April 18, 2014

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Internal Revenue Service
Room 5203
P.O. Box 7604
Ben Franklin Station
Washington, D.C. 20044

Ms. Ruth M. Madrigal, Attorney Advisor, Office of Tax Policy, Department of Treasury (via email)

Ms. Catherine Hughes, Department of Treasury (via email)

Re: Comments on Proposed Treasury Regulations with Respect to Required Distributions by Non-Functionally Integrated Type III Supporting Organizations

Ladies and Gentlemen:

We appreciate the opportunity to submit the enclosed comments, which represent the views of the Section of Real Property, Trust and Estate Law (“RPTE”) of the American Bar Association (“ABA”). This submission has not been approved by the Board of Governors or the House of Delegates of the ABA and, accordingly, in no way represents the policy of the ABA as a whole.

Although the attorneys who prepared this submission may have clients who would be affected by the federal tax principles addressed, or may have advised clients on the application of such principles, neither they nor their respective firms have been engaged by a client to make this submission or to otherwise influence the development or outcome of the specific subject matter of these comments.

Thank you in advance for your consideration. Representatives of RPTE’s Charitable Planning and Organizations Group are available to respond to any questions. Its designated contact persons are:

Stephanie B. Casteel        404-872-8158
Elaine W. Wilson            304-293-7802
Very truly yours,

Susan G. Talley
Chair, Section of Real Property, Trust and Estate Law

Enc: Comments on Proposed Distribution Requirements

cc: Thomas M. Susman, Governmental Affairs, American Bar Association
    Cara Lee T. Neville, Secretary, American Bar Association
AMERICAN BAR ASSOCIATION
SECTION OF REAL PROPERTY, TRUST AND ESTATE LAW
CHARITABLE PLANNING AND ORGANIZATIONS GROUP

COMMENTS ON PROPOSED DISTRIBUTION REQUIREMENTS FOR NON-FUNCTIONALLY INTEGRATED TYPE III SUPPORTING ORGANIZATIONS

I. INFORMATION ON THE DRAFT OF THIS RESPONSE

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 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. Elaine Waterhouse Wilson, as Chair 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 Carol G. Kroch, Grace Allison, and Sharon J. Bell. These comments were reviewed by Jonathan G. Blattmachr on behalf of the Section’s Committee on Governmental Submissions.

Contact persons: 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 may have clients who would be affected by the federal tax principles addressed, or may have advised clients on the application of such principles, 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.

II. BACKGROUND

Code Sections 509(f) and 4943(f)(5)\(^1\) were enacted eight years ago as part of the Pension Protection Act of 2006\(^2\) (the “PPA”). These provisions define the term “type III supporting

\(^{1}\) References in these comments to “Code Sections” are to sections of the Internal Revenue Code of 1986 as amended; references to “Treas. Reg. Section” are to sections of the Treasury Regulations promulgated under that Code.

organization” and distinguish between functionally integrated and non-functionally integrated type III supporting organizations. In particular, 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 because it performs the functions of, or carries out the purposes of, such supported organizations.

Section 1241(d) of the PPA directs the Secretary to promulgate new regulations governing required distributions by type III supporting organizations that are not functionally integrated. The express language of Section 1241(d) mandates that such regulations require non-functionally integrated type III supporting organizations to distribute 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.

Under Treasury Regulations existing prior to the PPA, type III supporting organizations, whether in corporate or trust form, were required to be responsive to their supported organizations.³ A supporting organization formed as a trust was deemed to be responsive to its supported organizations if its provisions could be enforced under state law by those supported organizations in their capacity as beneficiaries of the trust.⁴ PPA Section 1241(c) provides that a type III supporting organization in trust form may no longer rely solely on enforcement rights under state law to establish responsiveness.

Finally, Code Section 509(f)(1)(A), enacted as part of the PPA, requires type III supporting organizations to provide each of their 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 (the “Notice”) that asked for comments from the public. As described in the Notice, the Government intended to propose regulations that provided (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 would be required to provide to its supported organization(s) to demonstrate that it is responsive.⁵

The Government issued, on September 24, 2009, Proposed Regulations (the “2009 Proposed Regulations”) setting forth the requirements to qualify as a non-functionally integrated (“NFI”) type III supporting organization. The 2009 Proposed Regulations, if made final, would have imposed a five percent distribution requirement on NFI type IIIIs.⁶ Subsequently, on

December 28, 2012, in response to comments it received, the Government issued Final and Temporary Regulations. The text of the Temporary Regulations also serves as the text of certain Proposed Regulations (“the 2012 Temporary and Proposed Regulations”). The 2012 Temporary and Proposed Regulations significantly modified the original five percent rule, as described more fully below. Because the distribution provisions in the 2009 Proposed Regulations are significantly revised in the 2012 Temporary and Proposed Regulations, the Government has asked for comments.

We appreciate the opportunity to comment on the 2012 Proposed Regulations. We also appreciate your consideration of our comments and welcome an opportunity to discuss them with you.

III. SPECIFIC COMMENTS SOUGHT

As indicated, the 2009 Proposed Regulations required a NFI type III supporting organization to distribute five percent of the fair market value of its assets annually, the same amount required by non-operating private foundations under Code Section 4942. The 2012 Temporary and Proposed Regulations reduce the payout percentage for NFI type III supporting organizations from five percent to three-and-a-half percent. For the reasons set forth below and in our prior submissions, the Group strongly supports this change.

Less felicitously, the 2012 Temporary and Proposed Regulations include an alternative income distribution test which requires an NFI type III supporting organization to distribute a “distributable amount” equal to the greater of 85 percent of its adjusted net income or three-and-a-half percent of the fair market value of its non-exempt use assets. The addition of this alternative net income requirement reflects the questionable assumption that the required payment of substantially all of the supporting organization’s income (with “substantially all” considered to mean 85 percent or more) will prevent “unreasonable accumulations” by NFI type III supporting organizations. This assumption derives, in part, from the “integral part” test contained in the pre-PPA regulations, which provided that a type III supporting organization would be deemed to be an integral part of the affairs of its supported organization if it distributed “substantially all” of its income to its supported organizations. The Government seeks comments on these proposed provisions.

IV. SUMMARY RECOMMENDATION

We recommend that Treasury eliminate the proposed alternative “85 percent of adjusted net income test,” so that a NFI type III supporting organization would be required to distribute

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8 This percentage is the same amount required to be expended for “the active conduct of medical research” from the endowment of a medical research organization described in Code Section 170(b)(1)(A)(iii). Treas. Reg. Sec. 1.170A-9(d)(2)(v)(B)(2008).
annually a “distributable amount” equal to a “minimum asset amount,” as defined in Prop. Treas. Reg. Section 1.509(a)-4.11

V. COMMENTS

Section 1241(d) of the PPA directs Treasury to promulgate new regulations requiring NFI type III supporting organizations to distribute “a percentage of either income or assets to supported organizations…. in order to ensure that a significant amount is paid to such organizations.”12 The staff of the Joint Committee on Taxation13 has indicated that the concern with the existing income-based payout requirement14 for such organizations is that it does not result in a significant amount being paid to the charity if the assets held by a supporting organization produce little or no income, especially in relation to (i) the fair market value of the assets held by the organization, and (ii) amounts paid out by non-operating private foundations.15

The Government proposes to require NFI type III supporting organizations to distribute annually a “distributable amount” equal to the greater of 85 percent of its adjusted net income or three-and-a-half percent of the fair market value of its non-exempt use assets. This is a major change from the initially proposed five percent payout requirement, which is also applicable to non-operating private foundations under Code Section 4942.

As an initial matter, we agree with the Government’s decision to lower the asset-based payout percentage from the five percent requirement applicable to private non-operating foundations to three-and-a-half percent. 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 flexible, donor-focused vehicles, allowing contributors to meet their various philanthropic goals by funding any number of charitable organizations in a given year. A private foundation is not required to designate specific beneficiary organizations, and it therefore has the ability to pick and choose from a potentially unlimited pool of beneficiary organizations every year. As a result, the amount of support a private foundation provides 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. In many cases, it is a stated goal of the foundation to help a recipient organization become

12 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.
14 See superseded Treas. Reg. Section 1.509(a)-4(i)(3)(iii), which generally required a type III supporting organization to make payments of “substantially all of its income to or for the use of one or more publicly supported organizations.”
15 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, n.571.
self-sustaining, so that the private foundation can make grants to other organizations in future years.

Supporting organizations, by contrast, are relatively inflexible, charity-focused entities, whether created by the supported charities themselves or by their donors. 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; meanwhile, the donor is excluded from even an indirect control relationship.\(^{16}\) In the case of type III supporting organizations, the supported public charities must be specifically named in the organizing documents—thus ensuring a strong and ongoing relationship among a supporting organization and specific supported organizations.\(^{17}\) 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. 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 Government notes the importance of these differences in T.D. 9605\(^{18}\):

The Treasury Department and the IRS recognize that NFI Type III supporting organizations face a number of requirements and restrictions that do not apply to private foundations. . . These requirements. . . result in a relationship between the supporting organization and the supported organizations that does not necessarily exist between private foundations and their grantees.

The consistent, long-term support provided by a supporting organization is a significant advantage to its supported public charities. When a public charity beneficiary has a reliable, sustainable source of support, it is able to focus more time and energy on fulfilling its charitable mission rather than being consumed by constant fundraising. In addition, the long-term funding from a supporting organization, similar in effect to having a permanent endowment, allows a beneficiary to conduct long-term research and initiate programs on which its service populations can rely without fear of interruption. Many public charities prefer predictable, sustainable, and increasing distributions from a dedicated supporting organization to the short-lived—even if large—distributions from private foundations and the uncertainty of hand-to-mouth fundraising. This endowment function of an NFI type III supporting organization makes it very different from a private operating foundation, which is subjected to an alternative test under current law.

Moreover, statistical research has shown that a lower payout rate has the effect, over time, of increasing total payout.\(^{19}\) This result is attributable to both fluctuating market conditions and inflation. Although currently around one-and-a-half percent, the inflation rate has historically averaged approximately three percent per annum. For a permanent endowment to

\(^{16}\) Treas. Reg. § 1.509(a)-4(j)(1981)
\(^{18}\) Published December 26, 2012.
\(^{19}\) Bernstein Global Wealth Management, *Sustainable Spending for Endowments and Public Foundations* at 8 and 10 (Jan. 2010)
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.  

We agree that an NFI type III supporting organization operating appropriately as an integral part of its supported organizations should be making significant annual distributions for their support—and, in most cases, supporting organizations are doing just that. A three-and-a-half percent payout requirement both preserves a supporting organization’s ability to provide consistent support for its supported charitable organizations in the future and is sustainable—thus assuring both significant current support and undiminished long-term support. In addition, three-and-a-half percent is a payout rate that appropriately reconciles two seemingly competing objectives: (i) ensuring that a significant amount goes to the supported organizations and (ii) avoiding erosion of the real inflation-adjusted value of a permanent endowment. For these reasons, we recommend that the alternate requirement of an annual distribution amount equal to 85 percent of adjusted net income, if this amount is greater, be eliminated.

There are three major problems with adding an alternative test. First, the alternative test eliminates the smoothing that an asset-based percentage payout is supposed to provide. With an annual distribution based on a percentage of asset value, if the investment return on these assets exceeds the spending rate, the supporting organization can create a reserve for operations in years when there is no appreciation—or when assets depreciate in value. In lean years, these reserves will be available as a source for distributions. In other words, the critical advantage of a distribution requirement based on a percentage of net asset value is the ability to create reserves in good investment years which facilitate stable distributions in bad investment years. In contrast, the unfortunate consequence of the alternative test would be to require distributions in excess of three-and-a-half percent in good investment years, when the income produced is higher. As a result, the supporting organization would not be able to hold reserves for bad investment years. A supporting organization would effectively lose the opportunity to create an endowment and, as the Bernstein study demonstrates, charitable distributions decrease over the long-term.

Second, the alternative adjusted net income test may have an unintended impact on a supporting organization’s investment portfolio. Under Code Section 4942(f), the term “adjusted net income” means gross income, subject to certain adjustments (specifically including the addition of state and local bond income) and only taking into account short term capital gains. In order to avoid having to make distributions from net income, a supporting organization might simply manage its investments in such a way as to ensure that it does not have “adjusted net income,” as statutorily defined, in excess of the three-and-a-half percent payout threshold. In order to achieve that result, a supporting organization might well forgo higher current income returns, such as those currently provided by preferred stock, in favor of investments held for long term appreciation. Every supporting organization’s investment profile is different, based upon the size of its assets, its liquidity needs, and the risk tolerance of its beneficiaries. A net income-based distribution requirement has the potential to distort an organization’s investment portfolio.
based wholly on tax-related concerns, as opposed to sound investment allocations designed to improve total return for the supporting organization.\textsuperscript{21} To some degree, we already see similar issues with private foundations and the Section 4940 net investment income excise tax.

Finally, calculating both net income and net asset value increases administrative costs and reduces amounts distributed for truly charitable purposes. The test under Code Section 4942(f) requires various exclusions and modifications that result in additional administrative cost. In addition, we are concerned that investment professionals would need to spend additional time determining appropriate strategies to minimize the impact of the alternative income distribution test. As a result, we are concerned that supporting organizations will spend a significant amount of time and effort, and as mentioned above, sacrifice other investment goals, to avoid the adjusted net income requirement. Surely this cannot be the right result. One test is sufficient to address concerns of abuse and to maximize charitable distributions in the long-term.

The legislative history of Code Section 4942(d) is instructive on this point. As enacted in 1969, Section 4942(d)\textsuperscript{22} required private foundations to distribute the greater of adjusted net income or the “applicable percentage” of net asset value; the “applicable percentage,” as defined in then-Section 4942(e)(3), was to be determined annually by the Secretary and was to

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\text{bear a relationship to 6 percent}\text{ [the rate established by statute for 1970] which the Secretary or his delegate determines to be comparable to the relationship which the money rates and investment yields for the calendar year immediately preceding the beginning of the taxable year bear to the money rates and investment yields for the calendar year 1969}.\textsuperscript{23}
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This complex formulation quickly proved unworkable.

In 1976, the distributable percentage was fixed at five percent, and the requirement for annual adjustments by the Secretary was dropped.\textsuperscript{24} Even more relevant, in 1981, Congress eliminated the “adjusted net income” alternative test, requiring only that distributions equal at least five percent of net asset value.\textsuperscript{25} We find it ironic that an alternative test, discarded by Congress as unworkable more than thirty years ago, is now proposed to be imposed on NFI type III supporting organizations.

In January of 1981, the U.S. prime rate was 20.5 percent, leading the drafters of the Economic Recovery Tax Act of 1981 to believe that by eliminating the reference to “adjusted net income, they had reduced the required payout. Thus, the Senate Conference report notes:

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\text{21 The Uniform Prudent Management of Institutional Funds Act—enacted by 49 of the 50 states—and the Uniform Prudent Investor Act—enacted by 41 of the 50 states—both adopt a “total return” approach to investing. Uniform Prudent Management of Institutional Funds Act, Section 3(e)(2); Uniform Prudent Investor Act, Section 2(b); www.uniformlaws.org.}
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\text{23 Id. 528.}
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The Senate amendment reduces the required payout for private foundations so that they must distribute only their minimum investment return.\textsuperscript{26}

Today, the U.S. prime rate is three-and-a-quarter percent, illustrating the value of a single asset-based test in promoting the certainty, consistency and ease of administration that is the hallmark of good law.

Moreover, we note that use of an assets-based test only should not allow a supporting organization to avoid increasing its distributions as its income increases. If the supporting organization does have net adjusted income in excess of the three-and-a-half percent amount, such accumulated income will increase the fair market value of the supporting organization’s assets. That will, in turn, increase the actual payout in the following year of the supporting organization.

VI. CONCLUSION

We appreciate your consideration of our comments and welcome the opportunity to discuss them with you.

\textsuperscript{26} S.R. 97-176 at 281 (1981).