December 23, 2009

Via electronic submission

CC:PA:LPD:PR (REG-155929-06)
Internal Revenue Service
Room 5203
P.O. Box 7604, Ben Franklin Station
Washington, DC 20044

Re: Comments on Proposed Rulemaking on Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law in response to the proposed rulemaking referenced above. These comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

These comments were prepared by members of the Charitable Planning Committee (the “Committee”) of the Charitable Planning and Organizations Group of the Trust and Estate Division of the Section of Real Property, Trust and Estate Law (the “Section”) of the American Bar Association. Carol G. Kroch, Supervisory Council Member of the Charitable Planning and Organizations Group, supervised the preparation of these comments and participated in their preparation. The principal drafting responsibility was exercised by Stephanie B. Casteel, and substantive contributions were made by Grace Allison, Sharon J. Bell, Adam Damarow, Ramsay Slugg, and Clint Swanson. These comments were reviewed by Jerry J. McCoy on behalf of the Section’s Committee on Governmental Submissions.

If you have any questions, please do not hesitate to contact Stephanie B. Casteel at 404.572.3577, scasteel@kslaw.com.

Very truly yours,

Roger D. Winston
Section Chair

cc: Alan F. Rothschild, Jr., Section Vice-Chair, Trust & Estate Division, ABA-RPTE
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Charitable Planning and Organizations Group, Charitable Planning Committee

CONCERNING INTERNAL REVENUE CODE SECTIONS 509 AND 4943, IN RESPONSE TO IRS NOTICE OF PROPOSED RULEMAKING

I. INFORMATION ON THESE COMMENTS

The following comments are submitted on behalf of the American Bar Association Section of Real Property, Trust and Estate Law. These comments have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and should not be construed as representing the position of the American Bar Association.

These comments were prepared by members of the Charitable Planning Committee (the “Committee”) of the Charitable Planning and Organizations Group of the Trust and Estate Division of the Section of Real Property, Trust and Estate Law (the “Section”) of the American Bar Association. Carol G. Kroch, Supervisory Council Member of the Charitable Planning and Organizations Group, supervised the preparation of these comments and participated in their preparation. The principal drafting responsibility was exercised by Stephanie B. Casteel, and substantive contributions were made by Grace Allison, Sharon J. Bell, Adam Damarow, Ramsay Slugg, and Clint Swanson. These comments were reviewed by Jerry J. McCoy on behalf of the Section’s Committee on Governmental Submissions.

Contact person:            Phone Number:
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Although the members of the Section of Real Property, Trust and Estate Law of the American Bar Association who participated in preparing these comments have clients who would be affected by the federal tax principles addressed, or have advised clients on the application of such principles, except as described below, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these comments. Sharon J. Bell has been engaged by a client to make a submission solely with respect to a suggested three-year rolling average in computing the required annual distribution of non-functionally integrated Type III supporting organizations. Ms. Bell did not participate in the drafting of this letter with regard to this subject matter.
II. BACKGROUND

The Pension Protection Act of 20061 (the “PPA”) enacted Code Sections2 509(d) and 4943(f)(5), which define the term Type III supporting organization and distinguish between functionally integrated and non-functionally integrated Type III supporting organizations. New Code Section 4943(f)(5)(B) defines a functionally integrated Type III supporting organization as a Type III supporting organization that is 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 of, or carrying out the purpose of, such supported organizations. The PPA directed the Secretary to promulgate new regulations on the payments required by Type III supporting organizations that are not functionally integrated. Such regulations are to require non-functionally integrated Type III supporting organizations to make distributions of a “percentage of either income or assets to supported organizations (defined in new Code Section 509(f)(3) of the Code) in order to ensure that a significant amount is paid to their supported organizations.”

The PPA also modified the responsiveness test as it applies to charitable trusts. A Type III supporting organization organized as a trust may no longer rely solely on its enforcement rights under state law to establish that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization. Under the PPA, trusts that operated in connection with a publicly supported organization on August 17, 2006 had until August 17, 2007 to satisfy the modified responsiveness test under Treas. Reg. Section 1.509(a)-4(i)(2)(ii). For other trusts, the provision was effective on August 17, 2006.

Finally, the PPA enacted Code Section 509(f)(1)(A) to require Type III supporting organizations to provide each of its supported organizations with “such information as the Secretary may require to ensure that such organization is responsive to the needs or demands of the supported organization.”

The Internal Revenue Service and Treasury (the “Government”) issued on August 2, 2007 an Advance Notice of Proposed Rulemaking (“ANPRM”) for “comments from the public.” As described in the ANPRM, the Government sought comments on its intention to propose regulations that would provide (1) the payout requirements for Type III supporting organizations that are not functionally integrated, (2) the criteria for determining whether a Type III supporting organization is functionally integrated, (3) the modified responsiveness test for Type III supporting organizations that are organized as charitable trusts, and (4) the type of information a Type III supporting organization will be required to provide to its supported organization(s) to demonstrate that it is responsive. By letter dated January 3, 2008, the Committee submitted comments in response to the ANPRM.

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2 References in these comments to Code Sections are to sections of the Internal Revenue Code of 1986 (the “Code”), as amended and, if preceded by “Treas. Reg. Section,” to sections of the Treasury Regulations under the Code.
On September 24, 2009, the Government issued Proposed Regulations ("Notice") regarding the requirements to qualify as a Type III supporting organization that is operated in connection with one or more supported organizations. Written comments were requested by December 23, 2009.

These comments are in response to the Notice. We appreciate the opportunity to comment on the regulations that the Government intends to propose. We appreciate your consideration of our comments and welcome an opportunity to discuss them further with you.

III. SPECIFIC COMMENTS SOUGHT IN PROPOSED REGULATIONS

In the Notice, the Government invites comments on the clarity of the proposed rules and how they can be made easier to understand. In addition, the Notice specifically asks for comments on the following questions, among others:

1. All Type III supporting organizations organized as charitable trusts will be required to meet the responsiveness test under existing Treas. Reg. § 1.509(a)-4(i)(2)(ii). Is there a specific responsiveness rule for trusts that would be consistent with the existing responsiveness test and the Congressional intent behind section 1241 of the PPA, which removed the alternative test in the regulations?

2. A Type III supporting organization that is not functionally integrated will be required to meet a payout requirement equal to the qualified distribution requirement of a private non-operating foundation under Code Section 4942. The proposed regulations generally draw from the regulations under Code Section 4942 for principles on valuation, timing, and carryovers. However, the proposed regulations do not permit set-asides. Are set-asides necessary and consistent with Congressional intent in determining whether Type III supporting organizations that are not functionally integrated have distributed their annual distributable amount?

3. A Type III supporting organization that fails to meet the requirements of the proposed regulations, once they are published as final or temporary regulations, will be classified as a private foundation. Once classified as a private foundation, the Code Section 507 rules regarding termination of private foundation status apply. Are exceptions or special rules needed under Code Section 507 for Type III supporting organizations that are reclassified as private foundations as a result of the changes in the PPA?

4. Certain transition rules are provided. Is additional transition relief needed?

IV. SUMMARY OF RECOMMENDATIONS

1. We suggest that the “responsiveness test” for charitable trusts be broadened with regard to how trustees communicate with supported organizations by allowing types of meetings other than those that are face-to-face. We further recommend that charitable trusts formed before the date of enactment of the PPA be permitted under Prop. Treas. Reg. 1.509(a)-4(i)(3)(v) to rely on additional facts and circumstances, such as a historic and continuing relationship between organizations, to show compliance with the responsiveness test.

2. We again suggest that a distribution requirement of three and one-third percent would be more appropriate for Type III non-functionally integrated supporting organizations. Whatever
the distribution amount, however, we suggest, for purposes of calculating the required distribution amount, that the calculations permit a three-year rolling average and that set-asides and program related investments count toward meeting the annual distributable amount.

3. We suggest that there be a reasonable cause exception for the “one-third” and “10 percent” requirements of the attentiveness test for non-functionally integrated Type III supporting organizations. Also, for purposes of the “10 percent” requirement, we suggest that “total support” be defined as total public support for the immediately prior tax year.

4. We suggest that Type III supporting organizations that converted to private foundations after the effective date of the PPA, but prior to the issuance of the proposed regulations, be permitted to convert back to Type III supporting organization status simply by filing Forms 990 for tax years in question with a letter of explanation, and Form 990-PF requesting a refund for any excise taxes paid.

5. We suggest that certain transition rules be expanded.

6. We also suggest a few additional changes to the proposed regulations. We suggest that “control” be defined under Treas. Reg. 1.509(a)-4(f)(5) and that several clarifications be made to the written notification requirement of supporting organizations.

V. COMMENTS ON ISSUES RAISED IN PROPOSED REGULATIONS

1. *All Type III Supporting Organizations Organized as Charitable Trusts Will be Required to Meet the Responsiveness Test*

The PPA stated that for purposes of Code Section 509(a)(3)(B)(iii), an organization that is a trust shall not be considered to be organized “in connection with” solely because 1) the charitable trust is a charitable trust under state law, 2) the supported organization is a beneficiary of such trust, and 3) the supported organization has the power to enforce the trust and compel an accounting. In other words, it no longer will be possible for a supporting organization organized as a charitable trust to meet the responsiveness test under Treas. Reg. Section 1.509(a)-4(i)(2)(iii) on that basis alone. Instead, under the proposed regulations, all Type III supporting organizations organized as charitable trusts will be required to meet the alternate responsiveness test under Treas. Reg. Section 1.509(a)-4(i)(2)(ii).

Under the responsiveness test of Treas. Reg. Section 1.509(a)-4(i)(2)(ii), a Type III supporting organization organized as a charitable trust must demonstrate the necessary relationship between its trustees and those of its supported organizations, and further show that this relationship results in the officers, directors or trustees of its supported organization having a significant voice in the operations of the supporting organization. This test requires a charitable trustee to give its supported organizations a significant voice in the operations, including investments, of the charitable trust.

With respect to the Government’s initial efforts to clarify the close and continuous sub-requirement of the responsive test, we were very encouraged by the helpful examples in the proposed regulations. However, we believe an additional example that slightly modifies
proposed Example (1) would do much to clarify the existing law.\(^3\) We urge the Government to insert a variation on Example (1) as new Example (2) and retain current Example (2) as new Example (3). We suggest that new Example (2) read as follows:

Example (2) Same facts as Example (1) above, however, X supports multiple 509(a)(1) or (a)(2) organizations, one of which is M, a private university described in section 509(a)(1). In addition to other facts contained in Example (1), X provides each supported organization with the information required under paragraph (i)(2) of this section and satisfies the attentiveness test of paragraph (i)(5)(iii) of this section with respect to M. Based on these facts, X meets the responsiveness test of this paragraph (i)(3).

Additionally, we urge the Government to slightly modify the fifth full sentence of Example (1) to read as follows:

Representatives of Trustee and an officer of M have periodic meetings, at least twice per year, either face-to-face or via interactive technology which allows all persons participating in the meeting to communicate with each other, at which they discuss M’s projected needs for the university and ways in which M would like X to use its income and invest its assets.

The slight modification will clarify that the proposed regulation does not require the supporting organization trustee to meet face-to-face with officials of the supported organization, which may be located in a state thousands of miles from the office of the trustee. This is consistent with the corporate law of most states and would encourage the judicious use of charitable assets consistent with donor intent.

We also recommend that the exception for pre-November 20, 1970 organizations contained in Prop. Reg. 1.509(a)-4(i)(3)(v) be extended to organizations formed before the PPA was enacted. Just as supporting organizations formed before the Tax Reform Act of 1969 were given special treatment when the supporting organizations regulations first were enacted, so too organizations that may have been in existence for over 35 years when the PPA was enacted should be able to demonstrate their historic and continuing relationship with supported organizations and other additional facts and circumstances, in order to meet the requirements of the responsiveness test. This is particularly true for trusts, which were not previously subject to the responsiveness test, but may be able to demonstrate additional facts and circumstances that would not establish their compliance. It seems anomalous for regulations promulgated in 2009, with respect to an act enacted in 2006, to limit its transition relief to entities formed over 35 years before the statute was enacted.

2. The Five Percent Payout Requirement for Non-Functionally Integrated Type III Supporting Organizations

Section 1241(d) of the PPA directed Treasury to promulgate new regulations requiring non-functionally integrated Type III supporting organizations to distribute “a percentage of either income or assets to supported organizations…. in order to ensure that a significant amount

The distribution requirement should be three and one-third percent.  

The proposed regulations would apply to non-functionally integrated Type III supporting organizations the five percent payout requirement applicable to non-operating private foundations contained in Code Section 4942, but such an approach ignores the significant difference between effective supporting organizations and private foundations. Perhaps the most significant feature of a supporting organization is its close affiliation with its supported charities, rather than with its donors. Private foundations are donor-focused vehicles, providing flexible mechanisms for donors to meet various philanthropic goals by funding any number of charitable organizations in any given year. Private foundations are not required to designate specific beneficiary organizations, and they therefore have the ability to pick and choose from a potentially unlimited pool of beneficiary organizations each year. The amount of support private foundations provide to particular organizations can vary widely from year to year according to the shifting priorities of the foundation’s management; often private foundation funding is given only for a single project or for a few years.

Supporting organizations, by contrast, are intended to be charity-focused entities, whether they are created by the supported charities themselves or by interested benefactors. A large measure of donor discretion is forfeited when the supporting organization relationship is created. The supporting organization is bound to its designated supported public charities, often in perpetuity and excluding the donor from even an indirect control relationship. In the case of Type III supporting organizations, the supported public charities must be specifically named in their organizing documents—thus ensuring an ongoing relationship between a supporting organization and specific supported organizations. Although the Type III relationship has been identified as the “loosest” of the three supporting organization relationships, it is still a much closer relationship than the typical relationship between a private foundation and its grantees.

4 PPA, § 1241 (d), 120 Stat. at 1103; 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, at 360.


6 Id. at 360, n.571.

7 This argument also was made in the Committee’s previous comments in response to the ANPRM.

8 Treas. Reg. § 1.509(a)-4(d).

Unlike the typical private foundation, a supporting organization acts as an integral part of its designated supported organizations, consistently providing functional or financial support over the long term.

The consistent, long-term support provided by a supporting organization is a significant advantage to its supported public charities. When beneficiaries have a reliable, sustainable source of support, they are able to focus more time and energy on fulfilling their charitable mission rather than fundraising. In addition, the long-term support of a supporting organization, like having a permanent endowment, allows beneficiaries to conduct long-term research and initiate programs on which their service populations can rely without fear of interruption. Many public charities prefer predictable, sustainable and increasing distributions from a dedicated supporting organization rather than short-lived—even if large—distributions from private foundations and the uncertainty of hand-to-mouth fundraising.

In our view, an asset-based payout requirement for Type III supporting organizations of five percent is too high. To require such a payout in effect ignores the differences between supporting organizations and private foundations. Further, because Type III supporting organizations are relied upon by their supported organizations as a source of long-term support for their charitable programs—much as an endowment would be—a five percent fixed payout requirement likely would not preserve a supporting organization’s ability to continue to provide comparable levels of support in the future. The benefits of a permanent endowment are not a novel discovery; they are age-old and well-documented. Like a permanent endowment, a supporting organization can provide beneficiaries with a reliable source of support that ensures financial stability and security even in fluctuating market conditions. Historically, inflation has averaged approximately three percent per annum. For a permanent endowment to maintain its inflation-adjusted value, the principal must be permitted to grow by that much each year. At least one empirical study has demonstrated that a five percent annual distribution rate exposes the portfolio to a high probability of failing to meet that objective.10

We agree that non-functionally integrated Type III supporting organizations operating appropriately as an integral part of their supported organizations should be making significant annual distributions for their support—and in most cases, supporting organizations are doing just that. This requirement must be balanced, however, with the need to preserve a supporting organization’s ability to provide consistent support for its supported organizations and their charitable activities in the future. The key, therefore, is to select a minimum percentage payout rate that is sustainable—thus assuring both significant support for charitable programs now and undiminished purchasing power of the long-term support to the supported organizations.

Where there are minimum payout requirements in the Code or Regulations for organizations that are committed to particular charitable programs, they are set at rates lower than the five percent minimum payout rate for private foundations. For example, private operating foundations, which are engaged in charitable activities but may be controlled by a single donor or family, are generally required to annually distribute a minimum of three and one-

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third percent of the value of their endowments unless such endowments (including all assets not
used directly in their charitable programs) are small (35 percent or less of their assets).\textsuperscript{11} Significantly, Congress rejected imposition of the private non-operating foundation “minimum investment return” payout requirement (currently five percent) on such organizations, instead determining that two-thirds of that amount was sufficient to guard against insignificant expenditures on their charitable programs relative to the size of their endowments.\textsuperscript{12} Similarly, a medical research organization, which like a private operating foundation need not have broad public support or accountability, is required to expend “a significant percentage of its endowment” annually on its activities if its endowment is larger than half of its assets. In drafting this requirement, Treasury followed Congress’s lead and determined that a minimum payout of three and one-half percent is “a significant percentage” of the organization’s endowment.\textsuperscript{13} These payout rates allow the organizations to support their current operations at a level commensurate with their assets while permitting increases in principal sufficient to support future operations in the face of inflation. Payout rates for supporting organizations should similarly enable them to provide funding for the charitable programs of the supported organizations both now and in the future.

For all of these reasons, we respectfully ask that the Government reconsider the appropriate percentage for the proposed distribution requirement. We recommend a minimum payout requirement for non-functionally integrated Type III supporting organizations that is similar to the current law for private operating foundations and medical research organizations, \textit{i.e.,} a minimum distribution of three and one-third percent of asset value.\textsuperscript{14} Adopting a rate of three and one-third percent rather than five percent would ensure a stable, consistent payout from the supporting organization. But it would also recognize the need for a payout requirement that permits the supporting organization to be sustainable over time, so that it can continue to provide support to the supported organizations that rely on it for a significant source of their support.

\textit{Regardless of the required distribution amount, the rule should be revised to provide for a three-year rolling average.}

\begin{enumerate}
\item\textsuperscript{11} Code § 4942(j)(3) and Treas. Reg. § 53.4942(b)-2. A private operating foundation also is not subject to this 3 1/3 percent minimum distribution requirement if it has sufficiently broad sources of support.
\item\textsuperscript{12} Staff of Joint Comm. on Internal Revenue Taxation, 91\textsuperscript{st} Cong., \textit{General Explanation of the Tax Reform Act of 1969}, at 60-61 (Comm. Print 1970). If its income is sufficiently high, such a private operating foundation will be required to pay out more than this minimum amount, as all private operating foundations must expend 85 percent of adjusted net income-- up to a maximum payout requirement of 4.25 percent of their endowment. Treas. Reg. § 53.4942(b)-1(a)(1)(ii). We note that this maximum payout percentage is still substantially lower than the minimum payout requirement of five percent being proposed for non-functionally integrated Type III supporting organizations.
\item\textsuperscript{13} Treas. Reg. § 1.170A-9(c)(2)(v)(b). This appears to be a rounded up equivalent of the “two-thirds of the minimum investment return” private operating foundation payout standard that was initially included in the proposed regulation.
\item\textsuperscript{14} An additional requirement that supporting organizations distribute at least 85 percent of net income up to a maximum of 4.25 percent of endowment assets, also would be consistent with the current private operating foundation distribution requirement. However, for ease of administration, we recommend simply adopting the 3 1/3 percent minimum payout requirement.
\end{enumerate}
The proposed regulations adopt the valuation methodology for the distributable amount requirement that applies to private foundations, which was implemented almost 40 years ago! While we recommend following many aspects of the distribution rules applicable to private foundations, we suggest that the proposed regulations adopt a valuation rule that would calculate the fair market value of assets based on a three-year rolling average. This approach follows modern investment theory, which recognizes that charitable organizations now frequently invest in a diversified portfolio on a total return basis, and that the volatility of a portfolio can be “smoothed” by taking a longer view. For example, the Uniform Prudent Management of Institutional Funds Act\(^\text{15}\) provides that where payments from an endowment fund are capped at a percentage of the fair market value of the endowment, the calculation of fair market value is to be based upon an average of values, determined at least quarterly, for a period of at least three years. We recognize that adopting such a rule would diverge from the rules used by private foundations; however, as described above, supporting organizations have an even greater need than private foundations to ensure that their supported organizations receive a relatively steady payout.

Charitable set-asides, program related investments, and payments made for the use of a supported organizations should count toward meeting the required annual distributable amount.

In general, we believe that the same methodology and exceptions provided under the private foundation regulations should apply to supporting organizations. However, the proposed regulations do not provide for distributions in the form of charitable set-asides or program related investments, both of which are permitted qualifying distributions for private foundations. These provisions are just as important to the operational flexibility of Type III supporting organizations as they are to private foundations.

The comments to the proposed regulations suggest that a charitable set-aside should not be permitted because, while the Tax Reform Act of 1969 (TRA) specifically provided for charitable set-asides, no such statutory provision appears in the PPA. However, unlike the TRA, the PPA did not establish a specific distribution scheme, but instead directed the Secretary to consider alternative distribution requirements. In response, the Secretary chose to incorporate many of the statutory distributable amount provisions that appear in the TRA in the proposed supporting organization regulations. We submit that there is no barrier to also importing the charitable set-aside, which, in the context of a mandatory distribution requirement, merely amplifies the manner in which the distribution requirement may be met. Furthermore, in practice, some supported organizations request (and receive) very large discretionary distributions from their supporting organizations for capital projects. Allowing a charitable set aside in this case would not be inconsistent with the stated purpose of Section 1241(d) of the PPA.

Similarly, the proposed regulations should permit supporting organizations to meet the distribution requirement with program related investments. We see no reason to deprive supporting organizations of the same latitude permitted to private foundations in their grantmaking. This type of grant would be very useful to supported organizations in the current

\(^{15}\) Unif. Prudent Mgmt. of Institutional Funds Act (2006).
economic environment, where sources of capital are scarce -- and would allow the supporting organizations to recycle and thus “leverage” its resources. Accordingly, we recommend that Prop. Reg. 1.509(a)-4(i)(6) specifically provide that both charitable set-asides and program related investments are included as distributions that count toward the distribution requirement.

Further, Prop. Reg. 1.509(a)-4(i)(8)(c)(2) should be amended to provide that any interest in a program-related investment is used or held for use directly in carrying out the supporting organization’s exempt purpose, so that it is excluded in valuing the supporting organization’s assets for purposes of determining the annual distribution requirement.

Finally, Prop. Reg. 1.509(a)-4(i)(6)(i) should be revised to clarify that payments that count toward the distribution requirement include payments made to or for the benefit of the supported organizations. This change will conform the permitted distributions to the distribution requirements as stated in Prop. Reg. 1.509(a)-4(i)(5)(ii), which expressly provides that a supporting organization must distribute the required distributable amount “to or for the use of one or more supported organizations.” This conforming provision will clarify that supporting organizations have the flexibility to make payments to third parties directly on behalf of their supported organizations, which can in some circumstances reduce administrative burdens and assist supported organizations to meet their expenses in a timely fashion.

3. Practical Concerns Relating to the Attentiveness Requirement for “Non-functionally Integrated Type III Supporting Organizations”

Under Code Section 509(a)(3)(B)(iii), an organization may escape classification as a private foundation if it is “operated in connection with” one or more organizations described in Code Section 509(a)(1) or (2). Prop. Reg. Sec. 1.509(a)-4(i)(5)(iii)(A) requires that a non-functionally integrated Type III supporting organization distribute one-third or more of its annual distributable amount to one or more supported organizations that are attentive to the operations of the supporting organization and to which the supporting organization is responsive. Prop. Reg. Sec. 1.509(a)-4(i)(5)(iii)(B)(1) provides that a supported organization “is attentive to the operations of the supporting organization if the supporting organization distributes annually to the supported organization an amount equal to “10 percent or more of the supported organization’s total support.”

It would be helpful to have a reasonable cause exception to the “one-third” and “10 percent” requirements similar to that set forth in Prop. Reg. Sec. 1.509(a)-4(i)(5)(ii)(E). Both mathematical error and incorrect valuation of assets, for example, would seem to justify a reasonable cause exception for the “one-third” and “10 percent” requirements, provided the error is promptly corrected. Similarly, it is not clear why “ministerial error” may be treated as a failure due to reasonable cause for purposes of the distribution requirement but not here.

As a practical matter, even the supported organization itself may not know what its total support will be until after the end of the current tax year. For purposes of the “10 percent” requirement, therefore, we suggest that “total support” be defined as total public support for the immediately prior tax year.
Finally, we propose the following example to illustrate Prop. Reg. Sec. 1.509(a)-4(i)(5)(iii)(B)(3):

Example 5. S, an organization described in section 501(c)(3), was created in 1991 with the sole and express purpose of supporting a camp for children with juvenile rheumatoid arthritis. The five percent distribution from S, which is unrestricted as to use by the camp, generally represents about three percent of the camp’s total public support. The assured nature and long history of support from S, combined with the unique purpose of S, have fostered a close relationship between S and the camp, including attentiveness by camp officials to the nature and yield of S’s investments. Based on these facts, S meets the requirements of paragraph (i)(5)(iii)(B)(3) of this section.


As discussed above, the PPA eliminated the “charitable trust” test of responsiveness for Type III supporting organizations, effective one year after the adoption of PPA. The remaining responsiveness test requires either (i) one or more of the supported organization’s officers, directors or trustees are elected or appointed by the officers, directors, trustees or membership of the supported organization, (ii) one or more members of the governing bodies of the supported organization are also officers, directors, or trustees of, or hold other important offices in, the supporting organization, or (iii) the officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization; and by reason of such overlap or closeness, the officers, directors, or trustees of the supported organization have a “significant voice” in the investment policies of the supporting organization, the timing and manner of making grants, the selection of the grant recipients by the supporting organization, and otherwise directing the use of the income and assets of the supporting organization.16

The “charitable trust” option of the responsiveness test was originally adopted to recognize the inherent conflict between a trustee’s fiduciary duties and charitable beneficiaries’ involvement in the actual administration of a trust. Thus, the elimination of this option has caused a great deal of uncertainty and has worked an unnecessary hardship on otherwise compliant and non-abusive Type III charitable trusts.

For years, independent professionals and institutional trustees of charitable trusts have been quite responsive to the needs and desires of their supported organizations with respect to the timing and manner of distributions and investment policies without overlapping trustees. Where practical and consistent with prudent investment and impartiality standards, many charitable trustees work to accommodate the needs of each supported organization with respect to the timing and use of distributions and investment policies, carefully balancing the short-term demands with the ever-present need for long-term consistent support. Because many charitable trusts often support multiple organizations with wide variances in the level of sophistication—including some with competing interests—the donor often wisely selects independent professionals or institutional trustees to manage the charitable trust consistent with the supported

organization’s and donor’s charitable objectives. Thus, it is commonplace for the trust instruments of Type III supporting organizations organized as charitable trusts not to include a provision for trustee or board overlap by officials of the supported organizations.

Because of the nature of many Type III supporting organizations organized as charitable trusts, the trustees of these trusts were required to determine if the trusts for which they serve as trustee could continue to qualify for supporting organization classification under the “significant voice” test of responsiveness. Many institutional trustees were concerned that the significant voice test requirements were in conflict with their fiduciary duties to manage the trust, and that in most cases, allowing a beneficiary to have the level of involvement in managing trust investment polices, grant-making and use of income and assets would constitute an improper delegation of authority. In addition, the trustees lacked clear guidance as to precisely how the significant voice test could be met. Although another options for these trustees was to seek judicial permission to amend their trust instruments to permit trustee overlap, such judicial modification requires a significant amount of time—which can vary significantly by state—requiring the approval of the beneficiaries, the state Attorneys General, and the courts. Many trustees felt that, not only would such action be costly and uncertain, it would be in contravention of donor intent and so arguably be a breach of their fiduciary duty.

Given the effective date of PPA, the lack of definition and examples of how to apply the “significant voice” requirement to trusts that previously had relied on the “charitable trust” option for supporting organization classification, and exposure to interest and penalties for failure to properly calculate, report and pay the tax on net investment income for tax years subsequent to the effective date of PPA, many institutional trustees decided to convert many of the trust accounts for which they serve as trustee to private foundations.

In Notice 2008-6, the Internal Revenue Service provided some transitional relief stating that Type III charitable trusts did not have to file a private foundation information return (Form 990-PF) or pay private foundation excise taxes under Code Section 4940 until its first taxable year beginning on or after January 1, 2008.17 Unfortunately, for many charitable trusts the transitional relief deadline arrived well after the initial filing deadline and so close to the extended deadline that many trustees had already determined to treat such accounts as private foundations for tax years beginning after 12/31/07. Accordingly, these trustees began to calculate, report and pay quarterly estimates of the tax on net investment income, file Form 990-PF for such tax years, calculate and distribute amounts in accordance with the minimum required distribution applicable to private foundations, and otherwise administer such trust accounts in accordance with all requirements of private foundations.

Now that the Government has given some shape to the close and continuous requirement through the helpful examples in the proposed regulations, a number of organizations and institutional trustees have indicated a desire to convert back to type III supporting organization status. In light of significant uncertainty in which these organizations have been required to operate, we urge the Government to permit any Type III supporting organizations that converted to private foundation status after the effective date of the PPA, but prior to the issuance of the proposed regulations, to convert back to Type III supporting organization status simply by filing

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17 Notice 2008-6, 2008-3 IRB 275, (12/21/07).
a Form 990 for each tax year in question with a letter of explanation, and Form 990-PF requesting a refund for the taxes paid.

5. **Additional Transition Rules With Respect to the New Distributable Amount Requirement.**

A transition rule, similar to the transition rule that applied to pre-May 26, 1969 private foundations under Code Section 4942 (Treas. Reg. 53.4942(a)-2(e)(3)) should be adopted to provide relief to supporting organizations formed before September 23, 2009 that are prohibited by their governing instruments from distributing capital or corpus. We suggest that such organizations be exempt from the new distribution requirement until the end of the third calendar year following publication of the final regulations; during the pendency of any judicial proceeding commenced during such period to reform the governing instrument of the supporting organization; and following the termination of such reformation proceeding, to the extent that the governing instrument of the supporting organization does not permit compliance with the distribution requirement.

This transition rule is needed to give organizations whose governing instruments prohibit the distribution of capital or corpus time to comply with the new requirements. In particular, sufficient time is required to permit state legislatures an opportunity to adopt tax law conformance legislation, so that supporting organizations individually need not commence costly proceedings to reform their organizing instruments to permit the required distribution.

Additionally, the transition rule provided by Treas. Reg. 1.509(a)-4(i)(4) for pre-November 20, 1970 trusts should be extended to trusts existing on the date of issuance of the proposed regulations. Just as the regulations implementing the TRA provided transition relief for trusts then in existence, we suggest that the proposed regulations should provide transition relief for trusts formed before the issuance of the proposed regulations implementing the PPA, and not merely trusts that were in existence before the TRA.

6. **Additional Proposed Revisions to Proposed Regulations**

**Proposed amendment to define control under Reg. Sec. 1.509(a)-4(f)(5).**

Under Code Section 509(f)(2), an organization will not qualify as a Type I or Type III supporting organization if it accepts contributions from certain persons who control the governing body of one of its supported organizations. Notice 2006-109 defined “control” for this purpose by reference to Reg. Sec. 53.4942(a)-3(a)(3). We suggest that such a reference be included in the proposed regulations.

**Practical concerns relating to written notification requirement.**

In addition to the existing responsiveness and integral parts tests, Code Section 509(a)(1)(A) requires supporting organizations to provide certain information specified by the Treasury Secretary to each supported organization annually. The specific information required to satisfy the new notification requirement is set out in the proposed regulations.
Section 509(f)(1)(A), a Type III supporting organization must provide to each supported organization such information as the Secretary may require.

Under the new notification requirement, a supporting organization is required to provide each of its supported organizations (i) a written notice indicating the type and amount of support provided by the supporting organization in the past year addressed to the principal officer of the supported organization, (ii) a copy of the supporting organization’s most recently filed Form 990, and (iii) a copy of the supporting organization’s governing documents, including its charter or trust instrument and bylaws, and any amendments to such documents (however, copies of such documents are not required if such documents have been provided previously and have not been subsequently amended). The notice must be postmarked or transmitted by electronic media by the last day of the fifth month after the close of the organization’s tax year.

Presumably, the objective of the new notification requirement is to disclose information about the supporting organization’s finances and activities sufficient to enable the supported organization to better monitor activities of the supporting organization and to increase the supporting organization’s ability to make meaningful recommendations and requests of the supporting organization. We support the new notification requirement and believe it will do much to highlight the important charitable work of Type III supporting organizations. We suggest only four slight modifications.

First, while it seems logical for the notification date to coincide with the Form 990 due date, we suggest that the proposed regulations explicitly state that if the current year Form 990 is on extension, the requirement can be satisfied by providing the supported organization with a copy of the prior year’s Form 990.

Second, the proposed regulations require that the written notice be addressed to a “principal officer” of the supported organization. It is unclear whether the term “principal officer” includes, not only the elected officers of the entity (President, Vice-President, Secretary or Treasurer), but also executive staff. To resolve any ambiguity about who might qualify as a “principal officer,” we suggest that the regulations expressly designate the Treasurer or Chief Financial Officer of the supported organization as the person to whom the notice should be addressed.

Third, Prop. Reg. Sec. 1.509(a)-4(i)(2)(i) refers to “support provided . . . in the past year.” To increase clarity, we respectfully suggest that the reference be changed to “support provided . . . in the immediately preceding tax year.”

Fourth, the proposed regulations provide that notification may be provided by electronic media. The preamble notes that supporting organizations should retain proof of delivery in their records. Will a copy be sufficient? Or must the supported organization provide confirmation of receipt for the notification? Clarification here would be helpful.

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18 Prop. Treas. Reg. § 1.509(a)-4(i)(2).

19 Id. (While implicit within the language “most recently filed Form 990”, we urge the Government to explicitly state that if the current year Form 990 is on extension, then the prior year Form 990 will suffice.)
VI. CONCLUSION

Our hope is that additional consideration by the Government of proposed Treasury Regulations to be enacted for Type III supporting organizations will provide rules that increase confidence in the governance of such organizations, while at the same time do not decrease or harm the effectiveness of non-abusive Type III supporting organizations. We appreciate your consideration of our comments and welcome the opportunity to discuss them further with you.