRC 4940, and private foundations are not required to exercise expenditure responsibility under IRC 4945(d)(4) and (h) with respect to grants to them.)

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IRC 4942(j)(3) – Private Operating Foundations, Continued

General Requirements of Private Operating Foundation Status

Under IRC 4942(j)(3), a private operating foundation must meet an "income" test and, in addition, one of three alternative tests:

- An "assets" test,
- An "endowment" test, and
- A "support" test.

The tests are applied each year (on the basis of operations over the past three or four years, as discussed below).

Therefore, a private foundation might qualify as a private operating foundation in year 1 but not year 2, in which case the foundation would need to meet the distribution requirements of IRC 4942 for year 2 or else be subject to IRC 4942 excise tax.

Tests of Private Operating Foundation Status: Income Test - In General

To satisfy the income test of IRC 4942(j)(3)(A), a private foundation must make qualifying distributions directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated (i.e., must make direct exempt-function distributions) equal to substantially all of the lesser of :

- Its adjusted net income **or**
 - Its minimum investment return.
 - "Qualifying distributions" are defined in IRC 4942(g)(1) and generally include amounts paid or set aside to accomplish charitable, religious, educational, etc., purposes or amounts contributed to a governmental unit for exclusively public purposes. (Also included are reasonable and necessary administrative expenses that a foundation incurs in implementing these purposes, for example, salaries, wages, items of overhead, and other expenses paid in furtherance of a foundation's exempt purposes are, subject to a reasonable and necessary limitation, qualifying distributions. For a sample computation, *see* Reg. 53.4942(a)-3(a)(8), *Example 1.*)
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IRC 4942(j)(3) – Private Operating Foundations, Continued

Tests of Private Operating Foundation Status: Income Test - In General, continued

- "Substantially all," in this context, means 85 percent or more. Reg. 53.4942(b)-1(c).
 - "Minimum investment return" is defined in IRC 4942(e) and generally means 5 percent of the fair market value of the foundation's assets, other than assets used (or held for use) directly in the foundation's exempt functions, less related acquisition indebtedness. (If the adjusted net income exceeds the minimum investment return for the year, then substantially all of the foundation's qualifying distributions (except any in excess of adjusted net income) must be direct exempt-function distributions. *See* IRC 4942(j)(3) (last sentence); Reg. 53.4942(b)-1(a)(1).)
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Meaning of Directly for the Active Conduct of Exempt Activities -- In General

- The following standards, set forth under Reg. 53.4942(b)-1(b)(1) (unless otherwise noted), apply in determining whether a foundation has made a particular distribution directly for the active conduct of activities constituting its exempt purpose or function (i.e., whether a distribution is a direct exempt-function distribution).
- In general, such distributions must be used by the foundation itself - grants to other charities are considered an indirect rather than direct means of accomplishing exempt purposes.
 - Similarly, grants to individuals are also considered indirect unless they occur in the context of a program in which the foundation itself has significant involvement.
-

Exempt Activity Assets

Amounts paid to acquire or maintain assets used directly in the conduct of the foundation's exempt activities, such as the operating assets of a museum, public park, or historic site, are considered direct exempt-function distributions. (However, the depreciation of such assets is not a qualifying distribution. Rev. Rul. 74-560, 1974-2 C.B. 389.)

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Administrative Expenses Administrative expenses (such as staff salaries and traveling expenses) and other operating costs necessary to conduct the foundation's exempt activities (whether direct or indirect) are treated as direct exempt-function distributions if reasonable in amount.

- The administrative expenses of screening and investigating grant applicants may be treated as direct exempt-function distributions even if the grants themselves are not. Reg. 53.4942(b)-1 (b)(2)(i)(b). Reasonable legal fees paid to determine the proper beneficiary of a foundation are administrative expenses necessary to conduct the foundation's exempt activities. Rev. Rul. 75-495, 1975-2 C.B. 449.
- Administrative expenses and operating costs not attributable to exempt activities, such as expenses in connection with the production of income, are not treated as exempt-function distributions.
- Expenses attributable to both direct exempt programs and other functions or activities, such as the production of income, must be allocated on a reasonable and consistently applied basis.

Set Asides Any amount that a foundation sets aside for a specific project, such as for the acquisition of a building that will be used by the foundation directly for the active conduct of its exempt activities will qualify as a direct expenditure if the set-aside qualifies under IRC 4942(g)(2) and Reg. 53.4942(a)-3(b).

Example

A private operating foundation's conversion of a portion of its newly acquired land into an extension of its existing wildlife sanctuary and the remainder into a public park under a four-year construction contract under which payments are mainly during the last two years constitutes a "specific project" and the foundation's set-aside of all its excess earnings for four years, for which it files a timely justifying application with the Service, will be treated as a qualifying distribution under IRC 4942(g)(2), in applying the income test prescribed by IRC 4942(j)(3)(A), for each taxable year in which such earnings are set aside and remain unexpended. Rev. Rul. 74-450, 1974-2 C.B. 388.

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IRC 4942(j)(3) – Private Operating Foundations, Continued

IRC 4940 Tax Payment of the IRC 4940 investment excise tax is treated as a direct exempt function distribution. Reg. 53.4942(b)-1(b)(3).

Payments to Individual Beneficiaries -- The Meaning of Significant Involvement, continued

Grants, scholarships, program-related investments, or other payments to individuals constitute direct exempt-function distributions only if the grantor foundation maintains some "significant involvement" in the active programs in support of which such grants are made. Reg. 53.4942(b)-1 (b)(2)(i).

Reg. 53.4942(b)-1(b)(2)(ii)(A) and (B) describe two general contexts in which grant-making will be considered "significant involvement" by a foundation. They are:

- Where all three of the following circumstances exist:
 1. An exempt purpose of the foundation is relief of the poor or distressed, and its activities provide such relief;
 2. The making of such grants is direct and without the assistance of an intervening organization or agency; and
 3. The foundation maintains a staff of administrators, researchers, or other personnel who supervise and direct these activities on a continuing basis. See Reg. 53.4942(b)-1(d), *Example (8)*.

Note: In *The Miss Elizabeth D. Leckie Scholarship Fund v. Commissioner* 87 T.C. 251 (1986), *acq. in result*, 1987-1 C.B. 1, the Tax Court held that the requirements of Reg. 53.4942(b)-1(b)(2)(ii)(A) were met where, in addition to granting college scholarships to county high school students largely on the basis of need, the foundation engaged in activities to induce the scholarship recipients to return to the county after completing their education, conducted county tours, and compiled data to promote the county as a desirable place to live.

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Payments to Individual Beneficiaries -- The Meaning of Significant Involvement, continued

- There is significant involvement under Reg. 53.4942(b)(1)(b)(ii)(B) where all three of the following circumstances exist:
 1. The foundation has developed some specialized skills, expertise, or involvement in a particular substantive area;
 2. The foundation maintains a salaried staff of administrators, researchers, or other personnel who supervise and conduct programs in the foundation's particular area of interest; and
 3. The foundation, as part of its program or activities, makes grants or other payments to individuals to encourage their involvement in the foundation's particular area of interest and in some part of its programs or activities. (An example would be grants under which the recipients, in addition to independent study, attend classes, seminars, or conferences sponsored or conducted by the foundation, or grants to engage in social work projects under the general direction and supervision of the foundation.) *See Reg. 53.4942(b)-1 (d), Examples (3)-(7) and (9).*

Program-related investments within the meaning of IRC 4944(c) made to corporate enterprises as well as to individuals may qualify as direct exempt-function distributions if the significant involvement requirements of Reg. 53.4942(b)-1 (b)(2)(ii)(A) or (B) are met (treating the corporate enterprises as individuals for such purposes). *See Reg. 53.4942(b)-1 (b)(2)(i).*

Example:

Rev. Rul. 78-315, 1978-2 C.B. 271, holds that where a trust's sole activity is operating a cultural center and the managing trustees form a corporation to operate the cultural center only as a corporate trustee of the trust, the trust's distributions to the corporation are direct exempt-function distributions rather than distributions to a grantee organization.

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Payments to Individual Beneficiaries -- The Meaning of Significant Involvement, continued

The determination whether payments constitute direct exempt-function distributions depends on the facts and circumstances. Reg. 53.4942(b)-1(b)(2)(i).

- Because the significant involvement test is qualitative rather than quantitative, individual grants may qualify as direct exempt-function distributions even if more of the foundation's funds are devoted to grants than to the active programs that such grants support. Reg. 53.4942(b)-1(b)(2)(i).
- However, the mere selection, screening, and investigation of grant applicants is not treated as significant involvement. Reg. 53.4942(b)-1(b)(2)(i). (*See also Examples (2) and (10) of Reg. 53.4942(b)-1(d), Examples (2) and (10) for payments that do not qualify as direct exempt-function distributions.*)

Adjusted Net Income

In determining whether a private foundation meets the income test of IRC 4942(j)(3)(A), it is sometimes necessary to calculate its adjusted net income.

- Adjusted net income is gross income less deductions allowed to corporations subject to tax under IRC 11, with certain modifications to income and deductions. IRC 4942(f)(1).
- Gross income includes all amounts derived from, or in connection with, property held by the foundation, including property used directly in an exempt function, in an unrelated trade or business, or otherwise. Reg. 53.4942(a)-2(d)(1)(i) and (2)(viii).

In computing gross income and deductions, the principles of subtitle A of the Code apply (unless these principles are inconsistent with IRC 4942 or the IRC 4942 regulations), but exclusions, deductions, and credits are not allowed unless expressly provided for under IRC 4942 or the IRC 4942 regulations. Reg. 53.4942(a)-2(d)(1).

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IRC 4942(j)(3) – Private Operating Foundations, Continued

**Adjusted Net
Income,
continued**

Examples

- For purposes of IRC 4942, a private foundation receiving annual payments, as beneficiary of a decedent's deferred incentive compensation income plan, includes each payment as gross income to the extent that it exceeds the amount attributable to the value of the right to receive the payment on the decedent's date of death. Rev. Rul. 75-442, 1975-2 C.B. 448.
- An IRC 501(c)(3) private foundation amortizes bond premium pursuant to IRC 171. Rev. Rul. 76-248, 1976-2 C.B. 353 holds that the amortizable bond premium may be deducted (to the extent that it would be deductible under IRC 171) by the private foundation in computing its net investment income under IRC 4940 and in computing its adjusted net income under IRC 4942.

IRC 4942(f)(2)(C) contains a "recapture" rule, under which certain amounts previously taken by the foundation as qualifying distributions are included in gross income. Under this rule, income includes:

- Amounts received or accrued as repayments of amounts previously claimed as a qualifying distribution under IRC 4942(g)(1)(A) for any taxable year. IRC 4942(f)(2)(C)(i). The key here is whether the amount had been claimed as a qualifying distribution, as shown in the following example:

A private foundation that made an interest-free loan from corpus to a public charity in a year in which its distribution requirements had been met and that continued to meet the distribution requirements during the five-year adjustment period without use of the excess of qualifying distributions created by the loan is not required to include in its gross income repayments on the loan and may return the payments to corpus. Rev. Rul. 77-252, 1977-2 C.B. 390.

- Notwithstanding the general rule for capital gains (discussed on page 2-154), amounts received or accrued from the sale or other disposition of property are included in income to the extent that the amount paid to acquire the property was taken into account as a qualifying distribution under IRC 4942(g)(1)(B) for any taxable year. IRC 4942(f)(2)(C)(ii).

Continued on next page

IRC 4942(j)(3) – Private Operating Foundations, Continued

Adjusted Net Income, continued

- Any amount set aside under IRC 4942(g)(2) is included in income to the extent that the amount is determined not to be necessary for the purposes for which it was set aside. IRC 4942(f)(2)(C)(iii).
 - Amounts taken into account in a preceding taxable year as a qualifying distribution under IRC 4942(g)(3), but that are not properly redistributed by the close of the donee organization's succeeding taxable year, are included in the donor foundation's income for its taxable year beginning after the close of the donee organization's taxable year following the donee organization's taxable year of receipt. Reg. 53.4942(a)-2(d)(2)(ix).
-

Other Income Modifications

Gifts, grants, and contributions to the foundation are excluded from income. Reg. 53.4942(a)-2(d)(1).

Example

- A foundation that receives a bequest of a decedent's right to receive deferred compensation payments includes in income only the portion (if any) of each payment that exceeds the value of the right to receive the payment on the date of the decedent's death, the remainder being treated as a gift to the foundation. Rev. Rul. 75-442, 1975-2 C.B. 448.

Interest from exempt bonds is included in income. IRC 4942(f)(2)(A).

Capital gains and losses are not taken into account, except for any net short-term capital gain (which, under IRC 1222(5), is any excess of short-term capital gain over short-term capital loss). IRC 4942(f)(2)(B).

Continued on next page

IRC 4942(j)(3) – Private Operating Foundations, Continued

Other Income Modifications, continued

- *Stanley O. Miller Charitable Fund v. Commissioner*, 89 T.C. 1112 (1987), upheld this rule as applied to charitable trusts, and as against Constitutional challenges.
- Net short-term capital loss is not carried back or forward to other tax years. Reg. 53.4942(a)-2(d)(2)(ii).
- Capital gain dividends received by a private foundation from a regulated investment company described in IRC 851 are includible in the foundation's net investment income in the year received for purposes of determining the excise tax imposed by IRC 4940(a) but are **excluded** from the foundation's adjusted net income for purposes of IRC 4942(f). Rev. Rul. 73-320, 1973-2 C.B. 385.
- Similarly, net IRC 1231 gains are not taken into account, but net IRC 1231 losses (treated as ordinary under IRC 1231(a)(2)) are taken into account. Reg. 53.4942(a)-2(d)(2)(ii).

Certain amounts received by a foundation in the redemption of stock in a corporate disqualified person in order to avoid excess business holdings are treated as not essentially equivalent to a dividend under IRC 302(b)(1) (and thus as amounts received in exchange for the stock, giving rise to long-term capital gain or loss if the conditions of Reg. 53.4942(a)-2(d)(2)(iv) are met).

Example

The redemption of stock from a private foundation to the extent necessary for the foundation to avoid the excess business holdings tax under IRC 4943 is a sale or exchange not equivalent to a dividend under IRC 302(b)(1) and the proceeds will be taxed neither as investment income nor as undistributed income. Rev. Rul. 75-336, 1975-2 C.B. 110.

If, as of the date of distribution of property for purposes described in IRC 170(c)(1) or (2)(B), its fair market value exceeds its adjusted basis, the excess is not deemed an amount includible in income. Reg. 53.4942(a)-2(d)(2)(v).

Income received from an estate is excluded from income unless, due to a prolonged period of administration, the estate is considered terminated under Reg. 1.641(b)-3(a). Reg. 53.4942(a)-2(d)(2)(vi).

Continued on next page

IRC 4942(j)(3) – Private Operating Foundations, Continued

Other Income Modifications, continued

In general, distributions received by a private foundation from a trust created and funded by someone other than the foundation itself are excluded from the foundation's gross income. Reg. 53.4942(a)-2(d)(2)(vii).

- The income portion of distributions received from 4947(a)(2) trusts with respect to amounts placed in trust after May 26, 1969 are included in income. See Reg. 53.4942(a)-2(d)(2)(vii), which cross references Reg. 53.4942(a)-2(b)(2).
- While Reg. 53.4942(a)-2(b)(2) was held invalid as applied to the minimum investment return requirement of IRC 4942(d) in *Ann Jackson Family Foundation v. Commissioner*, 15 F.3d 917 (9th Cir. 1994), *aff'g* 97 T.C. 534 (1991), the courts did not decide whether the regulation is valid as applied to adjusted net income.

No interest is imputed under IRC 483 in an installment sale of property pursuant to a binding contract (including an irrevocable written option) made in a taxable year beginning before Jan. 1, 1970, unless a substantial change in the contract terms (determined under Reg. 1.483-1 (b)(4)) is made on or after Jan. 1, 1970. IRC 4942(f)(2)(D) and Reg. 53.4942(a)-2(d)(2)(x). Note, however, that payments expressly designated as interest on loans made before 1970 are included in income.

Example

Repayments of principal received by a private foundation in taxable years beginning after 1969 on loans made in prior years to individuals for charitable purposes are not includible in its gross income to determine its adjusted net income for purposes of IRC 4942(f); however, payments of interest on such loans are includible. Rev. Rul. 75-443, 1975-2 C.B. 449.

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Deductions

With respect to the deduction modifications in computing adjusted net income, first note that the IRC 4942(f)(3) modifications to deductions otherwise allowable against gross income under IRC 4942(f)(1)(B) allow far less deductions than those allowable to a corporation taxable under IRC 11.

- In general, no deduction is allowed other than all the ordinary and necessary expenses paid or incurred for the production or collection of gross income or for the management, conservation, or maintenance of property held for the production of such income. IRC 4942(f)(3)(A).
- Other deductions, such as the charitable contributions deduction under IRC 170, the net operating loss deduction under IRC 172, or the special deductions under IRC 241-249 including the dividends-received deductions, are not allowed. Reg. 53.4942(a)-2(d)(4)(i).
- Deductions for depreciation and depletion are allowed as determined under IRC 4940(c)(3)(B) (straight-line depreciation, cost depletion). IRC 4942(f)(3)(A).
- Since exempt-bond interest income is taken into account, related deductions are also, and IRC 265 does not apply. IRC 4942(f)(3)(B).
- Where an expense relates partly to production of income and partly to the conduct of exempt functions (such as an officer's compensation or a maintenance expense for property part of which is used for production of income), the expense must be allocated between the two functions, and only the portion relating to production of income is deductible. Reg. 53.4942(a)-2(d)(4)(i).

Assets Test -- In General

A private foundation will meet the assets test of IRC 4942(j)(3)(B)(i) and Reg. 53.4942(b)-2(a)(1) if substantially more than half of the fair market value of its assets must be:

- devoted directly to exempt functions,
- devoted directly to functionally related businesses,
- stock of a corporation which is controlled by the foundation and substantially all of the assets of which are so devoted, or
- some combination of the above.

Continued on next page

IRC 4942(j)(3) – Private Operating Foundations, Continued

Terms Used in the Assets Test

- "Substantially more than half" means 65 percent or more. Reg. 53.4942(b)-2(a)(5).
- "Fair market value" is generally determined in accordance with the rules of Reg. 53.4942(a)-2(c)(4) regarding the valuation of assets. The exception here involves assets that are devoted directly to the conduct of the foundation's exempt activities and for which neither a ready market nor standard valuation methods exist (such as historical objects or buildings, certain works of art, and botanical gardens). In such cases, the historical cost (unadjusted for depreciation) shall be considered equal to fair market value unless the foundation demonstrates that fair market value is other than cost. Reg. 53.4942(b)-2(a)(4)
- "Functionally related business" is any trade or business that is not unrelated under IRC 513, or that is an unrelated business but is carried on within a larger aggregate of similar activities or larger complex of other endeavors that is not unrelated. IRC 4942(j)(4) and Reg. 53.4942(a)-2(c)(3)(iii)(a). Note that Rev. Rul. 76-85, 1976-1 C.B. 357 holds that a business in which substantially all the work is performed without compensation is a functionally related business, because it falls under the volunteer labor exception of IRC 513(a)(1). Rev. Rul. 76-85, 1976-1 C.B. 357.
- "Controlled by the foundation" is determined in accordance with IRC 368(c).

Reg. 53.4942(b)-2(a)(6), *Example (1)*, describes an IRC 501(c)(3) private foundation that maintains and operates an historic area for the benefit of the public. It operates lodging and other visitor accommodations through a wholly-owned, separately incorporated taxable subsidiary. These facilities comprise substantially all of the subsidiary's assets. Since the operation of these facilities constitute a functionally related business with respect to the parent foundation, the subsidiary's stock will be considered part of the foundation's assets and may be taken into account in determining whether the foundation satisfies the assets test.

Continued on next page

IRC 4942(j)(3) – Private Operating Foundations, Continued

Assets Held for Part of the Year Assets held for part of the taxable year are taken into account by multiplying the fair market value by the fraction of the number of days that the foundation held the asset, divided by the number of days in the taxable year.

"Functionally Related Business" A "functionally related business" is any trade or business that is not an unrelated trade or business under IRC 513, or that is an unrelated business but is carried on within a larger aggregate of similar activities or larger complex of other endeavors that is not unrelated. IRC 4942(j)(4) and Reg. 53.4942(a)-2(c)(3)(iii).

Examples

A business in which substantially all the work is performed without compensation is a functionally related business. Rev. Rul. 76-85, 1976-1 C.B. 357.

Reg. 53.4942(b)(2)-(a)(6) *Examples*. The provisions of this paragraph may be illustrated by the following examples. It is assumed that none of the organizations described in these examples is described in section 509(a)(1), (2), or (3).

Example (1)

W, an exempt organization described in section 501(c)(3), is devoted to the maintenance and operation of an historic area for the benefit of the general public. W has acquired and erected facilities for lodging and other visitor accommodations in such area, which W operates through a wholly owned, separately incorporated, taxable entity. These facilities comprise substantially all of the subsidiary's assets. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of Sec. 53.4942(a)-2. Under these circumstances, the stock of the subsidiary will be considered as part of W's assets which may be taken into account by W in determining whether it satisfies the assets test described in this paragraph.

Example (2)

M, an exempt conservation organization described in section 501(c)(3), is devoted to acquiring, preserving, and otherwise making available for public use geographically diversified areas of natural beauty. M has acquired and erected facilities for lodging and other visitor accommodations in national park areas. The operation of such accommodations constitutes a functionally related business within the meaning of paragraph (c)(3)(iii) of Sec. 53.4942(a)-2. Therefore, M's assets, which are directly devoted to such visitor accommodations, may be taken into account by M in determining whether it satisfies the assets test described in this paragraph.

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IRC 4942(j)(3) – Private Operating Foundations, Continued

"Functionally Related Business", continued

Example (3)

P, an exempt organization described in section 501(c)(3), is devoted to acquiring and restoring historic houses. To insure that the restored houses will be kept in the restored condition, and to make the houses more readily available for public display, P rents the houses rather than sells them once they have been restored. The rental income derived by P is substantially less than the amount which would be required to be charged in order to recover the cost of purchase, restoration, and maintenance of such houses. Therefore, such houses may be taken into account by P in determining whether it satisfies the assets test described in this paragraph.

Example (4)

Z, an exempt organization described in section 501(c)(3), is devoted to improving the public's understanding of Renaissance art. Z's principal assets are a number of paintings of this period which it circulates on an active and continuing basis to museums and schools for public display. These paintings constitute 80 percent of Z's assets. Under these circumstances, although Z does not have a building in which it displays these paintings; such paintings are devoted directly to the active conduct of activities constituting Z's exempt purpose. Therefore, Z has satisfied the assets test described in this paragraph.

Whether an Asset is Devoted Directly to Exempt Functions or Functionally Related Businesses

An asset is devoted directly to exempt functions or functionally related businesses only if the foundation actually uses the asset in such manner. Reg. 53.4942(b)-2(a)(2)(i) and Reg. 53.4942(b)-2(a)(6), *Examples (2) and (4)*.

Assets held for investment, the production of income, or similar use are not devoted directly to exempt functions. Reg. 53.4942(b)-2(a)(2)(i).

- Whether an asset is held for such use is a question of fact. Reg. 53.4942(b)-2(a)(2)(i).
 - For example, use of an office building by endowment fund managers is not a direct exempt-function use. Reg. 53.4942(b)-2(a)(2)(i).
 - While the leasing of property to others is generally not a direct exempt function, property acquired for use in direct exempt functions may be considered as so used even though it is leased (in whole or part) for a limited and reasonable period of time (such as one year) during which the foundation arranges to use the property for the purpose acquired. Reg. 53.4942(b)-2(a)(2)(i).
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IRC 4942(j)(3) – Private Operating Foundations, Continued

Whether an Asset is Devoted Directly to Exempt Functions or Functionally Related Businesses, continued

- The leasing of property by the foundation to others is considered a direct exempt function if the rental income is less than the amount required to be charged in order to recover the cost of purchase and maintenance of the property (taking into account the deductions permitted in calculating adjusted net income, such as straight-line depreciation). Reg. 53.4942(b)-2(a)(2)(i) and Reg. 53.4942(b)-2(a)(6), *Example (3)*.

Dual Use Assets Allocation rules prevail here.

Example

A private foundation owns a building, a portion of which is used directly in carrying out its exempt purposes, with the remainder leased to commercial tenants. The percentage of exempt use of the building, for purposes of determining the foundation's minimum investment return under IRC 4942(e), should be determined by dividing the fair rental value of that portion of the building used for exempt purposes by the fair rental value of the entire building. (A square footage computation should not be used.) Rev. Rul. 82-137, 1982-2 C.B. 303.

Property is considered to be used exclusively for direct exempt functions if such use is 95 percent or more of the total use. Otherwise, if property is used only partly for direct exempt functions, allocation of the uses must be made. Reg. 53.4942(b)-2(a)(2)(i).

Amounts Set Aside / Assets Held for the Purpose of Extending Credit

For purposes of the assets test, amounts set aside are not treated as used directly for exempt functions. Reg. 53.4942(b)-2(a)(2)(ii)(B).

Similarly, assets held to extend credit or make funds available to members of a charitable class (e.g., assets set aside to guarantee student loans made by banks) are not considered as devoted directly to exempt functions. Reg. 53.4942(b)-2(a)(2)(ii)(A). However, a foundation's program-related investment is considered as devoted directly to exempt functions if the foundation meets the "significant involvement" requirement. Reg. 53.4942(b)-2(a)(2)(ii)(A).

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Other Guidance on Use of Assets

IRC 4942(e)(1)(A) (pertaining to assets excluded from calculating minimum investment return) and Reg. 53.4942(a)-2(c)(3) and authorities there under also provide guidance on whether a foundation uses an asset directly for exempt functions or in a functionally related business, although such rules also include assets "held for use" within a reasonable period of time even if they are not actually used for such purposes in the tax year at issue.

Examples

- A collection of paintings, owned by a private foundation formed to further the arts, that are loaned under an active loan program for exhibition in museums, universities, and similar institutions, are being used directly in carrying out the foundation's exempt purposes within the meaning of IRC 4942(e)(1)(A), and the value of the paintings is excludable in computing the foundation's minimum investment return. Rev. Rul. 74-498, 1974-2 C.B. 387.
- Private foundation's ownership and maintenance of island. The value of an island, owned by a private foundation dedicated to preserve the natural ecosystems and historical and archaeological remains on the island that has no residential use and to which present access is limited to invited public and private researchers, may be excluded from the foundation's minimum investment return under IRC 4942(e). Rev. Rul. 75-207, 1975-1 C.B. 361.

Endowment Test

To satisfy the endowment test of IRC 4942(j)(3)(B)(ii), a private foundation must normally make qualifying distributions directly for exempt functions in an amount not less than two-thirds of its minimum investment return.

- In effect, the endowment test requires direct exempt-function distributions of $3\frac{1}{3}$ percent (i.e., two-thirds of 5 percent) of the fair market value of the foundation's assets (other than assets used or held for use directly in carrying out the foundation's exempt purposes) less related acquisition indebtedness.
- In applying this test, no tracing is required to determine whether the qualifying distributions were made from investment income or contributions. Reg. 53.4942(b)-2(b)(1).

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Endowment Test, continued An example of how the endowment test operates is set forth in Reg. 53.4942(b)-2(b)(3):

X, an exempt organization described in section 501(c)(3) and not described in section 509(a)(1), (2), or (3), was created on July 15, 1970. X uses the cash receipts and disbursements method of accounting. For 1971, the fair market value of X's assets [for determining minimum investment return] is \$400,000. X makes qualifying distributions for 1971 directly for the active conduct of its exempt activities of \$17,000. For 1971 two-thirds of X's minimum investment return is \$16,000 (6 percent x \$400,000; $2/3 \times \$24,000 = \$16,000$). However, if X's qualifying distribution for 1971 directly for the active conduct of its exempt function activities were only \$15,000, X would not satisfy the endowment test for 1971, unless the fair market value of its assets [for determining the minimum investment return] was no greater than \$375,000 (6 percent x \$375,000 = \$22,500; $2/3 \times \$22,500 = \$15,000$).

In most cases, the foundation satisfies the endowment test if it satisfies the income test. Only where the minimum investment return is markedly higher than adjusted net income does the endowment test (and thus the other alternative tests as well) have independent significance.

Support Test There are three requirements for a private foundation to satisfy the support test of IRC 4942(j)(3)(B)(iii):

In General

1. Substantially all of its support (other than gross investment income as defined in IRC 509(e)) must normally be received from the general public and from five or more exempt organizations that are not private foundations described in IRC 4946(a)(1)(H) with respect to each other or the recipient foundation;
 2. Not more than 25 percent of its support (other than gross investment income) may normally be received from any one exempt organization; and
 3. Not more than half of its support may normally be received from gross investment income.
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IRC 4942(j)(3) – Private Operating Foundations, Continued

Meaning of Support

The term "support" has the same meaning as the term "support" in IRC 509(d). Reg. 53.4942(b)-2(c)(2)(i).

- For purposes of IRC 509(d) and chapter 42, the term "support" includes (but is not limited to):
 - Gifts, grants, contributions, or membership fees,
 - Gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business (within the meaning of section 513),
 - Net income from unrelated business activities, whether or not such activities are carried on regularly as a trade or business,
 - Gross investment income (as defined in subsection (e)),
 - Tax revenues levied for the benefit of an organization and either paid to or expended on behalf of such organization, and
 - The value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit referred to in section 170(c)(1) to an organization without charge.
- The term support does not include any gain from the sale or other disposition of property which would be considered as gain from the sale or exchange of a capital asset, or the value of exemption from any Federal, State, or local tax or any similar benefit.
- The support received from any one exempt organization may not be counted toward satisfaction of the support test unless the foundation receives support from at least five exempt organizations. Reg. 53.4942(b)-2(c)(2)(iii).
- Support received from any particular individual or nonexempt organization (other than a governmental unit) is taken into account as support from the general public only to the extent that it does not exceed 1 percent of the foundation's total support (other than gross investment income). Reg. 53.4942(b)-2(c)(2)(iv).

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Meaning of Support, continued

- Support from two or more persons related to one another as described in IRC 4946(a)(1)(C)-(G) is treated as support from one person. Reg. 53.4942(b)-2(c)(2)(iv).
 - Support from a governmental unit described in IRC 170(c)(1) is treated as support from the general public but is not subject to the 1 percent limitation. Reg. 53.4942(b)-2(c)(2)(iv).
-

Certain Elderly Care Facilities

IRC 4942(j)(5) and Reg. 53.4942(b)-1 (a)(2) provide that for purposes of IRC 4942 (but no other IRC provision), a private operating foundation includes a foundation that meets the following three requirements:

1. The foundation operates and maintains (as its principal functional purpose) residential facilities for the long-term care, comfort, maintenance, or education of permanently and totally disabled persons, elderly persons, needy widows, or children;
2. The foundation has operated and maintained such facilities continuously from May 26, 1969 to the close of the taxable year; and
3. The foundation meets the endowment test of IRC 4942(j)(3)(B)(ii).

To meet the "principal functional purpose" requirement, a foundation must be organized for such principal purpose and must directly operate and maintain such facilities as its primary activity. Reg. 53.4942(b)-1(a)(2)(ii).

Operating and maintaining such facilities is treated as a foundation's primary activity if at least 50 percent of its qualifying distributions are normally made to operate and maintain such facilities. Reg. 53.4942(b)-1(a)(2)(ii).

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Periods Over Which the Income and Alternative Tests Must Be Met and Permissible Methods of Calculation

Under Reg. 53.4942(b)-3(a), a foundation generally satisfies the income test and one of the three alternative tests for the tax year in question by satisfying the tests using one of two methods:

1. For any 3 tax years during the last 4 tax years including the year in question, considering each of the 3 years separately (the 3-out-of-4-year method), or
2. For the 4-tax-year period including the year in question, by aggregating the figures for the 4 years (the aggregation method).

Therefore, an organization in existence for 4 or more tax years cannot claim operating foundation status for a particular year unless it has met the income and alternative tests for at least two years prior to the year in question (using the 3-out-of-4-year method) or the 4-tax-year period ending on the year in question (using the aggregation method).

A foundation must use the same method for both the income test and the alternative test in its 3-year or 4-year calculations on Form 990-PF for a given year, but may use the other method for the two tests the following year. Reg. 53.4942(b)-3(a).

A foundation may fail to qualify as an operating foundation in one year and qualify in the following year, but the qualification in the latter year will not serve to retroactively qualify the foundation in the former year. Reg. 53.4942(b)-3(a).

Special Rules Pertaining to the Periods and Methods for New Organizations

For organizations in existence for at least 1 but fewer than 4 tax years, the organization must use the aggregation method, which is applied to all of the tax years. Reg. 53.4942(b)-3(b)(1).

An organization will be treated as a private operating foundation prior to the end of its first tax year if it has made a good-faith determination that it is likely to satisfy the tests for its first tax year. Reg. 53.4942(b)-3(b)(2). The good-faith determination is ordinarily considered as made where based on an affidavit or opinion of the organization's counsel, and must set forth sufficient facts for the Service to be able to determine that the organization is likely to satisfy the tests. Reg. 53.4942(b)-3(b)(2).

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Special Rules Pertaining to the Periods and Methods for New Organizations, continued

- A foundation that is treated as a private operating foundation for its first tax year based on the good-faith determination but actually fails to qualify will be treated as a non-operating foundation as of the beginning of its second tax year for all Code purposes, unless the foundation establishes to the satisfaction of the Service that it is likely to qualify as an operating foundation on the basis of its second, third, and fourth tax years. Reg. 53.4942(b)-3(b)(2).
 - If the foundation actually fails to qualify in its second, third, or fourth year, then it will be treated as a nonoperating private foundation as of the beginning of the year in which it fails to qualify and until it qualifies for a particular year on the basis of the aggregation method (for a full 4 tax years) or the 3-out-of-4-year method. Reg. 53.4942(b)-3(b)(2).
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Procedures for Obtaining Recognition of Private Operating Foundation Status

Reg. 1.508-1(b)(5) and Rev. Procs. 76-34, 1976-2 C.B. 657, and 98-4, 1998-1 I.R.B. 113, 122, 125, set forth procedures for applying for and issuing, modifying, and revoking rulings and determination letters on operating foundation status.

- Operating foundations may obtain the Service's recognition of such status in the process of applying for recognition of 501(c)(3) exemption by completing Schedule E of Form 1023.
- Foundations may also separately request a determination letter on private operating foundation status (Schedule E of Form 1023 may be used for submitting pertinent information).

Such applications and rulings are subject to the declaratory judgment rights under IRC 7428. *See* IRC 7428(a)(1)(C); Rev. Proc. 90-27, 1990-1. C.B. 514, §3.03.

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IRC 4942(j)(3) – Private Operating Foundations, Continued

Rules for Reliance by Contributors on Private Operating Foundation Status

A grant to a foreign organization that has not received a ruling on private operating foundation status may be treated as a grant to a private operating foundation if the grantor foundation makes a "good faith determination" that the grantee is a private operating foundation. Reg. 53.4942(a)-3(a)(6).

- Rev. Proc. 92-94, 1992-1 C.B. 507, sets forth a procedure for private foundations to make the good-faith determination.

Although rulings and determinations relating solely to private operating foundation status and other nondisclosable matters (and not part of the organization's application for tax-exempt status) are not subject to public disclosure under IRC 6104 or 6110 (Reg. 301.6104(a)-1 (i)(5)), organizations recognized as private operating foundations under IRC 4942(j)(3) are listed as such in Publication 78. Furthermore, all private foundations claiming operating foundation status must fill out the relevant schedule of Form 990-PF, which is subject to public disclosure.

Under Reg. 53.4942(b)-3(d), contributors, with respect to IRC 170, and grantors, (hereafter "contributors"), with respect to IRC 4942, may rely on a foundation's private operating foundation classification by the Service where all of the following circumstances exist:

- The Service has not published notice of the foundation's change in status (such as in the Internal Revenue Bulletin);
- The contributor has no knowledge that the Service has given notice to the foundation that it would be classified as a nonoperating foundation; and
- The contributor is neither responsible for nor aware of any act or failure to act resulting in the foundation's inability to satisfy the requirements of private operating foundation status (a contributor will not be considered responsible for or aware of such an act or failure to act if the contributor makes his contribution in reliance on a written statement, described in Reg. 53.4942(b)-3(d)(2), by the grantee foundation).

Note: *See also* Reg. 1.508-1(b)(5) and (6) and Rev. Proc. 82-39, 1982-1 C.B. 759.

IRC 507 – Termination of Private Foundation Status

Introduction

IRC 507, dealing with the termination of private foundation status, was enacted in the Tax Reform Act of 1969, at the same time as the chapter 42 private foundation provisions. chapter 42 imposes various rules on organizations and entities that qualify as private foundations as opposed to organizations that are public charities. These rules include the imposition of excise taxes on acts such as self-dealing or the making of taxable expenditures.

- The Joint Committee on Internal Revenue Taxation, in its *General Explanation of Tax Reform Act of 1969*, 91st Cong., 2d Sess. 54-55 (1970), explained the rationale of IRC 507 as follows:

Under prior law, an organization was exempt if it met the requirements of the code, whether or not it sought an “exemption certificate” from the IRS.

If an organization did not continue to meet the requirements for exemption, if it committed certain specifically prohibited acts (sec. 503), or if it dealt in certain prohibited ways with its accumulated earnings (sec. 504), it lost its exempt status. This loss of exempt status might relate back to the time the organization first violated the code’s requirements. However, if the violation occurred after the contributions had been made to the organization, no deductions were disallowed to such contributors. Also, the organization’s income tax exemption was not disturbed for years before the organization’s first violation.

Congress was concerned that in many cases under prior law the loss of exempt status would impose only a light burden on many foundations. This was true in those circumstances, for example, where the foundation had already received sufficient charitable contributions to provide its endowment and where the foundation could retain its exemption as to its current income by qualifying under an exemption category other than section 501(c)(3).

- The purpose of IRC 507 is to prevent private foundations from avoiding the chapter 42 provisions by becoming something other than an IRC 501(c)(3) private foundation, such as an IRC 501(c)(4) social welfare organization or a taxable entity. The benefits of receiving tax-deductible contributions and building up assets while receiving the benefits of a tax-exempt organization are balanced by the termination requirements of IRC 507. Essentially, Congress determined that a private foundation’s status could be terminated if:

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

Introduction, continued

- the assets were used by a public charity, or
- all of the income, estate, and gift tax benefits received by the private foundation and by its substantial contributors were recaptured.

Additionally, the transferee liability rules in IRC 507 ensure that a private foundation cannot avoid the chapter 42 rules by transferring its assets to one or more private foundations. IRC 507 provides that the transferee private foundation acquires the transferor private foundation's attributes.

Overview

This section covers the following topics:

- General rules for terminating private foundation status
 - Termination by distributing net assets to certain public charities
 - Termination by operation as a public charity
 - Transferring assets from one private foundation to another
 - Tax implications under IRC 507(c)
-

Technical Overview

- Once an organization is classified as a private foundation, by virtue of not meeting the requirements of IRC 509(a)(1) through (4), it is subject to the regulatory provisions of chapter 42 and to the supervision that results from its administrative enforcement.

Congress, however, did not believe that the private foundation provisions and supervision were necessary for those IRC 501(c)(3) organizations that were not private foundations by reason of being described in IRC 509(a)(1), (2), or (3). These organizations were already subject to broad public supervision due to their dependency on public support, their operation in the public interest, or their control by a publicly supported organization.

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IRC 507 – Termination of Private Foundation Status, Continued

Technical Overview, continued

- Once an organization is a private foundation, it can only terminate its private foundation status by demonstrating that regulatory supervision is no longer necessary. The only way an organization can terminate its private foundation status is to comply with the requirements of IRC 507, i.e., by showing that its assets are subject to public supervision, either through transfer of its assets to an IRC 509(a)(1) charity, by operation as an IRC 509(a)(1), (2) or (3) charity, or by payment of the IRC 507 tax.
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Presumption and Continuance of Private Foundation Status

IRC 508(b) sets up a presumption of private foundation status. Any organization which does not demonstrate that it falls within the definition of a publicly supported organization will be treated as a private foundation. Thus, an organization described in IRC 501(c)(3) is presumed to be a private foundation unless it rebuts that presumption by demonstrating that it is described in IRC 509(a)(1) through (4).

- An organization may be presumed to be a private foundation when in fact it is not.
 - For example, if an organization is presumed to be a private foundation because it failed to notify the Service, it is not precluded from later rebutting that presumption. If it proves that it was never a private foundation, it does not have to terminate under IRC 507. Private foundation status is only terminated once it has attached to an organization in fact, and the status only attaches if in fact the organization is not described in IRC 509(a)(1) through (4).
 - Once an organization described in IRC 501(c)(3) fails to meet the description of any of the IRC 509(a)(1) through (4) subsections, however, private foundation status attaches.
 - An organization which is a private foundation on October 9, 1969, or becomes one on any subsequent date, can therefore terminate that status only by one of the methods described in IRC 507. The rule is once a private foundation always a private foundation, unless status is terminated under IRC 507.
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IRC 507 – Termination of Private Foundation Status, Continued

**Relationship of
Private
Foundation
Status With
Exempt Status**

- Private foundation status exists independently of exempt status. Private foundation status may exist where an organization described in IRC 501(c)(3):
 - Has not applied for exemption,
 - Has had its exempt status revoked, or
 - Has applied for exemption under sections other than IRC 501(c)(3).
- For non-exempt charitable and split interest trusts, IRC 4947 provides that the trusts will be treated as organizations described in IRC 501(c)(3). Such organizations are, therefore, subject to the provisions of IRC 509, and, therefore, the provisions of chapter 42. IRC 507 is applicable to a non-exempt charitable trust which is a private foundation. IRC 507 is also generally applicable to split-interest trusts.
- If an organization, that is a private foundation, ceases to be described in IRC 501(c)(3), it will not lose its private foundation status. It will become a taxable private foundation. A taxable private foundation is still subject to chapter 42 and must meet the requirements of IRC 507 if it wishes to terminate its private foundation status.
- An organization cannot avoid private foundation status by reason of the fact that its activities are such that the organization could qualify under a section of the Code other than IRC 501(c)(3), where it no longer qualifies under IRC 501(c)(3).
- For example, if a social welfare organization qualifies under both IRC 501(c)(3) and (4) and is a private foundation, it cannot avoid private foundation status by then claiming exemption solely under IRC 501(c)(4).

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IRC 507 – Termination of Private Foundation Status, Continued

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| Termination of Private Foundation Status | <p>IRC 507 covers three areas that result in termination of private foundation status and one area in which private foundation status is not terminated.</p> <ul style="list-style-type: none">• IRC 507(a) terminations• IRC 507(b)(1)(A) terminations• IRC 507(b)(1)(B) terminations• IRC 507(b)(2) Transfers of Assets |
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| | |
|-------------------------------|--|
| IRC 507(a) Termination | <p>Under IRC 507A, a private foundation may be involuntarily terminated for repeated or flagrant violations of chapter 42 provisions. Private foundation status can also be voluntarily terminated under this section. The common result is the organization may be liable for the tax imposed under IRC 507(c).</p> |
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|-----------------------------------|---|
| IRC 507(b)(1) Terminations | <p>There are two kinds of termination of private foundation status described in IRC 507(b):</p> <ol style="list-style-type: none">1. Distribution of net assets to certain public charities. IRC 507(a)(1)(A)2. Operation as a public charity. IRC 507(a)(1)(B) <p>Private foundations terminating private foundation status under IRC 507(b) are not subject to the IRC 507(c) tax.</p> |
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| IRC 507(b)(1)(A) Terminations - Distributions of Net assets to Certain Public Charities | <p>A foundation may terminate its private foundation status if it distributes its net assets to one or more public charities. To accomplish the termination in this manner:</p> <ul style="list-style-type: none">• It must not have committed any act or failure to act giving rise to liability for tax under chapter 42;• It must distribute all of its right, title, and interest in and to all of its net assets;• The organization(s) to which it distributes must be public charities as described in IRC 170(b)(1)(A)(i)-(vi); and• The public charities must have been so described for a continuous period of at least 60 months. |
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IRC 507 – Termination of Private Foundation Status, Continued

**IRC
507(b)(1)(B)
Terminations**

A foundation may terminate its private foundation status by operating as a public charity for the designated period of time (60 months).

**IRC 507(b)(2)
Transfers**

A transferor private foundation may transfer all its assets to one or more private foundations that will, subject to the appropriate requirements in the regulations, “inherit” the characteristics of the transferor private foundation. The transferor private foundation may then go out of existence by a voluntary IRC 507(a) termination by "paying" an IRC 507(c) tax of zero because the transferor has zero assets at the date of termination.

**Status After
Termination**

An organization whose status as a private foundation is terminated under IRC 507 is treated as an organization created on the day after the date of such termination.

**Terminations
Under IRC
507(a)**

The status of an organization as a private foundation will be terminated only if:

- The organization notifies the Manager, Exempt Organizations Determinations, of its intent to accomplish such termination, or
- With respect to the organization there have been either willful repeated acts (or failures to act), or a willful or flagrant act (or failure to act), giving rise to tax liability under chapter 42; and the Service notifies the organization that it is therefore liable for IRC 507(c) taxes.

If tax liability is incurred, the organization either pays the IRC 507(c) tax, less any amount abated under IRC 507(g), if any, or has the entire amount abated under IRC 507(g). *See* Reg. 1.507-1(a).

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IRC 507 – Termination of Private Foundation Status, Continued

Voluntary IRC 507(a)(1) Terminations

- A statement of intent to voluntarily terminate private foundation status must set forth in detail the computation and amount of tax imposed under IRC 507(c). IRC 507(a)(1).
 - Full payment of the tax must be made when the statement is filed, less any amount that is the subject of an abatement request under IRC 507(g).
 - If a request for abatement is denied, the tax due must be paid in full upon notification of the denial. Reg. 1.507-1(b)(1).
- An IRC 507(a)(1) termination does not relieve a private foundation, or any disqualified person, of tax liability under chapter 42 for acts or failures to act prior to termination or for any additional taxes imposed for failures to correct such acts or failures to act. Reg. 1.507-1(b)(2).
- After an IRC 507(a)(1) termination, an organization wishing to be treated as described in IRC 501(c)(3) must apply for recognition of exemption under IRC 501(c)(3) in accordance with IRC 508(a). Reg. 1.507-1(b)(3).
- For purposes of the disallowance of charitable deductions under IRC 508(d), the Service will give public notice that it has received from a private foundation a notice of intent to terminate its status under IRC 507(a)(1). Reg. 1.507-1(b)(5).
- A transfer of assets described in IRC 507(b)(2) to one or more other private foundations (or one or more other private foundations and one or more IRC 509(a)(1), (2), (3), or (4) organizations) will not be a voluntary termination under IRC 507(a)(1). Reg. 1.507-1(b)(6).
- Neither a transfer of all of the assets of a private foundation nor a significant disposition of its assets will be deemed to result in a termination of the transferor's private foundation status under IRC 507(a)(1) unless the transferor elects to terminate pursuant to IRC 507(a)(1) or unless IRC 507(a)(2) is applicable. Reg. 1.507-1(b)(7).

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IRC 507 – Termination of Private Foundation Status, Continued

**Voluntary IRC
507(a)(1)
Terminations,
continued**

- If a transfer of all the assets of a private foundation or a significant disposition of its assets (Reg. 1.507-3(c)(2)) results in chapter 42 tax liability, or chapter 42 tax liability was incurred prior to the transfer by the transferor, transferee liability may be applied against the transferee organization for payment of such liability. Any chapter 42 tax liability incurred for failure to correct a past chapter 42 tax liability will be deemed incurred on the date on which the act or failure to act giving rise to the initial tax liability occurred. Reg. 1.507-1(b)(8).
- A private foundation that transfers all of its net assets must file the annual information return required by IRC 6033, and its managers must file the annual report of a private foundation required by IRC 6056, for the taxable year in which the transfer occurs. However, neither return is required for any taxable year following the taxable year in which the last of any such transfers occurred, if the organization has neither legal nor equitable title to any assets or engages in no activity during the subsequent years. Reg. 1.507-1(b)(9).

**Involuntary
IRC 507(a)(2)
Terminations**

For purposes of involuntary terminations under IRC 507(a)(2):

- The term "willful repeated acts (or failures to act)" means at least two acts or failures to act both of which are voluntary, conscious, and intentional (Reg. 1.507-1(c)(1));
- A "willful and flagrant act (or failure to act)" is one which is voluntarily, consciously, and knowingly committed in violation of any provision of chapter 42 (other than IRC 4940 or 4948(a)) and which would appear to be a gross violation to a reasonable person (Reg. 1.507-1(c)(2));
- An act (or failure to act) may be treated as an act by the private foundation for purposes of IRC 507(a)(2) even though tax is imposed upon one or more foundation managers and not upon the foundation (Reg. 1.507(c)(3));

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IRC 507 – Termination of Private Foundation Status, Continued

Involuntary IRC 507(a)(2) Terminations, continued

- A failure to correct an act or acts (or failure or failures to act) which gave rise to chapter 42 tax liability by the close of the correction period may be a willful and flagrant act (or failure to act) (Reg. 1.507(c)(4)); and
 - For an act (or failure to act) to be willful, a motive to avoid the restrictions of the law or the incurrence of any tax is not necessary; however, there must be knowledge on behalf of the foundation or a manager that an act (or failure to act) is one of self-dealing, a taxable expenditure, or other act (or failure to act) to which chapter 42 applies (Reg. 1.507-1(c)(5) and Reg. 53.4945-1(a)(2)(iii)).
-

Distribution of All Net Assets to Certain Public Charities – Termination Under IRC507(b)(1)(A)

Under IRC 507(b)(1)(A) a private foundation may terminate its status without incurring the tax imposed by IRC 507(c) provided:

- There have not been either willful, repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42; and
 - The organization distributes all of its net assets to one or more organizations described in IRC 170(b)(1)(A)(i) through (vi), each of which has been in existence and so described for a continuous period of at least 60 calendar months immediately preceding such distribution. Reg. 1.507-2(a)(1).
-

Notice Not Required

In order to terminate its private foundation status by distributing all of its net assets in compliance with the requirements of IRC 507(b)(1)(A), the organization is not required to file the notification described under IRC 507(a). The private foundation may, therefore, carry out the distributions without giving advance notice to the Service of its intent to terminate. Reg. 1.507-2(a)(1).

No Termination Tax

The IRC 507(c) termination tax is not imposed on organizations terminating under IRC 507(b)(1)(A); therefore, no abatement of such tax under IRC 507(g) is required. Reg. 1.507-2(a)(1).

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IRC 507 – Termination of Private Foundation Status, Continued

**Organizations
Qualifying as
Distributees**

The distribution of net assets must be to one or more organizations described in IRC 170(b)(1)(A)(i) through (vi), in effect, IRC 509(a)(1) organizations. IRC 509(a)(1) excludes these organizations from the definition of private foundations. Briefly, the types of organizations that generally qualify as distributees are:

- Churches or conventions or associations of churches—IRC 170(b)(1)(A)(i);
- Schools-IRC 170(b)(1)(A)(ii);
- Hospitals-IRC 170(b)(1)(A)(iii);
- Medical research organizations operated in conjunction with a hospital-IRC 170(b)(1)(A)(iii);
- Organizations receiving substantial public support or governmental support (exclusive of income received from the exercise or performance of their exempt function) and operated for the benefit of a college or university owned or operated by a governmental unit-IRC 170(b)(1)(A)(iv);
- Governmental units described in IRC 170(c)(1)-IRC 170(b)(1)(A)(v); and
- Organizations that normally receive a substantial part of their support (exclusive of income received from the exercise or performance of their exempt function) from the public or the government-IRC 170(b)(1)(A)(vi).

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IRC 507 – Termination of Private Foundation Status, Continued

Distributee Must Have Been in Existence for 60 Calendar Months

A distributee organization must have been in existence and must have been so described for a continuous period of at least 60 calendar months immediately preceding the distribution. Reg. 1.507-2(a)(1).

- However, a distributee organization in existence less than 60 months prior to receiving distribution will qualify as a proper distributee where it was formed from the consolidation of two public charities each of which would have been in existence for 60 months at the time of distribution had they not been consolidated. Rev. Rul. 75-289, 1975-2 C.B. 215.
 - For the effect of transfers to organizations not described in IRC 170(b)(1)(A)(i) through (vi), see section on Distribution of Net Assets, on page 2-180.
-

Other Issues Relating to Distributees

- An organization that qualifies under IRC 170(b)(1)(A)(i) through (vi) is not precluded from being a qualified distributee merely because it also appears to meet the description of an IRC 170(b)(1)(A)(vii) or (viii) organization. Reg. 1.507-2(a)(3).
 - If, within a period of three years from the date of transfer, the transferee organization becomes a private foundation, the transfer may be considered a transfer under IRC 507(b)(2). Reg. 1.507-3(e).
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Reliance on Distributee's Ruling Letter

An organization seeking to terminate its private foundation status under IRC 507(b)(1)(A) may, with respect to distributions made after December 29, 1972, rely on a final ruling or determination letter issued to a potential distributee organization that such distributee is described in IRC 170(b)(1)(A)(i) thru (vi) until public notice is given of revocation of the distributee's classification or public notice is given that grantors may be affected pending verification of the continued foundation status classification of the distributee except where the distributor or grantor:

- Had knowledge that the distributee's foundation classification letter was revoked, or
 - Was in part responsible for, or was aware of, the act, the failure to act, or the substantial and material change on the part of the organization which gave rise to the revocation of the distributee's determination letter.
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IRC 507 – Termination of Private Foundation Status, Continued

Distribution of Net Assets

In order to terminate its private foundation status under IRC 507(b)(1)(A), an organization is required to distribute all of its right, title, and interest in and to all of its net assets to one or more IRC 509(a)(1) organizations in existence and so described for a continuous period of at least 60 calendar months preceding the distribution. Reg. 1.507-2(a)(7).

- For the effect of restrictions and conditions upon distribution of net assets, *see* Reg. 1.507-2(a)(8).
- If a private foundation transfers all of its net assets, but less than all of its net assets to one or more 60-month IRC 509(a)(1) organizations, the foundation will not have terminated its private foundation status. If such a foundation subsequently receives a grant, the grant will be considered to have been made to a private foundation. Reg. 1.507-1(b)(7).
- Neither IRC 507(b)(1)(A) nor the regulations establish a fixed period of time within which the distribution of all of the organization's net assets must be completed. The distributing organization will be treated, however, as a private foundation for all purposes until the distribution is completed. Reg. 1.507-2(a)(4).
- Termination is effective on the date on which the distributing foundation has distributed all of its net assets to qualified distributees. Pending the complete distribution of assets to qualified distributees, the foundation remains subject to the provisions of chapter 42, except for IRC 4940 tax when the transitional period relating to medical research organizations and community trusts is applicable.
- An organization that remains in existence after terminating its private foundation status under IRC 507(b)(1)(A) must, unless specifically excepted by IRC 508(c), file an Application for Recognition of Exemption to be treated as an organization described in IRC 501(c)(3). *See* Rev. Rul. 74-490, 1974-2 C.B. 171.

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IRC 507 – Termination of Private Foundation Status, Continued

Transfer of All Right Title and Interest

To effectuate a transfer of "all of its right, title, and interest in and to all of its net assets" within the meaning of IRC 507(b)(1)(A), a transferor private foundation may not impose any material restriction or condition that prevents the transferee organization (the public charity) from freely and effectively employing the transferred assets, or derived income, in furtherance of its exempt purposes. Whether a particular condition or restriction imposed upon a transfer is "material" must be determined from all of the facts and circumstances of the transfer.

Factors to Consider to Determine Whether a "Material" Restriction Exists

Significant facts and circumstances to consider include whether the:

- Transferee is the owner in fee of the transferred assets;
 - Transferred assets will be held and administered in a manner consistent with its exempt purposes;
 - Governing body of the transferee has ultimate authority and control over the transferred assets and income derived from them; and
 - Governing body of the public charity is organized and operated independently from the transferor. Relevant considerations in determining the independence of the transferee's governing body include:
 - Whether the transferor or disqualified persons select members of the governing body of the transferee;
 - Whether the members of the governing body of the transferee are selected by public officials acting in their capacities as such; and
 - The length of time each member of the governing may serve as such.
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IRC 507 – Termination of Private Foundation Status, Continued

Factors Not Considered "Material"

Reg. 1.507-2(a)(8)(iii) provides that the following factors will not be considered "material" restrictions or conditions:

- The fund is given the transferor's name or similar designation or a name that memorializes the creator of the foundation or his family;
- The income or assets of the fund are to be used for a designated purpose or a particular IRC 509(a)(1), (2), or (3) organization and the use is consistent with the transferee's exempt purpose;
- The transferred assets are administered in a separate or identifiable fund, some or all of the principal of which is not to be distributed for a specified period as, for example, a fund to endow a chair at a university. The transferee must be the legal and equitable owner of the fund and the governing body must exercise ultimate and direct authority and control over the fund;
- The transferor requires that the transferred property be retained by the transferee if the retention is important to the achievement of exempt purposes because of peculiar features of the property, as, for example, the transfer of a woodland preserve to be maintained as an arboretum for the benefit of the community.

Factors Considered "Material"

Reg. 1.507-2(a)(8)(iv) sets out certain factors that will be considered "material" restrictions or conditions.

- The transferor, a disqualified person with respect to it or a person or committee designated by such a person, reserves the right to name the persons to which the transferee must distribute or to direct the timing of such distributions (other than as discussed in Factors to Consider to Determine Whether a "Material" Restriction Exists, on the previous page), as, for example, by power of appointment. For a listing of some specific factors that indicate whether the reservation of such a right exists, *see* Reg. 1.507-2(a)(8)(iv)(A)(2)-(3).

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IRC 507 – Termination of Private Foundation Status, Continued

Factors Considered "Material", continued

- The terms of the transfer agreement require the public charity to take or withhold action with respect to the transferred assets which furthers none of the transferee's exempt purposes and would, if performed by the transferor, subject it to tax under chapter 42.
 - The transferee assumes or takes assets subject to leases, contractual agreements or other liabilities of the transferor for purposes inconsistent with those of the transferee, other than the payment of the transferor's chapter 42 taxes incurred prior to the transfer to the extent of the value of the assets transferred.
 - The transferee is required by any express or implied agreement or restriction to retain assets transferred to it by the transferor,
 - An agreement is entered into giving the transferor or a disqualified person with respect to it the right of first refusal with respect to transferred property unless acquired by the transferor subject to a right of first refusal prior to October 9, 1969.
 - An agreement is entered into between the transferee and the transferor establishing an irrevocable relationship with respect to maintenance or management of the assets transferred such as with banks or brokerage firms.
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Termination by Operation as Certain Public Charities

Under IRC 507(b)(1)(B) a private foundation may voluntarily terminate its private foundation status without incurring the tax imposed by IRC 507(c), if:

- There have not been either willful, repeated acts (or failures to act) or a willful and flagrant act (or failure to act) giving rise to liability for tax under chapter 42;
 - Such organization meets the requirements of IRC 509(a)(1), (2), or (3) for a continuous period of 60 calendar months beginning with the first day of any taxable year which begins after December 31, 1969;
 - Such organization notifies the Service before the commencement of such 12-month or 60-month period (or before March 29, 1973) that it is terminating its private foundation status; and
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IRC 507 – Termination of Private Foundation Status, Continued

**Termination by
Operation as
Certain Public
Charities,
continued**

- Such organization establishes to the satisfaction of the Service immediately after the expiration of such 12-month or 60-month period, that such organization has complied with the requirements of IRC 509(a)(1), (2), or (3) for the prescribed period.

**General
Requirements**

- In order to accomplish an IRC 507(b)(1)(B) termination of its private foundation status, an organization must change its organizational structure, its operations, the sources of its support, or any combination of the foregoing, to the extent necessary to meet the requirements of IRC 509(a)(1), (2), or (3) for a continuous period of 60 calendar months beginning with the first day of any taxable year which begins after December 31, 1969.
- To establish a successful termination, an organization must within 90 days after the expiration of the 12-month or 60-month period, file such information with the Manager, Exempt Organizations Determinations, as is necessary to make a determination as to the organization's status as an organization described under IRC 509(a)(1), (2), or (3).
 - Failure to supply, within the time required, all of the information required to make such a determination will not alone constitute a failure to satisfy the requirements of IRC 507(b)(1)(B).
 - When information filed timely is incomplete, and additional information as requested by the Service is filed within the allowed time period, the original submission will be considered timely.

**Effect of 60-
Month Period
Termination**

An organization which has terminated its private foundation status under IRC 507(b)(1)(B) is not subject to the special rules set forth in IRC 508(a) and (b).

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IRC 507 – Termination of Private Foundation Status, Continued

Notification Requirement

- Generally, a private foundation is required to notify the Manager, Exempt Organizations Determinations, of its intention to terminate before the beginning of the 60-month period that it is terminating its private foundation status. Reg. 1.507-2(b)(1)(ii).
- Such notification should contain the following information:
 - Name and address of the private foundation;
 - Its intention to terminate its private foundation status;
 - Whether the 60-month period applies;
 - IRC section under which it seeks classification (IRC 509(a)(1), (2), or (3));
 - if IRC 509(a)(1) is applicable, the clause of IRC 170(b)(1)(A) involved;
 - Date its regular taxable year begins; and
 - Date of commencement of the 12-month or 60-month period.
- In Rev. Rul. 77-113, 1977-1 C.B. 152, a private foundation filed the requisite notice that it was terminating its private foundation status by operating as a public charity for a continuous period beginning with the first day of its next tax year. In conjunction with the notice, filed on February 1, the private foundation also gave notice that it was changing its annual accounting period from a calendar year to a fiscal year beginning April 1. The ruling holds that the private foundation could begin the 60-month period required for termination of its private foundation status with its tax year beginning April 1.
- A court has held that the notice element in the termination requirements is reflective of Congress's intent in 1969 to provide the Service and appropriate state officials with a means to gain more and ongoing information about the activities of private foundations. *Gladney v. Commissioner*, 745 F.2d 955 (5th Cir. 1984), *cert. den.*, 474 U.S. 923 (1985).

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IRC 507 – Termination of Private Foundation Status, Continued

Extension of Time to Assess Deficiencies

- When a private foundation files a notification of its intent to begin a 60-month termination and does not request an advance ruling, it may also elect to extend the period of limitation within which it may be assessed for IRC 4940 tax by filing Form 872-C.
- By consenting to such an extension, the organization can avoid having to pay IRC 4940 tax and having to file a claim for refund of the tax if it successfully accomplishes a 60-month IRC 507(b)(1)(B) termination.

Conversion to IRC 509(a)(1) Organizations

IRC 509(a)(1) organizations include only those organizations that are described in IRC 170(b)(1)(A)(i) through (vi).

Conversion to IRC 170(b)(1)(A)(vi) Organization

IRC 170(b)(1)(A)(vi) describes religious, charitable, educational, scientific, literary, etc., organizations that "normally" receive a substantial part of their support (exclusive of income received from related activities) from a governmental unit or from direct or indirect contributions from the general public. Generally, private foundations wishing to effect IRC 507(b)(1)(B) terminations by converting to a publicly-supported organization must satisfy either one of two public support tests described in Reg. 1.170A-9(e). Both tests involve mathematical computations to determine the degree of public financial support. (See text on 509(a)(1) and 170(b)(1)(A)(vi).)

Conversion to IRC 170(b)(1)(A)(vi) Organization for 60-Month Period

An organization attempting to terminate its private foundation status by qualifying as an IRC 170(b)(1)(A)(vi) (publicly supported) organization for the 60-month period will qualify only if:

- The total amount of support received from governmental units or from direct or indirect contributions from the general public during a continuous period of 60 calendar months equals one-third or more of its total support for the period, or
- The organization meets the 10 percent "facts and circumstances" test provided in the regulations under IRC 170(b)(1)(A), for a continuous period of 60 calendar months. Reg. 1.507-2(d)(1)(i) and (ii).

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IRC 507 – Termination of Private Foundation Status, Continued

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| Conversion to IRC 170(b)(1)(A)(iv) Organization | IRC 170(b)(1)(A)(iv) describes organizations receiving substantial public support or substantial governmental support that are operated for the benefit of a college or university owned or operated by a governmental unit. Reg. 1.507-2(c)(1)(iii). |
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| Meaning of the Term "Normally" | An organization must meet the organizational and operational requirements and must "normally" meet the support requirements of IRC 170(b)(1)(A)(iv) on or before commencement of the 60-month period and continuously thereafter for at least 60 calendar months. Reg. 1.507-2(d)(1)(i) and Reg. 1.507-2(d)(2). |
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| Conversions to Other 509(a)(1) Organizations | <ul style="list-style-type: none">• A private foundation may terminate its status as a private foundation if it changes its organizational structure or its operations, or both, so that it qualifies as an organization described in IRC 170(b)(1)(A)(i), (ii), (iii), or (v) continuously for the 60 calendar month period.• Organizations described in IRC 170(b)(1)(A)(i), (ii), (iii), or (v) are:<ul style="list-style-type: none">• Churches or conventions or associations of churches—IRC 170(b)(1)(A)(i)• Schools-IRC 170(b)(1)(A)(ii)• Hospitals-IRC 170(b)(1)(A)(iii)• Medical research organizations operated in conjunction with a hospital-IRC 170(b)(1)(A)(iii)• Governmental units-IRC 170(b)(1)(A)(v).• In order for an organization to qualify as a church, a school, a hospital, a medical research organization operated in conjunction with a hospital, or a governmental unit, it must meet the definitional requirements for such organizations set forth in Regs. 1.170A-9(a) through (d). |
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IRC 507 – Termination of Private Foundation Status, Continued

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| Conversion to IRC 509(a)(2) Organization | IRC 509(a)(2) defines certain types of broadly, publicly supported organizations. (See text on IRC 509(a)(2)). The rules for conversion require operation in such a manner that the support tests in Reg. 1.509(a)-3 of the regulations are met for a continuous period of 60 calendar months. |
| 60-Month Period Rule | An organization will be considered an IRC 509(a)(2) organization for the purposes of a 60-month termination under IRC 507(b)(1)(B) only if the organization meets the support requirements set forth in IRC 509(a)(2)(A) and (B) for the continuous period of 60 calendar months, rather than for any shorter period set forth in the regulations under IRC 509(a)(2). Reg. 1.507-2(d)(1)(iii). |
| Conversions to IRC 509(a)(3) Organization | IRC 509(a)(3) describes certain types of organizations that support one or more organizations described in IRC 509(a)(1) and (2). |
| 60-Month Period Rule | An organization will be considered an IRC 509(a)(3) organization for the purpose of a 60-month termination under IRC 507(b)(1)(B) only if the organization satisfies the organizational and operational test and other requirements of IRC 509(a)(3) on or before the commencement of the 60-month period and continuously thereafter during such period. Reg. 1.507-2(d) (2). |
| IRC 507(b)(1)(B) Terminations | <ul style="list-style-type: none">• IRC 507(a) does not apply to a termination described in IRC 507(b)(1)(B). Therefore, notification of commencing an IRC 507(b)(1)(B) termination will not be treated as a notification described in IRC 507(a), even if the private foundation does not successfully terminate its status pursuant to IRC 507(b)(1)(B). Reg. 1.507-2(b)(2).• A private foundation which terminates its status under IRC 507(b)(1)(B) does not incur tax under IRC 507(c) and, therefore, there would be no abatement of such a tax under IRC 507(g). |

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IRC 507 – Termination of Private Foundation Status, Continued

**Advance
Rulings or
Determinations**

Upon filing notification that it is commencing a 60-month termination under IRC 507(b)(1)(B), a private foundation may obtain an advance ruling or determination that it can be expected to satisfy the requirements of IRC 507(b)(1)(13)(i) during the 60-month period. Issuance of the ruling or determination is discretionary. Reg. 1.507-2(e)(1).

- In determining whether such an advance ruling or determination would be appropriate, the basic consideration is whether the foundation's organizational structure (including any revisions made prior to the beginning of the 60-month period), proposed programs or activities, intended method of operation, and projected sources of support indicate that the organization is likely to satisfy the requirements of IRC 509(a)(1), (2), or (3) and Reg. 1.507-2(d) during the 60-month period. Reg. 1.507-2(e)(2).
- Grantors and contributors may rely on such an advance ruling or determination for purposes of IRC 170, 545(b), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522, until the advance ruling or determination is revoked by public notice, but only if the grantor or contributor was not responsible for, or aware of, the act or failure to act that resulted in the foundation's failure to meet the requirements of IRC 509(a)(1), (2), or (3), or did not know that notice had been given to the organization that its advance ruling or determination would be revoked. Reg. 1.507-2(e)(3).
- A potential grantee organization may request a ruling whether a proposed grant or contribution, if accepted, will result in its failure to meet the requirements of IRC 509(a)(1), (2), or (3). The request should be filed with the Manager, Exempt Organizations Determinations, and issuance of a ruling is at the discretion of the Service. The foundation must submit all information necessary to make a determination on the factors listed in Reg. 1.507-2(e)(2). A favorable ruling may be relied on by the grantor or contributor of the contribution for purposes of the Code sections listed in IRC 170, 545(b), 556(b)(2), 642(c), 4942, 4945, 2055, 2106(a)(2), and 2522. Reg. 1.507-2(e)(3).

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IRC 507 – Termination of Private Foundation Status, Continued

Advance Rulings or Determinations, continued

- A foundation which obtained a favorable advance ruling or determination for a 60-month termination cannot rely on that ruling or determination if it fails to complete a successful termination under IRC 507(b)(1)(B) as an organization described in IRC 509(a)(1), (2), or (3), and is liable for IRC 4940 tax for taxable year(s) during the 60-month period. Any tax imposed during the period and not paid, will accrue interest under IRC 6601 but will not result in a penalty under IRC 6651, because failure to pay such tax during the 60-month period was due to reasonable cause. Reg. 1.507-2(e)(4).
- A favorable advance ruling or determination cannot be issued if the organization does not also file with the request a consent, by using form 872-C, under IRC 6501(c)(4) to extend the time limitation for the assessment of IRC 4940 tax deficiencies. Reg. 1.507-2(e) (5).

Organization's Status During Termination Period

If a private foundation successfully accomplishes a valid IRC 507(b)(1)(B) termination of its private foundation status, the termination is retroactive to the beginning of the 60-month period. Thus, the terminating organization will be treated for the entire 60-month period in the same manner as an organization described in IRC 509(a)(1), (2), or (3). Reg. 1.507-2(f)(1)(i).

Filing Requirements during Termination Period

- The terminating private foundation must continue to file Form 990-PF either in the year it distributes its assets and dissolves, or during the 60-month termination period. The applicable box for the particular type of terminating private foundation on the top of Form 990-PF should be checked. IRC 6043(b), Reg. 1.6043-3, and Reg. 1.507-2(a)(6).
- In the last year of a 60-month termination period, an organization files Form 990.
- An organization which makes an IRC 507(b)(1)(A) termination is not required to comply with the public inspection of private foundation annual reports requirements of IRC 6104(d). Reg. 1.507-2(a)(6)(ii).

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IRC 507 – Termination of Private Foundation Status, Continued

Failure to Meet Termination Requirements

If a private foundation fails to accomplish an IRC 507(b)(1)(B) termination during the 60-month period, it will be subject to IRC 507, 508, 509, and chapter 42 for any taxable year or years within the 60-month period during which it does not satisfy the requirements of IRC 509(a)(1), (2), or (3), and will be treated as an organization described in IRC 509(a)(1), (2), or (3) for any taxable year or years in which it does satisfy those requirements, making IRC 507, 508, 509, and chapter 42 inapplicable for that particular year(s). Grants and contributions made for any particular year will be treated according to its foundation status during that year. In determining whether an organization satisfies the requirements of IRC 509(a)(1), (2) or (3) for any taxable year in the 60-month period, the organization will be treated as if it were a new organization with its first taxable year beginning on the date of the commencement of the 60-month period. Regs. 1.507-2(f)(2)(i) and (ii).

- The organization's aggregate tax benefit will continue to be computed from the date from which such computation would have been made, but for the notice filed under IRC 507(b)(1)(B)(ii), except that any taxable year within such 60-month period for which such organization meets the requirements of IRC 509(a)(1), (2), or (3) will be excluded from such computations. Reg. 1.507-2(f)(2)(iii).

Transitional Rules for Organizations Operating as Public Charities

- An organization which terminates its private foundation status under IRC 507(b)(1)(B) will not be considered as carrying on activities subject to IRC 4940 tax during the 60-month termination period.
- When the organization's termination period has not expired prior to the due date for filing an annual return under IRC 6033 or 6012 for its first taxable year after December 31, 1969 (or any other taxable year ending before February 20, 1973), the organization must do one of the following:
 - Complete and file the annual return on time, paying any IRC tax due. If a successful termination is thereafter completed, file a claim for refund of IRC 4940 tax paid.

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IRC 507 – Termination of Private Foundation Status, Continued

Transitional Rules for Organizations Operating as Public Charities, continued

- Complete and file the annual return on time, except for the line relating to excise taxes on investment income. In lieu of paying IRC 4940 tax, it may file a statement with the annual return explaining that it has taken affirmative action to terminate its private foundation status. Such statement must specifically describe the action taken and must explain how the action will result in the termination of its private foundation status. If the organization fails to successfully terminate its private foundation status, the tax imposed under IRC 4940 will be treated as if due from the due date for its annual return, without regard to any extension of time for filing the return.
-

Certain Transfer of Assets

- Private foundations attempting to accomplish an IRC 507(b)(1)(B) termination might dispose of certain assets by making transfers to one or more private foundations or to other types of organizations.
 - A transfer to a private foundation during the termination period is a transfer described in IRC 507(b)(2), even though the transferor foundation thereafter successfully terminates under IRC 507(b)(1)(B).
-

Transfer of Assets from one Private Foundation to one or more Private Foundations

- IRC 507(b)(2) provides: "that in the case of a transfer of assets of any private foundation to another private foundation pursuant to any liquidation, merger, redemption, recapitalization, or other adjustment, organization, or reorganization, the transferee foundation will not be treated as a newly created organization."
 - Reg. 1.507-3(c)(1) provides:
 - That a transfer of assets described in IRC 507(b)(2) shall include any organization or reorganization described in subchapter C of chapter 1.
 - It also provides that for purposes of IRC 507(b)(2) the terms "other adjustment, organization, or reorganization" shall include any partial liquidation or any other significant disposition of assets to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. (For purposes of Reg. 1.507, a distribution out of current income shall include any distribution described in IRC 4942(h)(1)(A) and (B)." Also, the term "reorganization" is defined in IRC 368 and the IRC 368 regulation.)
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IRC 507 – Termination of Private Foundation Status, Continued

Filing Requirements

A private foundation is required to file an information return on Form 990-PF regarding any liquidation, dissolution, IRC 507(b)(1)(A) termination, partial liquidation, or "other significant disposition of assets." This requirement applies whether the private foundation is a corporation, association, or trust. IRC 6043(b), Reg. 1.6043-3.

- The fact that a private foundation must file as required by IRC 6043(b) does not necessarily mean that it has made an IRC 507(b)(2) transfer since it is subject to those filing requirements even though the transferees are not private foundations. Reg. 1.507-3(c)(3).

Meaning of Certain Terms

The meanings of the terms "liquidation, merger, reorganization, redemption, and recapitalization" are determined by the law of the state in which the private foundation was incorporated or otherwise created. Most states have nonprofit or not-for-profit corporation statutes that are expressly applicable to charitable corporations. Among other things, the statutes usually deal with mergers or consolidations, dissolutions, and sales or other dispositions of assets of charitable corporations. If the private foundation is a trust, the charitable trust law of the state applies in determining the meaning of the terms.

- The tests for determining whether a transfer represents a "significant disposition of assets" are set forth in Reg. 1.507-3(c)(2).
- The term "significant disposition of assets to one or more private foundations" includes any disposition (or series of related dispositions) by a private foundation to one or more private foundations of 25 percent or more of the fair market value of the net assets of the transferor foundation at the beginning of the taxable year in which the transfers occur.
- A disposition not otherwise significant in relation to the fair market value of the foundation's net assets may be a "significant disposition" when aggregated with other dispositions to private foundations in the same year and with "related" distributions in prior taxable years. The determination whether a "significant disposition" has occurred through a series of "related distributions" will be made on the basis of "all the facts and circumstances of the particular case."

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IRC 507 – Termination of Private Foundation Status, Continued

**Purpose and
Scope of IRC
507(b)(2)
Provisions**

IRC 507(b)(2) and the regulations there under also deal with the effect of partial liquidations or other significant disposition of assets made by a private foundation to one or more other private foundations. Reg. 1.507-3(c)(1).

- The broad purpose of the rules contained in the regulations is to preserve the applicable restrictions contained in chapter 42 in the case of assets that are transferred from one private foundation to another. The regulations thus provide that such transfers result in a carry-over of certain tax attributes and characteristics of the transferor organization to the transferee foundation. Reg. 1.507-3(a)(1).

With respect to the transferor private foundation, the regulations provide that a transfer described in IRC 507(b)(2) does not effect a termination. Reg. 1.507-1(b)(6) provides that if a private foundation transfers all or part of its assets to one or more private foundations, the transferor foundation will not have terminated its private foundation status under IRC 507(a)(1). Termination in such a situation, as Reg. 1.507-1(b)(7) and Reg. 1.507-3(d) explicitly state, only occurs if the transferor private foundation makes the election to terminate under IRC 507(a)(1), or IRC 507(a)(2) is applicable. Reg. 1.507-3(d) furnishes the following illustration of this provision:

- X, a private nonoperating foundation, transfers all its net assets to Y, a private operating foundation in 1971. X does not file the notice referred to in section 507(a)(1) and the transfer does not constitute either a willful and flagrant act (or failure to act) or one of a series of willful repeated acts (or failures to act) giving rise to liability for tax under chapter 42. Under these circumstances the transfer is described in section 507(b)(2) and the provisions of [Reg. 1.507-3(a), relating to the carry-over of the tax attributes and characteristics of the transferor to the transferee] apply with respect to Y. The private foundation status of X has not been terminated under section 507(a).

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IRC 507 – Termination of Private Foundation Status, Continued

**Effect on
Transferee
Foundations of
IRC 507(b)(2)
Transfer**

- A transferee private foundation succeeds to that part of the transferor's "aggregate tax benefit" (defined in Reg. 1.507-5) that is attributable to the assets transferred, based on the transferor's assets held just before the transfer. However, fair market value of assets held and transferred is determined at the time of the transfer. Furthermore, a transferee foundation not effectively controlled, directly or indirectly, by the same person or persons who effectively control the transferor organization cannot succeed to an aggregate tax benefit greater than the fair market value of the assets transferred, as determined at the time of the transfer. Reg. 1.507-3(a)(2).
- A substantial contributor to the transferor foundation will also be treated as a substantial contributor with respect to all transferee foundations regardless of whether such a person meets the \$5,000/two percent test with respect to any of the transferee foundations at any time. Reg. 1.507-3(a)(3). This would prevent a transferor foundation from avoiding the prohibitions of chapter 42 relating to substantial contributors (defined as disqualified persons under IRC 4946) by transferring its assets to another private foundations having different substantial contributors. Thus, a transferee foundation that has acquired "substantial contributors" by reason of an IRC 507(b)(2) transfer will be affected by the rules under IRC 4941 (self-dealing), IRC 4942 (income distributions), and IRC 4943 (excess business holdings) that relate to a private foundation and its "disqualified persons."

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IRC 507 – Termination of Private Foundation Status, Continued

**Effect on
Transferee
Foundations of
IRC 507(b)(2)
Transfer,
continued**

- A transferor foundation cannot prevent the use of its assets for the payment of chapter 42 tax liabilities by transferring such assets to another private foundation. In such a case the assets are subject to, in the hands of the transferee, any liability incurred by the transferor either prior to or as a result of the transfer, to the extent that the transferor foundation does not satisfy the liability. Reg. 1.507-3(a)(4).
- An IRC 507(b)(2) transfer will be counted toward the satisfaction of the transferor's IRC 4942 distribution requirements to the extent the assets transferred meet the requirements of IRC 4942(g). However, the record keeping requirements of IRC 4942(g)(3)(B) are inapplicable during any period in which the transferor has no assets. Reg. 1.507-3(a)(5).
- After an IRC 507(b)(2) transfer, the applicable time period described in IRC 4943(c)(4), (5), or (6) shall include the period during which the transferor foundation held the assets transferred, and the period during which the transferee foundation holds such assets. Reg. 1.507-3(a)(6).
- When the transferor foundation disposes of all of its assets, during any period in which it has no assets, IRC 4945(d)(4) and (h) shall not apply to the transferee or the transferor with respect to any "expenditure responsibility" grants made by the transferor. However, any information reporting requirements imposed by IRC 4945 would still apply for any year in which any such transfer is made. Reg. 1.507-3(a)(7).
- In an IRC 507(b)(2) transfer, if the transferee foundation(s) is effectively controlled (as stated in Reg. 1.482-1(a)(3)), directly or indirectly, by the same person or persons which effectively controlled the transferor foundation, for purposes of chapter 42 and IRC 507 through 509 such a transferee shall be treated as if it were the transferor. When the net assets are transferred to two or more foundations, then, when appropriate, each transferee shall be treated as if it were the transferor on a proportional basis, according to the fair market value of assets received and the fair market value of the net assets held by the transferor just before the transfer. Regs. 1.507-3(a)(9)(i).

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IRC 507 – Termination of Private Foundation Status, Continued

**Effect on
Transferee
Foundations of
IRC 507(b)(2)
Transfer,
continued**

Reg. 1.507-3(a)(9)(iii) Examples:

Example (1)

- The trustees of X charitable trust, a private foundation, form the Y charitable corporation, also a private foundation, in order to facilitate the conduct of their activities. The trustees of X are also the directors of Y. Y has the same charitable purposes as X. All of the assets of X are transferred to Y, and Y continues to carry on X's charitable activities. Under such circumstances, Y shall be treated as if it were X for purposes of chapter 42 and IRC 507 through 509. Thus, for example, Y will be permitted to take advantage of any special rules or savings provisions with respect to chapter 42 to the same extent as X could have if X had continued in existence.

Example (2)

- A and B are the trustees of the P charitable trust, a private foundation, and are the only substantial contributors to P. On July 1, 1973, in order to facilitate accomplishments of diverse charitable purposes, A and B create and control the R Foundation, the S Foundation and the T Foundation and transfer the net assets of P to R, S, and T. As of the end of 1973, P has an outstanding grant to Foundation W and has been required to exercise expenditure responsibility with respect to this grant under IRC 4945(d)(4) and (h). Under these circumstances, R, S, and T shall be treated as if they are P in the proportion the fair market value of the assets transferred to each bears to the fair market value of the assets of P immediately before the transfer. Since R, S, and T are treated as P, absent a specific provision for exercising expenditure responsibility with respect to the grant to W, each of them is required to exercise expenditure responsibility with respect to such grant. If, as part of the transfer to R, P assigned, and R assumed, P's duties with respect to the expenditure responsibility grant to W, only R would be required to exercise expenditure responsibility with respect to the grant to W. Since R, S, and T are treated as P rather than as recipients of "expenditure responsibility" grants, there are no expenditure responsibility requirements which must be exercised under IRC 4945(d) and (h) with respect to the transfers of assets to R, S, and T.
- Thus, if the transferees of an IRC 507(b)(2) transfer are effectively controlled by the same persons who control the transferor,

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

**Effect on
Transferee
Foundations of
IRC 507(b)(2)
Transfer,
continued**

Reg. 1.507-3(a)(9)(iii)(example 2) provides that because the transferee foundations are treated as the transferor, rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements which must be exercised under IRC 4945(d)(4) and (h) with respect to the IRC 507(b)(2) transfer.

- In an IRC 507(b)(2) transfer, the transferee foundation will not be treated as:
 - Being in existence prior to January 1, 1970, with respect to the transferred assets;
 - Holding the transferred assets prior to January 1, 1970; and
 - Having engaged in, or become subject to, any transaction, lease, contract, or other obligation with respect to the transferred assets prior to January 1, 1970. Reg. 1.507-3(a)(8)(i).
- In an IRC 507(b)(2) transfer, the provisions listed below (*see* Reg. 1.507-3(a)(8)(ii)) shall apply to the transferee foundation with respect to the assets transferred to the same extent they would apply to the transferor foundation had the transfer not been effected:
 - IRC 4940(c)(4)(B) as to basis of property,
 - IRC 4942(f)(4) as to distributions of income,
 - Section 101(l)(2) of the Tax Reform Act of 1969 (TRA '69) with respect to the provisions of IRC 4941,
 - Section 101(l)(3)(a) of TRA '69 as to IRC 4942, if the transferor qualified for the application of such section just before the transfer, and at least 85 percent of the fair market value of the net assets of the transferee immediately after the transfer were received pursuant to the transfer,
 - Section 101(l)(3)(B) through (E) of TRA'69 as to IRC 4942,
 - Section 101(l)(5) of TRA'69 as to IRC 4945, and
 - Section 101(l)(6) of TRA'69 as to IRC 508(e).

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IRC 507 – Termination of Private Foundation Status, Continued

Rev. Rul. 2002-28 Rev. Rul. 2002-28, 2002-20 IRB 1, was published on May 20, 2002. Rev. Rul. 2002-28 deals with IRC 507(b)(2) transfers, filing requirements, and chapter 42 implications. The ruling addresses straightforward issues that arise in the context of IRC 507(b)(2) transfers.

Issues of Rev. Rul 2002-28

1. If a private foundation transfers all of its assets to one or more private foundations, is the transferor foundation required to notify the Manager, Exempt Organizations Determinations, Tax Exempt and Government Entities Division (TE/GE), that it plans to terminate its private foundation status pursuant to IRC 507(a) and pay the tax under IRC 507(c)?
 2. What are a private foundation's tax return filing obligations after it transfers all of its assets to one or more transferee private foundations and:
 - (a) Terminates, or
 - (1) Does not terminate?
 3. If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled (within the meaning of the Income Tax Regulations under IRC 507), directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications under:
 1. IRC 4940,
 2. IRC 4941,
 3. IRC 4942,
 4. IRC 4943,
 5. IRC 4944, and
 6. IRC 4945?
 4. If a private foundation transfers all of its assets to one or more private foundations that are effectively controlled (within the meaning of the regulations under IRC 507), directly or indirectly, by the same person or persons who effectively control the transferor foundation, what are the implications for the transferor foundation's aggregate tax benefits under IRC 507(d)?
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IRC 507 – Termination of Private Foundation Status, Continued

**Fact Situations
of Rev. Rul.
2002-28**

In each of the situations described in Rev. Rul. 2002-28:

- (i) The transferee private foundations are effectively controlled (within the meaning of the regulations under IRC 507), directly or indirectly, by the same persons who effectively controlled the transferor private foundations;
- (ii) The private foundations have not committed either willful repeated acts (or failures to act), or a willful and flagrant act (or failure to act), giving rise to liability for tax under chapter 42;
- (iii) The private foundations have not terminated under IRC 507(a)(2) or (b)(1);
- (iv) Prior to the transactions described below, the transferor private foundations made outstanding grants to organizations not described in IRC 4945(d)(4)(A), which required the transferor foundations to exercise expenditure responsibility in accordance with IRC 4945(h); and
- (v) The private foundations are not operating foundations within the meaning of IRC 4942(j)(3).

Situation 1

P is recognized as exempt from federal tax under IRC 501(c)(3) and is classified as a private foundation under IRC 509(a). P's current directors have divergent charitable objectives.

X, Y, and Z are recognized as exempt from federal tax under IRC 501(c)(3) and are classified as private foundations under IRC 509(a). Pursuant to a plan of dissolution, after satisfying all of its outstanding liabilities, P distributes all of its remaining assets in equal shares to X, Y, and Z. As part of the plan of dissolution, X agrees to exercise expenditure responsibility for all outstanding grants made by P. The day after P distributes all of its assets, P files articles of dissolution with the appropriate state authority.

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IRC 507 – Termination of Private Foundation Status, Continued

Situation 2

T, a charitable trust, is recognized as exempt from federal tax under IRC 501(c)(3) and is classified as a private foundation under IRC 509(a). The trustees of T determine that T's charitable purposes can be more effectively accomplished by operating in corporate form.

The trustees of T create W, a not-for-profit corporation, for the purpose of carrying on T's activities. W is recognized as exempt from federal tax under IRC 501(c)(3) and is classified as a private foundation under IRC 509(a). T transfers all of its assets and liabilities to W.

Situation 3

J and K are not-for-profit corporations that are recognized as exempt from federal tax under IRC 501(c)(3) and are classified as private foundations under IRC 509(a). J and K generally confine their grantmaking activities to supporting charitable programs in the city in which both J and K are located.

V, a newly-formed entity, is recognized as exempt from federal tax under IRC 501(c)(3) and is classified as a private foundation under IRC 509(a). To eliminate the costs of maintaining two private foundations with identical charitable purposes, J and K transfer all of their assets and liabilities to V.

Law Cited in Rev. Rul. 2002- 28

Rev. Rul. 2002-28 cites the termination provisions of IRC 507(a)(1) and (2), the IRC 507(c) termination tax, and IRC 507(b)(2) relating to private foundation transfers of assets. See IRC 507(a)(1) and (2) (pages 2-175 to 2-177); IRC 507(b)(2) (page 2-194); and IRC 507(c) (page 2-215).

Regarding IRC 507(b)(2) transfers of assets, the revenue ruling cites various regulations under IRC 507(b)(2) that are discussed in this article (see specific page references below).

- Reg. 1.507-1(b)(6) (see page 2-175): IRC 507(b)(2) transfers do not constitute a termination of private foundation status of the transferor foundation under IRC 507(a)(1).
- Reg. 1.507-1(b)(7) (see page 2-175): A transfer of all the assets of a private foundation is not a termination under IRC 507(a)(1), unless the transferor elects to terminate under IRC 507(a)(1) or IRC 507(a)(2) is applicable.

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IRC 507 – Termination of Private Foundation Status, Continued

**Law Cited in
Rev. Rul. 2002-
28, continued**

- Regulations under 1.507-3(a)
 - These regulations include the transferee liability provisions, the substantial contributor provision, as well as the passing on to the transferee foundation(s) of any aggregate tax benefits. Reg. 1.507-3(a)(1) (see page 2-194); Reg. 1.507-3(a)(2)(i) (see page 2-195); Reg. 1.507-3(a)(3) (see page 2-195); Reg. 1.507-3(a)(4) (see page 2-196); Reg. 1.507-3(a)(5) (see page 2-196); Reg. 1.507-3(a)(6) (see page 2-196); Reg. 1.507-3(a)(7) (see page 2-196); Reg. 1.507-3(a)(9)(i and iii) (see pages 2-196 to 2-198). See portion of this article relating to IRC 507(b)(2) transfers in general, and in particular, the portion of this article relating to Effect on Transferee Foundations of IRC 507(b)(2) Transfer (pages 2-194 to 2-198).
- Regulations under 1.507-3(c) defining the terms "other adjustment, organization, or reorganization" and "significant disposition of assets to one or more private foundations." Reg. 1.507-3(c)(1) (see page 2-192) and Reg. 1.507-3(c)(2) (see page 2-193).
- Reg. 1.507-3(d) (see page 2-214): Unless a private foundation gives notice under IRC 507(a)(1), an IRC 507(b)(2) transfer will not constitute a termination under IRC 507(a)(1).

Rev. Rul. 2002-28 cites a regulation relating to the non-imposition of the IRC 507(c) tax.

- Reg. 1.507-4(b) (see page 2-214): Private foundations that make IRC 507(b)(2) transfers are not subject to the IRC 507(c) tax, unless the provisions of IRC 507(a) become applicable.

Rev. Rul. 2002-28 cites regulations dealing with the value of assets.

- Reg. 1.507-7(a) (see page 2-216): Rule for when the net value of assets for purposes of IRC 507(c) shall be determined.
- Reg. 1.507-7(b)(1) (see page 2-216) and Reg. 1.507-8 (see page 2-217): Rules regarding the termination date when IRC 507(c) will be applied. See later in this article, Valuation of Assets and Tax Liability on Transferred Assets (pages 2-216 to 2-217).

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IRC 507 – Termination of Private Foundation Status, Continued

**Law Cited in
Rev. Rul. 2002-
28, continued**

Regarding filing requirements, Rev. Rul. 2002-28 cites the following:

- Every organization exempt from taxation under IRC 501(a), with certain exceptions, shall file an annual return. IRC 6033(a)(1).
- With certain exceptions, a private foundation must provide information with respect to a liquidation, dissolution, termination or substantial contraction as required by the instructions accompanying the foundation's annual return. IRC 6043(b) and Reg. 1.6043-3(a)(1) (see page 2-193).
- A transferor foundation must comply with the requirements under IRC 6033, as well as the requirement under IRC 6043 that the transferor foundation file a return with respect to its liquidation, dissolution or termination. Reg. 1.507-3(a)(9)(ii).
- A private foundation that transfers all of its net assets is required to file the annual information return required by IRC 6033 for the taxable year in which such transfer occurs. However, the foundation will not be required to file such return for any taxable year following the taxable year in which the last of such transfers occurred, provided the foundation does not hold equitable title to any assets or engage in any activity during such subsequent taxable year. Reg. 1.507-3(a)(10), by reference to Reg. 1.507-1(b)(9).

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IRC 507 – Termination of Private Foundation Status, Continued

**Law Cited in
Rev. Rul. 2002-
28, continued**

Finally, Rev. Rul. 2002-28 cites the following law relating to chapter 42:

- IRC 4940(a) generally imposes an excise tax on a private foundation's net investment income for the taxable year.
- IRC 4940(c)(1) defines net investment income as the amount by which the sum of the gross investment income and the capital gain net income exceeds the deductions allowed under IRC 4940(c)(3).
- IRC 4941(a)(1) imposes a tax on each act of self-dealing between a disqualified person and a private foundation. Reg. 53.4946-1(a)(8) provides that, for purposes of IRC 4941, the term "disqualified person" shall not include any organization described in IRC 501(c)(3) (other than an organization described in IRC 509(a)(4)).
- IRC 4942(a) generally imposes a tax on the undistributed income of a private foundation (other than an operating foundation under IRC 4942(j)(3)) for any taxable year, which has not been distributed before the first day of the second (or any succeeding) taxable year following such taxable year.
- IRC 4942(c) defines "undistributed income" for any taxable year as the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made out of such distributable amount for such taxable year.
- IRC 4942(d) defines "distributable amount" as the amount equal to the sum of the minimum investment return, plus certain other amounts, reduced by the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and IRC 4940.
- IRC 4942(g)(1)(A) defines "qualifying distribution" as any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in IRC 170(c)(2)(B) other than a contribution to: (i) an organization controlled directly or indirectly by the foundation or by one or more disqualified persons with respect to the foundation, unless certain requirements are satisfied, or (ii) any private foundation which is not an operating foundation under IRC 4942(j)(3), unless certain requirements are satisfied.

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IRC 507 – Termination of Private Foundation Status, Continued

**Law Cited in
Rev. Rul. 2002-
28, continued**

- IRC 4942(i) provides for a carryover of the amount by which qualifying distributions during the five preceding taxable years (other than amounts required to be distributed out of corpus under IRC 4942(g)(3)) have exceeded the distributable amounts for such years.
- Rev. Rul. 78-387, 1978-2 C.B. 270, holds that when a private foundation transfers all its assets to another private foundation that is controlled by the same persons who controlled the transferor foundation, the transferee foundation may reduce its distributable amount under IRC 4942(d) by the amount of the transferor's excess qualifying distributions as described in IRC 4942(i).
- IRC 4943(a)(1) imposes a tax on the "excess business holdings" (as defined in IRC 4943(c)) of any private foundation in a business enterprise.
- IRC 4944(a)(1) imposes a tax on any amount invested by a private foundation in a manner that jeopardizes the carrying out of any of the foundation's exempt purposes.
- IRC 4945 imposes a tax on any "taxable expenditure" (as defined in IRC 4945(d)) made by a private foundation.
- IRC 4945(d)(4) provides that the term "taxable expenditure" includes any amount paid or incurred as a grant to a private non-operating foundation unless the grantor foundation exercises expenditure responsibility with respect to such grant in accordance with IRC 4945(h).
- IRC 4945(h) provides that the expenditure responsibility referred to in IRC 4945(d)(4) means a private foundation is responsible to exert all reasonable efforts and to establish adequate procedures to: (1) see that the grant is spent solely for the purpose for which made, (2) obtain full and complete reports from the grantee on how the funds are spent, and (3) make full and detailed reports with respect to such expenditures to the Service.
- IRC 4946(a)(1) defines a "disqualified person" for purposes of subchapter A of chapter 42.

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IRC 507 – Termination of Private Foundation Status, Continued

**Law Cited in
Rev. Rul. 2002-
28, continued**

- IRC 4942(c) defines "undistributed income" for any taxable year as the amount by which the distributable amount for such taxable year exceeds the qualifying distributions made out of such distributable amount for such taxable year.
- IRC 4942(d) defines "distributable amount" as the amount equal to the sum of the minimum investment return, plus certain other amounts, reduced by the sum of the taxes imposed on such private foundation for the taxable year under subtitle A and IRC 4940.
- IRC 4942(g)(1)(A) defines "qualifying distribution" as any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more purposes described in IRC 170(c)(2)(B) other than a contribution to: (i) an organization controlled directly or indirectly by the foundation or by one or more disqualified persons with respect to the foundation, unless certain requirements are satisfied, or (ii) any private foundation which is not an operating foundation under IRC 4942(j)(3), unless certain requirements are satisfied.

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IRC 507 – Termination of Private Foundation Status, Continued

Analysis – IRC 507 (Rev. Rul. 2002-28)

- IRC 507(b)(2) applies to a significant disposition of assets by one private foundation to one or more private foundations, other than transfers for full and adequate consideration or distributions out of current income. *See* IRC 1.507-3(c)(1). A transfer of all of a private foundation's assets to one or more private foundations constitutes a significant disposition. *See* Reg 1.507-3(c)(2). In Situations 1, 2 and 3, each transferor foundation transfers all of its assets to one or more private foundations. The transfers are not for full and adequate consideration and are not distributions out of current income. Thus, the transfers in Situations 1, 2 and 3 are IRC 507(b)(2) transfers.
- A transfer of assets described in IRC 507(b)(2) does not constitute a termination of the transferor's private foundation status under IRC 507(a)(1) unless the transferor voluntarily gives notice pursuant to IRC 507(a)(1). *See* Regs. 1.507-1(b)(6) and 1.507-3(d). The transferor foundation is not required to provide such notice. In Situation 1, P's dissolution under state law has no effect on whether P has terminated its private foundation status for federal tax purposes.
- In Situations 1, 2, and 3, if the transferor foundation does not give notice to the Manager, Exempt Organizations Determinations, of its intent to terminate, the transferor retains its private foundation status and the IRC 507(c) tax does not apply. *See* IRC 507(a)(1) and Reg. 1.507-4(b). The transferor foundation is required to file a Form 990-PF for the taxable year of the transfer(s), but is not required to file a Form 990-PF for subsequent taxable years during which it does not have equitable title to any assets and does not engage in any activity. *See* IRC 6033(a)(1) and IRC 6043(b), and Reg. 1.507-1(b)(9) and Reg. 1.507-3(a)(10). If, at any time following the transfer(s), the transferor foundation receives additional assets or engages in any activity, the transferor foundation must file a Form 990-PF. Additionally, because the transferor foundation has not terminated its private foundation status, the transferor foundation continues to be treated as a private foundation.

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IRC 507 – Termination of Private Foundation Status, Continued

Analysis – IRC 507 (Rev. Rul. 2002-28), continued

- In Situations 1, 2, and 3, if the transferor foundation does give notice to the Manager, Exempt Organizations Determinations, of its intent to terminate, then the IRC 507(c) tax applies on the date such notice is given. *See* Regs. 1.507-7(a) and (b)(1). Thus, in Situations 1, 2 and 3, if the transferor foundation provides notice at least one day after it transfers all of its assets, the tax imposed by IRC 507(c) will be zero. The transferor foundation is required to file a Form 990-PF for the taxable year of the transfer(s). *See* IRC 6033(a)(1) and IRC 6043(b).
- Regardless of whether the transferor foundation provides notice of its intent to terminate, the transferee foundations are treated as possessing the aggregate tax benefit of the transferor foundations. *See* Regs. 1.507-3(a)(1) and (2)(i). In Situation 1, X, Y, and Z succeed to P's aggregate tax benefit in proportion to the assets transferred to each. *See* Reg. 1.507-3(a)(2)(i).
- Moreover, regardless of whether the transferor foundation provides notice of its intent to terminate, where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to the transferor foundation's prior excise tax liabilities under chapter 42 (and any penalties resulting therefrom), if any, to the extent the transferor did not previously satisfy those liabilities. *See* Regs. 1.507-3(a)(1) and (4).

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IRC 507 – Termination of Private Foundation Status, Continued

IRC 4940 (Rev. Rul. 2002-28) In Situations 1, 2, and 3, the transfers do not constitute investments of the transferor for purposes of IRC 4940; therefore, the transfers do not give rise to net investment income subject to tax under IRC 4940(a).

- In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, any excess IRC 4940 tax paid by the transferor may be used by the transferees to offset the transferees' IRC 4940 tax liability. *See* Reg. 1.507-3(a)(9)(i). In Situation 1, where there are several transferees, proportionality is appropriate, and X, Y, and Z will each succeed to one third of any excess IRC 4940 tax paid by P. *See* Reg. 1.507-3(a)(9)(i).

IRC 4941 (Rev. Rul. 2002-28) In Situations 1, 2, and 3, the transfers are to IRC 501(c)(3) organizations, which are not treated as disqualified persons for purposes of IRC 4941. *See* Reg. 53.4946-1(a)(8). Thus, the transfers do not constitute self-dealing transactions and are not subject to tax under IRC 4941(a)(1).

IRC 4942 (Rev. Rul. 2002-28) In Situations 1, 2, and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of IRC 4942. *See* Reg. 1.507-3(a)(9)(i). Accordingly, the transfers to the transferee foundations are not treated as qualifying distributions of the transferor foundation. In addition, in Situations 2 and 3, each transferee foundation assumes all obligations with respect to the transferor's undistributed income within the meaning of IRC 4942(c), if any, and reduces its own distributable amount under IRC 4942 by the transferor foundation's excess qualifying distributions under IRC 4942(i). In Situation 1, where there are several transferee foundations, proportionality is appropriate, and X, Y and Z each becomes responsible for one third of P's undistributed income and succeeds to one third of P's excess qualifying distributions, if any. *See* Reg. 1.507-3(a)(9)(i) and Rev. Rul. 78-387.

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IRC 507 – Termination of Private Foundation Status, Continued

IRC 4943 (Rev. Rul. 2002-28) Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under IRC 4943(a) depends on the facts and circumstances. In Situations 1, 2 and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of IRC 4943 and IRC 4946. *See* Reg. 1.507-3(a)(9)(i). Accordingly, in determining whether a transferee foundation has excess business holdings, the disqualified persons of the transferee foundation are determined in part by treating the transferee as though it were the transferor. For example, both the substantial contributors of the transferee and the substantial contributors of the transferor are treated as a disqualified persons of the transferee in determining whether the transferee has excess business holdings as a result of the transfer. *See* IRC 4946(a)(1)(A) and Reg. 1.507-3(a)(9)(i); *see also* Reg. 1.507-3(a)(3). In addition, in determining whether a transferee foundation is subject to tax under IRC 4943, the transferee's holding period in the transferred assets for purposes of IRC 4943(c)(4), (5) and (6) includes both the period during which the transferor foundation held such assets and the period during which the transferee foundation holds such assets. *See* Reg. 1.507-3(a)(6).

IRC 4944 (Rev. Rul. 2002-28) In Situations 1, 2, and 3, the transfers do not constitute investments for purposes of IRC 4944; therefore the transfers do not constitute investments jeopardizing the transferor foundation's exempt purposes and are not subject to tax under IRC 4944(a)(1).

IRC 4945 (Rev. Rul. 2002-28) In Situations 1, 2 and 3, because each transferor foundation transfers all of its assets to one or more private foundations effectively controlled by the same persons that effectively control the transferor, the transferee foundations are treated as though they were the transferor for purposes of IRC 4945. *See* Reg. 1.507-3(a)(9)(i). Because the transferee foundations are treated as the transferor foundation rather than as recipients of expenditure responsibility grants, there are no expenditure responsibility requirements that must be exercised under IRC 4945(d)(4) or (h) with respect to the transfers to the transferee foundations. *See* Reg. 1.507-3(a)(9)(i) and (iii)(*example 2*).

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IRC 507 – Termination of Private Foundation Status, Continued

IRC 4945 (Rev. Rul. 2002-28), continued

- The transferor foundation is required to exercise expenditure responsibility over the transferor's outstanding grants until the transferor disposes of all of its assets. Thereafter, during any period in which the transferor foundation has no assets, the transferor foundation is not required to exercise expenditure responsibility over any outstanding grants. *See Reg. 1.507-3(a)(7)*. However, the transferor foundation still must meet the IRC 4945(h) reporting requirements for the outstanding grants for the year in which the transfers are made. *See Reg. 1.507-3(a)(7)*.
- The transferee foundations assume expenditure responsibility for all the transferor's outstanding grants. *See Reg. 1.507-3(a)(9)(i)*. In Situation 1, because X agreed to exercise expenditure responsibility for all of P's outstanding grants, Y and Z have no expenditure responsibility over P's grants. However, in the absence of such an agreement, X, Y and Z each would be required to exercise expenditure responsibility with respect to all of P's outstanding grants. *See Reg. 1.507-3(a)(9)(i) and (iii)(example 2)*.

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IRC 507 – Termination of Private Foundation Status, Continued

**Holdings of
Rev. Rul.
2002-28**

- (1) A private foundation that transfers all of its assets to one or more private foundations in a transfer described in IRC 507(b)(2) is not required to notify the Manager, Exempt Organizations Determinations, that it plans to terminate its private foundation status under IRC 507(a)(1). If the private foundation does not provide notice and does not terminate, the private foundation is not subject to the IRC 507(c) termination tax. If the private foundation chooses to provide notice, and therefore terminates, it is subject to the IRC 507(c) tax; however, if the private foundation has no assets on the day it provides notice (*e.g.*, it provides notice at least one day after it transfers all of its assets), the IRC 507(c) tax will be zero.

- (2) (a) A private foundation that has disposed of all of its assets and terminates its private foundation status must file a Form 990-PF for the taxable year of the disposition and must comply with any expenditure responsibility reporting obligations on such return.

(b) A private foundation that has disposed of all of its assets and does not terminate its private foundation status must file a Form 990-PF for the taxable year of the disposition and must comply with any expenditure responsibility reporting obligations on such return, but does not need to file returns in the following taxable years if it has no assets and does not engage in any activities. If, in later taxable years, it receives additional assets or resumes activities, it must resume filing a Form 990-PF for those taxable years in which it has assets or activities.

- (3) Where transferee liability applies, each transferee foundation is treated as receiving the transferred assets subject to the transferor foundation's prior excise tax liabilities under chapter 42 (and any penalty resulting therefrom), if any; to the extent the transferor foundation did not previously satisfy those liabilities.
 - (a) The transfers do not give rise to net investment income and are not subject to tax under IRC 4940(a). The transferee foundations may use their proportionate share of any excess IRC 4940 tax paid by the transferor to offset their own IRC 4940 tax liability.
 - (b) The transfers do not constitute self-dealing and are not subject to tax under IRC 4941(a)(1)

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

**Holdings of
Rev. Rul.
2002-28,
continued**

- (c) The transfers do not constitute qualifying distributions for the transferor foundation under IRC 4942. The transferee foundations assume their proportionate share of the transferor foundation's "undistributed income" under IRC 4942 and reduce their own distributable amount for purposes of IRC 4942 by their proportionate share of the transferors' excess qualifying distributions under IRC 4942(i).
- (d) Whether the transfers cause a transferee foundation to have excess business holdings and be subject to tax under IRC 4943(a) depends on the facts and circumstances. In making these determinations, the disqualified persons of a transferee foundation are determined in part by treating the transferee as though it were the transferor. In addition, the transferee's holding period in the transferred assets for purposes of IRC 4943(c)(4), (5) and (6) includes both the period during which the Transferor foundation held such assets and the period during which the Transferee foundation holds such assets.
- (e) The transfers do not constitute investments jeopardizing the transferor foundation's exempt purposes and are not subject to tax under IRC 4944(a)(1).
- (f) The transferor foundation is not required to exercise expenditure responsibility under IRC 4945(h) with respect to the transfers. The transferor foundation is required to exercise expenditure responsibility over any outstanding grants until the time it disposes of all of its assets and must satisfy the IRC 4945(h) reporting requirements for the taxable year in which the transfers were made. Following the transfers and during any period in which the transferor has no assets or activities, the transferor foundation is not required to exercise expenditure responsibility with respect to any of its outstanding grants.

Each transferee foundation must exercise expenditure responsibility with respect to all outstanding grants by the transferor foundation. If, however, the transferor foundation assigns and transferees assume the transferor's expenditure responsibility with respect to a grant, only the transferees assuming the transferor's expenditure responsibility are required to exercise such expenditure responsibility with respect to such grant.

- (4)The transferor foundation's aggregate tax benefits under IRC 507(d) are transferred to the transferee foundations in proportion to the transferor's assets transferred to each transferee.

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

Business Plan Item The 2003 Business Plan anticipates that additional guidance will be published under IRC 507.

Transfers to Organizations Not Described in IRC 501(c)(3) or 4947(a)(1) In general, a transfer of assets by a private foundation to an organization not described in IRC 501(c)(3) or treated as described in IRC 501(c)(3) under IRC 4947(a)(1) constitutes a taxable expenditure under IRC 4945(d)(5). If such a transfer is made and, in order to correct the taxable expenditure, later is transferred to a private foundation, IRC 507(b)(2) and Reg. 1.507-3(a) would be applicable as though the transfer had been made directly to the private foundation.

Transfers Made During IRC 507(b)(1)(B) Terminations A transfer from a private foundation to one or more other private foundations, during the course of an IRC 507(b)(1)(B) termination, whether during the course of a 12-month or 60-month period, will constitute a transfer described in IRC 507(b)(2) and Reg. 1.507-3. Even though the transferor satisfies the requirements of IRC 507(b)(1)(B) thereafter, thereby successfully terminating its private foundation status, Reg. 1.507-2(e) will not apply, and such transfer will still be treated as an IRC 507(b)(2) and Reg. 1.507-3 transfer, rather than as a transfer from an organization described in IRC 509(a)(1), (2), or (3).

Transfers Subject to Chapter 42 Excise taxes Unless a private foundation gives notice under IRC 507(a)(1) to terminate its status, a transfer of assets described in IRC 507(b)(2) will not constitute a termination of the transferor's private foundation status. However, such transfer must satisfy the requirements of all pertinent provisions of chapter 42 of the Code. *See* Reg. 1.507-3(d).

- For example, if the transfer constitutes a taxable expenditure as defined in IRC 4945, the transferor is liable for the chapter 42 tax that is incurred.

If a transfer described in IRC 507(b)(2) constitutes a willful and flagrant violation of chapter 42, as described in IRC 507(a)(2)(A), then the provisions of IRC 507(a)(2) dealing with involuntary terminations are applicable, rather than the provisions of IRC 507(b)(2). In that event, the transferor foundation would be subject to IRC 507(c) tax. *See* Reg. 1.507-3(d) and Reg. 1.507-4(b).

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

Imposition of IRC 507(c) Tax

- IRC 507(c) imposes on a private foundation whose status as such has been terminated either voluntarily or involuntarily under IRC 507(a) a tax equal to the lower of:
 - The aggregate tax benefit defined in IRC 507(d) resulting from the IRC 501 (c)(3) status of the organization, or
 - the value of its net assets. Reg. 1.507-4(a). See also *Peters v. United States*, 624 F2d 1020 (Ct. Cl. 1980) (application of termination tax upon voluntary termination of private foundation status is neither confiscatory nor retroactive in its application.)
 - IRC 507(c) tax does not apply to IRC 507(b)(1)(A) or 507(b)(2) transfers unless IRC 507(a) becomes applicable. Reg. 1.507-4(b).
-

Aggregate Tax Benefit Defined

For purposes of IRC 507(c)(1), the aggregate tax benefit resulting from the IRC 501(c)(3) status of a private foundation is the sum of:

- the aggregate increases in tax under chapters 1, 11, and 12 (or the corresponding provisions of prior law) that all substantial contributors to the foundation would have incurred if their contributions had not been deductible after February 28, 1913,
- the aggregate increases in tax under chapter 1 (or the corresponding provisions of prior law) that the private foundation would have incurred for taxable years beginning after December 31, 1912, had it not been exempt from tax under IRC 501(a) (or the corresponding provisions of prior law); and, in the case of a trust, if deductions under IRC 642(c) (or the corresponding provision of prior law) had been limited to 20 percent of the taxable income of the trust (computed without benefit of IRC 642(c) but with the benefit of IRC 170(b)(1)(A)),
- the amount succeeded to from transferors under Reg. 1.507-3(a) and IRC 507(b)(2), and
- Interest on the increases in tax determined in (a), (b), and (c) above from the first day on which each such increase would have been due and payable to the date on which the organization ceases to be a private foundation. Reg. 1.507-5(a).

In computing the amount of the aggregate increases in tax, all deduction benefits attributable to a particular contribution shall be included. Reg. 1.507-5(b).

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IRC 507 – Termination of Private Foundation Status, Continued

Substantial Contributor

For the definition of "substantial contributor" and its related rules, *see* Reg. 1.507-6.

Valuation of Assets

- For purposes of IRC 507(c), the value of the net assets of a private foundation shall be determined at whichever time such value is higher:
 - The first day on which action is taken by the organization which culminates in its ceasing to be a private foundation, or
 - The date on which it ceases to be a private foundation. Reg. 1.507-7(a).
 - For terminations under IRC 507(a)(1), the date on which the private foundation gives notification of a voluntary termination is the day referred to in (1)(a). Reg. 1.507-7(b)(1).
 - For terminations under IRC 507(a)(2), the date referred to in (1)(a) is the date of occurrence of the willful and flagrant act (or failure to act) or the first of the series of willful repeated acts (or failures to act) giving rise to liability for tax under chapter 42 and the imposition of tax under IRC 507(a)(2). Reg. 1.507-7(b)(2).
 - Fair market value of the net assets shall be determined pursuant to the provisions of Reg. 53.4942(a)-2(c)(4). Reg. 1.507-7(c).
 - The term "net assets" means the gross assets of a private foundation reduced by all liabilities of the foundation, including appropriate estimated and contingent liabilities (such as liability for tax imposed under chapter 42). Reg. 1.507-7(d).
-

Tax Liability on Transferred Assets

- In determining IRC 507(c) tax liability in the case of assets transferred by a private foundation, the tax will be deemed to have been imposed on the first day on which action is taken by the organization which culminates in its ceasing to be a private foundation.
-

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

Tax Liability on Transferred Assets, continued

- If private foundation status is terminated under IRC 507(a)(2), the first day on which action is taken which culminates in its ceasing to be a private foundation will be the date:
 - Of occurrence of the willful and flagrant act (or failure to act) or the first of the series of willful repeated acts (or failures to act) giving rise to liability for chapter 42 tax and IRC 507(a)(2) tax.
 - On which the foundation gave the notification described in IRC 507(a)(1). *See Reg. 1.507-8* for the rules under these paragraphs (1) and (2).
-

Abatement of Taxes

The Service may at its discretion abate the unpaid portion of IRC 507(c) tax imposed, if:

- The private foundation distributes all of its net assets to one or more organizations described in IRC 170(b)(1)(A) (other than in clauses (vii) or (viii)), each of which has been in existence and so described for a continuous period of at least 60 calendar months, or
 - Effective assurance is given to the Service that the assets of the organization which are dedicated to charitable purposes will, in fact, be used for charitable purposes. *See Reg. 1.507-9(b) and (c)*, below, for the procedures by which effective assurance is given to the Service.
-

Effective Assurance

Reg. 1.507-9(b) and (c) provides as follows:

(b) State proceedings.

(1) The Service may at its discretion abate the unpaid portion of the assessment of any tax imposed by section 507(c), or any liability in respect thereof, under the procedures outlined in subparagraphs (2) and (3) of this paragraph. Such tax may not be abated by the Service unless it determines that corrective action as defined in paragraph (c) of this section has been taken. The Service may not abate by reason of section 507(g) any amount of such tax, which has already been collected since only the unpaid portion thereof can be abated.

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IRC 507 – Termination of Private Foundation Status, Continued

Effective Assurance, continued

(2) The appropriate State officer shall have 1 year from the date of notification prescribed in section 6104(c) that a notice of deficiency of tax imposed under section 507(c) has been issued with respect to a foundation, to advise the Service that corrective action has been initiated pursuant to State law as may be ordered or approved by a court of competent jurisdiction. Corrective action may be initiated either by the appropriate State officer or by an organization described in section 509(a)(1), (2), or (3) which is a beneficiary of the private foundation and has enforceable rights against such foundation under State law. Copies of all pleadings and other documents filed with the court at the initial stages of the proceedings shall be attached to the notification made by the State officer to the Service. Prior to notification by the appropriate State officer that corrective action has been initiated, the Service shall follow those procedures which would apply with respect to the assessment and collection of the tax imposed under section 507(c) without regard to section 507(g)(2). Subsequent to notification by the appropriate State officer that corrective action has been initiated, the Service shall suspend action with respect to the assessment or collection of tax imposed under section 507(c) until notified of the final determination of such corrective action, as long as any such resulting delay does not jeopardize the collection of such tax and does not cause collection to be barred by operation of law or any rule of law. In any case where collection of such tax is about to be barred by operation of section 6502 and the Service has not been advised of the final determination of corrective action, the Service should make every effort to obtain appropriate agreements with the foundation subject to such tax to extend the period of limitations under section 6502(a)(2). Where such agreements are obtained, action with respect to the assessment and collection of such tax may be suspended to the extent not inconsistent with this subparagraph.

(3) Upon receipt of certification from the appropriate State officer that action has been ordered or approved by a court of competent jurisdiction, the Service may abate the unpaid portion of the assessment of tax imposed by section 507(c), or any liability in respect thereof, if in its judgment such action is corrective action within the meaning of paragraph (c) of this section. In the event that such action is not corrective action, the Service may in its discretion again suspend action on the assessment and collection of such tax until corrective action is obtained, or if in its judgment corrective action cannot be obtained, it may resume the assessment and collection of such tax.

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IRC 507 – Termination of Private Foundation Status, Continued

Effective Assurance, continued

(c) Corrective action. The term 'corrective action' referred to in paragraph (b) of this section means vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42 and insure that the assets of such private foundation are preserved for such charitable or other purposes specified in section 501(c)(3). Except where assets of the terminated private foundation are transferred to an organization described in section 509(a)(1) through (4) the State is required to take such action to assure that the provisions of section 508(e)(1)(A) and (B) are applicable to the terminated foundation (or any transferee) with respect to such assets as if such organization were a private foundation. Thus, the governing instrument of such organization must include provisions with respect to such assets:

- (1) Requiring its income therefrom for each taxable year to be distributed at such time and in such manner as not to subject such organization to tax under section 4942 (as if the organization were a private foundation),
- (2) Prohibiting such organization from engaging in any act of self-dealing (as defined in section 4941(d) as if the organization were a private foundation),
- (3) Prohibiting such organization from retaining any excess business holdings (as defined in section 4943(c) as if the organization were a private foundation),
- (4) Prohibiting such organization from making any investments in such manner as to subject such organization to tax under section 4944 (as if the organization were a private foundation), and
- (5) Prohibiting such organization from making any taxable expenditures (as defined in section 4945(d) as if the organization were a private foundation). Consequently, in cases where the preceding sentence applies, although the private foundation status of an organization is terminated for tax purposes, it is contemplated that its status under State law would remain unchanged, because the tax under section 507(c) has been abated solely because the Service has been given effective assurance that there is vigorous enforcement of State laws sufficient to assure implementation of the provisions of chapter 42. Therefore, in such a case while chapter 42 will not apply to acts occurring subsequent to termination which previously would have resulted in the imposition of tax under chapter 42, it is contemplated

Continued on next page

IRC 507 – Termination of Private Foundation Status, Continued

Effective Assurance, continued

that there will be vigorous enforcement of State laws (including laws made applicable by the provisions in the governing instrument) with respect to such acts. Notwithstanding the preceding three sentences, no amendment to the organization's governing instrument is necessary where there are provisions of State law which have the effect of requiring a terminated private foundation to which the rules of subparagraphs (1) through (5) of this paragraph apply to be subject to such rules whether or not there are such provisions in such terminated private foundation's governing instrument.

See the discussion of IRC 6104(c) in the article, "Disclosure, FOIA and Privacy - An Exempt Organization's Primer," in the 2003 CPE Text.

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