

Grants from Private Foundations to Supporting Organizations after the Pension Protection Act of 2006

The Pension Protection Act of 2006 brought many changes to the charitable sector.¹ However, the most significant changes for private foundations are the new rules for making grants to some supporting organizations – a type of public charity. The Internal Revenue Service (IRS) is expected to issue guidance clarifying some ambiguities in the law. Nonetheless, private foundations should act now to review and update their policies to ensure they have appropriate grant-processing procedures in place to avoid potential IRS penalty taxes. Such a review and update of policies is necessary even for private foundations that only make grants to Section 501(c)(3) organizations. Simply checking a potential grantee’s Section 501(c)(3) status alone is no longer sufficient to comply with the law.

The New Rules

Since grants to non-charities require private foundations to follow a detailed expenditure responsibility process, private foundations have long understood the need to determine whether a grantee is a public charity *before* making a grant.² However, the Pension Protection Act (PPA)³ now requires grantmakers to follow the expenditure responsibility process when making a grant to certain types of public charities – supporting organizations – in certain situations. Furthermore, private non-operating foundations cannot count grants to these supporting organizations as part of their minimum distribution requirement (also known as the “5 percent payout”). While the number of grants actually affected by the new rules is small, private foundations must implement new processes to identify the affected grants.

¹ For the text of the statute and background information on the other provisions of the Pension Protection Act, see www.cof.org/ppa.

² Very generally, the private foundation rules define expenditure responsibility as a five-step process that includes:

1. Conducting a pre-grant inquiry, including a reasonable investigation of the grantee to ensure that the proposed activity is charitable and that the grantee is able to perform the proposed activity.
2. Executing a written agreement with the grantee that specifies the charitable purposes of the grant, includes provisions that prohibit use of the funds for lobbying activities, and requires the grantee to return any funds not used for the designated purposes.
3. Requiring the grantee to maintain the grant funds in a separate fund so that charitable funds are segregated from non-charitable funds.
4. Requiring the grantee to provide regular reports on the use of the funds and the charitable activity supported by the grant.
5. Including a report on Form 990-PF about the grant including a brief description of the grant, the amount, the charitable purpose, and the current status of the grant.

³ Details about expenditure responsibility may be found in *Expenditure Responsibility Step by Step* (available from the Council online store at www.cof.org).

As mentioned above, a supporting organization is a type of public charity. When a public charity has a particular relationship with another publicly supported charity or government unit, the IRS determines it to be a supporting organization rather than a private foundation. Based on the relationship with the other charity or government unit, the supporting organization is defined as Type I, Type II, or Type III. Type III supporting organizations are further broken down into functionally integrated or non-functionally integrated. Descriptions of supporting organizations can be found following this article in “Supporting Organizations, Definitions.”

Grants to the following supporting organizations require all private foundations – both operating and non-operating – to follow the expenditure responsibility process. Such grants do not count toward a private non-operating foundation’s minimum distribution requirement:

- Type III non-functionally integrated supporting organizations
- Type I, Type II, or Type III functionally integrated supporting organizations, if one or more disqualified persons of the private foundation control directly or indirectly either the supporting organization or an organization supported by the Type I, II, or III organization

The key to following these rules is to determine first whether the grantee falls within one of the above categories of supporting organizations.

Determining Supporting Organization Status and Type

The IRS issued guidance ([Notice 2006-109](#)) to help private foundations determine whether an organization is a supporting organization and, if so, how to determine what type. We broke this guidance into three steps, which should help private foundations develop procedures to determine whether they must exercise expenditure responsibility.

Step 1: Determining Whether a Public Charity Is a Supporting Organization

IRS guidance states that private foundations may rely on information from any of the following sources to determine whether a public charity is a supporting organization:

- the [IRS Business Master File](#) (BMF)⁴
- the potential grantee’s IRS determination letter
- a report from a third party that includes the following:
 - the grantee’s name, Employer Identification Number, and public charity classification under Section 509(a)(1), (2), or (3)
 - a statement that the information is from the most currently available IRS monthly update to the BMF, along with the IRS BMF revision date
 - the date and time of the grantmaker’s search

⁴ The Business Master File is not the same as IRS *Publication 78*. The Business Master File includes significantly more details about charities than *Publication 78*, including how the organization qualifies for its status as a public charity. *Publication 78* does not currently contain sufficient information to determine whether an organization is a supporting organization.

The grantmaker must retain the report in electronic or hard copy form.

Step 2: Determining the Type of Supporting Organization

If an organization is a supporting organization, grantmakers must next determine its type. The IRS guidance prescribes one process for Type I or Type II organizations and a more complex one for Type III organizations. In all cases, the grantmaker must first verify that the organization is a public charity by checking either the organization's determination letter or its status in [IRS Publication 78](#).

Basis for Determining that an Organization is a Type I or II Supporting Organization:

Grantmakers may rely on a written representation signed by an officer, director, or trustee of the grantee if both of the following are true:

- The representation describes the process used to select the grantee's officers, directors, or trustees and references the pertinent provisions of the grantee's organizing documents that establish the grantee's relationship to its supported organizations.
- The grantmaker collects and reviews copies of the grantee's governing documents. If the grantee's organizing documents are not sufficient to establish the relationship, the grantmaker must also collect organizing documents from the supported organization.

Basis for Determining that an Organization is a Functionally Integrated Type III Supporting Organization:

- The grantee's written representation identifies the organizations it supports.
- The grantmaker collects and reviews the grantee's organizing documents (and those of the supported organizations if necessary).
- The grantmaker collects a written representation signed by an officer, director, or trustee of each supported organization which states that the supporting organization is functionally integrated and that, but for the involvement of the supporting organization, the supported organization normally would engage in those activities itself.

Alternative: Grantmakers may also rely on a reasoned written opinion of counsel of either the grantee or the grantmaker to determine that a supporting organization is a Type I, Type II, or functionally integrated Type III supporting organization.

Step 3: Determining Whether a Supporting or Supported Organization is Controlled by One or More Disqualified Persons

If the foundation has determined that the potential grantee is a supporting organization which is not a Type III non-functionally integrated supporting organization (since, in that case, expenditure responsibility is required automatically), the private foundation must determine whether the supporting organization grantee or the organization supported by the grantee is

controlled by one or more disqualified persons of the private foundation. This final step will determine whether expenditure responsibility is required.

While the IRS has not yet issued new guidance on this subject, current guidance (IRS [Notice 2006-109](#)) states that a supported organization is controlled by a disqualified person⁵ if “any such persons may, by aggregating their votes or positions of authority, require the supporting or supported organization to make an expenditure, or prevent the supporting or the supported organization from making an expenditure, regardless of the method by which the control is exercised or exercisable.”

For example, in the case of a family foundation where a member of the substantial contributor’s family is the executive director of the Type I supporting organization grantee, the IRS would likely consider the supporting organization to be controlled by a disqualified person. Consequently, the IRS would likely require the grantmaker to exercise expenditure responsibility for the grant, even though the grantee is a Type I or Type II supporting organization. In addition, the grant would not count toward the private non-operating foundation’s minimum distribution requirements.

The available guidance suggests one method for determining whether control is present. Specifically, if the private foundation is considering making a grant to a Type I, Type II, or functionally integrated Type III supporting organization, the foundation may request a list of organizations that the potential grantee supports. Then, the foundation may work with its disqualified persons to determine whether the grantee or any of those supported organizations are controlled by disqualified persons. For example, the private foundation might ask the foundation’s disqualified persons to certify whether they control the grantee or one of the grantee’s supported organizations, either directly or indirectly. Other foundations may choose to seek certifications directly from the grantee and its supported organizations which indicate that disqualified persons of the private foundation (as identified by the private foundation) do not control the organization. At some point, the IRS may issue guidance to clarify the steps. However, until that time, a private foundation should work with its local counsel to determine policies and procedures that adhere to the law.

At the end of this article, you will find a chart that outlines which grants to Section 501(c)(3) organizations from private foundations require expenditure responsibility. You will also find a

⁵ Disqualified persons with respect to a private foundation includes:

- foundation managers (officers, directors, trustees, or individuals with similar responsibilities)
- substantial contributors (defined as any person who has contributed an aggregate amount of more than \$5,000 to a private foundation, if such amount is more than two percent of the total contributions received by the foundation in the year in which the person makes a contribution)
- individuals who own more than 20 percent of a business enterprise that is a substantial contributor
- family members of any person described above (spouse, ancestors, lineal descendants, and spouses of lineal descendants)
- corporations, partnerships, trusts, or estates in which a person described above owns more than 35 percent of the voting power, profits interest, or beneficial interest

flow chart that summarizes one method for answering the question of whether expenditure responsibility is required for a particular grant.

Final Considerations

A private foundation likely will find that these new rules affect only a few grants. However, the key is having a process in place to identify those few. What happens next is up to the foundation.

Some foundations may determine that the foundation or giving program makes so few grants to supporting organizations that it is easier to exercise expenditure responsibility for *all* such grants, rather than undertake an inquiry about supporting organization type or control relationships. Others will develop processes that go through all the steps necessary to determine whether expenditure responsibility is required and then only exercise expenditure responsibility in cases absolutely required by law. Still others may choose to make a grant directly to a supported organization rather than exercise expenditure responsibility over a grant to an affected supporting organization.

Regardless of the foundation's policy, each foundation should review it on an ongoing basis to ensure it addresses all of the necessary questions about a grantee's charitable status.

The information provided here is based on our continuing analysis of the Pension Protection Act. Every effort has been made to ensure accuracy of these documents. Please understand, however, that due to the complexity of the law and the fact that many of these provisions introduce issues that are new to the Internal Revenue Code, this information is subject to change. The information is not a substitute for expert legal, tax, or other professional advice. We strongly encourage grantmakers and donors to work with their counsel to determine the impact of this legislation on your particular situations. This information may not be relied upon for the purposes of avoiding any penalties that may be imposed under the Internal Revenue Code.

Supporting Organizations, Definitions

What is a supporting organization?

To oversimplify, a supporting organization is a Section 501(c)(3) organization that qualifies as a public charity (and not a private foundation) because it has a close relationship with another publicly supported Section 501(c)(3) organization. Usually, in order to qualify as a public charity, an organization must receive at least one-third (or in special cases as little as ten percent) of its support each year from gifts, grants, and contributions from a variety of sources. A “supporting organization” is not required to meet this “public support test” on its own if it provides meaningful support (financial, programmatic, or both) and gives some degree of structural and operational control to another organization that is already classified as a public charity rather than as a private foundation. Based upon the relationship of the supporting organization to the public charity it supports, a supporting organization will be classified as a Type I, Type II, or Type III. A supporting organization may not be controlled by someone who is a disqualified person with respect to the supporting organization.

What are the different classifications of supporting organization?

As a general overview, supporting organizations fall into three categories: Type I, Type II, and Type III. The type refers to the nature of the relationship between the supporting organization and the charity being supported.

- **Type I:** By far the most common, this type is often described as a parent-subsidiary relationship. It generally involves the charity appointing a majority of the board of the supporting organization.
- **Type II:** The least common, this type usually involves an overlapping board relationship where at least a majority of the supporting organization board members are also members of the supported charity’s board.
- **Type III:** This type operates with a greater degree of independence from the organization it supports. Typically, the supported organization appoints one member of the supporting organization’s governing board and institutes other procedures to ensure that the supporting organization is responsive to it. A Type III supporting organization may provide financial support to or directly carry out a program or function for the supported organization.

What is a supported organization?

A supported organization is the Section 509(a)(1) or 509(a)(2) organization that the supporting organization is designed to support. A supporting organization may have one or many supported organizations. In some cases, a supporting organization may have a class of supported organizations, such as all public universities in a particular state.

Which grants from private foundations to Section 501(c)(3) organizations require expenditure responsibility?

Section 501(c)(3)

**Public
Charity**

**Private
Foundation**

Operating

Non-operating

**Section 509(a)(1)
Traditional Organizations**

- 170(b)(1)(A)(i) Churches
- 170(b)(1)(A)(ii) Schools
- 170(b)(1)(A)(iii) Hospitals
- 170(b)(1)(A)(iv) Support organizations to schools
- 170(b)(1)(A)(v) Governmental units
- 170(b)(1)(A)(vi) Publicly supported organizations (including community foundations)

**Section 509(a)(2)
Gross Receipts Organizations**

**Section 509(a)(3)
Supporting Organizations**

**Section 509(a)(4)
Testing for Public Safety Organizations**

Type I




Type II

Type III

Functionally Integrated

Non-functionally Integrated*

Key

-  Expenditure responsibility required. Includes distributions from private foundations to:
 - Private foundations
 - Section 509(a)(4) organizations
 - Non-functionally integrated Type III supporting organizations
 - Non-charities (including grants to for-profit and other 501(c) organizations)
-  Expenditure responsibility only required for distributions from private foundations to these Section 509(a)(3) supporting organizations where one or more disqualified persons of the private foundation control either the supporting organization or a charity the supporting organization supports.
-  Expenditure responsibility not required for distributions from private foundations to these organizations.

* Note that even with the exercise of expenditure responsibility, grants to these organizations from private *non-operating* foundations will not count toward the private foundation's minimum distribution requirement.