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April 27, 2010

Hon. Douglas Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments on Proposed Regulations Under Section 509(a)(3) Regarding Type III Supporting Organizations

Dear Commissioner Shulman:

Enclosed are comments on proposed regulations under section 509(a)(3) regarding Type III supporting organizations. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stuart M. Lewis
Chair, Section of Taxation

Enclosure

cc: Michael F. Mundaca, Assistant Secretary (Tax Policy), Department of the Treasury
William Wilkins, Chief Counsel, Internal Revenue Service
Joshua Odintz, Acting Tax Legislative Counsel, Department of the Treasury
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**ABA SECTION OF TAXATION
COMMENTS ON PROPOSED
REGULATIONS UNDER SECTION 509(a)(3)
REGARDING TYPE III SUPPORTING ORGANIZATIONS**

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by LaVerne Woods of the Committee on Exempt Organizations of the Section of Taxation. Substantive contributions were made by Alyssa DiRusso, Richard S. Gallagher, Richard L. Sevcik and David A Shevlin. Susan D. Brown made substantive contributions solely with respect to the need for special rules under section 507, and did not participate in the preparation of the remaining portion of the Comments because of her role in the development of the proposed rules while employed by the Department of Treasury. The Comments were reviewed by Frederick J. Gerhart, Committee Chair. The Comments were further reviewed by Joseph E. Lundy of the Section’s Committee on Government Submissions and by Andrew Dubroff, Council Director for the Committee on Exempt Organizations.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: April 27, 2010

EXECUTIVE SUMMARY

On September 24, 2009, the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued proposed regulations (“Proposed Regulations”)¹ to implement sections 1241 and 1243 of the Pension Protection Act of 2006 (“PPA”), which amended the law with respect to Type III supporting organizations.² These Comments respond to the request in the Proposed Regulations for public comments.³ The Proposed Regulations amend Regulation section 1.509(a)-4 regarding the requirements for qualification as a Type III supporting organization (“SO”), and Regulation section 53.4943-11 regarding the effective date of the application of excess business holdings rules under section 4943 to certain Type III SOs. The Proposed Regulations are to apply to taxable years beginning after the date they are published in the Federal Register as final or temporary Regulations. Prior to issuing the Proposed Regulations, Treasury and the Service issued an Advance Notice of Proposed Rulemaking (“ANPRM”) on August 2, 2007, regarding the issues addressed by the Proposed Regulations.⁴

We commend Treasury and the Service for the helpful guidance that would be provided by the Proposed Regulations, including the following:

1. Providing an example to clarify how a Type III SO that is formed as a charitable trust may satisfy the responsiveness test.
2. Eliminating the ANPRM’s proposed expenditure and assets tests for qualification as a functionally integrated Type III SO.
3. Eliminating the ANPRM’s proposed limitation on the number of supported organizations that a non-functionally integrated Type III SO may support.
4. Providing a special rule allowing “parent” organizations to qualify as functionally integrated Type III SOs.
5. Providing a reasonable cause exception and an emergency temporary reduction for the annual distribution requirement of non-functionally integrated Type III SOs.
6. Providing an excess distribution carryover for non-functionally integrated Type III supporting organizations that distribute more than their distributable amount, and

¹ REG-155929-06, 74 Fed. Reg. 48,672 (2009).

² Pub. L. No. 109-280, 120 Stat. 780. References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.

³ 74 Fed. Reg. 48,672 (2009). The Section previously submitted comments in response to interim guidance on supporting organizations under Notice 2006-109, 2006-2 C.B. 1121. ABA Section of Taxation “Comments in Response to IRS Notice 2006-109 on the Application of the Pension Protection Act of 2006 to Donor Advised Funds and Supporting Organizations” (June 4, 2007), *available at* <http://www.abanet.org/tax/pubpolicy/2007/070604irsnotice2006109.pdf>.

⁴ REG-155929-06, 72 Fed. Reg. 42,335 (2007); Announcement 2007-87, 2007-2 C.B. 753.

favorably stacking amounts paid out in the future year as first counting toward any excess amount carried forward, followed by amounts paid out in the later year.

7. Providing relief provisions for pre-1970 charitable trusts.
8. Providing transitional relief under the excess business holdings rules of section 4943 for SOs that were reclassified as private foundations as a result of the PPA.

We recommend that Treasury and the Service consider the following amendments to the Proposed Regulations:

1. Changing the due date for the notice that a Type III SO is required to provide to its supported organization to the last day of the month in which the SO's Form 990, Return of Organization Exempt from Income Tax, is due, including extensions.
2. Revising Example 1, illustrating how a charitable trust may satisfy the responsiveness test, so as to allow the test to be satisfied by meetings using interactive technology as well as by face-to-face meetings.
3. Providing that the determination of whether "substantially all" of a functionally integrated Type III SO's activities further the required purposes will be determined on the basis of facts and circumstances.
4. Replacing the requirement that "substantially all" of a functionally integrated Type III SO's activities "directly further" the purposes of its supported organization with a requirement that "substantially all" of the SO's activities be "directly for the active conduct" of the functions or purposes of its supported organization, and defining this phrase by reference to the private operating foundation rules.
5. Expanding functionally integrated status for Type III SOs that support a single governmental entity to allow them to support multiple governmental entities.
6. Replacing the "five percent annual distribution" requirement for non-functionally integrated Type III SOs with a "three and one-third percent annual distribution" requirement.
7. Allowing non-functionally integrated Type III SOs to satisfy their annual distribution requirements with set-asides as well as with actual distributions.
8. Providing rules for program-related investments ("PRIs") that allow non-functionally integrated Type III SOs to apply PRIs against their annual-distribution requirements and exclude PRIs from the asset base used to calculate their annual-distribution requirements.
9. Providing transition relief from the annual-distribution requirement of non-functionally integrated Type III SOs that hold unmarketable assets.

10. Providing transition relief from the annual-distribution requirement for any Type III SO whose organizing documents on August 17, 2006, prohibited distributions from capital or corpus.
11. Providing a multi-year averaging provision for valuing assets in calculating the annual-distribution requirement for non-functionally integrated Type III SOs.
12. Providing that direct-charitable-program expenditures by a non-functionally integrated Type III SO count toward its annual-distribution requirement.
13. Providing special rules for terminating private-foundation status for SOs that are reclassified as private foundations as a result of the PPA.
14. Providing a procedure under which Type III SOs may claim a refund of estimated private-foundation-excise tax on investment income they paid on the erroneous assumption that they had become a private foundation as a result of the PPA.

DISCUSSION

A. Provisions Applicable to All Type III Supporting Organizations

1. Reconsider Due Date of Required Notice to Supported Organizations.

The Proposed Regulations provide that a Type III SO must provide a written notice to its supported organization⁵ containing certain information, including the type and amount of support provided to the supported organization in the past year, along with a copy of the SO's "most recently filed Form 990."⁶ The due date for the notice is the last day of the fifth month after the close of the SO's tax year.⁷

The due date for the notice is based on the due date for the SO's Form 990 without regard to extensions, which is the fifteenth day of the fifth month after the close of the SO's tax year. For an SO that extends the due date of its Form 990, this means that its most recently filed Form 990 will be for the second preceding year, not the immediately preceding year. For example, the Form 990 for 2010 for an SO using a calendar year is due on May 15, 2011, and under the Proposed Regulations the SO's required notice to its supported organization is due on May 31, 2011. But if the SO extends the due date for its 2010 Form 990, the SO will be providing the Form 990 for 2009 with its notice to the supported organization. This means that the information the notice requires, regarding the type and level of support, will not match the information on the Form 990 that accompanies the notice. It also means that the SO may not yet have final support figures for 2010.

Recommendation: Change the due date for the notice to the last day of the month in which the supporting organization's Form 990 is due, including extensions.

We recommend that Treasury and the Service consider changing the due date for the notice to the last day of the month in which the SO's Form 990 is due, including extensions. A notice due date that reflects extension of the filing date for the Form 990 would be simpler, would result in fewer missed deadlines and inaccuracies, would avoid confusion from conflicts between the notice and the Form 990 accompanying the notice, and would ensure that the supported organization receives the SO's Form 990 for the immediately preceding year with the notice.

2. Revise Charitable Trust Example.

Treasury and the Service have requested comments on whether there should be a special responsiveness test⁸ for Type III SOs that are trusts that would be consistent with

⁵ Any reference in these Comments to a single "supported organization" includes, when appropriate, a reference to multiple supported organizations.

⁶ Prop. Reg. § 1.509(a)-4(i)(2).

⁷ Prop. Reg. § 1.509(a)-4(i)(2)(v).

⁸ REG-155929-06, 74 Fed. Reg. 48,672, 48,675 (2009).

the Congressional intent behind the PPA’s removal of the prior alternative responsiveness test for trusts in the now-obsolete Regulations.⁹

Under the Proposed Regulations, a Type III SO formed as a charitable trust must satisfy the general responsiveness test of the Proposed Regulations¹⁰ by demonstrating the necessary relationship between its trustees and the officers, directors or trustees of its supported organization and demonstrating that this relationship results in the officers, directors or trustees of its supported organization having a significant voice in the operations of the SO, including its investment policies, the timing of grants, the manner of making grants, the selection of grant recipients, and other aspects of the use of its income or assets. The Proposed Regulations include a helpful illustration of how a trust may satisfy the responsiveness test.¹¹

We commend Treasury and the Service for providing the helpful illustration. In it, representatives of the trustee and an officer of the supported organization have quarterly face-to-face meetings in which they discuss the supported organization’s projected needs and ways in which the supported organization would like the trust to use its income and invest its assets. While we recognize that the reference to face-to-face meetings is an illustration, and not a requirement, we believe that it also would be helpful for the example to specify that other means of having regular interaction, beyond the participants being physically present in the same location, may satisfy the test.

Recommendation: Revise Example 1 to specify that meetings may be held with interactive technology.

Specifically, we suggest that the example, when finalized, provide that representatives of the trustee and an officer of the supported organization have quarterly face-to-face meetings, “*or meetings via interactive technology that allows all persons participating in the meeting to communicate with one another.*” We believe that this would appropriately recognize the valuable role that technology increasingly plays to promote efficiency and conservation of charitable (as well as natural) resources.

B. Provisions Applicable to Functionally Integrated Type III Supporting Organizations.

1. Elimination of Assets Test and Expenditures Test.

New section 4943(f)(5)(B), added by the PPA, defines a functionally integrated Type III SO as a Type III SO “which is not required under regulations established by the Secretary to make payments to supported organizations (as defined under section 509(f)(3)) due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.”

⁹ Reg. § 1.509(a)-4(i)(2)(iii).

¹⁰ Prop. Reg. § 1.509(a)-4(i)(3).

¹¹ Prop. Reg. § 1.509(a)-4(i)(3)(iv), Ex. (1).

The Staff of the Joint Committee on Taxation, in its Technical Explanation¹² of the provision, notes that there is “concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations.”¹³ The Technical Explanation states that, if the distinction is retained between those organizations that are required to pay out and those that are not, “the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out.”¹⁴ The Technical Explanation further notes that, “[f]or example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.”¹⁵

The ANPRM proposed that functionally integrated Type III SOs be required to satisfy (a) the “but for” test in the existing Regulations,¹⁶ (b) an expenditure test that would resemble the qualifying distribution test for private operating foundations, and (c) an assets test that would resemble the alternative assets test for private operating foundations. The expenditure test would require that a functionally integrated Type III SO “use substantially all of the lesser of (a) its adjusted net income or (b) five percent of the aggregate fair market value of all its assets (other than assets that are used, or held for use, directly in supporting the charitable programs of the supported organizations) directly for the active conduct of activities that directly further the exempt purposes of the organizations it supports.”¹⁷ The assets test would require that a functionally integrated Type III SO “devote at least 65 percent of the aggregate fair market value of all its assets directly for the active conduct of activities that directly further the exempt purposes of the organizations it supports.”¹⁸ The assets and expenditures tests would be based on the premise that Type III functionally integrated SOs “share strong similarities” with private operating foundations defined in section 4942(j)(3) and should be subject to similar requirements.¹⁹

The Proposed Regulations do not include the ANPRM’s assets and expenditures tests. Instead, the Proposed Regulations provide that a Type III SO is functionally integrated if it either (a) engages in activities substantially all of which directly further the exempt purposes of the supported organization to which it is responsive, by performing the functions of, or carrying out the purposes of, such supported organization and that, but for the involvement of the SO, would normally be conducted by the supported organization; or (b) is the parent of each of its supported organizations.²⁰

¹² Staff of the Joint Committee on Taxation, *Technical Explanation of H.R. 4, The “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* (JCX-38-06) (Aug. 3, 2006) (“Technical Explanation”).

¹³ *Id.* at 360, fn. 571.

¹⁴ *Id.*

¹⁵ *Id.*

¹⁶ Reg. § 1.509(a)-4(i)(3)(ii).

¹⁷ ANPRM, 72 Fed. Reg. 42,335, 42,338 (2007).

¹⁸ *Id.*

¹⁹ *Id.* at 42,337.

²⁰ Prop. Reg. § 1.509(a)-4(i)(4)(i).

We commend Treasury and the Service for eliminating the ANPRM’s assets and expenditures tests for functionally integrated Type III SOs. We further commend Treasury and the Service for the special rule allowing “parent” organizations to qualify as functionally integrated Type III SOs.

2. Guidance Clarifying Application of the “Substantially All” Test.

Treasury and the Service have requested comments on how guidance might clarify the application of the “substantially all” test for functionally integrated Type III SO status.²¹ We note that the Technical Explanation suggests that the Secretary consider “whether *substantially all* of the activities [of a functionally integrated Type III SO] should be activities in direct furtherance of the functions or purposes of supported organizations.”²²

Consistent with the suggestion in the Technical Explanation, the Proposed Regulations look to whether “substantially all” of the “activities” of a functionally integrated SO directly further the purposes of its supported organization. The Proposed Regulations do not define “substantially all” for this purpose.

The Code and the Regulations apply a “substantially all” standard in other contexts involving tax-exempt organizations. For example, a private operating foundation must make qualifying distributions directly for the active conduct of its exempt purposes equal to “substantially all” of the lesser of its adjusted net income or its minimum investment return.²³ The Regulations define “substantially all” for this purpose as 85% or more.²⁴ Similarly, the integral-part test for Type III SO status would be satisfied if an SO made payments of “substantially all” of its income to or for the use of a supported organization, and the amount of support received by the supported organization were sufficient to insure the attentiveness of the supported organization to the operations of the SO.²⁵ The Regulations do not define “substantially all” for this purpose, but Treasury and the Service have taken the position that the term means 85% or more.²⁶ The unrelated business income tax rules provide another example in which property that would otherwise be “debt-financed property” under section 514 is not debt-financed property if “substantially all” of the property is used in a manner that is substantially related to the exercise or performance of charitable or other functions constituting the basis for the organization’s exemption.²⁷ The Regulations define “substantially all” for this purpose as 85% or more.²⁸

²¹ See Prop. Reg. § 1.509(a)-4(i)(4)(i)(A)(1).

²² Technical Explanation, *supra* at 360, fn. 571 (emphasis added).

²³ I.R.C. § 4942(j)(3)(A).

²⁴ Reg. § 53.4942(b)-1(c).

²⁵ Reg. § 1.509(a)-4(i)(3)(iii)(a).

²⁶ Rev. Rul. 76-208, 1976-1 C.B. 161.

²⁷ I.R.C. § 514(b)(1)(A)(i).

²⁸ Reg. § 1.514(b)-1(b)(1)(ii).

Recommendation: Apply a “facts and circumstances” test.

A private operating foundation’s adjusted net income and minimum investment return, and an SO’s income, must be quantified and reported under the tax law. It is a relatively straightforward exercise to determine what constitutes “substantially all” for this purpose (*i.e.*, 85% or more of such measures). Similarly, it is relatively easy to determine how much of that amount has been expended or distributed.

In contrast, the question of what constitutes “substantially all” of an SO’s “activities” under the Proposed Regulations is not subject to the same level of precise measurement. Nor will it always be clear whether an “activity” furthers the required purposes. Accordingly, whether or not Treasury and the Service choose to define “substantially all” in this context (*e.g.*, as 85% or more), we recommend that the determination of whether “substantially all” of an SO’s activities are directly in furtherance of the required purposes be made on a facts and circumstances basis.

A facts and circumstances analysis would be consistent with the approach that the debt-financed income Regulations under section 514 take in determining when “substantially all” of the use of any property is substantially related to exempt purposes. This question, like the question of whether “substantially all” activities directly further exempt purposes, is much less susceptible to precise quantification than questions of net income and expenditures. The Regulations provide:

The extent to which property is used for a particular purpose shall be determined on the basis of all the facts and circumstances. These may include (where appropriate) –

(a) A comparison of the portion of time such property is used for exempt purposes with the total time such property is used,

(b) A comparison of the portion of such property that is used for exempt purposes with the portion of such property that is used for all purposes, or

(c) Both the comparisons described in (a) and (b) of this subdivision.²⁹

We recommend that Treasury and the Service adopt a similar facts and circumstances analysis to determine whether “substantially all” of a Type III SO’s activities directly further the required purposes. Such an analysis could include a variety of factors, such as the percentage of payroll, the percentage of employee time, the percentage of volunteer time, the percentage of expenditures, and the percentage of assets that are used in various activities, with no one factor being dispositive.

²⁹ Reg. § 1.514(b)-1(b)(1)(ii).

3. Requirement that Activities “Directly Further” Exempt Purposes of Supported Organizations.

The Proposed Regulations require that substantially all of a functionally integrated Type III SO’s activities “directly further” the exempt purposes of those supported organizations with respect to which the SO satisfies the responsiveness test. Treasury and the Service have requested comments on the requirement that the SO’s activities “directly further” such purposes.³⁰

As noted above, the Technical Explanation suggests that the Secretary consider “whether substantially all of the activities [of a functionally integrated Type III SO] should be activities in *direct furtherance* of the functions or purposes of supported organizations.”³¹

The ANPRM states that Treasury and the Service anticipated that the Proposed Regulations would define a functionally integrated Type III SO as an organization that satisfies the “but for” test in the existing Regulations,³² and that satisfies an expenditure test and an assets test. (As noted above, the expenditure and assets tests were eliminated in the Proposed Regulations.) The existing Regulations provide:

The activities engaged in for or on behalf of the publicly supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves.³³

By contrast, the Proposed Regulations provide that an organization satisfies the integral-part test as a functionally integrated Type III SO if the SO engages in activities:

(1) Substantially all of which *directly further* the exempt purposes of the supported organization(s) to which the supporting organization is responsive, by performing the functions of, or carrying out the purposes of, such supported organization(s); and

(2) That, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s).³⁴

The Proposed Regulations thus add two new requirements for functionally integrated status: (a) substantially all of the SO’s activities must “directly further” the exempt purposes of the supported organization(s); and (b) the supported organization(s) whose exempt purposes are furthered must be those with respect to which the SO satisfies

³⁰ 74 Fed. Reg. 48,672, 48,676 (2009).

³¹ Technical Explanation, *supra* at 360, fn. 571 (emphasis added).

³² Reg. § 1.509(a)-4(i)(3)(ii).

³³ *Id.*

³⁴ Prop. Reg. § 1.509(a)-4(i)(4)(i)(A) (emphasis added).

the responsiveness test. The Proposed Regulations go on to define “directly further” as follows:

(ii) “*Directly further.*” Holding title to exempt-use property and managing exempt-use property are activities that directly further the exempt purposes of the supported organization within the meaning of paragraph (i)(4)(i)(A) of this section. Except as provided in paragraph (i)(4)(iii) of this section [regarding SOs that support a single governmental entity], fundraising, investing and managing non-exempt-use property, and making grants (whether to the supported organization or to third parties) are not activities that directly further the exempt purposes of the supported organization within the meaning of paragraph (i)(4)(i)(A) of this section.³⁵

We suggest reconsideration of the conclusion that fundraising, managing investment property and grantmaking do not “directly further” exempt purposes. Grantmaking in particular may “directly further” exempt purposes. For example, we believe that an SO that provides scholarship grants to students at a private secondary school that it supports “directly furthers” the school’s exempt purposes, contrary to the conclusion reached in the Proposed Regulations.³⁶

Recommendation: Refer to private operation foundation standards to define qualifying activities.

We understand that the term “directly further” is derived from the Technical Explanation’s suggestion that the Secretary consider a requirement under which “substantially all of the activities [of the SO] should be activities in direct furtherance of the functions or purposes of supported organizations.”³⁷ We recommend that Treasury and the Service adopt the language and standards from the private operating foundation rules under section 4942(j)(3) to which the Technical Explanation appears to refer. A private operating foundation must make “substantially all” of its expenditures “directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated,” within the meaning of section 4942(j)(3)(A).

We recognize that the ANPRM considered applying the private operating foundation expenditure and assets tests to functionally integrated Type III SOs, and we agree with the decision reflected in the Proposed Regulations to abandon those tests. We recommend application of the private operating foundation rules to determine whether a Type III SO’s *activities* qualify it as a functionally integrated Type III SO, rather than applying the proposed “directly further” standard. As noted in the ANPRM, “private operating foundations under section 4942(j)(3) share strong similarities with Type III functionally integrated supporting organizations under section 4943(f)(5)(B) in that both

³⁵ Prop. Reg. § 1.509(a)-4(i)(4)(ii).

³⁶ Prop. Reg. § 1.509(a)-4(i)(4)(iv) Ex. 4.

³⁷ Technical Explanation, *supra* at 360, fn. 571.

are expected to be *directly engaged in the active conduct* of charitable activities rather than only making grants to, or for the use of, charitable organizations.”³⁸

We recommend that Treasury and the Service either (a) replace the term “directly further” with the phrase “directly for the active conduct” of the activities that constitute a supported organization’s purpose or function, or (b) define the term “directly further” by reference to the phrase “directly for the active conduct” as defined for purposes of the private operating foundation rules in section 4942(j)(3). Under those rules a private operating foundation’s involvement in grantmaking to individual beneficiaries may be so significant as to constitute the active conduct of charitable activities.³⁹ We recommend that the same rule apply in establishing the test for a functionally integrated Type III SO.

4. Rules Regarding Organizations that Support a Single Governmental Entity.

The Proposed Regulations provide special rules for Type III SOs that support governmental entities. Specifically, the Proposed Regulations provide that an SO supporting a single governmental entity may treat investing and managing non-exempt use assets as activities that “directly further” an exempt purpose, so long as a “substantial part” of the SO’s total activities directly furthers the exempt purposes of the governmental entity.⁴⁰

We agree that a Type III SO supporting a governmental entity merits special consideration, and we commend Treasury and the Service for proposing this special rule. We suggest, however, that this rule not be limited to Type III SOs that support only a *single* governmental entity. We are unaware of any other context in which an SO is limited to supporting a single supported organization, and this limitation would put governmental entities at a disadvantage. The Type III form is commonly used to support governmental entities to avoid the SO becoming subject to state laws applicable to governmental entities and organizations they control. This “single entity” limitation seems similar to the ANPRM’s rule that a non-functionally integrated Type III SO could support no more than five supported organizations,⁴¹ which commentators criticized as arbitrary⁴² and which is not included in the Proposed Regulations.

We also note that it is often difficult to identify a “single” governmental entity. Governmental entities may or may not be separately incorporated, and the lines between them may be much less clearly defined than those between nonprofit corporations or charitable trusts. Revenue Ruling 75-436⁴³ provides an example. It involved a charitable trust, the sole purpose of which was to grant scholarships to students from a city’s public high schools. The city council was the sole trustee and the trust’s funds were managed by the city treasurer or a commission created by the city. The school system in the city was not separately incorporated, and the ruling states that it was an integral part of the

³⁸ ANPRM, 72 Fed. Reg. 42,335, 42,337 (emphasis added) (2007).

³⁹ See Reg. § 53.4942(b)-1(b)(2).

⁴⁰ Prop. Reg. § 1.509(a)-4(i)(4)(iii).

⁴¹ See 74 Fed. Reg. 48,672, 48,677 (2009).

⁴² See *id.*

⁴³ 1975-2 C.B. 217.

city. But it may be difficult in similar fact patterns to determine whether the city and the school system are separate entities.

Recommendation: Expand special rule to apply to organizations that support multiple governmental entities.

We understand that the purpose of the special rule for SOs that support governmental entities is to enhance flexibility regarding the nature of the SO's activities, but we do not understand why the special rule should be limited to SOs that support only a single governmental entity. We recommend that Treasury and the Service consider eliminating the "single entity" restriction. We do not believe that expanding the special rule in this way would create an opportunity for abuse given the responsiveness test and the other tests that these Type III SOs would be required to satisfy.

C. Provisions Applicable to Non-Functionally Integrated Type III Supporting Organizations.

1. Reconsider Proposed Five Percent Payout Rate.

The Proposed Regulations require that a non-functionally integrated Type III SO distribute annually an amount equal to at least five percent of the net value of its non-exempt use assets.⁴⁴ This distribution requirement mirrors in most respects the distribution requirement for private non-operating foundations under section 4942(e).

Current economic analysis suggests that a spending rate of five percent may be too high to sustain the real value of an endowment fund on a long-term basis. By way of background, the distinction between income and corpus for payout purposes is derived from historical trust accounting concepts, the objective of which was to provide a balance between current and future spending. A requirement to keep the principal of charitable assets intact allows for the preservation and investment of such assets in perpetuity so the resulting income is available to provide benefits to future generations. Many charitable donors desire to create or contribute to a permanent endowment. A study commissioned by the Michigan Council on Foundations in 2000⁴⁵ concluded that a five percent spending rate is slightly too high to maintain purchasing power in perpetuity, and that payout rates in excess of five percent almost guarantee the depletion of the real value of a foundation over the long term, resulting in it being unable to maintain its spending in constant dollar terms without liquidating.

The distribution provisions of the Uniform Prudent Management of Institutional Funds Act ("UPMIFA"),⁴⁶ which has now been adopted in 44 states and introduced in another four states and the U.S. Virgin Islands, address the concern that determining endowment spending based on strict accounting concepts of income versus principal

⁴⁴ Prop. Reg. § 1.509(a)-4(i)(5)(ii)(B).

⁴⁵ Cambridge Associates, Inc. "Sustainable Payout for Foundations," Council of Michigan Foundations, April 2000, *available at*

http://www.michiganfoundations.org/s_cmf/bin.asp?CID=2528&DID=11840&DOC=FILE.PDF.

⁴⁶ *Available at* <http://www.nccusl.org/Update/ActSearchResults.aspx>.

often results in insufficient current distributions when assets are prudently invested under modern investment portfolio theory. The National Conference of Commissioners on Uniform State Laws (“NCCUSL”) approved UPMIFA in 2006. The drafters devoted a great deal of time and thought to the determination of an appropriate annual payout from endowment funds. The following excerpt is from the discussion in the 2006 comments of NCCUSL to UPMIFA on the issue of whether to include a specific presumption that spending at or above a given percentage level is imprudent:

Perhaps the biggest problem with including a presumption in the statute is the difficulty of picking a number that will be appropriate given the range of institutions and charitable purposes and the fact that economic conditions will change over time. Under current economic conditions, a spending rate of seven percent is too high for most funds, but in a period of high inflation, seven percent might be too low. In making a prudent decision regarding how much to spend from an endowment fund, each institution must consider a variety of factors, including the particular purposes of the fund, the wishes of the donors, changing economic factors, and whether the fund will receive future donations.

. . . .

The presumption of imprudence does not create an automatic safe harbor. Expenditures at six percent might well be imprudently high. *Indeed, evidence discussed by the Drafting Committee suggests that few funds can sustain spending at a rate above five percent. And under current conditions five percent may be too high.* Further, spending at a lower rate, particularly in the early years of an endowment, may result in greater distributions over time. A presumption of imprudence can serve as a reminder that *spending at too high a rate will jeopardize the long-term nature of an endowment fund. If an endowment fund is intended to continue permanently, the institution should take special care to limit annual spending to a level that protects the purchasing power of the fund.*⁴⁷

We believe the NCCUSL comments indicate that an asset-based payout percentage should not be set at a rate that, based on current conditions and historical data, may be expected to result in erosion of the value over time (and a resulting decrease in

⁴⁷ National Conference of Commissioners on Uniform State Laws, Drafting Committee on Uniform Prudent Management of Institutional Funds Act, 2006 Annual Meeting Draft Comment, July 7-14, 2006 (emphasis added and citations omitted), *available at* <http://www.law.upenn.edu/bll/archives/ulc/umoifa/2006amdraft.htm>.

the annual payout amounts in future years on an inflation-adjusted basis) of many Type III SOs.⁴⁸

Recommendation: Apply three and one-third percent payout rate.

The Section of Taxation suggested, in comments dated August 1, 2007, regarding IRS Notice 2007-21,⁴⁹ as an alternative to the proposed five percent payout rate, an annual minimum asset-based spending rate of three and one-third percent, consistent with the spending rate under the “endowment test” for private operating foundations.⁵⁰ That rate is calculated as two-thirds of the “minimum investment return” (*i.e.*, five percent of investment assets less any acquisition indebtedness).⁵¹

We recognize that Treasury and the Service, in selecting a payout rate, have proposed the five percent minimum rate reflected in section 4942(e), at least in part based on there being legislative authority for that rate in the private foundation context. But there is equally compelling legislative authority for the three and one-third percent minimum in section 4942(j)(3)(B)(ii).

Applying the private operating foundation standard for asset-based distributions would be consistent with the existing interpretation of the income-based expenditure requirement in the existing Regulations.⁵² Currently, a Type III SO must distribute “substantially all” of its income. Treasury and the Service, in Revenue Ruling 76-208,⁵³ looked to the private operating foundation rules, which define “substantially all” as 85%, and applied the same standard in the Type III SO context.⁵⁴ A payout rate of three and one-third percent appropriately balances the competing objectives of ensuring that a significant amount is distributed to the supported organization and avoiding the erosion of the real inflation-adjusted value of the permanent endowments of Type III SOs to the detriment of future generations.

2. Need for Set-Asides for Type III Non-Functionally Integrated SOs.

Treasury and the Service have requested comments on whether set-asides are necessary and consistent with Congressional intent in determining the annual distributable amount of Type III SOs that are not functionally integrated.⁵⁵ While the preamble notes that the Proposed Regulations “generally draw from the regulations under

⁴⁸ We note that the foregoing UPMIFA comments focus on a *maximum* prudent spending percentage, while the focus of the Proposed Regulations discussed here is on a revised *minimum* distribution requirement for Type III SOs.

⁴⁹ Notice 2007-21, 2007-1 C.B. 611.

⁵⁰ ABA Section of Taxation “Comments in Response to IRS Notice 2007-21 on Treasury Study on Donor Advised Funds and Supporting Organizations,” *available at* <http://www.abanet.org/tax/pubpolicy/2007/070801irs200721treasurystudy.pdf>.

⁵¹ I.R.C. § 4942(j)(3)(B)(ii); Reg. § 53.4942(b)-2(b)(1).

⁵² See Reg. § 1.509(a)-4(i)(3)(iii)(a).

⁵³ 1976-1 C.B. 161

⁵⁴ See Reg. § 53.4942(b)-1(c); *see also* PLR 9021060 (Feb. 28, 1990); PLR 9714006 (Dec. 18, 1996); PLR 9730002 (Jan. 7, 1997) (all looking to the rules for private operating foundations for purposes of defining “income” for the Type III SO distribution rules).

⁵⁵ 74 Fed. Reg. 48,672, 48,677 (2009).

section 4942 for principles on valuation, timing, and carryovers,”⁵⁶ the Proposed Regulations do not provide for “set asides.”⁵⁷

Recommendation: Provide for set-asides.

We recommend that a set-aside procedure comparable to the procedure in section 4942(g) be made available for Type III non-functionally integrated SOs. We believe that set-asides are necessary and consistent with Congressional intent.

The preamble to the Proposed Regulations states that, while Congress statutorily provided that set-asides constitute qualifying distributions for private foundations, there is no comparable statutory provision for Type III non-functionally integrated SOs.⁵⁸ Rather the preamble states that Congress directed in the PPA that a payout requirement be implemented that would result in a “prompt, robust flow of support to supported organizations.”⁵⁹

Set-asides are a critical and beneficial tool for private foundations in the accomplishment of their exempt purposes. As set forth in the Regulations, the set-aside exception is intended to apply in instances “in which relatively long-term grants or expenditures must be made in order to assure the continuity of particular charitable projects or program-related investments (as defined in section 4944(c)) or where grants are made as part of a matching-grant program.”⁶⁰ Examples in the Regulations of specific projects for which set-asides may be appropriate include a plan to erect a building to house the direct exempt activities of the private foundation (*e.g.*, a museum building), even though the location of the building and architectural plans have not been finalized; a plan to purchase an additional group of paintings offered for sale only as a unit that requires an expenditure of more than one year's income; and, a plan to fund a specific research program that requires an accumulation of funds before beginning the research, even though not all details of the program have been finalized.⁶¹ Numerous rulings have approved set-asides.⁶²

The fact that the PPA did not specifically include a statutory provision for set-asides does not mean that Congress intended that there should be no set-asides for Type III non-functionally integrated SOs. The PPA directed the Secretary of the Treasury to

⁵⁶ 74 Fed. Reg. 48,672, 48,677 (2009).

⁵⁷ An amount “set aside” by a private foundation for a specific project that comes within one or more purposes described in section 170(c)(2)(b) may be treated as a qualifying distribution if certain requirements are satisfied. I.R.C. § 4942(g)(2).

⁵⁸ 74 Fed. Reg. 48,672, 48,677 (2009).

⁵⁹ *Id.*

⁶⁰ Reg. § 53.4942(a)-3(b)(2).

⁶¹ *Id.*

⁶² *See, e.g.*, Rev. Rul. 74-450, 1974-2 C.B. 388 (set aside for the conversion of an acquired farmland into a wildlife sanctuary and public park); PLR 9430042 (May 5, 1994) (set aside for repair and restoration of a section 501(c)(3)'s headquarters building); PLR 9447055 (Aug. 31, 1994) (set aside for grant toward a new Latin American Art Center); PLR 9524033 (Mar. 23, 1995) (set aside for organization serving the homeless to repair and upgrade its facilities and to locate some services to new locations); PLR 9521006 (Feb. 21, 1995) (set aside toward a multi-year grant for construction of a multi-purpose sports arena complex).

promulgate new payout Regulations applicable to Type III non-functionally integrated SOs “in order to ensure that a significant amount is paid” to the supported organization(s).⁶³ Section 4942 contains very specific and detailed provisions regarding a private foundation’s payout requirements, including an extensive provision defining “qualifying distributions.” A payout requirement consistent with the provisions of section 4942, including an allowance for set-asides, would be consistent with the Congressional intent expressed in the PPA.

A set-aside procedure for non-functionally integrated Type III SOs comparable to that set forth in section 4942(g) would not thwart Congress’ expressed desire for a “prompt, robust flow of support.” Section 4942(g) requires advance approval by the Secretary, with a showing that the amounts set aside will be paid within five years and (a) the Secretary is satisfied that the project is one that can be better accomplished by such set-aside than by the immediate payment of funds, or (b) certain payout requirements have been satisfied. The foregoing requirements, as applied to non-functionally integrated Type III SOs, would ensure that the flow of support by the SO to its supported organization remains prompt and robust.

Recommendations for additional implementation requirement.

We recommend that the set-aside procedure for non-functionally integrated Type III SOs include an additional requirement not found in the private foundation set-aside procedure. Specifically, we recommend that the application for the Secretary’s approval include (a) a statement that the SO has provided notice to its supported organization of the proposed set-aside, and (b) an explanation of how the project benefits the supported organization.

The payout requirement is intended to satisfy the integral-part test, which requires that the SO be significantly involved in the operations of the supported organization and that the supported organization be dependent upon the SO for the type of support the SO provides.⁶⁴ The set-aside procedure set forth in section 4942(g), with this additional requirement, would be consistent with the integral-part test.

We further recommend that the set-aside provision for non-functionally integrated Type III SOs require an increase in the distributable amount for any amount previously set aside that was treated as a qualifying distribution but is no longer necessary for the purposes for which the amount was set aside. The increase would be consistent with section 4942(d)(1) and (f)(2)(C)(iii).

3. Need for Program-Related Investments for Non-Functionally Integrated SOs.

While the proposed distribution requirement for non-functionally integrated Type III SOs mirrors in many respects the private foundation distribution rules under section 4942, the Proposed Regulations do not include the private foundation requirement

⁶³ PPA, *supra* at § 1241(d) (a statutory, non-Code direction to the Secretary of the Treasury).

⁶⁴ See Reg. § 1.509(a)-4(i)(3); Prop. Reg. § 1.509(a)-4(i)(4).

that treats a program-related investment (“PRI”), as defined in section 4944(c), as a qualifying distribution.⁶⁵ We are unaware of any policy rationale that precludes a non-functionally integrated Type III SO from satisfying its distribution requirements by this means of furthering a supported organization’s purposes. In addition, the rule under which a PRI is treated as a qualifying distribution for purposes of the private foundation distribution requirement was made by Regulation. Finally, in the PPA Congress granted Treasury broad discretion to promulgate new payout Regulations for Type III SOs.⁶⁶

Recommendation: Include PRI provision.

We recommend that PRIs be counted toward the distribution requirement for non-functionally integrated Type III SOs. We further recommend that, consistent with the private foundation rules, the value of a PRI be excluded from the base for calculating the SO’s annual distribution requirement.⁶⁷

4. Need for a Transition Rule for Non-Functionally Integrated Type III SOs whose Assets are not Readily Marketable.

Treasury and the Service have requested comments regarding the need for a transition rule for non-functionally integrated Type III SOs whose assets, as of the effective date of the final Regulations, consist predominantly (in any event more than one-half) of assets that are not readily marketable.⁶⁸

Recommendation: Include additional transition relief.

We recommend that the Proposed Regulations, when issued in final form, include such a transition rule. The Proposed Regulations contain some degree of transitional relief and flexibility with respect to the payout requirement for non-functionally integrated Type III SOs.⁶⁹ Most notably, the annual distributable amount for the first taxable year in which an organization is treated as a non-functionally integrated Type III SO is zero.⁷⁰ We believe that additional transitional relief is necessary for SOs whose assets are not readily marketable.

SOs that have substantial investments in assets that are not readily marketable may be limited by a variety of restrictions that affect their ability to convert such assets to cash or cash equivalents in order to satisfy the payout requirement in a timely manner. One type of restriction is a “contractual restriction.” SOs may be invested in collective investment vehicles that (i) restrict the ability of an investor to redeem or (ii) allow for redemptions only upon certain rolling dates, or after an initial lock-up period. SOs also may have investments in private equity, venture capital, real asset funds and similar investment vehicles that commonly do not provide for redemption at all. Rather, such

⁶⁵ See Reg. § 53.4942(a)-3(a)(2)(i).

⁶⁶ Pension Protection Act of 2006 § 1241(d)(1), Pub. L. No. 109-280, 120 Stat. 780.

⁶⁷ See Reg. § 53.4942(a)-2(c)(3)(ii)(d).

⁶⁸ 74 Fed. Reg. 48,672, 48,678 (2009).

⁶⁹ See Prop. Reg. § 1.509(a)-4(i)(5)(ii)(C), -4(i)(5)(ii)(D), -4(i)(5)(ii)(E).

⁷⁰ Prop. Reg. § 1.509(a)-4(i)(5)(ii)(C).

funds make distributions to investors in accordance with the terms of their governing documents, and such terms generally provide for distributions only upon disposition of their underlying holdings.

Legal restrictions also may affect an SO's ability to convert its assets to cash or cash equivalents. For example, the securities laws limit the manner in which securities may be sold in the United States without registration. Donor-imposed restrictions on disposition (particularly those that pre-date the PPA) also may limit dispositions. Finally, apart from contractual and legal restrictions, an SO's governing body may, consistent with state law fiduciary considerations, be hesitant to sell assets in a "fire sale" manner that might not result in the realization of fair market value for such assets.

Recommendation: Provide phase-in.

We recommend that Treasury and the Service consider a transitional rule for affected organizations that would phase in the required distribution rate over a specified number of tax years after the final Regulations become effective to allow SOs sufficient time to achieve the liquidity necessary to satisfy the distribution requirement. We believe a three-to-five-year transition period would be sufficient.

5. Need for a Transition Rule for Non-Functionally Integrated Type III SOs whose Organizing Documents Prohibit Distributions from Capital.

The current private foundation Regulations provide special transition rules regarding distribution requirements for private foundations whose organizing documents, as in effect on May 26, 1969, prohibit distributions from capital or corpus.⁷¹

Recommendation: Provide transitional period for reforming organizational documents.

We recommend that the Proposed Regulations provide similar transition rules regarding distribution requirements for non-functionally integrated Type III SOs whose organizing documents, as in effect on August 17, 2006, included similar restrictions.

6. Need for an Averaging Provision for the Value of Assets for Calculating the Distributable Amount.

The Proposed Regulation provide that, for purposes of determining a non-functionally integrated Type III SO's annual distributable amount, the determination of the fair market value of non-exempt-use assets is made in the year preceding the year of the required distribution.⁷²

Recommendation: Provide a "smoothing" mechanism.

We recommend that Treasury and the Service consider including an averaging or "smoothing" mechanism for the calculation of the fair market value of non-exempt-use

⁷¹ See Reg. § 53.4942(a)-2(e).

⁷² See Prop. Reg. § 1.509-4(i)(8).

assets, such as a rolling average of values over three to five years. The experience of the last two years illustrates both the potential for extreme volatility in investment markets and the challenges that such volatility creates for private foundations due to the requirement that their distributions be calculated on the basis of a single year's values. While we agree that it is desirable generally to draw on the private foundation rules for purposes of implementing an annual distribution regime for non-functionally integrated Type III SOs, we believe that it also is advisable to consider modifying the existing private foundation rules in this circumstance.

We commend Treasury and the Service for including an excess distribution carryover rule in the Proposed Regulations that improves upon the private foundation rules by first counting excess amounts carried forward (*i.e.*, those excess amounts that will expire earliest) toward the annual distributable amount, followed by amounts paid out in the later year (rather than vice versa).⁷³ We recommend that Treasury and the Service similarly exercise their authority to improve the rules for calculating the value of non-exempt use assets by providing a smoothing mechanism.

7. Definition of Distribution Should Include Exempt Purpose Expenditures.

The Proposed Regulations specify three categories of expenditures that count toward the distribution requirement for non-functionally integrated Type III SOs: (a) amounts paid to a supported organization to accomplish its exempt purposes; (b) amounts paid to acquire an asset used to carry out the exempt purposes of the supported organization; and (c) amounts expended for reasonable and necessary administrative expenses.⁷⁴

Recommendation: Add exempt purpose expenditures.

We recommend that the proposed list be expanded to include amounts expended by the SO that directly further the exempt purposes of the supported organization (*i.e.*, charitable program expenditures by the SO). We believe that these expenditures should count toward satisfying the distribution requirement, and it would be helpful if this issue were addressed in the final Regulations.

D. Transition and Relief Provisions.

1. Need for Special Rules under section 507 for Type III SOs that are Reclassified as Private Foundations.

The preamble to the Proposed Regulations provides that a Type III SO that fails to satisfy the requirements of the Proposed Regulations, once they become final and effective, will be classified as a private foundation and will be subject to the section 507 rules regarding termination of private foundation status.⁷⁵ Treasury and the Service have requested comments on whether exceptions or special rules under section 507 are needed

⁷³ Compare Prop. Reg. § 1.509(a)-4(i)(7) with Reg. § 53.4942(a)-3(e).

⁷⁴ Prop. Reg. § 1.509(a)-4(i)(6).

⁷⁵ 74 Fed. Reg. 48,672, 48,678 (2009).

for Type III SOs that are reclassified as private foundations as a result of the changes made by the PPA.⁷⁶

There are at least six ways that an organization may cease to qualify as a Type III SO under the Proposed Regulations, and therefore be reclassified as a private foundation:

- It supports a supported organization that is organized outside the United States in violation of section 509(a)(3)(f)(1)(B);⁷⁷
- It accepts a gift or contribution from a person who has a control relationship to a supported organization as described in section 509(f)(2)(B);⁷⁸
- It does not provide the annual notice to its supported organization required by section 509(a)(3)(f)(1)(A) in a timely manner;⁷⁹
- It is a charitable trust that does not satisfy the responsiveness test;⁸⁰
- It is a non-functionally integrated Type III SO that fails to make sufficient annual distributions to its supported organization; and⁸¹
- It is a non-functionally integrated Type III SO that distributes less than one-third of its annual distribution requirement to organizations that satisfies the attentiveness test.⁸²

Two of these potential grounds for disqualification (failure to satisfy the responsiveness test and support for a foreign organization) are structural in nature. The other four grounds for disqualification are not structural and may be quickly remedied once the mistake is discovered. Nevertheless, the effect of each of these “foot faults” is that the organization is reclassified as a private foundation, even if it corrects the error immediately upon discovery. For example, an organization that is late in delivering reports to its supported organization, or that mistakenly accepts a contribution from an impermissible source, is reclassified under the Proposed Regulations as a private foundation—subject to excise taxes on its net investment income and the other restrictions of Chapter 42 of the Code—and may extricate itself from that status only by successfully terminating its private foundation status under section 507(b)(1)(B). We believe that this “cliff effect” is unnecessarily harsh and justifies certain special rules.

Recommendation: Provide additional reasonable cause relief to avoid reclassification.

The Proposed Regulations provide welcome relief in the case of a non-functionally integrated Type III SO that fails to satisfy its payout requirement for a particular year, if the failure was due to reasonable cause.⁸³ We commend Treasury and

⁷⁶ *Id.*

⁷⁷ Prop. Reg. § 1.509(a)-4(i)(10).

⁷⁸ Prop. Reg. § 1.509(a)-4(f)(5).

⁷⁹ Prop. Reg. § 1.509(a)-4(i)(2).

⁸⁰ Prop. Reg. § 1.509(a)-4(i)(3).

⁸¹ Prop. Reg. § 1.509(a)-4(i)(5)(ii).

⁸² Prop. Reg. § 1.509(a)-4(i)(5)(iii). This is a more precise requirement than the pre-PPA requirement that a “substantial amount” of the SO’s total support must go to those publicly supported organizations that satisfy the attentiveness requirement.

⁸³ Prop. Reg. § 1.509(a)-4(i)(5)(ii)(E).

the Service for including this sensible provision and recommend revising the Proposed Regulations to provide similar “reasonable cause” relief when a failure to satisfy one or more non-structural qualification requirements is due to reasonable cause and is promptly cured by the organization.

Recommendation: Clarify timing of reclassification.

As noted above, the Proposed Regulations provide that a Type III SO that fails to satisfy the requirements of the Regulations will be classified as a private foundation. The Proposed Regulations do not specify when the reclassification will be effective. Because reclassification as a private foundation has serious consequences under Chapter 42, we suggest that the final Regulations clarify when the reclassification will be effective.

The Proposed Regulations require an SO that uses the calendar year as its fiscal year to deliver a prescribed notice to each of its supported organizations by May 31.⁸⁴ If an SO failed to do so, the Proposed Regulations do not specify whether the SO would be reclassified as a private foundation retroactive to January 1, or effective as of the May 31 deadline. Retroactive reclassification to January 1 might generate a host of other issues under Chapter 42. For example, if the organization had engaged in activities during the first five months of the tax year that are permitted for an SO, but would be prohibited for a private foundation (*e.g.*, a fair market rental of property to a “disqualified person” within the meaning of section 4946(a)), the disqualified person (*not* the reclassified organization) would be subject to an excise tax under section 4941(a), which the Service has no authority to abate.⁸⁵

To avoid a trap for the unwary, we recommend that the Proposed Regulations be clarified to provide that an organization will be reclassified as a private foundation as of the beginning of the tax year only for purposes of sections 507 (termination of private foundation status) and 4940 (excise tax on net investment income), and that the organization, its managers and its donors will be subject to the other provisions of Chapter 42, as well as section 170, as of the first day of its next taxable year. We also recommend that, for purposes of Chapter 42, the identity of substantial contributors to the organization within the meaning of section 507(d)(2) be determined by taking into account only contributions received after the date the organization is reclassified as a private foundation.

Recommendation: Simplify advance ruling process for 60-month terminations.

Providing the recommended, additional reasonable-cause relief would reduce the number of SOs reclassified as private foundations due to “foot faults.” For organizations that do not qualify for reasonable cause relief, we suggest that Treasury and the Service simplify the section 507(b)(1)(B) termination process.

The current Regulations permit an organization that seeks to terminate its private foundation status, by operating as a public charity described in section 509(a)(3), to

⁸⁴ Prop. Reg. § 1.509(a)-4(i)(2).

⁸⁵ See I.R.C. § 4962(b).

obtain an advance ruling from the Service that it can reasonably be expected to satisfy the requirements of section 509(a)(3) during the 60-month termination period.⁸⁶ The issuance of this advance ruling is discretionary with the Commissioner.⁸⁷ In deciding whether to issue an advance ruling, the Service will consider “all pertinent facts and circumstances,” including whether the organization’s “organizational structure (taking into account any revisions made prior to the beginning of the 60-month period), current or proposed programs or activities, actual or intended method of operation, and current or projected sources of support are such as to indicate that the organization is likely to satisfy the requirements of section 509(a)(1), (2) or (3)” during the 60-month period.⁸⁸

A Type III SO that is reclassified as a private foundation and begins the section 507(b)(1)(B) termination process would want to ensure that it is treated as a section 509(a)(3) organization—and that its grantors and contributors may rely on such status—during the 60-month termination period. We believe that it is unnecessary to require that such an organization apply for an “advance ruling” because the organization (before reclassification as a private foundation) already had a definitive section 509(a)(3) ruling.

We recommend that a section 509(a)(3) organization that is reclassified as a private foundation for non-structural reasons be treated as having received an advance ruling if it (a) includes in its notification of termination⁸⁹ an explanation of the specific failure that led to its reclassification as a private foundation, and (b) describes the steps it has taken to correct the error and to prevent a recurrence.⁹⁰

Recommendation: Allow additional time for notice of 60-month termination.

The Code provides that an organization must give notice before commencement of the 60-month termination period, and that the 60-month termination period must begin with the first day of a tax year.⁹¹ This will almost certainly result in a lag between when (a) an organization is reclassified as a private foundation, and (b) it can commence the 60-month termination period. If an organization discovers a disqualifying failure after the close of its tax year, the organization may be classified as a private foundation for the year in which the failure occurred (year 1) and the year in which the failure was

⁸⁶ Temp. Reg. § 1.507-2T(d); 86 REG-142333-07, 73 Fed. Reg. 52,218 (2008).

⁸⁷ *Id.*

⁸⁸ Temp. Reg. § 1.507-2T(d)(2).

⁸⁹ Temp. Reg. § 1.507-2T(b)(3) (the information currently required to be contained in the notification).

⁹⁰ This recommendation also could be implemented by revising the proposed and temporary Regulations issued in 2008 under section 507(b)(1). See T.D. 9423, 73 Fed. Reg. 52,528 (2008); REG.-142333-07, 73 Fed. Reg. 52,218 (2008). The Section previously submitted comments recommending that Treasury and the Service simplify the procedure for terminating private foundation status by operation as a section 509(a)(3) organization, by eliminating the requirement of an additional filing within 90 days after the end of the 60-month termination period. ABA Section of Taxation “Comments Concerning Temporary and Proposed Regulations Implementing the Redesigned form 990 for Tax Exempt Organizations and Revising the Public Support Test under Section 170 (b)(1)(A)(vi) and 509(a)(2) available at <http://www.abanet.org/tax/pubpolicy/2009/090817form990.pdf>.

⁹¹ I.R.C. § 507(b)(1)(B)(ii); Temp. Reg. § 1.507-2T(b)(3).

discovered (year 2). The earliest the organization could begin the 60-month termination period is the first day of the following tax year (year 3).

We recommend that Treasury and the Service consider allowing organizations to provide notice after the commencement of the 60-month termination period in appropriate cases. For example, it may be appropriate to provide relief for one or two years after the new rules become effective, in recognition of the fact that many SOs will learn of the new requirements for the first time when they are preparing Form 990 and discover that one or more requirements were not satisfied.

Recommendation: Provide special relief for charitable trusts.

We recommend that Treasury and the Service consider special transition relief for Type III SOs formed as charitable trusts that voluntarily reclassified themselves as private foundations prior to the issuance of the Proposed Regulations, but that have satisfied the requirements of the Proposed Regulations on a continuous basis for all tax years beginning on or after January 1, 2008.⁹² Notice 2008-6,⁹³ provided transition relief for charitable trusts that became private foundations during 2007 by virtue of section 1241(c) of the PPA. Under Notice 2008-6, the trust was not required to file an information return on Form 990-PF, Return of Private Foundation or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation, or to pay excise taxes on net investment income under section 4940, until its first tax year beginning on or after January 1, 2008.

Notice 2008-6 instructed charitable trusts that satisfy the “significant voice” responsiveness test in the Regulations to continue filing Form 990.⁹⁴ In light of uncertainty about how the Service would apply that test to a charitable trust, and in the absence of clear regulatory guidance, some charitable trusts elected to begin filing Form 990-PF for tax years beginning after 2007. In response to the apparent confusion, the Proposed Regulations contain two new examples involving charitable trusts.⁹⁵ We recommend that Treasury and the Service permit, but not require, charitable trusts that began filing Forms 990-PF during the “gap” between the expiration of the transitional relief under Notice 2008-6, and the issuance of the Proposed Regulations, to file amended returns on Form 990 for those prior years, and to resume filing Form 990, without the need to comply with the 60-month termination period. We also recommend that Treasury and the Service provide additional transition relief to take into account any changes made when the Regulations are finalized.

2. Transitional Relief from Excess Business Holdings for Organizations Reclassified as Private Foundations.

We commend Treasury and the Service for providing transitional relief under the section 4943 excess-business-holdings rules for Type III SOs that were reclassified as

⁹² Prop. Reg. § 1.509(a)-4(i)(3) (establishing standards).

⁹³ 2008-1 C.B. 275.

⁹⁴ Reg. § 1.509(a)-4(i)(2)(ii).

⁹⁵ Prop. Reg. § 1.509(a)-4(i)(3)(iv), Ex. (1), (2).

private foundations as a result of the PPA. We believe that the transitional relief provided in the Proposed Regulations achieves a fair and equitable result.⁹⁶

3. Relief for Pre-1970 Trusts.

We commend Treasury and the Service for providing relief for pre-1970 trusts in a manner consistent with the provisions in the existing Regulations applicable to tax years prior to the effective date of the PPA amendments. We believe that the relief provisions in the Proposed Regulations adequately address the issues for such trusts.

4. Mechanism for Refunds of Estimated Tax Payments of Private Foundation Excise Tax.

There was concern for some Type III SOs prior to the issuance of the Proposed Regulations that they would not continue to qualify as Type III SOs and would be reclassified as private foundations. This was true particularly with respect to charitable trusts, due to the uncertainty of the requirements for satisfying the responsiveness test. We understand that some of these organizations made estimated payments of the private foundation excise tax on investment income under section 4940. For Type III SOs that made such payments, but that are now able to continue as Type III SOs, the procedure for claiming a refund of the excise tax is unclear. A taxpayer normally would claim a refund by filing an amended tax return, but these organizations may never have filed a Form 990-PF. Notice 2008-6⁹⁷ specifically instructed charitable trusts that believed they had become private foundations as a result of the PPA to file Form 990, and not Form 990-PF, for taxable years beginning before January 1, 2008.

Recommendation: Establish refund procedure.

We recommend that Treasury and the Service establish a procedure for claiming refunds of excise tax on investment income under section 4940.

⁹⁶ Prop. Reg. § 53.4943-11(f).

⁹⁷ 2008-1 C.B. 275.