Supporting Organizations That Change Their Status

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What happens to a supporting organization that loses or terminates its supporting organization status? In the wake of the Pension Protection Act of 2006 ("PPA"), many supporting organizations are now having to face that question. Many organizations, especially those that are classified as Type III supporting organizations, find that the new rules imposed by PPA impose restrictions that are not acceptable. This problem can be particularly troublesome for those that find they are not "functionally integrated" under the PPA rules. Some managers, faced with the prospect of the new law and possible frustration of intended operations of a supporting organization, may opt for a voluntary change of status. For others, the change will be involuntary, as they simply no longer qualify.

An organization losing or abandoning its supporting organization qualification will probably end up following one of the following approaches:

- Cease operations, and go out of business
- Find an acceptable public charity and transfer all of its net assets to that charity and go out of business
- Accept the inevitable, and continue on as a private foundation.

The first two alternatives involve the distribution of all the remaining funds. This may not seem appealing if the creator and his/her family have any interest in continuing a charitable program. Such concerns may be eased by selecting a community foundation or other public charity operating a donor-advised fund as the recipient of the supporting organization's assets. A donee organization of this type can permit the creator to continue operating a grant-making program with those assets. True, the donor-advised fund structure would not give the creator complete legal control of the subject funds; the creator's new role as donor/advisor would allow him nothing more than a right to make grant recommendations, subject to the discretion of the donor-advised fund charity. The donor/advisor could not demand or direct the grants from the fund created with the assets transferred from the former supporting organization. This, however, might well be acceptable, since he or she could not legally have controlled the former supporting organization either, by virtue of the restriction in IRC §509(a)(3)(C).

Consequences of Private Foundation Status

If the former supporting organization declines to take active steps, and instead simply allows itself to become a private foundation, it will be thereupon become subject to all of the Internal Revenue Code provisions that limit and restrict private foundations. Accordingly, the Chapter 42 excise taxes will be applicable, including the section 4940 tax on investment income. In addition, it is likely that any subsequent contributions to the new foundation will be subject to reduction under IRC §170(e)(1)(B)(ii) and lower percentage limitations under IRC §170(b)(1)(B).

These adverse deduction consequences may be avoided if the former supporting organization is able to fit within either of two special private foundation categories. It may qualify as a *private operating foundation* if its activities consist of the operation of a program of active charitable operations rather than mere passive grant-making. See IRC §4942(j)(3) for the actual definition of a private operating foundation. Alternatively, the stricter deduction rules applicable to most foundations may be avoided if the new foundation makes timely distributions out of corpus equal to all contributions received during the year, thus qualifying as a "*conduit*" or "*pass-through*" foundation. Details may be found in IRC §170(b)(1)(F)(ii) and in §1.170A-9(g) of the Regulations. Another category of foundation that escapes the restrictive deduction limitations applicable to most private foundations, the "*pooled fund foundation*" (described in IRC §§170(b)(1)(A)(vii) and 170(b)(1)(F)(iii), and in §1.170A-9(h) of the Regulations), is of limited application.

But in most cases, a disqualified supporting organization is likely simply to fall into the private foundation category. The actual conversion of the former supporting organization to a private foundation creates a number of tax issues that are more complicated than a simple change of status. As this issue went to press, the Internal Revenue Service had not yet issued comprehensive guidance on what happens in this situation. However, a 1998 private letter ruling [*Private Letter Ruling 9852023* (9/28/98)] discusses some of the other tax effects arising from such a change of status.

1. Because the former supporting organization will, after its change of status, be a ***new*** foundation, it will apparently take a new basis in its assets for tax purposes, including the computation of gain or purposes of the section 4940 tax.
2. Also, it will apparently be eligible for a phase-in of distributable amounts under regulations §53.4942(a)-3(b)(4).
3. If the former supporting organization already hold stock in a for-profit corporation or an interest in the partnership for LLC, such interests will apparently be treated as if they were acquired other than by purchase within the meaning of section 4943(c)(6), irrespective of how they were actually acquired and without regard to capital contributions. This would entitle the new foundation to a transition period of five years (or even longer) to dispose of such interests if they should constitute excess business holdings.
4. Similarly, pre-existing investments held by the organization will not be treated as jeopardy investments under section 4944(a).
5. For the taxable year in which it changes its status, the organization must file two separate tax returns – Form 990 for the period up to the date of conversion – the date on which its supporting organization status terminated and it ceased to be a public charity– and Form 990-PF or the balance of the year, during which it was a private foundation.

Special problems may arise when the organization in question is a Type I supporting organization controlled by the public charity or charities it supports or,

possibly, even in the case of a Type II supporting organization. In such situations, the public charity or charities would likely have controlled the former supporting organization. Although it would have no ownership interest in the assets of the supporting organization, it would nevertheless be interested, and adversely affected, by any diversion or disposition of those assets.

Under IRC §509(a)(3)(C)), a supporting organization may not be controlled directly or indirectly by one or more disqualified persons other than foundation managers or other public charities. If the board of the former supporting organization simply amends its governing documents to sever the relationship with the supported organization, this can create some unfavorable implications. For example, if supporting organization status is terminated simply because the disqualified persons want to "take back" the supporting organization and operate it as a family foundation, this could be viewed as implying that those disqualified persons actually had effective control of the supporting organization. That would call into question the entity's status as a supporting organization and a public charity.

Only one ruling, a private letter ruling issued in 1990, deals with the consequences of such a situation. *Private Letter Ruling 9052055* involved a supporting organization operated for the benefit of a university. When one of the trustees died, his widow, who was also a trustee, decided that she wished to broaden the purposes of the supporting organization so that it could also serve her other charitable interests in addition to the university. Accordingly, she proposed to amend the organization's articles of incorporation and bylaws to delete all references to the university as a supported organization, thereby converting it to a private foundation. The university representatives on the board would resign and be replaced by family representatives. Once that had occurred, the organization (which at that point would have become a private foundation for tax purposes) would transfer to the university stock with a value estimated at approximately fifty percent of its assets. It was not clear from the ruling whether this asset transfer was a part of the original plan, or was a requirement imposed by the IRS as a condition of the ruling.

On these facts, PLR *9052055* held that the organization's classification as a supporting organization would terminate and it would thereupon become a private foundation. The ruling went on to hold that the transfer of half of the foundation's assets to the university after the conversion would be a qualifying distribution for purposes of the foundation's minimum distribution requirement under IRC §4942. This holding might be regarded as a model for a supporting organization that decides to become a private foundation and sever its connection with the public charity or charities is supports, rather than live with the stricter rules for supporting organizations by the PPA.