

Proposed Regulations for Type III Supporting Organizations

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On September 23, 2009, the IRS released long-awaited proposed regulations regarding Type III supporting organizations (SO). As expected, non-functionally integrated Type III SOs are required to annually distribute 5% of the fair market value of their non-exempt-use assets, but the five supported organization limit of the Advance Notice of Proposed Rulemaking (ANPR) was not adopted. There is a reasonable cause exception for failure to meet the distribution requirement, and the IRS may provide for a temporary reduction of the annual distributable amount in the case of a disaster or emergency. In addition to the distribution requirement, non-functionally integrated Type III SOs must meet an attentiveness test: the SO must distribute at least 1/3 of the distributable amount to one or more supported organizations that are attentive to the SO and with respect to which the SO meets the responsiveness test. For functionally integrated Type III SOs, the expenditure and assets tests contemplated by the ANPR were eliminated, and only a modified "but for" test was adopted. Type III SOs that manage and invest funds generally are not considered to be functionally integrated, but there is an exception for SOs that support a single governmental entity. In addition, a Type III SO that serves as the parents of its supported organization is considered to be functionally integrated. Finally, each taxable year, a Type III SO must provide to each of its

supported organizations a written notice identifying the SO and describing the amount and type of support it provided to the supported organization during the prior year, a copy of the SO's most recently filed Form 990, and a copy of the SO's governing documents. There are transitional rules for pre-1970 trusts, as well as other transition rules. The proposed regulations are effective as of the date of publication of final or temporary regulations. Comments are being accepted through December 23, 2009. The proposed regulations may be viewed at <http://edocket.access.gpo.gov/2009/pdf/E9-22866.pdf>

Law Prior to Pension Protection Act of 2006

Supporting Organizations. Supporting Organizations (SOs) are public charities under section 509(a)(3) by providing support to one or more organizations described in section 509(a)(1) or 509(a)(2) (supported organizations). Under section 509(a)(3), an SO must satisfy an organizational test, an operational test, a relationship test, and a disqualified person control test. The proposed regulations focus primarily on the relationship test.

There are three types of SOs. An SO is “operated, supervised or controlled by” its supported organization (often referred to by practitioners as Type I) if the supported organization appoints at least a majority of the board of the SO. An SO is “supervised or controlled in connection with” its supported organization (often referred to by practitioners as Type II) if at least a majority of the boards of the SO and its supported organization consist of the same persons. An SO is “operated in connection with” its supported organization (often referred to by practitioners as Type III) if the SO satisfies a “responsiveness test” and an “integral part test.”

Responsiveness Test. Under the responsiveness test, the SO must be responsive to the needs or demands of the supported organization. The responsiveness test is satisfied if 1) the supported organization appoints or elects one or more of the officers, directors or trustees of the SO; 2) one or more members of the governing body of the supported organization serve as officers, directors, or trustees of, or hold other important offices in, the SO; or 3) the officers, directors, or trustees of the SO maintain a “close continuous working relationship” with the officers, directors, or trustees of the supported organization. In all three cases, the relationship must result in the supported organization having a significant voice in the investment policies of the SO, the timing and manner of making grants, the selection of the grant recipients of the SO, and direction over the use of the income and assets of the SO.

There is an alternative means for charitable trusts to satisfy the responsiveness test: 1) the trust is a charitable trust under state law; 2) each supported organization is named as a beneficiary under the trust’s governing instrument; and 3) each beneficiary organization has the power to enforce the trust and compel an accounting under state law.

If an SO was supporting more than one organization before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship also may be taken into account to establish compliance with the responsiveness test.

Integral Part Test. Under the integral part test, the SO must maintain a significant involvement in the operations of one or more supported organizations that are dependent upon the SO for the type of support it provides. The integral part test is satisfied if the SO meets either 1) the “but for” test or 2) the attentiveness test. To meet the “but for” test, the SO must engage in activities that “but for” the SO would be engaged in by the supported organization itself. To meet the “attentiveness test,” the SO must 1) make payments of substantially all of its income (85%) to or for the use of one or more supported organizations; 2) provide enough support to one or more supported organizations to ensure the attentiveness of such organizations to the SO; and 3) pay a substantial amount of the total support of the SO to those supported organizations that meet the attentiveness requirement.

The Pension Protection Act of 2006

1. For the first time, the types of SOs are statutorily defined as Type I, Type II and Type III, and Type III SOs are further categorized into two types: functionally integrated and non-functionally integrated.
2. “Functionally integrated” Type III SOs are defined as those that are not required, under regulations established by the Secretary, to make payments to supported organizations due to the activities of the organization related to performing the functions or, or carrying out the purpose of, such supported organizations.
3. The Secretary of the Treasury must set a new payout requirement for “non-functionally integrated” Type III SOs (those organizations that meet the integral part test by satisfying the attentiveness test rather than the “but for” test) to ensure that such organizations pay a “significant amount” to their supported organizations.
4. Type III SOs organized as charitable trusts can no longer satisfy the responsiveness test by showing that they are enforceable by their charitable beneficiaries under state law (the “alternative test” for charitable trusts).
5. Type III SOs must annually provide to each of its supported organizations such information as the Secretary may require to ensure that the SO is responsive to the needs or demands of its supported organizations.
6. Type I or Type III SOs cannot accept a gift or contribution from a person who together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type I or Type III SO.

7. Type III SOs cannot support organizations organized outside of the United States
8. The private foundation excess business holdings rules apply to non-functionally integrated Type III SOs; there is a transitional rule to allow such SOs additional time to comply.

Advanced Notice of Proposed Rulemaking (August 2, 2007)

1. A Type III functionally integrated SO must meet not only the “but for” test but also two additional tests – an expenditure test and an asset test.
2. A Type III non-functionally integrated SO must distribute 5% of the FMV of its non-exempt-use assets.
3. A Type III non-functionally integrated SO cannot support more than five organizations. Existing SOs that support more than five organization may continue to do so only if the SO distributes at least 85% of its total required payout amount to, or for the use of, supported organizations to which the SO is responsive.
4. All Type III SOs organized as charitable trusts will be required to meet the responsiveness test (applicable as of August 17, 2007 to trusts already in existence).
5. The proposed regulations will provide rules for the form, content and timing of information that Type III SOs are required to provide to their supported organizations.
6. What transitional rules are necessary?

Proposed Regulations (September 23, 2009)

Comments accepted for 90 days.

1. *Notification Requirements.* Each taxable year, a Type III SO must provide to each of its supported organizations: a) a written notice addressed to a principal officer of the supported organizations identifying the SO and describing the amount and type of support it provided to the supported organization in the past year; b) a copy of the SO’s most recently filed Form 990 (or other return required to be filed under federal tax law); and c) a copy of the SO’s governing documents, including any amendments (copies of governing documents need only be provide once). Requirements may be met by electronic media, but the SO must have

proof of delivery. Information must be provided by the end of the fifth month after the close of its tax year.

2. *Responsiveness Test for Charitable Trusts.* All Type III SOs (including charitable trusts) must meet the responsiveness test. No special rule for trusts.
 - a. The proposed regulations retained the transitional rule allowing organizations that were operating before November 20, 1970 to qualify as Type III SOs: additional facts and circumstances, such as an historic and continuing relationship with a supported organization, may be taken into account in establishing compliance with the responsiveness test.
3. *Functionally Integrated Type III SO.* A Type III SO is “functionally integrated” if it either a) engages in activities *substantially all* of which *directly* furthers the exempt purposes of the supported organizations 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 engaged in by the supported organizations, or b) is the parent of each of its supported organizations (parent: exercises a substantial degree of direction over the policies, programs, and activities of the supported organization, and the majority of the officers, directors or trustees of the supported organization must be appointed or elected, directly or indirectly, by the officers, governing body or members of the governing body of the SO).
 - a. Further guidance is provided on the types of activities that are considered to “directly further” the exempt purposes of a supported organization. Holding title to and managing exempt use property are considered to so directly further, but fundraising, investing and managing non-exempt-use property and making grants are not.
 - b. Exception for SO that supports a single governmental entity—it 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 further the exempt purposes of such governmental entity.
 - c. The SO’s activities must directly further the exempt purposes of those supported organizations with respect to which the SO meets the responsiveness test.
 - d. The expenditure and assets tests contemplated by the ANPR were eliminated.

4. *Non-functionally Integrated Type III SO.* A Type III SO is “non-functionally integrated” if it distributes 5% of the FMV of non-exempt-use assets.
 - a. The five organization limit of the ANPR was not adopted.
 - b. A new SO is not required to distribute any amount in its first year of existence.
 - c. Existing SOs will be given a two-year transition rule to come into compliance with the distribution requirement.
 - d. The regulations generally draw from the regulations under section 4942 for principles of valuation, timing and carry-overs.
 - e. But the proposed regulations do not permit set-asides to count toward the distribution requirement, and the ordering rule for carryovers of excess distributions is reversed. Any excess amount carried forward count first toward the distributable amount, followed by amounts paid out in the later year.
 - f. There is a reasonable cause exception for failure to meet the distribution requirement: 1) the failure was due solely to an incorrect valuation of assets, a ministerial error, or unforeseen events or circumstances beyond the SO’s control; 2) the failure was due to reasonable cause and not willful neglect; and 3) the distribution requirement is met within 180 days after the date the incorrect valuation or ministerial error was or should have been discovered, or 180 days after the organization is first able to make its required payout notwithstanding the unforeseen event or circumstances.
 - g. The Service may provide by publication in the Internal Revenue Bulletin for a temporary reduction in the annual distributable amount in the case of a disaster or emergency.
5. *Non-functionally Integrated Type III SO/Attentiveness Test.* In addition to the distribution requirement, the SO must distribute at least 1/3 of the distributable amount to one or more supported organizations that are attentive to the SO and with respect to which the SO meets the responsiveness test.
 - a. To demonstrate that a supported organization is attentive, a SO must either 1) provide 10% or more of the supported organization’s total support, 2) provide support that is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization; or 3) provide an amount of support that

based on all the facts and circumstances is a sufficient part of a supported organization's total support.

- b. Distributions to a donor-advised fund in and of itself will not cause the sponsoring organization of the donor-advised fund to be attentive to the SO.

6. *Transitional Rule for pre-1970 trusts.* Certain trusts created before November 20, 1970 may meet the integral part test by meeting certain requirements in existing Treas. Reg. section 1.509(a)-(4)(i)(4). This test allows such trusts to bypass the distribution and attentiveness requirements, but classifies them as non-functionally integrated Type III SOs for all other purposes.

7. *Excess Business Holding Rules.*

- a. The transitional rules for Type III non-functionally integrated SOs also applies to organizations previously classified as Type III SOs but were re-classified as private foundations as a result of the Pension Protection Act.
- b. Charitable trusts that meet the exception from the integral part test for trusts established before November 20, 1970 are exempt from the excess business holding rules.

8. *Transition Rules.*

- a. The proposed regulations will become effective on the first day of an organization's taxable year that begins after the date when the rules are published in the Federal Register as final or temporary regulations.
- b. Organizations previously classified as Type III SOs under the "but for" test of the existing regulations will be treated as functionally integrated Type III SOs until the proposed regulations are effective. Such organizations must meet the new requirements by the first day of their first taxable year beginning after the date when the final or temporary regulations are published.
- c. Organizations previously classified as Type III SOs under the "substantially all income" test of the existing regulations will be treated as non-functionally integrated until the proposed regulations are effective. Such organizations must meet the new requirements by the first day of their second taxable year beginning after the date

when the final or temporary regulations are published, except that the first year after the final or temporary regulations are published must be used to value the organization's assets and the mandatory distributions must commence in the second year based on those values. The distributable amount for the first tax year after publication of final or temporary regulations will be zero.

- d. After the proposed regulations are published as final or temporary regulations, an organization that was previously classified as a Type III SO but fails to meet the requirements of the proposed regulations will be classified as a private foundation for the taxable year in which it fails such requirements and all subsequent tax years.