UT LAW CLE THE UNIVERSITY OF TEXAS SCHOOL OF LAW

Presented:
31st Annual Nonprofit Organizations Institute

January 15, 16-17, 2014
Austin, TX

Public Charity Basics Reference Outline

Darren B. Moore
Bourland, Wall & Wenzel, P.C.
Fort Worth, Texas

Author contact information:
Darren B. Moore
Bourland, Wall & Wenzel, P.C.
Fort Worth, TX

dmoore@bwwlaw.com
817-877-1088

Table of Contents

I. Introduction/Public Charities in Context

The Internal Revenue Code provides thirty-nine different exemptions from federal income tax for various types of nonprofits. Section 501(c)(3) organizations, those organized and operated for charitable, religious, and educational purposes, make up far and away the majority of the nation's tax-exempt organizations. Yet within Section 501(c)(3) a variety of activities are pursued. Some organizations are private family foundations operating as grant-makers while others are churches or vast hospital systems. The major dividing line is between private foundations and public charities.

The Internal Revenue Code categorizes organizations exempt from federal income tax under Section 501(c)(3) as private foundations unless the organization can show it qualifies as a public charity. Once qualifying as a public charity, the organization must meet certain maintain its status by operating for its exempt purposes and reporting to appropriate regulators such as the IRS. This paper will discuss qualifying as a public charity, maintaining that status once initially obtained, regulation of public charities, issues involved in raising funds (through donations as well as commercial activities), and ultimately terminating the charity when that becomes necessary or advisable. The paper will also touch on discrete Texas statutes applicable to Section 501(c)(3) organizations but having particular significance to public charities. As the title shows, the goal of this paper is to provide a basic overview and serve as a primer into the area of public charities.

II. Categories of Public Charities

A. Institutions: Organizations that are, by definition or by activity, public charities. I.R.C. § 509(a)(1); I.R.C. § 170(b)(1)(A)(i-v)
    1. Churches and conventions and associations of churches;
    2. 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 the activities are regularly carried on;
    3. Hospitals and medical research organizations;
    4. Endowment funds for state and municipal universities;
    5. Governmental units, including a state, a possession of the United States, a political subdivision of a state or the United States, the United States, or the District of Columbia

B. Donative Public Charities: Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. §509(a)(1); I.R.C. §170(b)(1)(A)(vi)

C. Service Provider Publicly Supported Public Charities: Organizations receiving a substantial amount of support from the general public or from governmental entities, I.R.C. § 509(a)(2) (sometimes called "gross receipts" publicly supported charities);

D. Supporting Organizations: Organizations excluded from private foundation treatment due to their close association with public charities treated as other than private foundations, I.R.C. § 509(a)(3); and;

E. Public Safety Organizations: Organizations organized and operated exclusively to test for public safety, I.R.C. § 509(a)(4)

III. Qualifying as an Institutional Public Charity

A. Churches and Conventions and Associations of Churches

1. The term "church" is found, but not defined in the Internal Revenue Code.
2. In *Foundation for Human Understanding v. Commissioner*, the IRS set out its fourteen factor test for determining whether an organization qualifies as a church. 88 T.C. 1341 (1987). None of the fourteen factors are exclusive. Rather, the test is one utilized by the IRS (significantly, as Schedule A to Form 1023 discussed below) for determining whether an organization has the markers commonly associated with a church. Those factors include the following:
   a) Distinct legal existence.
   b) Recognized creed and form of worship.
   c) Definite and distinct ecclesiastical government.
   d) Formal code of doctrine and discipline.
   e) Distinct religious history.
   f) Membership not associated with another church.
   g) Organization of ordained ministers.
   h) Ordination after prescribed studies.
   i) Literature of its own.
   j) Established place of worship.
   k) Regular congregations.
   l) Regular worship services.
   m) Sunday schools for religious instruction of the young.
   n) Schools for the preparation of ministers.
3. While none of the criteria are controlling, it has become increasingly clear that the IRS as well as courts focus on the associational aspect (i.e. people joining together) as central.
   a) In a 2004 Technical Advice Memorandum, the IRS noted that churches, while not being required to meet all of the criteria, ought to at least meet some minimum standard—those standards centered around this associational concept—having regular religious worship services, having a regular congregation, having an established place of worship, etc. TAM 200437040.
   b) This issue has been litigated in the context of Internet and radio based ministries with courts determining that such organizations lack the requisite associational aspect. *See e.g.*, *Foundation of Human Understanding v. United States*, 88 Fed. Cl. 203 U.S.C.T. Fed. Cl. (2009)).
4. The phrase "convention or association of churches" has not been defined in the Code or Regulations either. Rather, it is a historical phrase generally referring to groupings of churches that are congregational as opposed to hierarchical in nature. *See Lutheran Social Servs. of Minn. v. United States*, 758 F.2d 1283, 1288 (8th Cir. 1985). Associations of churches may include both churches and individuals. *See* I.R.C. § 7701(o).

5. The phrase "integrated auxiliary of a church" is defined in the Regulations. Specifically, Section 1.6033-2(h) defines integrated auxiliary of church as referring to a class of organizations related to a church or association of churches that (1) fits the definition of public charity; (2) is affiliated with a church or association of churches; and (3) receives its financial support primarily from internal church sources (with limited exceptions).
    a) An organization is affiliated with a church or association of churches if its governing documents evidence such affiliation (through common doctrine, authority to appoint and remove directors, annual reporting, or other similar factors whereby the organization is akin to a subsidiary of the church or association of churches).
    b) An organization is internally supported when it receives more than 50% of its support from internal church sources.

B. Educational Organizations
    1. Section 170(b)(1)(a)(ii) of the Code and Section 1.170A-9(b)(1) of the Regulations provide the definitions for the phrase "educational organization."
    2. An educational organization is one that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of students in attendance at a place where its educational activities are regularly carried on.
    3. The Regulations further make clear that the term "educational" relates to "(a) the instruction or training of the individual for the purpose of improving or developing his capabilities; or (b) the instruction of the public on subjects useful to the individual and beneficial to the community."
    4. The Regulations go on to explain that an organization may be educational even where it is advocating a specific viewpoint so long as it gives a "full and fair exposition of the pertinent facts as to permit an individual or the public to form an independent opinion or conclusion."
        a) This phraseology has been the subject of litigation which resulted in the "full and fair exposition test" being struck down as unconstitutionally vague.
        b) The IRS now commonly relies on a methodology test whereby it considers the methodology by which the proponent of the purported educational materials developed its argument in an effort to test whether there is "factual foundation for the viewpoint or position being advocated." *See* Rev. Proc. 86-43, 1986-2 C.B. 729.

C. Hospitals and Medical Research Organizations
    1. Hospitals
        a) Defined in the IRC as "an organization the principle purpose or functions of which are the providing of medical or hospital care or

medical education or medical research, if the organization is a hospital . . ." *See* IRC § 170(b)(1)(A)(iii)

b) Regulations add rehabilitation institutions, outpatient clinics, and community mental health or drug treatment centers if their "principal purpose or function is the providing of hospital or medical care" *See* § 1.170A-9(c)(1)

c) To qualify as charitable (promotion of health), a hospital must demonstrate it operates for a public interest
    i. Prior to 1956: relief of illness and distress; care of the poor
    ii. 1956-1969: charity care standard/financial ability test
    iii. 1969-2010: community benefit standard/facts and circumstances (still applies to healthcare entities that are not "hospitals" for purposes of Section 501(r))
        (a) Emergency room opened to all (unless no ER because community already served or specialty hospital)
        (b) Non-emergency care (open to all who can pay)
        (c) Community board (disinterested)
        (d) Open medical staff (privileges available to all qualified physicians consistent with size and nature of facility)
        (e) Surplus funds used to improve quality of care, expand facilities, advance education, research, training programs
        (f) Provide other services to meet healthcare needs of community (education)
        (g) Charity care and research
    iv. 2010-Current: Community benefit standard + Section 501(r) – applies to a "hospital organization" defined as (i) an organization that operates a facility required by the State to be licensed, registered, or similarly recognized as a hospital, or (ii) any other organization that the Secretary of the Treasury determines has the provision of hospital care as its principal function or purpose constituting the basis for its exemption under Section 501(c)(3)
        (a) Community Health Needs Assessment
        (b) Written financial assistance policy
        (c) Limitation on charges (restricted from charging eligible patients more than the amounts generally charges to insured patients for emergency or other medically necessary care)
        (d) Billing and collection practices limitations

2. Medical Research Organizations
    a) Organization "directly engaged in the continuous active conduct of medical research in conjunction with a hospital" *See* § 1.170A-9(c)(2)(i)

b) Medical research must be principal function *See* § 1.170A-9(c)(2)(iv)
c) Must devote a substantial portion (more than 50%) of assets to, or expend a significant percentage (3.5% of FMV) of its endowment for, medical research *See* § 1.170A-9(c)(2)(v)
d) Must be in conjunction with (joint effort) a hospital

D. Certain Endowment Funds for State and Municipal Universities
1. Must normally receive a substantial part of support (exclusive of exempt function income) from the U.S. or any state or political subdivision thereof or from contributions from general public. *See* § 1.170A-9(b)(2)
2. Use substantial support tests under § 1.170A-9(e) for determination but must tweak for differences in appropriate sources of support. *See* Rev. Rul. 82-132.

E. Governmental Entities - *See* § 170(b)(1)(A)(v)

IV. Qualifying as a Publicly Supported Donative Charity

A. Definition
1. Defined in I.R.C. § 509(a)(1) and § 170(b)(1)(A)(vi) is an organization that receives a substantial part of its support from the public or governmental units.
2. It generally does not provide any services in exchange for fees but rather is supported through contributions and donations, so it is sometimes referred to as a "donative" public charity.

B. Public Support Tests: The public support test is broken into two additional "either/or" tests - mechanical test or mathematical formula and the subjective "facts and circumstances test." If the foundation fails to satisfy either test, it will be treated as a private foundation.
1. Mechanical Test: An organization is publicly supported under I.R.C § 170(b)(1)(A)(vi) if it normally receives at least 33 1/3% of its total support from governmental units, direct or indirect contributions from the general public, or a combination of these sources. Treas. Regs. § 1.170A-9(e)(2). Such organizations must thus calculate their public support by constructing a support fraction.
a) The numerator (public support) includes: i) gifts and grants from private donors (persons [up to 2% of the total gifts over the five year test period; excess cannot be counted because it is a gift by a Disqualified Person], private foundations, bequests and corporations); ii) gifts and grants from public donors (governmental agencies or certain other publicly supported charities); membership fees; tax revenues levied on behalf of the organization; and, government services or facilities given without charge.
b) The denominator (total support) includes: i) gifts and grants from private donors (persons, private foundations, bequests and corporations); ii) gifts and grants from public donors (governmental agencies or certain other publicly supported charities); membership fees; tax revenues levied on behalf of the

organization; government services or facilities given without charge; gross investment income; and net unrelated business income.

c) Excluded from support fraction: i) gross receipts income, ii) unusual grants, iii) voluntary services, and, iv) capital gains.

2. Facts and Circumstances Test: Even if the organization does not meet the 33 1/3% test, the organization may, nonetheless, be considered publicly supported if it normally receives a substantial part, which the regulations state is 10% or more, of its support from governmental units, the general public or a combination of these sources and if it meets other factors tending to show that it is organized and operated to attract public and governmental support on a continuing basis. Treas. Regs. § 1.170A-9(e)(3)(i).
   a) Must maintain a continuous and bona fide program for soliciting funds from the general public or conduct activities so as to attract support from governmental units or other publicly oriented organizations described in I.R.C. § 170(b)(1)(A)(i) through (vi) Treas. Regs. § 1.170A-9(e)(3)(ii).
   b) The Treasury Regulations state that in determining whether a continuous and bona fide solicitation program is maintained, the Service will look to three factors. The first is whether the scope of the organization's fundraising activities is reasonable in light of its charitable activities. The second is that a new organization may rely on limited sources or amounts of support until it can expand its solicitation program or activities. The third is that the facts and circumstances of each case will be analyzed in accordance with the organization's nature and purpose. Treas. Regs. § 1.170A-9(e)(3)(ii).
   c) An organization that does not normally receive at least 10% of its support from a governmental entity or the public will not qualify as a public charity under either the facts and circumstances test or the 33 1/3% test. Treas. Regs. § 1.170A-9(e)(3)(i).
   d) Under the 10% facts and circumstances test, the greater the organization's governmental or public support is in excess of 10% of total support normally received, the lesser is its burden of establishing its publicly supported nature through other factors, and vice versa. Treas. Regs. § 1.170A-9(e)(3)(iii).
      i. If an organization's public support is derived from a representative number of persons rather than from members of a single family, this factor indicates a publicly supported nature. This factor is less important when dealing with a new organization or an organization whose activities can be expected to limit its appeal to a particular segment of the public. Treas. Regs. § 1.170A-9(e)(3)(iv).
      ii. If an organization's governing body represents the broad interests of the public rather than the private interests of a

limited number of donors, this factor indicates a publicly supported nature. In general, the broad interests of the public will be served by a governing body comprised of public officials or their representatives, persons with expertise in the organization's field of operation, community leaders or persons elected by a broadly based membership. Treas. Regs. § 1. 170A9(e)(3)(v).

iii. If an organization provides a facility or service directly for the benefit of the general public on a continuing basis, this factor indicates a publicly supported nature. Such organizations include museums and libraries whose facilities are open to the public, symphony orchestras and senior citizens' homes providing housing or nursing services for the general public. Treas. Regs. § 1.170A-9(e)(3)(vi)(a).

iv. Other factors useful in considering whether membership organizations have the requisite publicly supported nature include whether solicitations for dues-paying members is designed to enroll a substantial number of persons in the community area or in a particular profession or field of interest; whether membership dues for individual members have been fixed at rates designed to make membership available to a broad cross section of the interested public; 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. Treas. Regs. § 1.170A-9(e)(3)(vii).

V. Qualifying as a Publicly Supported Service Provider Public Charity

A. Definition

1. A “gross receipts” or “service provider” publicly supported charity is defined in I.R.C. §509(a)(2). If an organization meets the support tests described in I.R.C. §509(a)(2), it will be treated as a public charity and will not be subject to the private foundation restrictions.
2. Fundraising activities should solicit a broad range of public support to satisfy test.

B. Public Support Test: There are two public “support” tests that must be applied in determining whether the organization meets the requirements of an I.R.C. §509(a)(2) public charity, the “more than 1/3 support test,” and the “not more than 1/3 support test.” The organization must normally receive more than 1/3 of its total annual support from the public, and not more than 1/3 of its total annual support from gross investment income and excess unrelated business taxable income.

1. The "More than 1/3" Support Test: The organization must "normally" receive more than one-third (1/3) of its support from gifts, grants, contributions, membership fees, or gross receipts from the public.
    a) Total support (denominator), includes contributions, memberships, and grants, gross receipts, UBTI, and gross investment income as defined in §509(e). Capital Gains and the value of exemption from federal, state or local taxes are excluded from total support. Support is determined on the cash receipts/disbursements method of accounting, which may be used to spread contributions from Disqualified Persons over a period of years.
    b) Public support (numerator) includes amounts received from governmental units, amounts received from persons other than Disqualified Persons (as defined in I.R.C. §4946(a)), and amounts received from I.R.C. §509(a)(1) organizations, (most I.R.C. §170(b)(1)(A) charitable organizations).
    c) Contributions, grants, gifts and memberships are distinguished from gross receipts because of different limitations. Receipts from Disqualified Persons as defined in §4946(a) are not counted at all in determining public support. Disqualified Persons include Substantial Contributors (any person who has contributed more than $5,000 to the organization, if this amount is more than 2% of all the contributions and bequests received by the organization since its creation as of the close of the taxable year of the contribution), directors/trustees, officers, entities controlled by Disqualified Persons or by family members of Disqualified Persons, and family members of Disqualified Persons.
    d) Gross receipts are receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in any activity which is not an unrelated trade or business. Gross receipts are subject to different limitations than contributions. Receipts from Disqualified Persons are not counted as Public Support, but are counted as Total Support. Gross receipts are counted as Public Support only to the extent that the total amount received from each person or governmental unit during the taxable year does not exceed $5,000 or 1% of total support for the year. Unrelated business taxable income is not included in gross receipts for purposes of determining public support.
    e) The "Not More Than 1/3 of Support" Test: No more than 1/3 of the organization's total support can come from the sum of gross investment income plus the excess of unrelated business taxable income over the amount of tax imposed on such unrelated business taxable income.
    f) Gross Investment Income is defined as the gross amount of income from interest, dividends, payments with respect to securities loans, rents and royalties, but not including any such income to the extent included in computing the tax imposed by I.R.C. §511.

g) Unrelated Business Taxable Income (UBTI) does not include income from the sale of merchandise, substantially all of which has been received by the organization as gifts or contributions, or the mere acknowledgement of contributions or sponsorship in fundraising activities. Valuable advertising, marketing, and similar services on a quid pro quo basis for the sponsor will raise issues of UBTI.

2. The determination of whether the organization has "normally" met these two support tests is determined on the basis of a five year moving average (year in question and previous four years). The sum of public support for the five-year period must total more than 1/3 of the organization's aggregate total support for the five-year period, and gross investment income and excess unrelated business taxable income for the five-year period must not exceed 1/3 of the organization's total support. If the organization meets the five-year test, it is considered to qualify for the year in question and the following year. If there is a material change in the organization's support during the two-year period (other than unusual grants), compliance with the two support tests is determined on the basis of the year of the material change and the four preceding taxable years.
3. An unusual grant is one which is: (1) received from disinterested parties; (2) attracted by reason of the publicly supported nature of the organization; (3) is unusual and unexpected in amount; and (4) by reason of its size, would adversely affect the status of the organization under the 1/3 public support test. Grants paid over a number of years may be excluded in their entirety if they qualify as unusual grants. If the grant does not meet the above stated criteria, then a "facts and circumstances" test is applied. Treas. Regs. §1.509(a)-3(c)(4). The IRS will also consider, if the grant or contribution is to underwrite operating expenses, rather than capital expenditures, whether the terms and amount of the grant or contribution are expressly limited to no more than one year's operating expenses. Rev. Proc. 81-7, 1981-1 C.B. 621.
4. Effect of Ruling on Grantors and Contributors:
    a) If there are material changes in an organization's support, the organization's status remains unchanged as to innocent grantors and contributors until the IRS gives public notice that the organization no longer qualifies under §509(a)(2). (This protection does not apply to any grantor or contributor who was responsible for, or aware of, the material change in support or who knows the IRS has notified the organization that it no longer qualifies under §509, even though notice has not been formally published.)
    b) Grantor can rely on a written statement from the organization (signed by a responsible officer and including information from the prior 4 years sufficient to indicate that the contribution will not disqualify the organization).

VI. Qualifying as a 509(a)(3) Supporting Organization

A. Definition

1. A supporting organization is an organization exempt under I.R.C. § 501(c)(3) and § 509(a)(3) which supports one or more public charities qualifying under I.R.C. § 509(a)(1) or (2). It may also, under certain circumstances, support a social welfare league, civic league, labor or agricultural organization, real estate board, or business league that is exempt under I.R.C. § 501(c)(4), (5) or (6) [(4) describing civic leagues, social welfare organizations and local associations of employees, (5) describing labor, agricultural or horticultural organizations and (6) describing business leagues, chambers of commerce, real estate boards, boards of trade, and professional football leagues].
2. A supporting organization is organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the exempt purposes of one or more public charities.

B. No "Support" Tests: Supporting organizations are not required to meet the public "support" tests that some I.R.C. § 509(a)(1) and all I.R.C. § 509(a)(2) organizations must satisfy to establish the public support necessary to exempt them from the private foundation rules. As long as a supporting organization is organized and operated exclusively to support one or more public charities it does not matter whether the organization's funding is from one or from multiple sources.

C. Organizational Test: The governing instruments of the supporting organization must:

1. State that the purposes of the organization are limited to the purposes of one or more benefited public charities;
2. Not expressly empower the supporting organization to engage in activities that do not further the charitable purposes of the benefited public charity or charities;
3. Designate by class or purpose or by name, the public charities to be benefited; and,
4. Not authorize the supporting organization to benefit any other public or private charity or charities.

D. Operational Test: The supporting organization must be "operated exclusively" for the support of the supported organizations, including the making of 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 organizations (sometimes referred to as the "permissible beneficiary" requirement).

1. The supporting organization must either pay over its income to the supported organization or use its income to carry on an independent activity or program which supports or benefits the supported organization (sometimes referred to as the "permissible activities" requirement).
2. Supporting organizations are prohibited from making any payments or loans (including reasonable compensation for services) to any individual who is a substantial contributor or is a family member of a substantial

contributor or to any company in which a substantial contributor or family member owns 35 percent or more of the controlling interest.

E. Must Not Be Controlled By Disqualified Persons: A supporting organization must not be controlled directly or indirectly by one or more Disqualified Persons (as defined in I.R.C. § 4946) other than foundation managers and other than one or more organizations described in I.R.C. § 509(a)(1) or (2).
    1. An organization will be considered "controlled" if the Disqualified Person(s), by aggregating their votes or positions of authority, may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act. This control is demonstrated if the voting power of such Disqualified Persons is 50 percent or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization. (There is a narrow exception to this rule, in situations such as a religious organization operated in connection with a church, where the majority of the organization's governing body is composed of lay persons who are substantial contributors to the organization. If a representative of the church, such as a bishop or other official has control over the policies and decisions of the organization, the Disqualified Persons on the governing body will not disqualify the organization under 509(a)(3)(C). Treas. Reg. §1.509(a)-4(j)(2)).
    2. All pertinent facts and circumstances will be taken into consideration in determining whether a Disqualified Person does in fact indirectly control an organization. For example, if the governing body of the supporting organization is composed of seven (7) directors, none of whom has a veto power over the actions of the supporting organization and no more than three directors are at any time Disqualified Persons, such foundation will not be considered to be controlled directly or indirectly by one or more Disqualified Persons by reason of this fact alone.
    3. Likewise, all of the facts and circumstances will be examined to determine if a Disqualified Person (or persons) has indirect control over the organization. Where persons on the governing body have a relationship with a Disqualified Person such that the Disqualified Person could exert control over such persons (e.g. an employer-employee relationship), the Disqualified Person may be deemed to possess indirect control of the organization.

F. Three Subclasses of Supporting Organizations: At least one of the following relationships must be present in order to qualify as a supporting organization:
    1. "Operated, supervised, or controlled by" one or more publicly supported organizations (parent-subsidiary relationship) [Type I organization]:
        a) Includes a substantial degree of direction by the publicly supported organization(s) over the conduct of the supporting organization.
        b) Existence established by majority of officers, directors or trustees of the supporting organization being appointed or elected by the governing body, members of the governing body, officers or

membership of one or more of the supported organizations. (If multiple charitable organizations are being supported, then it is not necessary that each supported organization has a voice in management of the supporting organization.)

c) Purposes Requirement: The purposes of the supporting organization as set forth in the governing instrument may be similar to, but no broader than, the purposes set forth in the governing instrument of the controlling publicly supported organizations.

d) Specified Organization Requirement: May specify the publicly supported organizations in one of three ways: 1) designate by name in the governing instruments; 2) designate by class or by purpose in governing instruments; and 3) remain silent in the governing instruments if two conditions met: i) there exists a historic and continuing relationship between the supporting organization and the supported organization; and ii) by virtue of such relationship, there has developed a substantial identity of interest between the organizations.

2. "Supervised or controlled in connection with" one or more publicly supported organizations (brother-sister relationship) [Type II organization]:
   a) Common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations, such that the supporting organization will be responsive to the needs and requirements of the supported organization. To meet this requirement, the control or management of the supporting organization must be vested in the same persons that manage the supported organization.
   b) The mere making of payments to the publicly supported organizations, even if such payment is enforceable by state law, does not provide a sufficient "connection" between the payor organization and the needs and requirements of the publicly supported organization to constitute supervision or control in connection with such organization.
   c) Other Requirements: The organizational test may be satisfied for a Type II organization in the same manner as Type I "operated, supervised or controlled by" supporting organization.
3. "Operated in connection with" one or more publicly supported organizations [Type III organization]:
   a) The third sub-class of supporting organization is one that is "operated in connection with" one or more publicly supported organizations.
   b) Type III supporting organizations are the most independent form of the supporting organizations, as they may have an independent board, with specified beneficiary organizations. Because of this, a

Type III supporting organization has two additional tests to meet: the responsiveness test and integral part test.

i. Responsiveness Test: A Type III supporting organization satisfies the Responsiveness Test if it is responsive to the needs and demands of the supported organization. The supported organization must have a "significant voice" in the Type III supporting organization's investment policies, operations and grant-making activities. Treas. Reg. § 1.509(a)-4(i)(3). The supported organization can have the required significant voice in one of the three following ways:
    (a) If one or more officers or directors of the supporting organization are appointed or elected by the supported organization's officers, directors, trustees or members;
    (b) If one or more members of the supporting organization's governing body are also officers, directors or trustees of, or hold other important offices in, the supported organization; or,
    (c) The supporting organization's officers, directors or trustees maintain a close and continuous working relationship with the supported organization's officers, directors or trustees.

    Whether a supported organization has this significant voice in directing the use of the supporting organization's income or assets, and whether it has a close and continuous relationship with the supporting organization, will be determined based on all relevant facts and circumstances. The IRS and Treasury Department have concluded that the term "significant voice" requires only that the officers, directors or trustees of the supported organization have the ability to influence the supporting organization's decisions on the use of its income or assets, not that they have complete control over those decisions.

    Prior to the final regulations effective December 28, 2012, charitable trusts were able to meet this requirement under an alternative responsiveness test pursuant to Treas. Reg. § 1.509(a)-4(i)(2)(iii); however, this alternative test has been removed by the 2012 regulations. Trustees must actually have a close, continuous working relationship with the directors, trustees or officers of the supported organization, just like any other Type III supporting organization.

ii. Integral Part Test: The Type III supporting organization must meet one of the two alternate prongs of the Integral Part Test, which further classifies the supporting

organization as either “Functionally Integrated” or “Non-Functionally Integrated.”

(a) Functionally Integrated: A functionally integrated Type III supporting organization actually conducts direct programs, rather than merely holding investment assets to produce income to then fund operations conducted by the supported organization. To be a functionally integrated organization, it must meet one of the following criteria:

1. Engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations. This means the activities directly further the supported organization(s)’s exempt purposes, by either performing the functions or carrying out the purposes of such supported organization(s), and but for the involvement of the supporting organization, those activities would usually be done by the supported organization(s). Treas. Reg. § 1.509(a)-4(i)(4)(ii).
    a. To be considered direct furtherance activities, a supporting organization’s grants, scholarships or other payments to individual beneficiaries must satisfy three prongs: (1) the individual beneficiaries must be members of the charitable class benefitted by a supported organization; (2) the officers, directors or trustees of that supported organization must have a significant voice in the timing of the payments, the manner of making them and the selection of recipients; and (3) the individual beneficiaries must be selected on an objective and non-discriminatory basis. Examples provided in the regulations include operating a food pantry and maintaining local parks on behalf of the supported organization.
    b. Fundraising, making grants and investing and managing non-exempt-use assets are not considered to be

activities bringing the organization within this provision, but holding title to and managing exempt-use assets are considered to be such activities.

2. The supporting organization is the parent of each of its supported organizations.
    a. A supporting organization is considered the parent of its supported organization if it exercises a substantial degree of direction over the policies, programs and activities of the supported organization and a majority of the officers, directors or trustees of the supported organization is appointed or elected (directly or indirectly) by the governing body, members of the governing body or officers of the supporting organization. Treas. Reg. § 1.509(a)-4(i)(4)(iii).
    b. The IRS and Treasury Department intend to issue proposed regulations in the near future to provide a new definition of "parent", to specifically address the power to remove and replace officers, directors or trustees of the supported organization.
3. Supports a governmental supported organization.
    a. This option is not currently explained further under the regulations. The Treasury Department and IRS are considering comments received regarding this option, such as the ability to support multiple governmental organizations.
    b. The Treasury Department and IRS intend to issue proposed regulations in the near future which will provide further guidance on how supporting organizations can qualify by supporting a governmental entity.

(b) Non-Functionally Integrated: The second way to meet the Integral Part Test is to meet the requirements of being a "non-functionally

integrated" supporting organization ("NFI"), determined by the amount of support provided to the supported organization(s).

1. Distribution Requirement: Each taxable year, to qualify as an NFI, the organization must distribute to, or for the use of, one or more supported organizations an amount equal to the greater of 85% of adjusted net income (based on the principles of § 4942) or the supporting organization's minimum asset amount for the prior taxable year (essentially, 3.5% of the fair market value of the organization's non-exempt use assets, described in further detail below).
2. Because this distributable amount is significantly different from that described in the 2009 proposed regulations, the Treasury Department and IRS have issued the provisions regarding the distributable amount as temporary and proposed regulations, to provide an opportunity for comment.
3. The minimum asset amount is calculated similar to a private foundation's minimum investment return – it is the average of the fair market value of the organization's non-exempt use assets, less the average acquisition indebtedness related to those assets, multiplied by 3.5%.
    a. This number is then added to the recoveries of any amounts taken in a prior year to meet the distribution requirement,
    b. Plus amounts received from the sale or disposition of property (to the extent the acquisition of that property was taken into account to meet the distribution requirement),
    c. Plus any set-aside that was not ultimately deemed necessary for that purpose for which it was set-aside, and was taken into account to meet the distribution requirement.
4. In valuing the organization's assets, the same rules for valuing assets of a private foundation apply (i.e. § 4942). "Exempt-

use" assets include those assets used or held for use in carrying out the exempt purposes of either the supporting organization or its supported organization (if made available to the supported organization for no or nominal cost).

5. The distributable amount for the first taxable year an organization is treated as an NFI is zero; however, for determining whether an excess amount is created, the distributable amount for the first year is considered equivalent to the amount that would otherwise apply. If an excess amount is created, it can be used to reduce the distributable amount in a following year, for a period of up to five years. An excess is created if the total distributions made in that year which count toward the distribution requirement exceed the distributable amount for that taxable year. The distributable amount is reduced by any excess amounts carried over from prior years first (the oldest excess amounts are applied first), and then by any distributions made in that taxable year.
6. Distributions which count toward the distribution requirement include:
    a. Amounts paid to a supported organization to accomplish its exempt purposes;
    b. An amount paid to perform an activity that furthers the exempt purpose of the supported organization, but only to the extent it exceeds any income derived by the supporting organization from the activity;
    c. Reasonable and necessary administrative expenses paid to accomplish the supported organization's exempt purposes (not including expenses incurred in producing investment income);
    d. Amounts paid to acquire an exempt-use asset that would be excluded

from the payout requirement calculations; and

e. Amounts set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive, following the set-aside rules for private foundations (not including the cash distribution set-aside).

7. A NFI Type III supporting organization which fails to meet the distribution requirement will be treated as a private foundation for that taxable year, unless it can prove reasonable cause for the failure, and meets the distribution requirement within 180 days of the time it discovers the deficiency or becomes able to distribute following unforeseen events. Treas. Reg. § 1.509(a)-4(i)(5)(ii)(F). Reasonable cause is shown if the failure was due solely to unforeseen events or circumstances that were beyond the organization's control, a clerical error, or an incorrect valuation of assets, and not due to willful neglect.
8. Attentiveness Test: The NFI's support must be sufficient to assure that the supported organization will be attentive to its operations. The NFI must distribute at least 1/3 of its distributable amount to one or more supported organizations that are "attentive" to the operations of the supporting organization and to which the supporting organization is "responsive" (as defined in the Responsiveness Test, above). Treas. Reg. § 1.509(a)-4(i)(5)(iii). In determining whether a supported organization will be considered attentive to the operations of a supporting organization, any amount received from the supporting organization that is held by the supported organization in a donor advised fund is disregarded.
9. A supported organization is considered attentive to the operations of the supporting organization during a taxable year if, in the

taxable year, at least one of the following requirements is satisfied:

a. The supporting organization distributes to the supported organization an amount equal to at least 10% of the supported organization's total support received during the last taxable year ending before the beginning of the supporting organization's taxable year; or
b. The amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization. The program or activity does not have to be the supported organization's primary activity, so long as it is a substantial one. Support is considered "necessary" if the supporting organization or the supported organization earmarks the support for that particular program or activity of the supported organization; or
c. Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supporting organization and its supported organization(s) and the purpose to which the funds are used, the amount of support received from the supporting organization is a sufficient part of a supported organization's total support to ensure attentiveness. The more substantial the amount involved in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from

the supporting organization is sufficient to ensure the attentiveness of the supported organization to the operations of the supporting organization (including attentiveness to the nature and yield of the supporting organization's investments), evidence of actual attentiveness by the supported organization is of almost equal importance.

d. A supported organization is not considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

10. Alternate Test: An NFI Type III supporting organization formed as a trust on or before November 20, 1970 does not have to satisfy the integral part requirements described above (i.e. the Distribution Requirement and Attentiveness Test), if it satisfies the following:
    a. For taxable years beginning October 16, 1972, the trustee of the trust makes annual written reports to all of the trust's supported organizations, setting forth a description of the trust's assets, including a detailed list of the assets and income derived therefrom;
    b. All of the unexpired interests in the trust are devoted to charitable purposes and a deduction (under appropriate Code sections) was allowed regarding such interests;
    c. The trust has not received any grants, contributions, bequests or other transfers since November 20, 1970;
    d. The trust is required by its governing instrument to distribute all of its net income to a designated beneficiary supported organization. (If there is more than one beneficiary, all of the net income must be distributable in fixed amounts to each beneficiary);

e. The trustee does not have discretion to vary the beneficiary supported organizations or the amounts payable to them. The ability to cease making payments to a particular supported organization in the event of certain occurrences such as the supported organization's loss of exemption or failure to operate for charitable purposes is not treated as impermissible discretion; and
f. None of the trustees would be disqualified persons within the meaning of § 4946(a) with respect to the trust if it were a private foundation (not including foundation managers in the definition of disqualified persons).

G. Additional Requirements for Type III Supporting Organizations
   1. Foreign Supported Organizations: Type III supporting organizations may not support a supported organization which is organized outside of the United States. Treas. Reg. § 1.509(a)-4(i)(10).
   2. Notification Requirement: All Type III supporting organizations must satisfy the notification requirement for taxable years including December 28, 2012 and following, based on the new final regulations. Treas. Reg. § 1.509(a)-4(i)(2). This requires the supporting organization to provide annual notice to each supported organization(s) including information to help ensure the supporting organization is responsive to the supported organization's needs.
      a) The information must meet the following requirements:
         i. Written notice addressed to a principal officer of the supported organization, with the amount and type of support it provided to the supported organization during the immediately preceding taxable year of the supporting organization, and during any other taxable year of the supporting organization ending after December 28, 2012, for which support information has not previously been provided;
         ii. A copy of the supporting organization's Form 990 or other annual information return most recently filed as of the date the notification is given, and any other return for other taxable years ending after December 28, 2012 and which has not been previously provided to the supported organization; and
         iii. A copy of the supporting organization's governing documents as in effect on the date the notification is

provided, including its articles of organization and bylaws (if any) and any amendments to such documents, unless such documents have been previously provided and not subsequently amended.

b) The notification may be provided electronically, and must be postmarked or electronically transmitted by the last day of the fifth calendar month following the close of that taxable year.

3. Transition Rules: The December, 2012 regulations provide for special transition rules for meeting the notification requirements and the Integral Part Test for (both functionally integrated and non-functionally integrated) Type III supporting organizations. Type III supporting organizations will be treated as having satisfied the notification requirement or its taxable year that includes December 28, 2012, if the required notification is postmarked or electronically transmitted by the later of the last day of the fifth calendar month following the close of that taxable year or the due date (including extensions) of the supporting organization's annual information return (Form 990) for that taxable year. Treas. Reg. § 1.509(a)-4(i)(11). A Type III supporting organization qualifying as functionally integrated that has met and continues to meet the requirements in effect before December 28, 2012 will continue to be treated as meeting the Integral Part Test until the first day of its second taxable year following December 28, 2012. Both Type III functionally integrated and non-functionally integrated supporting organizations must meet the new regulation requirements effective the first day of its second taxable year beginning after December 28, 2012, if they wish to continue such classification.

VII. Obtaining Tax Exempt Status

A. Choice of Form (State Law): Within the broad rubric of the nonprofit sector only a limited number of organizational forms are eligible for tax-exempt status:

1. Charitable trust
   a) Created by a settlor irrevocably transferring property to a person or entity as trustee with the intention of creating a charitable trust.
   b) Governed by the Texas Trust Code as well as common law relating to trusts.
2. Nonprofit corporation
   a) Defined as a nonprofit corporation as a corporation no part of the income of which is distributable to a member, director or officer of the corporation. *See* Tex. Bus. Orgs. Code Ann. at § 22.001(5)
   b) Created by the filing of a Certificate of Formation with the Texas Secretary of State. Bylaws are to be adopted at the first organizational meeting of the new corporation.
   c) Governed by Chapter 22 of the BOC. *See* Tex. Bus. Orgs. Code Ann § 22.001 et. seq.
3. Unincorporated association
   a) Defined as an unincorporated organization, other than one created by a trust, consisting of three or more members joined by mutual

consent for a common, nonprofit purpose. *See* Tex. Bus. Orgs. Code Ann. § 252.001 et seq.

b) Formation is not governed by statute and does not require any organizational documents although an unincorporated association will typically have articles of association, a constitution, or bylaws.

c) The IRS will expect to see some type of governing document such as articles of association, with certain provisions regarding organization, operation and dissolution of the association in order to qualify for 501(c)(3) status.

d) Governed by Chapter 252 of the Texas Business Organizations Code.

4. Limited liability company

a) LLCs are unique in their eligibility for exemption. Unlike the other forms discussed above, the LLC is used as a single-member entity with an exemption organization as the single member or alternatively as a multi-member LLC with all of the members being exempt.

b) Created by the filing of a Certificate of Formation with the Texas Secretary of State. A Company Agreement is to be adopted thereafter.

c) Governed by Chapter 101 of the Texas Business Organizations Code.

d) Where the LLC is a single-member LLC with the single member being an exempt organization, federal tax law provides that the LLC will be disregarded meaning that the LLC does not need to separately apply for tax-exempt status (discussed below), but rather will effectively take on the tax attributes of its parent member.

e) Should a single member LLC wish to apply for exemption (as opposed to being disregarded entity) or should the LLC have multiple members, the IRS will recognize the 501(c)(3) exemption of the LLC if the LLC otherwise meets the qualification for exemption and meets certain other conditions.[1]

B. Requirements for Tax Exemption under Section 501(c)(3) (*See* Reg. 1.501(c)(3)-1(a))

1. Proper organizational structure (as addressed above in Section VII.A.);
2. Organized exclusively for charitable or otherwise exempt purposes.

a) Pursuant to Section 1.501(c)(3)-1(b)(1)(i) of the Regulations, an organization is organized for exempt purposes if its organizational documents limit its purposes to one or more exempt purposes and do not otherwise empower the organization to engage in a more than insubstantial manner in activities which are not in furtherance of one or more exempt purposes.

[1] These twelve conditions can be found in the IRS 2001 EO CPE under *Limited Liability Companies as Exempt Organizations—Update*.

b) To demonstrate compliance with this "organizational" test, an organization must show that its assets are dedicated to an exempt purpose. *See* Reg. 1.501(c)(3)-1(b)(4). Such dedication is accomplished by way of a dissolution provision requiring that upon dissolution, the assets of the organization will be distributed for exempt purposes or to the Federal government, or to a State or local government, for a public purpose.

3. Operated exclusively for charitable or otherwise exempt purposes.
   a) Section 1.501(c)(3)-1(c)(1) of the Regulations provides that "[a]n organization will be regarded as "operated exclusively" for one or more exempt purposes only if it engages primarily in activities which accomplish one or more such exempt purposes specified in section 501(c)(3)."
4. No part of the net earnings may inure to the benefit of a private individual.
   a) Section 1.501(c)(3)-1(d)(1)(ii) of the Regulations provides that to be organized and operated for one or more exempt purposes the organization must serve a public rather than a private interest. This equates to a requirement that no part of the net earnings inures to the benefit of a private individual.
5. Not an action organization.
   a) Section 1.501(c)(3)-1(c)(3) provides that an action organization—that is an organization that is attempting to influence legislation by propaganda or otherwise—is ineligible for exemption as it is not operated exclusively for exempt purposes.
6. Not violative of public policy.
   a) Case law has appended the foregoing elements with the requirement that an organization must not be created to violate public policy in order to qualify for exempt status.

C. Application for Recognition of Exempt Status
   1. With certain exceptions, an organization seeking to qualify under Section 501(c)(3) will file Form 1023 with the Internal Revenue Service to obtain recognition of exemption.[2] Forms 1023 can be downloaded from the IRS's website (www.irs.gov).
   2. A substantially complete Form 1023 contains the following:
      a) The signature of an authorized individual;
      b) The organization's employer identification number or a completed Form SS-4;
      c) Information concerning previously filed federal income tax and exempt organization returns;
      d) A statement of receipt and expenditures and a balance sheet for the current year and the three preceding years (or for the number of years of the organization's existence, if less than four years) [Note: If the organization has not yet commenced operations or completed one accounting period, financial data for the current year and

[2] For example, churches, associations of churches, and integrated auxiliaries of churches are exempt from the filing requirement.

proposed budgets for the next two accounting periods are sufficient.];

e) A statement of actual and proposed activities, Treas. Regs. § 1.501(a)-1(b)(2)(iii), and a description of anticipated receipts and contemplated expenditures;

f) A copy of the articles of incorporation, trust indenture or other organizational or enabling document signed by a principal officer or accompanied by a written declaration signed by an authorized individual certifying that the document is a complete and accurate copy of the original [Note: Any originals submitted will become part of the file and will not be returned.];

g) If the organization is a corporation or unincorporated association which has adopted bylaws, a current copy thereof;

h) Form 2848, Power of Attorney and Declaration of Representative, if applicable;

i) Form 8718, User Fee for Exempt Organization Determination letter request, and a check made payable to the IRS in payment of the user fee applicable to the organization. The current user fee is $850 for initial applications for exempt status for organizations seeking exemption under I.R.C. Section 501(c) whose actual or anticipated gross receipts exceed $10,000. Applications for exempt status of organizations (other than pension and profit sharing plans) that have had annual gross receipts averaging not more than $10,000 during the preceding four years, or new organizations anticipating gross receipts averaging not more than $10,000 during their first four years, must pay a user fee of $400. If the organization does not include the correct user fee with the application, the application will be returned.

3. Local Applications

a) Application should also be made to state and local taxing authorities for exemption from franchise taxes, real and personal property taxes, rent taxes and sales taxes. Application should be made to the Texas Comptroller of Public Accounts for exemption from the Texas franchise tax and sales and use tax based on the foundation's status as a I.R.C. §501(c)(3) organization. The application is available on the Comptroller's website (http://www.window.state.tx.us/). Property tax exemptions are not based on Section 501(c)(3) status but are rather based on satisfaction of requirements in the Texas Property Tax Code. Public charities should be aware that qualification for property tax exemption in Texas is much narrower than qualification for exemption from federal income tax under Section 501(c)(3). Application for exemption from property tax is made to the local county tax assessor.

VIII. Regulation of Public Charities

A. Reporting Requirements

1. Form 990: Return of Organization Exempt from Income Tax.
2. State Reports
    a) Texas Corporation Franchise Tax Report: A public charity organized as a Texas nonprofit corporation or limited liability company will be required to file this report until such time as the organization has applied for and received exemption from the franchise tax. Note: Limited liability companies that are single member LLC's but do not have separate exemption status are not eligible for franchise tax exemption and will be required to file even if no tax is due.
    b) Texas Nonprofit Public Information Report/BOC 22.357 Report: Every four years, the organization may be required to file with the Texas Secretary of State a report which states the name of the corporation, its address, the name and address of its registered agent and the names and addresses of its officers and directors.
    c) Texas Workforce Commission Status Report: If the organization has employees, it must complete a Texas Workforce Commission Status Report and file it with the Tax Department of the Texas Workforce Commission.
    d) Employer Returns: If the foundation has employees, it must withhold, deposit, pay and report federal income taxes, social security taxes, and federal unemployment taxes, unless specifically excluded by statute.

B. IRS Regulation of Public Charities

1. Excess Benefit Transactions and Intermediate Sanctions
    a) Public charities are not subject to the excise taxes imposed on private foundations under I.R.C. §§ 4940-4945. Rather, a public charity is subject to the intermediate sanctions rules under I.R.C. §4958 and the related Treasury Regulations (Treas. Reg. §§53.4958-1 through 53.4958-8).
    b) Tax Imposed: Any Disqualified Person who benefits from an excess benefit transaction with an applicable tax-exempt organization is liable for a tax of 25% of the excess benefit. The Disqualified Person is also liable for a tax of 200% of the excess benefit if the excess benefit is not corrected by a certain date. Additionally, organization managers (officer, director, or trustee) who knowingly participate in the excess benefit transaction (unless such participation was not willful and was due to reasonable cause) are assessed a tax of 10% of the excess benefit transaction.
    c) "Disqualified Person" is defined as any person who was in a position to exercise substantial influence over the affairs of the applicable tax-exempt organization at any time during a five-year period ending on the date of the transaction, a member of the family of that person, or an entity that is 35% controlled by a

Disqualified Person. I.R.C. §4958(f). [Note that there is a difference between a Disqualified Person for private foundation purposes (I.R.C. §4946) and for intermediate sanctions purposes.]

i. The following persons are considered to have substantial influence:
    (a) President, CEO, COO,
    (b) Treasurer, CFO,
    (c) Persons with a material financial interest in a provider-sponsored organization (generally, in the context of nonprofit hospitals)
ii. The following persons are deemed NOT to have substantial influence:
    (a) Tax-exempt organizations described in I.R.C. §501(c)(3),
    (b) Certain I.R.C. §501(c)(4) organizations,
    (c) Employees receiving economic benefits of less than a specified amount in a taxable year
iii. Facts and circumstances govern in all other instances. Treas. Reg. §53.4958-3

d) Excess Benefit Transaction. An excess benefit transaction means any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any Disqualified Person, and the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received by the organization for providing the benefit.

i. An excess benefit can occur in an exchange of compensation and other compensatory benefits in return for the services of a Disqualified Person, or in an exchange of property between a Disqualified Person and the exempt organization.
ii. For purposes of determining the value of economic benefits, the value of property, including the right to use property, is its fair market value.
    (a) Rebuttable Presumption of Reasonableness
iii. Compensation paid to a Disqualified Person is not excessive if it is reasonable. Reasonableness is determined under an I.R.C. §162 standard, which is the value that would ordinarily be paid by like enterprises under like circumstances
iv. All items of compensation provided by an applicable tax-exempt organization in exchange for the performance of services are taken into account in determining the value of compensation
v. There is a rebuttable presumption of reasonableness, and the payments under a compensation arrangement are

presumed to be reasonable and the transfer of property (or right to use property) is presumed to be at fair market value, if the tax-exempt organization follows the following procedures:

(a) The transaction is approved by an authorized body of the organization (or an entity it controls) which is composed of individuals who do not have a conflict of interest concerning the transaction,

(b) Prior to making its determination, the authorized body obtained and relied upon appropriate data as to comparability. If the organization has gross receipts of less than $1 million, appropriate comparability data includes data on compensation paid by three comparable organizations in the same or similar communities for similar services,

(c) The authorized body adequately documents the basis for its determination concurrently with making that determination. The documentation should include:

1. The terms of the transaction that was approved and the date it was approved,
2. The members of the authorized body who were present during the debate on the transaction that was approved and who voted on it,
3. The comparability data obtained and relied upon by the authorized body and how the data was obtained, and
4. Any actions taken with respect to consideration of the transaction by anyone who is otherwise a member of the authorized body but who had a conflict of interest with respect to the transaction. Treas. Reg. §53.4958-6

(d) If the payment is not a fixed payment, generally, the rebuttable presumption arises only after the exact amount of the payment is determined, or a fixed formula for calculating the payment is specified, and the three requirements for the presumption are satisfied.

2. Audit Activity of IRS
   a) Type of examinations conducted by Exempt Organizations Division
      i. Traditional examinations (both field and correspondence)

ii. Compliance Checks
(a) Gather data and educate
(b) Focus on specific subject or specific sector
(c) Response not required (but fail to respond at own risk)
(d) Not determining tax liability/revocation
(e) May lead to audit

b) General areas of inquiry
i. Ongoing qualification for exemption
(a) Organizational test
(b) Operational test
(c) Private inurement
(d) Substantial lobbying/political intervention
(e) Reporting of unrelated business income
ii. Financial Compliance
iii. Tax Compliance
iv. Governance Issues (especially public charities)
(a) Independence of board of directors
(b) Conflict of Interest Policy compliance
(c) Regular meetings (minutes)
(d) Compensation
(e) Financial oversight
(f) Document retention

C. Texas Attorney General Regulation of Public Charities
1. Common Law Authority
2. Constitutional Authority
3. Statutory Authority
a) Charitable Trusts Chapter 123 of the Texas Property Code
i. Defines charitable trusts to include virtually all charitable entities
ii. AG is a proper (although not necessary party) to proceedings involving charitable trusts (must receive notice and have right to intervene on behalf of public)
iii. Does not provide substantive rights

b) Business Organizations Code
i. Provides AG various powers and investigative authority over nonprofits. Many powers implied from provisions of the Act which require corporate compliance (*e.g.* keeping accurate books and records)
ii. Provides AG authority to present a written request to examine the operations of the corporation (without notice)
iii. Authority to apply for involuntary dissolution (and liquidation)
iv. Authority to apply for appointment of a receiver

c) AG Authority Under the DTPA

i. False, misleading, or deceptive acts or practices in the conduct of any trade or commerce
ii. Applies to nonprofits even if they do not charge
iii. Applies to fraudulent solicitations regardless of whether goods or services are offered as part of the solicitation
iv. Authorizes pre-suit investigations
v. Authorizes suits for enforcement
vi. Imposes penalties for noncompliance
vii. Enhanced penalty in the event AG determines act or practice seeking to acquire or deprive money from a consumer 65 or older

IX. Raising Funds

A. Charitable Contributions and Substantiation

1. Donor's Income Tax Deduction: Presuming the foundation qualifies as a public charity, the value of the donor's federal income tax deduction is a function of the kind of property contributed to the foundation.
   a) Gift of cash and non-appreciated property: In the year of the gift, the donor's charitable income tax deduction is based on the fair market value of the property contributed, but is limited to 50% of the donor's adjusted gross income ("AGI") in the gift year, with a five year carry-forward. I.R.C. § 170(b)(1)(A); Treas. Reg. § 1.170A-8(a)(2).
   b) Gift of appreciated property: In the year of the gift, the donor's charitable income tax deduction is based on the fair market value of the property contributed but is limited to 30% of the donor's AGI in the year of the gift, with a five year carry-forward. I.R.C. § 170(b)(1)(C)(i); Treas. Reg. § 1.170A-8(a)(2).
   c) Itemized Deduction Limitation - Subject to the limitations above, a donor's federal income tax deduction for a gift to a qualified charity (whether public charity or a private foundation) in any year is reduced by the lesser of 80% of the donor's Itemized Deductions for that year (excluding medical expenses, investment interest, wagering losses in excess of wagering gains and casualty losses) or 3% of the amount by which the donor's Adjusted Gross Income for that year exceeds that year's Adjusted Gross Income Threshold Amount (2014 - $305,050 [$254,200 for single filers].
2. Donor's Estate Tax Deduction: The value of property transferred at decedent's death to a community foundation is 100% deductible in determining the amount of federal estate tax. I.R.C. § 2055(c).
3. Donor's Gift Tax Deduction: The donor receives a 100% gift tax charitable deduction for the value of the assets donated during life to the community foundation. I.R.C. § 2522(a).
4. Substantiation: In order for a donor to claim an income tax deduction for a charitable gift (cash or property), the donor must

a) Maintain a record of the donation (bank record, written communication from done; pay stub or related documents where made by payroll deduction;
b) Obtain a written acknowledgement of the gift if over $250; and
c) In quid pro quo contributions over $75, obtain appropriate written disclosure from the charitable donee.
d) A donor must procure an appraisal as part of completing Form 8283 in the case of claimed contributions of non-cash items over $500, and to include as an attachment to his or her income tax return, when claiming a deduction for a non-cash gift of over $5,000. Finally, the charitable organization must file Form 8282 when it disposes of the contributed property within three years of the donation (with limited exceptions).
e) For a more detailed discussion of these rules, see IRS Publication 1771, *Charitable Contributions: Substantiation and Disclosure Requirements*

B. Fundraising
1. State Registration
a) Texas does not require registration or reporting by public charities based on solicitation in the state (unless soliciting for the benefit of law enforcement, public safety personnel and veterans – see https://www.oag.state.tx.us/consumer/nonprofit.sthml for more information)
b) Organizations intending to solicit in other states should determine if the subject state is one of the 39 states with some form of a charitable solicitation act and whether registration is required or an exception applies
2. Raising funds over the internet
a) No clear guidance but non-binding principles known as *The Charleston Principles* promulgated by the National Association of State Charity Officials
b) If targeting donors in another state (particularly if using direct mail to direct to website), consider registering
c) If receiving contributions from another state on a repetitive basis, consider registering
d) May consider completing a unified registration (tweaks necessary for some states)
3. Fiscal Sponsorship
a) Agreement between a Section 501(c)(3) public charity and a project (which may be an unincorporated association or nonprofit corporation) pursuing charitable or otherwise exempt activities but lacking its own Section 501(c)(3) recognition.
b) Important resource: Fiscal Sponsorship: 6 Ways to Do It Right, Greg Colvin. Provides models known as Model A-F.
i. Model A: Public charity agrees to act as fiscal sponsor for the project; project belongs to the public charity sponsor

organization and is carried out by employees/volunteers of sponsor

ii. Model C: public charity agrees to act as fiscal sponsor for the project, entering into a grant agreement with the project, accepting contributions on behalf of the project subject to the fiscal sponsor's discretion and control, and re-granting those funds to the project for exclusively tax-exempt purposes.

(a) The sponsored organization reports back to the fiscal sponsor while such grants are outstanding.

(b) This process continues until such time as the project receives recognition of its Section 501(c)(3) status or is completed.

4. Donor Advised Funds
   a) Owned and controlled by a sponsoring organization (public charity);
   b) Tracked with reference to donor(s) or related persons; and
   c) With respect to which a donor, donor appointee or related party has advisory privileges concerning distributions or investments.
   d) If any one of the above three elements is absent, the fund is not donor-advised.
5. Commercial Activities
   a) Unrelated Business Taxable Income: generally arises in two situations: 1) when the charitable organization has income from an unrelated trade or business; or, 2) when the charitable organization has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1); § 514(a)(1); and § 514(a)(2).

i. Income from an unrelated trade or business: A charitable organization must include in its unrelated business income and pay income tax on the gross income from any regularly conducted trade or business which is not substantially related to the performance of the organization's exempt function. Treas. Reg. § 1.513(b); *U.S. v. American Bar Endowment*, 477 U.S. 105, (1986).

(a) This includes income when an exempt organization is a partner, limited or general, in a partnership which carries on a trade or business wholly unrelated to the exempt organization's purposes, regardless of whether or not the income from the trade or business is actually distributed. See I.R.C. § 512(c)(1); Treas. Reg. § 1.681(a)-2(a). See also, *Service Bolt & Nut Co. Profit Sharing Trust v. Comr.*, 78 T.C. 812 (1982).

(b) "Unrelated trade or business" does not include: 1) any trade or business in which substantially

all the work in carrying on the trade or business is performed for the exempt organization without compensation; 2) any trade or business carried on by an I.R.C. § 501(c)(3) organization or by an I.R.C. § 511(a)(2)(B) governmental college or university, primarily for the convenience of its members, students, patients, officers or employees; or 3) any trade or business which consists of selling merchandise, substantially all of which is received by the organization as gifts or contributions. I.R.C. § 513(a).

(c) The income and deductions are subject to the modifications under I.R.C. § 512(b).

(d) Exclusion of Items from UBTI: Some items excluded from UBTI include dividends and interest, royalties, certain rents, certain gains or losses from the sale, exchange or other disposition of property, income from research for the U.S., income of a college, university or hospital, or income for fundamental research. I.R.C. § 512(b).

ii. Income or deductions incurred with respect to "Debt-Financed Property": A charitable organization has unrelated business income and must pay income tax if it has income incurred with respect to debt-financed property. I.R.C. § 512(a)(1), § 514(a)(2).

(a) "Debt-financed property" includes any property held to produce income (including gains from disposition of property) and with respect to which there is an acquisition indebtedness (determined without regard to whether the property is debt-financed property or the property secures the debt) at any time during the taxable year. I.R.C. §514 (b)(1); Treas. Reg. § 1.514(b)-1.

(b) "Acquisition indebtedness" is generally the indebtedness incurred in connection with the acquisition or improvement of property, whether the debt is incurred before, after, or at the time of the acquisition. See I.R.C. § 514(c)(1); Treas. Reg. § 1.514 (c)-1. If proceeds from the debt financed property are used to acquire or improve property, the debt is considered to be "acquisition indebtedness" related to "debt financed property" even if the

debt is not secured by the property. Deeds of trust, conditional sales contracts, chattel mortgages, security interests under the Uniform Commercial Code, pledges, agreements to hold title in escrow and tax liens not subject to I.R.C. § 514(c)(2) are all treated as similar to mortgages for purposes of applying I.R.C. § 514(c)(2)(A).

(c) Exclusions from "Debt-Financed Property"

1. Property used by an organization in performing its exempt function, I.R.C. § 514(b)(1)(A).
2. Debt-financed property used in an unrelated trade or business to the extent that the income from the property is taken into account in computing the gross income of the unrelated trade or business so as to prevent double taxation of a single item of income as both income from an unrelated business under I.R.C. § 514(a)(1) and debt-financed income under I.R.C. § 514(b)(1)(B).
3. Property used to derive research income, I.R.C. §514(b)(1)(C); Treas. Reg. §1.514(b)-1.
4. Property used in certain excepted trades or businesses [not including any property to the extent that the property is used in a trade or business subject to the volunteer exception, the convenience exception or the donations exception]. I.R.C. § 514(b)(1)(D).
5. Life income contracts. Treas. Reg. § 1.514(b)-1(c)(3)(i).
6. Property acquired for prospective exempt use. Treas. Reg. §1.514(b)-1(d).
7. Although a very limited exclusion, I.R.C. § 514(c)(9)(A) provides that indebtedness incurred in acquiring or improving any real property is excluded from the application of I.R.C. § 514, subject to the exceptions outlined in I.R.C. § 514(c)(9)(B). The four "qualified organizations" eligible to use the exception under I.R.C. § 514(c)(9) are as follows:
    a. Educational organizations described in I.R.C. §170(b)(1)(A)(ii);

b. Affiliated support organizations described in I.R.C. § 509(a)(3) of educational organizations described in I.R.C. § 170(b)(1)(A)(ii);
c. Qualified trusts under I.R.C. § 401 that consist of a trust that forms part of a stock bonus, pension, or profit-sharing plan of an employer for the exclusive benefit of employees and their beneficiaries; and,
d. Multiple-parent title holding organizations described in I.R.C. § 501(c)(25).

b) Commerciality Doctrine
   i. Not in IRC or Regs (court-created and IRS-adopted) – no clear guidance
   ii. Related to the "exclusivity" requirement for operations
   iii. Commercial activities overly competitive with for-profit counterparts ("counterpart test")
   iv. Prohibits operating with a distinctly "commercial hue" – facts and circumstances test
      (a) direct competition with commercial firms (including in same locales)
      (b) pricing structure designed to maximize profits
      (c) extensive advertising and use of commercial advertising materials
      (d) Ceasing programs and products that are not profitable
      (e) Paid staff vs. volunteers
      (f) Lack of charitable contributions received

c) Joint Ventures
   i. Care must be taken to avoid operating more than insubstantially for any other than exempt purpose.
   ii. The IRS has developed a two-pronged test to make such determination.
      (a) The exempt organization's participation must be substantially related to the exempt purpose of the exempt organization.
      (b) The structure of the partnership arrangement must avoid conflicts between the exempt organization's purpose and the exempt organization's duty (if any) to further the private interests of non-exempt partners in the venture.
         1. Looks to whether the exempt organization retains sufficient control of the joint venture

to ensure that such exempt purposes are actually met.

2. Requires a determination that any benefits conferred upon private interests are incidental, both quantitatively and qualitatively. This requires looking to the benefit conferred on private partners and comparing that benefit to the benefit received by the exempt organization with respect to the furthering of the exempt organization's purposes.
3. Factors the IRS considers favorable with respect to the structure of a joint venture arrangement:
    a. Limited contractual liability of the exempt partner;
    b. Limited rate of return on invested capital of the non-exempt parties;
    c. Exempt organization's right of first refusal on sale of partnership assets;
    d. Presence of additional general partners/managers obligated to protect the interests of the non-exempt organization partners;
    e. Lack of control by the non-exempt organization partners except during the initial start-up;
    f. Absence of any obligation to return the non-exempt organization's capital from exempt organization funds;
    g. Absence of profit as a primary motivation;
    h. Arm's length transactions with partners;
    i. The management contract, if any, is terminable for cause by the joint venture (controlled by the exempt organization partner), has a limited term, any renewal is subject to approval of the joint venture, and provides for management by a party with independent activities;
    j. The exempt organization has effective control over major

decisions of the venture, as well day to day operations; and

k. There is a written commitment in the governing documentation of the joint venture to a fulfillment of the exempt purposes.

4. Factors the IRS considers unfavorable with respect to the structure of a joint venture arrangement:
    a. Disproportionate allocation of profits and/or losses in favor of non-exempt organizations;
    b. Commercially unreasonable loans by the exempt organization of the partnership;
    c. Inadequate compensation received by the exempt organization for services it provides or excessive compensation paid by the exempt organization for services it receives;
    d. Control of the exempt organization by the non-exempt organizations or a lack of sufficient control by the exempt organization to ensure it is able to carry out its exempt purposes;
    e. An abnormal or insufficient capital contribution by non-exempt organizations;
    f. A profit motivation by the exempt organization; and
    g. A guarantee of non-exempt organization protected tax credits or return on investment to the detriment of the exempt organization.

d) Use of Subsidiaries
    i. Reasons supporting use of subsidiaries
        (a) Avoid jeopardizing tax-exempt status (when engaging in substantial and unrelated business activities or highly profitable business activities)
        (b) Liability insulation: Particularly useful for isolating high risk activities including short-term high risk activities
        (c) Fundraising/Lenders: Some funders/lenders prefer to see a single purpose business entity with a dedicated board and officers; attract

private investors who want an interest in the project

(d) Flexibility in competition; more easily adaptable to competitive market; attract staff competitively with marketplace by offering higher salaries, bonus compensation, incentive plans, etc.

(e) Regulatory/Licensing Issues

(f) Focus/specialized skill (board members/senior staff)

(g) Other (e.g. lobbying, etc.)

ii. Reasons to avoid use of subsidiaries

(a) Costs/complexity (Incorporation and filing fees; administrative maintenance, etc.)

(b) Inability to directly receive grants from many charities if not itself a 501(c)(3)

(c) Public perception (Does the goodwill of the nonprofit transfer?)

(d) Taxation: receipt of passive income from controlled subsidiary treated as item of gross income from unrelated trade or business to the extent the payment reduces the net unrelated income of the controlled entity or increases any unrelated loss of the controlled entity. (*See* IRC 512(b)(13))

(e) Less day to day control

(f) New reporting and filing requirements

(g) Other (ex. diversion of funds from primary purpose)

X. Other Statutes Applicable to Public Charities in Texas

A. Uniform Prudent Management of Institutional Funds Act ("UPMIFA") (Texas Property Code §163.000 et. seq.)

1. Defines standard of care in investing charitable assets.
2. Applies to organizations that manage and invest institutional funds exclusively for charitable purposes regardless of how organized.
3. Does not apply to trusts with commercial or individual trustees unless a charitable institution serves as trustee.
4. Provides for great latitude for donors to supersede the UPMIFA default rules so long as donors do not control the management of the institution.
5. Includes rules of construction to allow institutions to make determinations as to donor intent.
6. With respect to endowment spending, the test is one of prudence allowing the institution to spend or accumulate in such manner as they determine to be prudent, taking into account donor intent, the duration of the fund, general economic conditions, preservation of the endowment fund, and the purposes of the institution.

7. Contains presumptions as to imprudence in an effort to guide institutions and protect the institutions against spending an endowment too quickly.
8. Allows delegation to outside investment managers so long as such delegation is made in good faith and exercising the standard of care of an ordinary prudent person in selecting the agent, establishing the scope and terms of delegation, and making periodic review and supervision of the agent. Once delegation is made, the agent has a duty to use reasonable care.

B. Texas Charitable Immunity and Liability Act
   1. Immunity: Parameters
      a) An organization exempt from federal income taxation as a 501(c)(3), organized and operated exclusively for charitable or religious purposes
      b) Any bona fide religious or charitable organization organized and operated exclusively for the promotion of social welfare [if it meets a six part test which mirrors the test for 501(c)(3) status]
      c) Once within the definition, the volunteers, employees, and organization qualify for immunity under specific guidelines
   2. Volunteer Immunity
      a) A volunteer is a person rendering services to or on behalf of a charitable organization who does not receive compensation (other than reimbursement for expenses)
      b) Volunteer is immune if acting in course and scope of duties or functions, including as an officer, director or trustee
      c) A director or officer must be in good faith
      d) Still have liability up to personal insurance if damage arises from operation of any motor-driven equipment
      e) No Volunteer immunity for intentional torts, willful misconduct, gross negligence
   3. For employees and organizations (other than hospitals and their employees), limited immunity if obtain requisite amounts of insurance
      a) $500,000/$1,000,000/$100,000
      b) Must be in course and scope
      c) Act does not apply to acts/omissions that are willful, intentional, wantonly negligent, or done with conscious indifference or reckless disregard

C. Volunteer Protection Act (42 U.S.C. Sec. 14501 et al (1997))
   1. Federal law which preempts state law, except where the state law provides additional protection from liability relating to volunteers or to any category of volunteers in the performance of services for a nonprofit organization or governmental entity.
   2. Generally, the Act provides that no volunteer of a nonprofit organization or governmental entity shall be liable for harm caused by an act or omission of the volunteer on behalf of the organization or entity if:
      a) The volunteer was acting within the scope of his or her responsibilities at the time of the act or omission;

b) If appropriate or required, the volunteer was properly licensed, certified, or authorized in the state in which the harm occurred, where the activities were or practice was undertaken within the scope of the volunteer's responsibilities;
c) The harm was not the result of willful or criminal misconduct, gross negligence, reckless misconduct, or a conscious flagrant indifference to the rights or safety of the individual harmed by the volunteer; and,
d) The harm was not caused by the volunteer's operation of a motor vehicle, vessel, aircraft or other vehicle for which the state requires the operator or the owner of the vehicle, craft or vessel to a)possess an operator's license or b) maintain insurance.

3. With limited exceptions, punitive damages may not be awarded against a volunteer in an action brought for harm based on the action of a volunteer acting within the scope of the volunteer's responsibilities to a nonprofit organization or governmental entity unless the claimant establishes by clear and convincing evidence that the harm was proximately caused by an action of such volunteer which constitutes willful or criminal misconduct, or a conscious, flagrant indifference to the rights or safety of the individual harmed.

XI. Terminating the Public Charity: While a nonprofit organization will face many significant events during its life, the ultimate significant event is when the organization reaches the end of its life. This can come about by dissolution (voluntary or through an involuntary proceeding) or through a merger.

A. Terminating State Status: For purposes of state law, nonprofit corporations (as well as limited liability companies) must wind up and terminate in compliance with the Texas Business Organizations Code.

1. A resolution to wind up must be adopted.
a) If the corporation has no voting members, the board of directors adopts such resolution.
b) If the corporation has voting members, the resolution must be approved by the members.
c) Because a voluntary winding up and adoption of a plan of distribution is considered a "fundamental action" under the BOC, the vote required by the members is 2/3 of the votes that members present in person or by proxy are entitled to cast or simply the affirmative vote of the majority of directors in office if there are no voting members. *See* BOC § 22.164.
2. A proposed plan of distribution must receive a like vote.
3. The organization must pay or make provision for the payment of liabilities and obligations before conveying its assets pursuant to its plan of distribution.
4. Once assets are appropriately conveyed (including following any provisions of the organization's governing documents regarding transfer of assets on dissolution), an officer of the organization must sign and file a certificate of termination.

B. Terminating Federal Status: For purposes of federal law, terminating/merging organizations must inform the IRS of this action by filing a final Form 990, 990-N or 990-EZ (as applicable) by the 15th day of the 5th month after the end of the period for which the return is due.
    1. The final form should reflect that it is a final form with the filer checking the "terminated" box in the header and providing answers as appropriate with respect to questions regarding liquidation, termination, dissolution, or significant disposition of assets.
    2. Schedule N, *Liquidation, Termination, Dissolution or Significant Disposition of Assets* must be provided with respect to Form 990 and Form 990-EZ.
    3. The organization must provide a certified copy of its Articles of Dissolution or Merger or such other applicable document.