

Understanding the Critical Section 509(a) Classification for Auxiliary Organizations

Each auxiliary organization should have an IRS tax-exemption determination letter that the entity is an IRC §501(c)(3) – as a charitable organization -- and classifying it into one of the three (3) “public charity” subsets under Section §509(a).¹ The §509(a) subset is where the *Internal Revenue Code* defines a “private foundation” by listing entities that are not private foundations. Under §509(a), an organization is presumed to be a private foundation unless it can prove that it is a public charity based upon its activities. The §509(a) subset classification typically is set when the organization applies for tax-exempt status. But reclassifications can occur with the filing of a change on the IRS Form 990, or as a result a perceived change in the role/function of the organization. Each §509(a) subset involves certain qualification “tests” and the subsets are not necessarily mutually exclusive – that is an organization might fit within any one of the three subsets.

Section 509(a)(1) “publicly supported organizations” are the most common “public charities.” They typically include educational organizations, churches, hospitals, and public institutions, or organizations for the benefit of colleges and universities. The qualifying test for a 509(a)(1) organization is that it must receive a substantial part (receive at least one-third) of its support from a governmental unit or from the general public, and be organized and operated exclusively to receive, hold, invest, and administer property and make expenditures to or for the benefit of a governmental unit. Campus auxiliary organizations serving as the campus fund-raising arm are typically classified as 509(a)(1) organizations.

Section 509(a)(2) “governmental affiliate organizations” receive support from the general public in the form of receipts for services rendered or for other activities related to the organization’s exempt function. If an organization cannot qualify as a 509(a)(1) entity it may fall into the 509(a)(2) subset if it meets two specific tests: a similar one-third support test, and a not-more-than one-third gross investment test. Some auxiliary organizations have this classification.

Section 509(a)(3) “supporting organizations” receive little, if any, general public support if it supports a qualified 509(a)(1) or (2) public charity on an exclusive basis, and meets three tests relating to organization, operation, and relationship with its supported public charity. Many auxiliary organizations are classified under §509(a)(3). Three relationship-driven “types” of 509(a)(3) supporting organizations are now recognized under more recent law. Type I: operated, supervised, or controlled by a public supported charity; Type II: supervised by a publicly supported charity; or Type III: operated for a designated public supported charity.

On the face of it there appears to be some flexibility in these “public charities” subsets for auxiliary organizations, but a misclassification can have considerable – and perhaps unintended -- consequences. Some critical examples:

Student FICA Exception. Under current (and long-standing) federal law (IRC Sec. 3121(b)(10)(B)), only auxiliary organizations classified as 509(a)(3) entities are eligible to exclude qualified student employees from FICA/FUTA. Steep penalties and contribution liability can result from failure to recognize covered employees, including student assistants.

¹ There are apparently a handful of auxiliary organizations with IRC Section 170(b)(1)(A) (iv) “university endowment fund “ or (vi) “public supported organization” determination letters from the IRS.

IRA Direct Rollover Gifts. The *Pension Protection Act of 2006* (PPA '06) included a charitable contribution (income tax exclusion) provision (IRC §408(d)(8)) to permit certain donors to directly “roll over” IRA funds to a qualified public charities (but not a 509(a)(3) entity). The Emergency Economic Stabilization Act of 2008, signed into law on October 3, renews a temporary provision that allows donors age 70½ or older to make a direct, tax-free rollover of up to \$100,000 from a traditional or Roth IRA to a qualified charitable organization – but only until the end of 2009. In 2010, Congress extended this exclusion through 2011 (2010 Tax Act). There is some prospect that the exclusion again be extended through at least 2012.

Private Foundation Grants to Supporting Organizations. The PPA '06 also included some rather stringent provisions (IRC §4942(g) and 4945(d)(4)(A)) regulating private foundation grants (so-called *qualifying distributions*) to supporting organizations. To avoid punitive excise taxation and other penalties, private foundations must apply specific criteria to supporting organizations to judge whether the grantee is 1) a supporting organization (§509(a)(3)); if so, 2) into which of the three “types” does it fall; and if it is a Type III supporting organization, then 3) whether it is a “functionally integrated” Type III supporting organization. Thus, auxiliary organizations not fitting this precise 509(a)(3) classification would not be likely grant recipients from private foundations. This “pregnant due diligence” by private foundation grantors does not apparently apply to other public charities subsets. Private foundations seem increasingly reluctant to make awards to “supporting organizations” no matter the “type.” Supporting organizations are receiving renewed scrutiny by Congress and the IRS, and additional qualifying tests are in the offing.

**

Auxiliary organizations should periodically review their exemption classification and applicable qualification tests to judge if the classification is operationally suitable and in compliance with tax-related laws and regulations.