To: Victoria Bennett  
From:  
Re: American Morgan Horse Charitable Educational Trust 509(a)(3) Status  
Date: February 19, 2019


ISSUE

Is the American Morgan Horse Educational Charitable Trust complying with the Internal Revenue Code and applicable treasury regulations with respect to its status as a 509(a)(3) Type II supporting organization that supports a 501(c)(5) tax-exempt agricultural organization?

SHORT ANSWER

No. The American Morgan Horse Educational Charitable Trust (AMHECT) is no longer maintains the required relationship to its supported organization, American Morgan Horse Association, Inc. (AMHA) to qualify as a Type II supporting organization. It also appears from the record available that AMHECT does not provide the support necessary to AMHA to qualify as a supporting organization under the Internal Revenue Code and related regulations.

FACTS

AMHECT was chartered in New York in September 2002 in support of AMHA, a New York nonprofit corporation recognized by the IRS as exempt from federal taxes under section 501(c)(5) of the Internal Revenue Code. AMHECT is exempt from federal taxes as a 509(a)(3) Type II supporting organization of AMHA, as of April 1, 2003. From 2002 until May 2011, the members of the AMHA board of directors served as the trustees of AMHECT, satisfying the statutory requirement that a Type II supporting organization be supervised or controlled in connection with the organization it supports. However, in May 2011, the AMHA board voted unanimously to essentially separate these two governing bodies by amending the AMHECT charter to restructure the board of trustees. Whereas the original charter stated the “Board of Trustees will refer to the then serving Board of Directors of the American Morgan Horse Association, Inc. (AMHA),” the revised charter provided that the board of trustees would consist of the president of AMHA, and
four to eight members of AMHA elected by the AMHA board but who need not members of the AMHA board of directors. Vacancies were to be filled through appointment by the AMHA board.

In October 2012, AMHECT apparently adopted bylaws,¹ which stated trustees must be elected by majority vote of the board of trustees and gave the president of the board of trustees discretion to appoint an individual to fill any vacancy. The bylaws further provided that the AMHA president could fill a vacancy by appointment, but only if the individual appointed was a member of the AMHA board, an at large member of AMHA (with special consideration given to members of the Grand National Show Committee), or a member of the board of trustees of the American Morgan Horse Institute. Trustee nominees were also not required to be approved by the AMHA board.

From 2012 through present, the AMHECT board inconsistently elected its trustees and the results yielded varying degrees of overlap between the AMHECT trustees and the AMHA board. According to the information provided, the trustees were elected pursuant to the revised charter in 2012, with the AMHA board electing eight trustees plus the AMHA board president for a total of nine trustees, six of whom were also AMHA board members. From 2013 through 2017, however, the AMHECT trustees were elected by majority vote of the AMHECT board of trustees pursuant to the bylaws and the trustees overlapped with the AMHA board as follows: six common members in 2013; three in 2014; three in 2015; three in 2016; and two in 2017. AMHECT voted to further amend its charter in 2017 to allow the AMHA president to serve as the president of the AMHECT trustees or designate someone else to do so. In 2018, the AMHA board elected the AMHECT trustees pursuant to the revised charter, and only one AMHA director was elected as an AMHECT trustee. In 2019, AMHA again elected the trustees pursuant to the charter and increased the number of AMHA directors serving as AMHECT trustees to five.²

In 2012, AMHECT and AMHA entered into a five-year agreement to allow AMHECT use of AMHA’s intellectual property in connection with the staging of the annual Grand National and World Championship Horse Show. The terms of the agreement require AMHECT to pay an annual licensing fee of $65,000 to AMHA. AMHECT has reported these payments on its annual Form 990 as follows as support to a supporting organization. See AMHECT 2017 Form 990, Schedule A, Part I, Line 12g, p. 16. AMHA has reported the licensing fee as income related to program services rather than as contributions from a related organization. See e.g., AMHA 2016 Form 990, Part VIII, Line 2(d). A license agreement extension was signed in July 2017 by the AMHA president but not presented to the board for vote.

---

¹The bylaws were dated and subsequently revised in 2013, 2014, and 2015, but there is no certification or indication they were officially adopted in the records provided.
²A court of law will likely require meeting minutes to prove these elections took place in accordance with the information provided.
LEGAL ANALYSIS

The American Morgan Horse Charitable Educational Trust (AMHCET or the “Trust”) does not meet the statutory or regulatory requirements to maintain its status as a 509(a)(3) Type II supporting organization. Under section 509(a) of the Internal Revenue Code, all tax-exempt organizations described in section 501(c)(3) are considered private foundations unless they meet one of the exemptions specified in section 509(a)(1) through (4). See Cockerline Mem’l Fund v. Comm’r, 86 T.C. 53, 56 (1986). One such exemption, as described in section 509(a)(3), is for organizations that qualify as a supporting organization. Supporting organizations are exempt from private foundation status, which requires extensive regulation compared to public charities, because their relationship to the public charities they support exposes them to the public support, and thereby public scrutiny, private foundations lack. See Quarrie v. Comm’r, 603 F.2d 1274, 1277-78 (7th Cir. 1979). “The Treasury Regulations therefore provide that the supporting organization must be responsive to the needs of the public charity and intimately involved in its operations.” Id. at 1277.

There are three primary requirements to be a supporting organization. See 26 U.S.C. § 509(a)(3)(A)-(C). First, supporting organizations must be “organized, and at all times there after [be] operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more” organizations that qualify as a publicly supported charity under section 509(a)(1) and (2). 26 U.S.C. § 509(a)(3)(A). Courts and the IRS have developed two tests—an organizational test and an operational test—to ensure the 509(a)(3)(A) requirement is met. The second component of a supporting organization is its relationship to the organization it supports. See 26 U.S.C. § 509(a)(3)(B)(i)-(iii) (describing the three types of supporting organizations based on their relationship to the organizations they support). The third requirement of supporting organizations is they cannot be controlled, directly or indirectly, by individuals deemed to be disqualified persons under the Internal Revenue Code other than foundation managers such as directors and trustees. See 26 U.S.C. § 509(a)(3)(C). Thus, an organization must pass the control test to be considered a supporting organization under the Internal Revenue Code and Treasury Regulations.

1. AMHCET does not meet the relationship requirement under section 509(a)(3)(B)(ii) to qualify as a Type II supporting organization.

In its annual IRS Form 990 information returns, AMHCET identifies itself as a Type II supporting organization, yet since 2012 has failed to meet the relationship requirements of a Type II supporting organization. Section 509(a)(3)(B) of the Internal Revenue Code lists three types of supporting organizations. Type I supporting organizations are “operated, supervised, or controlled by one or more” supported organizations. Id at § 509(a)(3)(B)(i). Type II supporting organizations are “supervised or controlled in connection with one or more” supported organizations. Id at § 509(a)(3)(B)(ii). Type III supporting organizations are “operated in connection with one or more” supported organizations. Id at § 509(a)(3)(B)(iii). To satisfy the standard of supervision or control in connection with one or more publicly supported
organizations required of Type II supporting organizations, “the control or management of the supporting organization must be vested in the same persons that control or manage the publicly supported organizations.” 26 C.F.R. § 1.509(a)-4(h)(1). This relationship ensures “the supporting organization will be responsive to the needs and requirements of the publicly supported organizations. Id. The Treasury Regulations identify the “common supervision or control among the governing bodies of all organizations involved” as the “distinguishing feature” of Type II organizations. Id at § 1.509(a)-4(f)(4). The Treasury Regulations further provide that merely making payments, whether mandatory or discretionary, to the supported organization does not constitute a Type II relationship. Id at § 1.509(a)-4(h)(2). Courts have compared the relationship between Type II supporting organizations and their supported organizations to brother and sister organizations subject to common control. See Cockerline, 86 T.C. at 59; Polm Family Foundation, Inc. v. U.S., 655 F. Supp. 2d 125, 128 (D.D.C. 2009).

In Polm, the governing board of the organization seeking recognition as a Type II supporting organization was structured such that all directors were appointed by a disqualified person “from an infinitely large number of public charities within its supported class.” 655 F. Supp. 2d at 129. The court found this arrangement decreased any assurance that the supporting organization would remain responsive to the needs and requirements of its publicly supported organizations and limited the scrutiny of members of its supported class. Id. The court noted “the power of appointment or election of the directors of the supporting organization who supply the common supervision or control must somehow be vested in or supervised by the common leaders of the organizations in order to insure that the supporting organization remains subject to the scrutiny of the public charities.” Id. (internal quotation omitted).

The minutes of the 2011 meeting at which the AMHA board voted to revise the trustee election provisions in the charter reveal the intent of the revised structure was to establish an “independent” AMHECT board of trustees “to ensure arms length transactions and establish greater independence between the two governing bodies.” See Minutes of AMHA Board of Directors Meeting, p. 17 (May 7, 2011). The minutes detail the proposed revisions and explicitly state “[o]nce the [AMHECT] trust document is revised to reflect these changes, the AMHA Board will no longer be the body to vote on any future revisions.” Id. This change in the governance structure of AMHECT effectively changed it from a Type II supporting organization to a Type I supporting organization. A Type I supporting organization vests the supported organization with the power to regularly appoint or elect a majority of the trustees of the supporting organization. See 26 C.F.R. § 1.509-4(g). There are two issues with this transition, however. First, AMHECT did not file an IRS Form 8940, Request for Miscellaneous Determination to reclassify itself as a Type I rather than a Type II supporting organization. Second, AMHECT did not consistently elect trustees in accordance with the revised charter. Instead, from 2013 through 2017, AMHECT trustees were elected by a majority vote of the board of trustees pursuant to the election provisions in the AMHECT bylaws. The 2013 vote, though not conducted in accordance with the revised charter, still resulted in a majority of the elected trustees also being members of the AMHA board in compliance with the Type II supporting organization requirement. However, from
2014 through 2017 there was not a majority of AMHA board members elected to serve as AMHECT trustees. As a result, AMHECT did not qualify as a Type I or a Type II organization during those years. Instead, as in Polm, the arrangement during this period decreased any assurance AMHECT would remain responsive to the needs and requirements of AMHA, the publicly supported charity it purports to benefit.

AMHECT’s relationship to AMHA is what exposes it to public scrutiny and prevents it from being classified as a private foundation and subject to extensive IRS regulation and oversight. That relationship was completely lacking from 2014 to 2017 and has been inconsistent at best since the 2011 revision of the Trust charter. It appears the desire of the AMHA board in voting to revise the AMHECT charter was to create some independence between the two organizations. However, as the tax court noted in Quariie, the regulations require the relationship between the two be structured such that AMHECT is responsive to the needs of AMHA and “intimately involved” in its operations. Based on the information provided, it appears both organizations have been taking steps since 2011 to ensure AMHECT is no longer intimately involved in AMHA’s operations. While the recent AMHA board vote to elect the 2019 AMHECT trustees resulted in a majority of the trustee board being members of the AMHA board in compliance with the Type II relationship requirement, the cumulative actions of both organizations could ultimately cause the IRS to revoke AMHECT’s status as an exempt 509(a)(3) Type II supporting organization.

2. AMHECT likely fails the organizational and operational requirements under section 509(a)(3)(A).

Section 509(a)(3)(A) requires supporting organizations to pass both an organizational test and an operational test to ensure they are “organized and at all times thereafter [ ] operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes” of their supported organizations. See also 26 C.F.R. § 1.509(a)-4(c), (e) (specifying the requirements to meet the organizational test and operational test, respectively).

a. The AMHECT organizational instrument does not specify the requisite charitable purposes to satisfy the specialized organizational tests for supporting organizations that support 501(c)(5) organizations.

The Treasury Regulations and related guidance and rulings from the IRS establish a different organizational test for 509(a)(3) organizations that support organizations exempt under sections 501(c)(4), (5), or (6) of the Internal Revenue Code. See 26 C.F.R. § 1.509(a)–4(c). Essentially, the supporting organization must ensure the organization it supports meets the public charity public support tests under section 509(a)(2) such that (1) over a third of its support is derived from gifts, grants, contributions, membership fees, or gross receipts from permitted sources, and (2) no more than a third of its support is derived from gross investment income and unrelated business taxable income. See IRS Supporting Organizations Guide Sheet Explanation:

---

As discussed above, a court will likely require meeting minutes to prove the elections were conducted as described.
Type I and Type II, p. 6 (March 13, 2008), https://www.irs.gov/pub/irs-tege/509a3_typeiandi_gsexplanation.pdf. The supporting organization must also state in its organizing document that it is organized exclusively for charitable purposes as outlined in section 170(c)(2) of the Internal Revenue Code, rather than exclusively to benefit, perform the functions of, or carry out the purposes of its supported organization. 26 C.F.R. § 1.509(a)-4(c). The supporting organization must also have sufficient safeguards in place to ensure the support provided to a 501(c)(5) supported organization is used exclusively for charitable purposes.

Although AMHECT failed to report its support of a 501(c)(5) organization in its 2017 Form 990, AMHA is a 501(c)(5) organization, and AMHECT is required to make the assurances specified in the specialized organizational test. AMHA's support is primarily derived from membership contributions and program services, both of which constitute public support and account for over a third of its total support. Additionally, its gross investment income and its unrelated business taxable income account for less than a third of its support. See generally, AMHA 2016 Form 990. As a result, AMHA passes the public support tests. AMHECT's satisfaction of the other two organizational test requirements is less clear. While the AMHECT Declaration of Trust and subsequent amendments make frequent references to charitable purposes of organizations receiving trust income and property distributions, they do not specifically state AMHECT was organized for charitable purposes that fit within the meaning of section 170(c)(2) of the Internal Revenue Code. The bylaws reference the purposes set forth in the Articles of Incorporation filed with the State of New York; however, the Trust is not incorporated. Lastly, there appears to be no evidence AMHECT has enacted any safeguards to ensure any support provided to AMHA has been used exclusively for charitable purposes. Thus, unless AMHECT can produce evidence to the contrary during discovery, it appears AMHECT does not meet the specialized organizational test required of organizations that support a 501(c)(5) organization.

b. AMHECT likely does not provide the support necessary to AMHA to meet the operational test.

A 1976 Revenue Ruling issued by the Internal Revenue service interpreted the regulatory requirement to satisfy a specialized organizational test for organizations that support 501(c)(4), (5), or (6) organizations, rather than a 501(c)(3) organization, was also implied in the regulation regarding the operational test under section 509(a)(3)(A). See Rev. Rul. 76-401, 1976-2 C.B. 175. The specialized operational test would require the supporting organization to show it has continuously operated to carry on charitable purposes. Id. However, later IRS guidance regarding exempt organization tax law rules applicable to supporting organizations does not make such a distinction between organizations that support 501(c)(4), (5), or (6) organizations versus those that support 501(c)(3) organizations. See IRS Supporting Organizations Guide Sheet, p. 8.

---

4 In Schedule A, Part IV, Line 3a (Did the organization have a supported organization described in section 501(c)(4), (5), or (6)?), the AMHECT 2017 990 preparer marked no and, as a result, did not answer the two subsequent questions regarding whether AMHECT confirmed its supported organization satisfied the public support tests and ensured all support provided was used exclusively for charitable purposes.

5 These purposes can include on or more of the following purposes: religious, charitable, scientific, literary, educational, or for the prevention of cruelty to children or animals. See 26 U.S.C. § 170(c)(2).
To pass the operational test, a supporting organization must make payments to or for the use of the supported organization or provide services or facilities to or for the use of the supported organization. A supporting organization may make payments: (1) only to or for the use of its supported organization, (2) to or for the use of individual members of the charitable class benefited by the supported organization, (3) indirectly through another unrelated organization to or for the use of a member of a charitable class benefited by the supported organization, provided it constitutes an individual rather than an organizational grant, or (4) to or for the use of another supporting organization that also supports or benefits the supported organization. See id. The supporting organization may also satisfy the operational requirements by providing services or facilities: (1) only to or for the use of the supported organization; (2) to or for the use of individual members of the charitable class benefited by the supported organization; or (3) to or for the use of another supporting organization that also supports or benefits the supported organization. See id.

AMHECT’s support of AMHA is convoluted at best. AMHECT purports to provide annual support to AMHA in the amount of $65,000. See AMHECT 2017 Form 990, Schedule A, Part I(12)(g), p. 16. However, the AMHECT 990 also reveals the annual $65,000 payment is a licensing fee AMHA charges pursuant to a five-year license agreement between AMHA and AMHECT. See AMHECT 2017 Form 990, Schedule R, Part VII. In its own Form 990, AMHA reports this income as revenue related to program services rather than as support from a related organization. See AMHA 2016 Form 990, Part VIII, p. 9. The only other references to support of AMHA in AMHECT’s most recent 990 are as follows. Schedule D, Part X lists $25,927 due to AMHA under “other liabilities,” and Schedule R, Part V (Transactions with Related Parties) lists $250 to AMHA as a loan or loan guarantee to or for related organizations and $38,823 to AMHA under “other transfer of case or property to related organization.” On their face, these payments may constitute the support required to pass the operational test under section 509(a)(3)(A). However, based on the information provided, it appears the amounts AMHECT has reported to the IRS as support to AMHA have been contractually obligated (licensing fees to use AMHA intellectual property, minimal rent to use AMHA facilities, or compensation to use AMHA employees for AMHECT purposes); a return of funds that originated with AMHA and are held in a trust fund under AMHECT’s tax ID number for the museum AMHA operates; and sponsorship of events and other event support that also benefit AMHECT. These payments could be characterized as benefiting AMHECT rather than for the benefit of AMHA. AMHECT also incorrectly identified itself as a supporting organization that does not support a section 501(c)(4), (5) or (6) organization (Schedule A, Part IV, p. 4, line 3a-c), so it is unclear whether the support it has reported to the IRS is completely accurate. At the very least, whether AMHECT provides the requisite support to pass the operational test would be a question for the court to consider.

3. AMHECT passes the control test but may have private inurement concerns.

Section 509(a)(3) supporting organizations must not be controlled, directly or indirectly, by individuals deemed to be disqualified persons under the Internal Revenue Code other than foundation managers such as directors and trustees. 26 U.S.C. § 509(a)(3)(C). Because trustees
and directors are explicitly exempted from this provision, there is no improper control under the statute. However, the AMHECT trustees and AMHA directors cannot impermissibly benefit from an arrangement with the organization. See generally, 26 U.S.C. § 501(c)(3); 26 C.F.R. § 1.501(c)(3)-1(c). If any trustees or other individuals who have significant influence over AMHECT (such as high-level managers, founders, major donors, highest paid employees, family members of the above, or a business of which any of the listed individuals owns more than 35 percent), defined in the Internal Revenue Code as disqualified persons, have entered into any arrangements with AMHECT and received benefits greater than he or she provided in return, private inurement has occurred and could also jeopardize AMHECT’s exemption status unless the disqualified persons make restitution to the organization. Id.

CONCLUSION

AMHECT’s support of a 501(c)(5) organization puts it in a unique situation in terms of evaluating its compliance with the supporting organization requirements of section 509(a)(3). There is no precedent we can rely on to definitively state what the outcome will be. It is possible the IRS could revoke AMHECT’s exemption for failing to maintain a requisite relationship with its supported organization, as detailed in Part 1 of this memo, or for failing to provide the necessary to support to pass the operational test, as detailed in Part 2(b) above. The IRS could also classify AMHECT as a private foundation or require it to file a request for miscellaneous determination to change its status to a Type I supporting organization (provided it can show it meets the support requirements). At the very least, the actions by both boards indicate an intent to separate AMHECT’s operations and finances from AMHA’s operations and finances. Under the spirit of the law, there is not enough oversight by AMHA, which receives public scrutiny as a publicly supported charity, to prevent classification of AMHECT as a private foundation, which receives scrutiny and extensive regulation from the IRS.6

6 It is possible, AMHECT could incorporate or amend its trust instrument to include the requisite charitable purposes and petition the IRS to change its public charity classification from a Type II supporting organization to a public charity exempt under section 501(c)(3), which would not require it to maintain any relationship to AMHA. In order to do so, however, AMHECT would also have to show it passes the public support tests discussed in Part 2(a), above.