February 25, 2015

Notice.Comments@irscounsel.treas.gov

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:

In April 2014, members of the Charitable Planning and Organizations Group, Section of Real Property, Trust and Estate Law (“RPTE”) of the American Bar Association (“ABA”), met with Treasury representatives to discuss, inter alia, the above-captioned proposed Treasury regulations. At that time, Treasury (i) asked if there were recent studies regarding foundation payouts and (ii) requested copies of prior submissions on this topic from RPTE or the Section on Taxation of the ABA. We appreciate the opportunity to submit the following materials now in response to Treasury’s request.

2. Letter submitted to Treasury dated April 18, 2014 (RPTE, ABA);
3. Letter submitted to Treasury dated April 27, 2010 (Section on Taxation, ABA); and
The 2013 Cambridge Associates study may be of particular interest to you. After reviewing investment market performance from 2004 through 2010, Cambridge determined that a spending rule of 5% or greater would erode $100 million invested in 1968 to $87.39 million in 2010. In contrast, a 4% spending rule would grow the $100 million to $132.86 million (Cambridge at 11). As we have argued in the past, Type III Supporting Organizations have, by definition, a close nexus with their supported organizations. A spending rule which does not waste Type III Supporting Organizations better preserves the income stream flowing to supported organizations, thereby safe-guarding for the long-term the charitable missions of both the distributing entity and the recipient. As the Cambridge study concludes:

[A] high payout rate will initially provide higher levels of spending, but will over time erode the value of both the fund and the absolute level of dollars being paid out from the fund. Conversely, a lower payout rate will enable the fund to accumulate value and will result in higher absolute levels of real spending in the future. Cambridge at 7.

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. This letter and the enclosed comment letters do, however, represent the views, respectively, of RPTE or the Section on Taxation of the ABA.

Although the attorneys who prepared this submission and the attached prior submissions 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.

If you have any questions, please contact Elaine W. Wilson, Chair of the Charitable Planning and Organizations Group at elaine.wilson@mail.wvu.edu or (304) 293-7802.

Very truly yours,

Gideon Rothschild
Chair, Section of Real Property, Trust and Estate Law

Enc:
Cambridge Associates 2013 Study
Comment letters on Proposed Distribution Requirements dated April 14, 2014; April 27, 2010; and December 23, 2009
March 2013
Sustainable Payout for Foundations
2013 Update Study

CAMBRIDGE ASSOCIATES LLC

Supported by:
Council of Michigan Foundations
Council on Foundations
The Philanthropy Roundtable
March 2013

Sustainable Payout for Foundations
2013 Update Study

Petra G. Bignami
The Purpose of the 2013 Update

This paper serves as an update to the studies conducted in 2000 and 2004, which were commissioned by the Council of Michigan Foundations (CMF) at the request of its members. The purpose of this update study is to evaluate the sustainable real (inflation-adjusted) level of payout for private foundations in light of the actual experience of a sample of private foundations with diversified portfolios. Given the extreme market movements since our last update, we updated the sample foundations’ data to test whether the passage of eight more years of data (2003–2010) challenged the conclusions of the original report.

In keeping with both the April 2000 study as well as the 2004 update, Part I of this paper will focus on the actual investment returns and payout histories of the Michigan sample group between 1973 and 2010, both in absolute terms and relative to the performance of a passive blend of stock and bond indices. The two passive portfolios modeled for comparison against the Michigan sample are as follows: one invested in 65% U.S. equities and 35% in U.S. bonds, and the other invested in 75% U.S. equities and 25% U.S. bonds. As noted in the 2000 study, a 65/35 hypothetical portfolio was chosen because it approximated the average asset allocation of the sample group. A 75/25 hypothetical portfolio is included in this 2013 update to examine the implications of a broader range of portfolio risk. In our experience, the majority of foundations’ level of portfolio risk (in this study and more broadly across the U.S.) typically falls somewhere between these two hypothetical portfolios. Additionally, since Internal Revenue Service (IRS) aggregate data on U.S. private foundations has become widely available in the years since our original study, we also test the results from the Michigan sample and the hypothetical portfolios against a national sample.

Part II then examines the direct effects of various payout rates on real payout levels and market values of the two hypothetical portfolios noted above, and we report the expected multi-year returns of these two portfolios as indicated by our proprietary asset class return assumptions.

Conclusions

The inclusion of updated market data from 2003-2010 confirms the major points of both the original 2000 study as well as the study in 2004.

- The actual return experience of a sample of Michigan foundations does not support a spending rate higher than 5%. The average annualized return, adjusted for inflation, for the sample foundations for the period 1973–2010\(^1\) is 5.11%, only slightly above the IRS mandated payout rate of 5%.

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\(^1\) In the 2004 update paper, CA found that, adjusted for inflation, the same sample group had an average annualized return of 5.08% for the period (1973-2002). In the original study, CA found that, adjusted for inflation, the same sample group had an average annualized return of 5.27% for the period (1973-1998).
The return experience of a sample of Michigan foundations is consistent with that of aggregate private foundations nationwide. Additionally, the nationwide IRS data for private foundations indicates a persistently higher payout rate when compared to Michigan foundations for the period for which data is available (1985-2009). The data also suggest that foundations as a whole have been willing to spend in excess of the federally mandated 5% payout level during the time period, highlighting that many foundations may consider the 5% legal requirement payout rate as a minimum or ‘floor’ when establishing spending practices.

Updated simulations using historical hypothetical portfolio data from 1969–2010 confirm that a 5% payout rate makes the goal of maintaining purchasing power in perpetuity somewhat challenging. The addition of eight years of return data from 2003-2010 confirms that the market value of a fund earning market returns and paying 5% annually during this 38-year period would end up below its 1973 value in real terms by 2010. This conclusion holds for both the 65/35 and 75/25 hypothetical portfolios. Additionally, our proprietary models would indicate that earning a return in excess of an inflation-adjusted 5% will be challenging.

The Purpose of the Original Study

At the request of several of its members, the Council of Michigan Foundations (CMF) retained CA in the late fall of 1998 to evaluate the private foundation payout rate required by the federal government, based on the real returns of a group of Michigan private foundations over a 25-year period. To that end, CA assembled and analyzed historical data from 48 Michigan foundations that had been in continuous operation since 1973, and included data up through the end of 1997 (a 25-year period).

For the purposes of the original study, three approaches were taken to answer the question of how much a fund can spend without depleting its real value over time:

• Using historical index returns, analysis of hypothetical portfolios invested 65% in U.S. equities and 35% in U.S. bonds from 1969-1998 was reviewed to determine what would happen if a foundation’s annual spending was set at various payout rates.

• The actual returns earned by the sample group of Michigan foundations over the period 1973-1997 were analyzed to test whether the actual experience of these foundations tracked closely with index results over the same period.

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2 For the purposes of the actual historical spending analysis, data from all 48 foundations in the sample group were used. For the purposes of the actual historical returns analysis, returns data from 33 of the 48 foundations were used, excluding those 15 foundations with significant single-stock holdings. The results of the original study were published in April of 2000, and are available on the Council of Michigan Foundations website at www.cmif.org/documents/payout.pdf.
• In addition, the actual spending history of the sample foundations was analyzed over the same period to determine the foundations’ ability to comply with the 5% spending rule given the market volatility of the preceding three decades.

2004 Update

CA conducted an update to the original study to include 5 additional years of data (1998-2002). The update confirmed all of the major points of the original study: generally, a 5% spending rate is too high to provide confidence in the ability to maintain purchasing power in perpetuity, and the real returns of the sample 33 Michigan foundations did not support a spending rate of higher than 5%.

Part I. 2013 Update Study

Return Experience of the Response Pool

Prior to the original publication of our study in 2000, much of the analysis regarding the sustainable level of spending for private foundations was done by modeling passive index returns. Chart 1 below illustrates the extent to which actual returns of the Michigan sample group mirrored those of 75/25 and 65/35 hypothetical portfolios described above. For the sake of comparison, we have included both the 30-year time period included in the 2004 update study (1973-2002) as well as the 38-year period (1973-2010) for this update.

Michigan Foundations

<table>
<thead>
<tr>
<th>HISTORICAL RATES OF RETURN – MICHIGAN FOUNDATIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>Chart 1. Index Portfolio vs. Actual Michigan Foundation Historical Rate of Return</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>1973-2002 Returns (30 Years)</th>
<th>1973-2010 Returns (38 Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Index Portfolio Returns (65%/35%)</td>
<td>Index Portfolio Returns (75%/25%)</td>
</tr>
<tr>
<td>Nominal</td>
<td>10.37%</td>
<td>10.41%</td>
</tr>
<tr>
<td>Inflation-adjusted</td>
<td>5.17%</td>
<td>5.20%</td>
</tr>
<tr>
<td></td>
<td>9.44%</td>
<td>9.57%</td>
</tr>
<tr>
<td></td>
<td>4.82%</td>
<td>4.94%</td>
</tr>
</tbody>
</table>
For the 30-year period between 1973 and 2002, real foundation returns for the Michigan group closely tracked the performance of the passive indexes. The real return for the sample foundations exceeded the current 5% rule by only 8 basis points, as seen in the top red box on Chart 1. The results for the 38-year period from 1973-2010 are also in line with the performance of the hypothetical portfolios. Real returns increased slightly from 5.08% for the 30-year period ending 2002 to 5.11% for the 38-year period ending in 2010, and the spread over the passive index blends widened, possibly as a result of broader diversification of foundation portfolios in more recent years.

**National Foundations**

Looking beyond the sample of foundations based in Michigan, we applied the same analysis using data from a national aggregate of private foundations obtained from the IRS. At the time of the writing of this study, only data from the period 1986-2009 was available for this particular analysis. Returns are IRS estimates for all domestic private foundations based on IRS methodology.

The results suggest that the return experience of the Michigan foundations closely reflects that of private foundations nationally, as seen on the highlighted red boxes on Chart 2 below. For the 24-year period from 1986-2009\(^3\), national foundations returned 6.49% real while Michigan foundations returned 6.64% real. Over this time period, the 65/35 and 75/25 hypothetical portfolios returned 6.18% and 6.35% real, respectively.

### HISTORICAL RATES OF RETURN – NATIONAL FOUNDATIONS

<table>
<thead>
<tr>
<th>1986-2009 (24 Years)</th>
<th>Index Portfolio Returns (65%/35%)</th>
<th>Index Portfolio Returns (75%/25%)</th>
<th>Actual Michigan Foundation Returns</th>
<th>National Foundation Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal</td>
<td>9.24%</td>
<td>9.41%</td>
<td>9.71%</td>
<td>9.56%</td>
</tr>
<tr>
<td>Inflation-adjusted</td>
<td>6.18%</td>
<td>6.35%</td>
<td>6.64%</td>
<td>6.49%</td>
</tr>
</tbody>
</table>

The difference between the nationwide data and the Michigan sample over this 24-year period is 15 basis points (0.15%). This modest difference suggests that the 48 Michigan foundations (33 for return data) used in our original report collectively are a strong proxy for the overall performance of foundations in the United States during these time periods. Additionally, the two hypothetical portfolios, particularly the 75/25, also closely track the national foundations’ returns.

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\(^3\) Data was gathered from over 30,000 U.S. foundations. Data is publically accessible at the following link: http://www.irs.gov/uac/SOI-Tax-Stats-Domestic-Private-Foundation-and-Charitable-Trust-Statistics.
Conclusion

The initial conclusions of the 2000 study and 2004 are confirmed by the addition of both eight more years of data and a robust national sample of foundations. In 2000, we noted that modeling based on passive indexes was likely to provide a reasonable approximation of actual foundation experience. We also concluded that, in order for foundations to be sustainable over long periods of time, a payout rate in excess of 5% is not likely to maintain the real portfolio market value over the long term. Furthermore, the return experience of Michigan foundations closely reflects that of a robust national private foundation sample, suggesting that the same conclusions likely apply on a national scale.

IRS Payout Requirements

While the return experience of the two hypothetical portfolios and the sample of Michigan and national foundations exhibited similar returns over long periods of time, payouts were more variable. Exhibit 1 plots the weighted average payout ratio for the Michigan foundation sample group from 1973 to 2010\(^4\). A horizontal line is drawn beginning in 1982 to indicate the period in which the 5% payout rule was in force. As noted in the original report, prior to 1983, actual payout rates averaged 6.6%, since payout requirements mandated that neither the higher of adjusted net income (including interest and dividends) or a “minimum investment return” ranging from 4.4% to 6% be spent. Average payout between 1983 and 1993 was actually below the 5% level for the following reasons:

- The IRS allowed carry-forward credits for over disbursements in years prior to 1982.
- Higher bond and equity valuations, coupled with a one-year grace period for payout requirements, resulted in effective annual disbursements of less than 5%. In the five years following 1993, payout rates hovered around the 5% mark with relatively little volatility.

2003-2010 Update

A vertical line is drawn at 2002 in Exhibit 1 to indicate the period for which data was added since the 2004 update was published. Since 2002, foundation payout rates have steadily risen, reaching levels witnessed before the mandated 5% payout rate was instituted\(^5\).

We also included the payout rates of all national private foundations based on estimates from the IRS for the years 1985-2009. At the time of the writing of this study, data from only this period was available from the IRS. Returns are IRS estimates for all domestic private foundations based on IRS methodology. We find that the payout rates for private foundations in the United States as a whole are

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\(^4\) Exhibit 1 serves to update Exhibit 1 from the 2004 update.

\(^5\) However, this graph is dollar-weighted, giving the few largest foundations disproportionate weight. According to the 2004 study, volatility was around the 5% mark between 1999 and 2002. If the single largest foundation were removed from the 2004 analysis, volatility around the 5% mark actually increases between 1999 and 2002. The 2004 study suggested that this may be more reflective of the typical foundation’s experience during this period. As equity markets surged in the late 1990s, effective payout rates dropped below 5%, and as markets slumped after 2000, payouts spiked significantly.
higher than those of the Michigan foundations, and have also steadily risen since 2002. The payout rate for national foundations is consistently 1% to 2% higher than the Michigan foundations’ weighted payout rate, which has significant implications. Our analysis suggests that the 5% payout rule currently mandated by law may serve as a ‘floor’, rather than a ‘ceiling’, for many foundations’ spending practices. To that end, this suggests that while many Foundations may manage to this rate, many have historically paid out levels far in excess of the currently federal mandate of 5%. As such, the combination of a lower real return than the Michigan foundation sample (15 basis points) and consistently higher payout rates suggests that on average, national foundations’ funds will gradually lose their real wealth over time.

Part II. 2013 Update Study

The Effect of Various Spending Rates on Real Payout Levels and Fund Market Values

Since the analysis in the previous section demonstrated that hypothetical portfolios approximates the return history for both the Michigan and national samples, we can use the same hypothetical portfolios (65/35 and 75/25) to illustrate the effect of market cycles on foundation assets and payout over long periods of time. This is shown in Exhibits 2A and 2B, in which we model the 65/35 and 75/25 hypothetical portfolios, respectively.

Findings from 1969 – 2010

- The period shown here begins towards the end of the great bull market of the 1950s and 1960s. By 1968, the diversified Michigan foundations we surveyed had over 50% of their assets allocated to equities, virtually all invested in U.S. stocks. In the decade of the 1970s that followed, stocks posted anemic nominal returns and negative real returns. The bull market between 1998 and 2000 resulted in a brief recovery of real spending rates and fund market values, bringing all funds except the one spending 7% above their 1969 payout levels for the first time in 30 years. This holds for both the 65/35 and 75/25 hypothetical portfolios. Following the tech bubble crash, the early 2000s brought all funds, except for the 4% spending fund, back down to sub-1969 market value levels for both the hypothetical portfolios. In other words, only the funds with 4% spending rate recovered from the periods of pronounced market volatility to fully preserve purchasing power.

- Markets rebounded between 2002 and 2007, but the financial crisis of 2008 again brought a decline in real fund values.

- By the end of 2010, real inflation adjusted spending for each of these funds remained below the 1969 level of 5%, with the sole exception of a hypothetical fund spending 4% for both the 65/35 and 75/25 indexed portfolios.
• As of 2010, only the 4% fund had preserved its real wealth since 1969 after enduring periods of protracted market volatility. For the 65/35 portfolio that spent at the 5% mandated level, this implies a 13% decline in real market value from 1969. For the more aggressively invested 75/25 portfolio, this implies a 9% drop in real market value.

• Since the 2004 update (2003 - 2010), there was a 18% decline in real market value for the 65/35 portfolio spending at the 5% mandated level and a 13% decline for the 75/25 portfolio spending at the 5% mandated level.

• If we assume foundations can achieve a moderate increase in portfolio return without an attending increase in portfolio risk through access to top quality investment managers and alternative asset classes, the 5% spending rate may be just low enough to preserve purchasing power over the long term. If, however, the legally required spending rate increased to 5.5% or 6%, our analysis suggests foundations may not be able to preserve their real wealth over time. If foundations are not able to preserve their wealth over time, their ability to execute on their stated missions falls commensurately.

• As the data and graph suggest, a high payout rate will initially provide higher levels of spending, but will over time erode the value of both the fund and the absolute level of dollars being paid out from the fund. Conversely, a lower payout rate will enable the fund to accumulate value and will result in higher absolute levels of real spending in the future.

**Variable Versus Constant Spending Rates in Bull and Bear Markets**

Exhibit 3A examines a hypothetical 65/35 portfolio of $100 million in 1969 and the subsequent real market value through 2010 after employing two different spending rules. Rule A spends a constant 5% of a trailing four quarter average beginning market value each year. Rule B, however, increases spending in response to rising portfolio value (bull market), and correspondingly lowers it in response to falling portfolio value (bear market). The exhibit shows the corrosive effect variable spending has on a portfolio’s real wealth over time. Note that over this 38-year period, the constant payout rate (Rule A) nearly preserves the portfolio’s purchasing power (down 3.9% from 1969), the variable payout rate (Rule B) does not (down 26.8% from 1969).

• Through 2010, cumulative spending from both funds over the period was quite similar (Fund A had cumulative spending of $165.19 per $100 of original value and Fund B had $166.02).

• Despite the negligible differences in cumulative spending between the two funds over the period, Fund B is more than 30% less valuable than Fund A in real terms at the end of the period. This is due to the increased payout during the bull markets of the 1990s and period leading up to the more recent financial crisis.
By 2010, the spending level of Fund B drops almost 40% from its initial 1969 level in real dollar terms for both the 65/35 portfolio and the 75/25 portfolio (see Exhibit 3B). In contrast, Fund A’s spending level drops only 20% for both portfolios.

The higher absolute spending achieved by the constant payout rate (Fund A) by the end of the period means that if the two funds follow identical spending rules, in the long run Fund A exhibits higher cumulative spending. This is exacerbated if Fund B continues to vary its spending heading into a bear market.

The results from the analysis of the constant payout rate (Fund A) and variable payout rate (Fund B) are very close for both the 65/35 and 75/25 hypothetical portfolios. This illustrates that spending patterns have a similar impact on the value and absolute spending of a fund regardless of the actual investment composition (simple stocks and bonds) of the portfolio. The real value of a foundation’s portfolio is highly sensitive to annual spending rates, and will diminish over time if a variable payout rate is administered.

Future Return Expectations

Finally, using CA’s proprietary asset class return assumptions, we calculate the real expected compound returns for hypothetical 65/35 and 75/25 portfolios, and find that they are 4.9% and 5.2%, respectively, over the long term. The main objective of our asset class assumption is to present a base case of equilibrium returns. In particular, equilibrium assumptions are independent of current valuations, targeted toward a generic 25+ year time horizon and with a risk premium between global bonds and global stocks that is reasonable and represents our long-term expectation. Given these return expectations going forward, our models suggest that the probability of maintaining purchasing power at a payout rate of 5% is about 50% over the next 5 to 25 year time frames, as summarized in Chart 3 below.

<table>
<thead>
<tr>
<th>Index Portfolio</th>
<th>5 Years</th>
<th>10 Years</th>
<th>15 Years</th>
<th>20 Years</th>
<th>25 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>65%/35%</td>
<td>49%</td>
<td>48%</td>
<td>48%</td>
<td>47%</td>
<td>47%</td>
</tr>
<tr>
<td>75%/25%</td>
<td>50%</td>
<td>51%</td>
<td>51%</td>
<td>51%</td>
<td>51%</td>
</tr>
</tbody>
</table>

The inputs used in this modeling exercise represent our current estimates of long-term (25-year) equilibrium real rates of return. This includes a real arithmetic average return of 7.00%, 3.00% and 1.00% for U.S. Equity, U.S. Fixed Income, and U.S. Cash, respectively, as well as an inflation rate of 3.00%. The original report included modestly higher equilibrium real arithmetic average returns of 7.75%, 3.75%, and 1.00% for U.S. Equity, U.S. Fixed Income, and U.S. Cash, respectively, as well as an inflation rate of 3.00%.
Implications

This study provides quantitative analysis on the investment portfolio performance and payout rates for both a sample of 48 Michigan foundations through 2010 and a larger sample of over 30,000 national foundations through 2009. Our extension of the time period to include the most recent financial crisis corroborates the conclusions reached in our previous research in 2000 as well as in 2004. While nominal returns of foundations have been near 10%, the data suggests that the combination of inflation and mandated annual payouts may erode foundations’ real wealth over time.

Because foundations generally exist to serve a stated social good or purpose in perpetuity, their real wealth over the long term is often central to their mission. Put simply, foundations’ real wealth is a function of three variables: nominal investment returns, inflation, and payout rates. While the first two are unpredictable in the short run, one may reasonably assume that over longer periods they may interact to produce an annual real return between 5% and 7%. Our analysis supports this not only theoretically but also empirically. Payout rates are the only element of relative certainty of these three variables and as the evidence suggests, unsustainable rates may permanently impair foundations’ portfolios.

While some foundations admittedly are set up to liquidate over time, most donors create foundations with the goal of pursuing their missions in perpetuity. For foundations to maintain intergenerational equity, spending rates should not exceed the expected real return. Boosting returns to a level sufficient to justify increases in spending would likely require taking on considerable risk in a foundation’s portfolio, which many may not be positioned to implement or monitor effectively. As such, our analysis, as it did in 2000 and in 2004, again confirms that a payout rate higher than 5% may compromise foundations’ ability to sustain the grant-making capacity of their endowments over the long term.
Sources: Response pool comprised of all 48 Michigan foundations who responded to the survey.
National foundations data comprised estimates for all domestic foundations provided by the IRS (1985-2009).

Note: Prior to 1982 a higher of adjusted net income or variable percentage rule was in force.
From 1982 on a constant 5% rule was mandated.
The actual sample size for each individual year may vary due to data availability constraints.
Exhibit 2A

REAL SPENDING SIMULATION
65% U.S. EQUITY / 35% U.S. FIXED INCOME

SPEND VARIOUS %'s OF A FOUR-QUARTER AVERAGE BEGINNING MARKET VALUE
(Calendar Years 1969-2010)

Real Spending

Real Fund Market Values After Spending

Assumptions:
- Begin with $100 million on January 1, 1969.
- Constant asset allocation of 65% U.S. stocks and 35% U.S. fixed income rebalanced to target policy each year.
- Performance is based on annual market index data.
Exhibit 2B

REAL SPENDING SIMULATION
75% U.S. EQUITY / 25% U.S. FIXED INCOME

SPEND VARIOUS %'s OF A FOUR-QUARTER AVERAGE BEGINNING MARKET VALUE

(Calendar Years 1969-2010)

Real Spending

Real Fund Market Values After Spending

Assumptions:
- Begin with $100 million on January 1, 1969.
- Constant asset allocation of 75% U.S. stocks and 25% U.S. fixed income rebalanced to target policy each year.
- Performance is based on annual market index data.
Assumptions:
- Rule A: Spend 5% of a 4 quarter average beginning market value each year.
- Rule B: Spend 5% in 1969, 5.5% in 1970, 6% in 1971, 6.5% in 1972, 7% from 1973 through 1975, 6.5% in 1976, 6% in 1977, 5% from 1978 to 1996, 5.5% in 1997, 6% in 1998, 6.5% in 1999, 7% in 2000, 6% in 2001, 5% in 2002 and 2003, 5.5% in 2004, 6% in 2005, 6.5% in 2006, 7% in 2007 and 2008, 6% in 2009, and 5% in 2010. All annual spending is of a 4 quarter average beginning market value.
- Begin with $100 million on January 1, 1969.
- Constant asset allocation of 65% U.S. stocks and 35% U.S. fixed income rebalanced to target policy each year. Performance is based on annual market index data.
Exhibit 3B

REAL SPENDING SIMULATION
75% U.S. STOCK / 25% U.S. FIXED INCOME

VARIABLE VERSUS CONSTANT SPENDING RATES IN BEAR MARKET

(Calendar Years 1969-2010)

Real Spending

<table>
<thead>
<tr>
<th>Year</th>
<th>Rule A</th>
<th>Rule B</th>
</tr>
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<tbody>
<tr>
<td>1969</td>
<td>$3.05</td>
<td>$4.01</td>
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<tr>
<td>1970</td>
<td>$0.00</td>
<td>$1.00</td>
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<td>1971</td>
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<td>$3.00</td>
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<td>1972</td>
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<td>1973</td>
<td>$7.00</td>
<td>$6.00</td>
</tr>
<tr>
<td>1974</td>
<td>$10.00</td>
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Real Fund Market Values After Spending

<table>
<thead>
<tr>
<th>Year</th>
<th>Rule A</th>
<th>Rule B</th>
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<tbody>
<tr>
<td>1969</td>
<td>$74.04</td>
<td>$4.01</td>
</tr>
<tr>
<td>1970</td>
<td>$97.36</td>
<td>$5.04</td>
</tr>
</tbody>
</table>

Assumptions:
- Rule A: Spend 5% of a 4 quarter average beginning market value each year.
- Rule B: Spend 5% in 1969, 5.5% in 1970, 6% in 1971, 6.5% in 1972, 7% from 1973 through 1975, 6.5% in 1976, 6% in 1977, 5% from 1978 to 1996, 5.5% in 1997, 6% in 1998, 6.5% in 1999, 7% in 2000, 6% in 2001, 5% in 2002 and 2003, 5.5% in 2004, 6% in 2005, 6.5% in 2006, 7% in 2007 and 2008, 6% in 2009, and 5% in 2010. All annual spending is of a 4 quarter average beginning market value.
- Begin with $100 million on January 1, 1969.
- Constant asset allocation of 75% U.S. stocks and 25% U.S. fixed income rebalanced to target policy each year.
- Performance is based on annual market index data.
April 18, 2014

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,

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Enc: Comments on Proposed Distribution Requirements

cc: Thomas M. Susman, Governmental Affairs, American Bar Association  
    Cara Lee T. Neville, Secretary, American Bar Association
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.

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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 20062 (the “PPA”). These provisions define the term “type III supporting...

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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. 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. 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.

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. 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.8 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.9 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.10 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.  

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.” The staff of the Joint Committee on Taxation has indicated that the concern with the existing income-based payout requirement 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.

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. 9605¹⁸:

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

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.20

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. 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) 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 bear a relationship to 6 percent [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.

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. 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. 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:

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.
23 Id. 528.
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).
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

April 27, 2010

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  
Philip T. Hackney, Senior Technical Reviewer, Exempt Organizations Branch 2, Office of Chief Counsel, Internal Revenue Service  
Emily M. Lam, Attorney-Advisor, Office of Tax Policy, Department of the Treasury
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.

Contact: LaVerne Woods
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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

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.
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.


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 organization 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.” The due date for the notice is the last day of the fifth month after the close of the SO’s tax year.

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 test 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).
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 Regulations\(^{10}\) 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.”

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\(^9\) 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 Explanation\textsuperscript{12} 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.”\textsuperscript{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.”\textsuperscript{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.”\textsuperscript{15}

The ANPRM proposed that functionally integrated Type III SOs be required to
satisfy (a) the “but for” test in the existing Regulations,\textsuperscript{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.”\textsuperscript{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.”\textsuperscript{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.\textsuperscript{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.\textsuperscript{20}

\textsuperscript{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
\textsuperscript{13} Id. at 360, fn. 571.
\textsuperscript{14} Id.
\textsuperscript{15} Id.
\textsuperscript{16} Reg. § 1.509(a)-4(i)(3)(ii).
\textsuperscript{17} ANPRM, 72 Fed. Reg. 42,335, 42,338 (2007).
\textsuperscript{18} Id.
\textsuperscript{19} Id. at 42,337.
\textsuperscript{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. 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.”

   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. The Regulations define “substantially all” for this purpose as 85% or more. 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. 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. 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. The Regulations define “substantially all” for this purpose as 85% or more.

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22 Technical Explanation, supra at 360, fn. 571 (emphasis added).
24 Reg. § 53.4942(b)-1(c).
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.

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29 Reg. § 1.514(b)-1(b)(1)(ii).

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


\(^{31}\) 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

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.\textsuperscript{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.\textsuperscript{39} We recommend that the same rule apply in establishing the test for a functionally integrated Type III SO.


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.\textsuperscript{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,\textsuperscript{41} which commentators criticized as arbitrary\textsuperscript{42} 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 75-436\textsuperscript{43} 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

\textsuperscript{39} See Reg. § 53.4942(b)-1(b)(2).
\textsuperscript{40} Prop. Reg. § 1.509(a)-4(i)(4)(iii).
\textsuperscript{42} See id.
\textsuperscript{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. 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 2000 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”), 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

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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

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

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,\footnote{Notice 2007-21, 2007-1 C.B. 611.} 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.\footnote{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.} That rate is calculated as two-thirds of the “minimum investment return” (\textit{i.e.}, five percent of investment assets less any acquisition indebtedness).\footnote{I.R.C. § 4942(j)(3)(B)(ii); Reg. § 53.4942(b)-2(b)(1).}

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.\footnote{See Reg. § 1.509(a)-4(i)(3)(iii)(a).} Currently, a Type III SO must distribute “substantially all” of its income. Treasury and the Service, in Revenue Ruling 76-208,\footnote{1976-1 C.B. 161} looked to the private operating foundation rules, which define “substantially all” as 85\%, and applied the same standard in the Type III SO context.\footnote{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).} 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. \textbf{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.\footnote{74 Fed. Reg. 48,672, 48,677 (2009).} While the preamble notes that the Proposed Regulations “generally draw from the regulations under...
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

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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).
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

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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. 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.

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.

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.

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. 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. 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

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


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...
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.

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\(^{73}\) *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.  

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); 
- 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); 
- It does not provide the annual notice to its supported organization required by section 509(a)(3)(f)(1)(A) in a timely manner; 
- It is a charitable trust that does not satisfy the responsiveness test; 
- It is a non-functionally integrated Type III SO that fails to make sufficient annual distributions to its supported organization; and 
- 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. 

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. We commend Treasury and

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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. 
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

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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. The issuance of this advance ruling is discretionary with the Commissioner. 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.

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 termination 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.

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. 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

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


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.

97 2008-1 C.B. 275.
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
Bernice B. Donald, Secretary, American Bar Association
Thomas M. Susman, Governmental Affairs, American Bar Association
American Bar Association
Section of Real Property, Trust And Estate Law
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: Stephanie B. Casteel 404-572-3577

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 2006\(^1\) (the “PPA”) enacted Code Sections\(^2\) 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 subrequirement 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. 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

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is paid to such organizations.” The staff of the Joint Committee on Taxation has indicated that the concern with the existing income-based payout requirement 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 the value of the assets held by the organization, and as compared to amounts paid out by non-operating private foundations. Prop. Reg. Sec. 1.509(a)-4(i)(5)(ii) requires a 5% payout for non-functionally integrated Type III supporting organizations.

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.

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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).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.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.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, i.e., a minimum distribution of three and one-third percent of asset value.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.

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

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.

12 Staff of Joint Comm. on Internal Revenue Taxation, 91st Cong., 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.

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.

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.
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\textsuperscript{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.

\textit{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

\textsuperscript{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 policies, 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. 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

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, 19070 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. Under Code
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 supported 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.