June 22, 2016

The Honorable John A. Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Type III Supporting Organizations

Dear Messrs. Koskinen and Wilkins:

Enclosed please find comments on certain requirements for Type III supporting organizations (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

George C. Howell, III
Chair, Section of Taxation

Enclosure

cc: William M. Paul, Deputy Chief Counsel (Technical), Internal Revenue Service
Victoria A. Judson, Associate Chief Counsel (Tax Exempt & Government Entities), Internal Revenue Service
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Sunita Lough, Commissioner (Tax Exempt & Government Entities Division), Internal Revenue Service
Tamera Ripperda, Director (Exempt Organizations), Internal Revenue Service
Hon. Mark Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
Emily McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON CERTAIN REQUIREMENTS
FOR 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 John N. Bennett, Jennifer L. Franklin, Marisa Meltebeke and Jean Tom of the Exempt Organizations Committee of the Section of Taxation. The Comments were reviewed by David A. Shevlin, Chair of the Exempt Organizations Committee, Lisa Johnsen, Vice Chair of the Exempt Organizations Committee, and Carolyn (Morey) Ward, Vice Chair of the Exempt Organizations Committee. The Comments were further reviewed by LaVerne Woods of the Section’s Committee on Government Submissions; Stewart M. Weintraub, Council Director for the Exempt Organizations Committee; and Peter H. Blessing, the Section’s Vice Chair (Government Relations).

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

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Date:  
June 22, 2016
COMMENTS ON CERTAIN REQUIREMENTS FOR TYPE III SUPPORTING ORGANIZATIONS

EXECUTIVE SUMMARY

On February 19, 2016, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the “Service”) issued a Notice of Proposed Rulemaking\(^1\) containing proposed regulations (the “Proposed Regulations”)\(^2\) regarding, among other things, certain requirements for organizations exempt from federal income tax under section 501(c)(3),\(^3\) and classified as Type III supporting organizations described in section 509(a)(3)(B)(iii). Treasury and the Service have requested comments on all aspects of the Proposed Regulations.

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

1. The requirement that a Type III supporting organization must be responsive to each of its supported organizations.

2. The additional example included in the Proposed Regulations that clarifies that a Type III supporting organization may have a different qualifying relationship with each of its supported organizations and still satisfy the responsiveness test.

3. The revised definition of governmental supported organization.

4. The ability of a functionally integrated Type III supporting organization to support more than one governmental supported organization.

5. The ability of a non-functionally integrated Type III supporting organization to count certain fundraising expenses towards its annual distribution requirement.

We recommend that Treasury and the Service consider revisions to the Proposed Regulations that would:

1. Further clarify the following two points: (a) first, that a parent supporting organization can qualify as functionally integrated not only as the parent of its direct subsidiary but also as the parent of a second-tier or lower subsidiary, and (b) second, that a parent supporting organization must

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\(^3\) References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
have not only the power to appoint or elect officers, directors or trustees, but must also have the authority to remove and replace such officers, directors, or trustees, or otherwise have an ongoing power to exercise such appointment or election authority with reasonable frequency.

2. Include additional examples of activities that are typical of a parent supporting organization of an integrated system for purposes of determining whether such an organization meets the integral part test for a functionally integrated Type III supporting organization.

3. Include examples, in addition to the example of a hospital system, of “integrated systems” that may have a qualifying parent supporting organization for purposes of the integral part test for a functionally integrated Type III supporting organization, such as affiliated continuing care retirement communities, residential rehabilitation facilities, or private schools and universities.

4. Exclude from the definition of “control” at Proposed Regulation section 1.509(a)-4(f)(5)(ii) the control exercised by a parent supporting organization over its supported organizations, for purposes of the prohibition under section 509(f)(2) against a Type I or Type III supporting organization accepting gifts or contributions from a donor who controls a supported organization.

5. Permit a Type III supporting organization that supports a governmental supported organization and more than one non-governmental supporting organization to qualify as functionally integrated, so long as (a) the supporting organization conducts activities that perform the functions of and carry out the purposes of its governmental supported organization and (b) its non-governmental supported organizations operate in the same geographic region or work in close coordination with that governmental supported organization.

6. Conform the language in Proposed Regulation section 1.509(a)-4(i)(4)(iv)(A)(1)(ii), which refers to governmental supported organizations working “in close coordination or collaboration,” to similar language in Proposed Regulation section 1.509(a)-4(i)(4)(iv)(D), which, in elaborating upon the same requirement, refers to governmental supported organizations working in “close cooperation or coordination.”

7. Permit fundraising, grant-making and managing non-exempt use assets to qualify as activities that “directly further” the functions and purposes of governmental supported organizations for purposes of the integral part test for functionally integrated Type III supporting organizations.
8. Provide a clear definition of what constitutes a “substantial part” of a supporting organization’s activities for purposes of the provision in the Proposed Regulations that a Type III supporting organization to one or more governmental supported organizations will be considered functionally integrated only if a “substantial part” of its total activities directly furthers the exempt purposes of its governmental supported organization(s).

9. Provide that contributions which are received as a matter of convenience by a non-functionally integrated Type III supporting organization in connection with a fundraising solicitation for a supported organization be deemed as contributions received directly by the supported organization so long as (a) the supporting organization is contractually obligated to remit the contributions to the supported organization and (b) the contributions are actually distributed to the supported organization within a reasonable time period (e.g., 90 days).

10. Provide that fundraising expenses incurred by a non-functionally integrated Type III supporting organization in one fiscal year, where direct contributions from the solicitation are not received directly by a supported organization until the subsequent fiscal year, count towards the supporting organization’s distribution requirement for the first fiscal year, so long as the corresponding contributions are received by the supported organization within a reasonable time period following the end of that fiscal year (e.g., 90 days).

11. Address how a supported organization will track contributions for purposes of demonstrating that those contributions have been received directly by the supported organization from the solicitation activity of a non-functionally integrated Type III supporting organization.

12. Clarify that a writing, for purposes of the requirement that a supported organization substantiate the amount of contributions actually received by it in order for a non-functionally integrated Type III supporting organization to count expenses incurred to solicit those contributions towards its annual distribution requirement, includes an electronic mail message that is maintained in the non-functionally integrated Type III supporting organization’s electronic records.

13. Permit a non-functionally integrated Type III supporting organization that makes a program-related investment that carries out the supported organization’s purposes to count the program-related investment towards satisfaction of its annual distribution requirement.
DISCUSSION

Background

A supporting organization is defined as an organization which is (i) organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more public charities; (ii) operated, supervised or controlled by, supervised or controlled in connection with, or operated in connection with one or more public charities; and (iii) not controlled directly or indirectly by any disqualified person.\textsuperscript{4} Prior to the enactment of the Pension Protection Act of 2006 (the “PPA”),\textsuperscript{5} the applicable Regulations placed supporting organizations into three categories, or "types," based on the relationship between the supporting organization and its supported public charity or charities (known as “supported organizations”). The PPA amended the Code so that it reflects this division of supporting organizations among the three types: Type I, Type II and Type III, with Type III further subdivided into functionally integrated and non-functionally integrated categories.\textsuperscript{6}

On September 24, 2009, Treasury and the Service issued proposed regulations that refined the then-existing Code definitions of functionally integrated and non-functionally integrated Type III supporting organizations\textsuperscript{7} and included provisions requiring that every Type III supporting organization satisfy a notification requirement, in addition to continuing to meet a “responsiveness test” and continuing to demonstrate that it is an “integral part” of one or more supported organizations (the “2009 Regulations”).\textsuperscript{8} On April 27, 2010, the Committee on Exempt Organizations of the American Bar Association Section of Taxation submitted comments to the 2009 Regulations (the “Prior Comments”).\textsuperscript{9}

On December 28, 2012, Treasury and the Service finalized portions of the 2009 Regulations and issued temporary and proposed regulations that set forth an annual distribution requirement that a non-functionally integrated Type III supporting organization must satisfy to demonstrate that it is an “integral part” of one or more

\textsuperscript{4} See I.R.C. §§ 509(a)(3)(A), (B) and (C).
\textsuperscript{5} Public Law 109-280 (120 Stat. 780 (2006)).
\textsuperscript{6} See I.R.C. §§ 509(a)(3)(B) and 4943(f)(3).
\textsuperscript{7} The distinction between functionally integrated and non-functionally integrated Type III supporting organizations is significant for a private non-operating foundation, because a grant from the foundation to a non-functionally integrated Type III supporting organization does not count towards the foundation’s annual five percent payout obligation and requires expenditure responsibility to avoid an excise tax under section 4945. The distinction is also significant for a sponsoring organization of donor advised funds, which must exercise expenditure responsibility over a grant to a non-functionally integrated Type III supporting organization to avoid an excise tax under section 4966.
\textsuperscript{8} Notice of Proposed Rulemaking, “Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated,” 74 Fed. Reg. 48,672 (September 24, 2009).
supported organizations (the “2012 Regulations”). On December 23, 2015, Treasury and the Service issued final regulations adopting that annual distribution requirement without substantive modification (the “2015 Regulations”).

1. Responsiveness Test for Type III Supporting Organizations with Multiple Supported Organizations.

Under the 2012 Regulations, all Type III supporting organizations must satisfy a responsiveness test by demonstrating that one of three alternative relationships exist between the officers, directors or trustees of the supporting organization and the supported organization, with that relationship resulting in the officers, directors or trustees of the supported organization having a significant voice in directing the use of the supporting organization’s income and assets. The three alternative relationships are: (a) one or more officers, directors or trustees of the supporting organization are elected or appointed by the officers, directors, trustees or members of the supported organization; (b) one or more members of the supported organization’s governing body also are officers, directors or trustees of, or hold important offices in, the supporting organization; or (c) 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. The Preamble to the 2012 Regulations stated that Treasury and the Service intended (x) to issue proposed regulations clarifying that Type III supporting organizations must be responsive to all of their supported organizations, and (y) to request comments regarding, and continue to consider, how Type III supporting organizations could satisfy the responsiveness test, including through additional examples.

2. Integral Part Test for Functionally Integrated Type III Supporting Organizations.

Whether a Type III supporting organization is classified as functionally integrated or non-functionally integrated depends on how the organization meets the “integral part” test. The 2012 Regulations provided that, to satisfy the integral part test as a functionally integrated Type III supporting organization, a Type III supporting organization must satisfy one of three alternative requirements: (a) the supporting organization must engage in activities substantially all of which “directly further” the exempt purposes of one or more supported organizations and which, but for the involvement of the supporting organization, would normally be engaged in by the supported organizations; (b) the

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12 See Reg. § 1.509(a)-4(i)(3).

13 See Reg. § 1.509(a)-4(i)(3)(ii).

supporting organization must be the parent of each of its supported organizations; or (c) the supporting organization must support a governmental supported organization.  

For purposes of the first alternative, the 2012 Regulations clarified that fundraising, making grants and investing and managing non-exempt use (i.e., investment) assets are not activities that “directly further” the exempt purposes of a supported organization.  

For purposes of the second alternative, the 2012 Regulations provided that a supporting organization would be the parent of a supported organization if the supporting organization exercises a substantial degree of direction over the policies, programs and activities of the supported organization and a majority of the officers, directors or trustees of the supported organization are appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacities) of the supporting organization. However, the Preamble to the 2012 Regulations also stated that Treasury and the Service intended to issue proposed regulations in the future that would include a new definition of “parent” for purposes of the integral part test for functionally integrated Type III supporting organizations and that definition would specifically address the power to remove and replace officers, directors or trustees of the supported organization.  

For purposes of the third alternative, the 2009 Regulations provided that a functionally integrated Type III supporting organization could support only a single governmental entity. The 2012 Regulations then withdrew this provision and reserved as to how a Type III supporting organization could qualify as functionally integrated to a governmental entity. Under language in the Preamble to the 2012 Regulations, Type III supporting organizations to governmental entities have been permitted (and, under the Proposed Regulations, are still permitted) to continue to qualify as functionally integrated by meeting the “but for” test set forth in the regulations in effect prior to the enactment of the 2012 Regulations (i.e., the “Prior Regulations”) during a transitional period.

15 See Reg. § 1.509(a)-4(i)(4)(i).
16 See Reg. § 1.509(a)-4(i)(4)(ii)(C).
17 See Reg. § 1.509(a)-4(i)(4)(iii).
20 See Reg. § 1.509(a)-4(i)(4)(iv).
22 Under the 2012 Regulations, the transitional period for reliance on the “but for” test in the Prior Regulations was until the first day of a Type III supporting organization’s second taxable year beginning after December 28, 2012. In IRS Notice 2014-4, 2014-2 IRB 274, this transition period was extended until the earlier of the date that final regulations are published under Regulation section 1.509(a)-4(i)(4)(iv) or
3. **Integral Part Test for Non-Functionally Integrated Type III Supporting Organizations: Annual Distribution Requirement.**

In order to satisfy the integral part test, a non-functionally integrated Type III supporting organization must meet both an annual distribution requirement and an attentiveness requirement.\(^{23}\)

The 2012 Regulations proposed, and the 2015 Regulations finalized, an annual distribution requirement for non-functionally integrated Type III supporting organizations. Pursuant to the annual distribution requirement, a non-functionally integrated Type III supporting organization must distribute annually a “distributable amount” equal to the greater of (i) 85\% of its adjusted net income, or (ii) three and one-half percent of the fair market value of its non-exempt-use assets, measured as of the preceding taxable year.\(^{24}\)

For purposes of the annual distribution requirement, the 2012 Regulations provided that distributions which qualify towards satisfying the requirement would include but would not be limited to: (a) any amount paid to a supported organization to accomplish the supported organization’s exempt purposes;\(^{25}\) (b) any amount paid by the supporting organization to perform an activity that directly furthers the exempt purposes of the supported organization that, but for the supporting organization’s involvement, would normally be engaged in by the supported organization, but only to the extent that expenditures on the activity exceed the revenue derived from the activity;\(^{26}\) (c) any reasonable and necessary administrative expenses paid to accomplish the exempt purposes of a supported organization, except for those expenses incurred in the production of investment income;\(^{27}\) (d) any amount paid to acquire an exempt-use asset;\(^{28}\) and (e) any amount set aside for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive.\(^{29}\) The Preamble to the 2012 Regulations stated that future proposed regulations would address in further detail (a) the types of expenditures that would or would not count towards a non-functionally integrated Type III supporting organization’s annual distribution requirement, and (b) whether program-related investments would count towards a non-

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\(^{23}\) As the attentiveness requirement is not addressed in the Proposed Regulations, further detail regarding the attentiveness requirement has not been included in these comments.

\(^{24}\) *See Reg. § 1.509(a)-4(i)(5)(ii).*

\(^{25}\) *See Reg. § 1.509(a)-4(i)(6)(i).*

\(^{26}\) *See Reg. § 1.509(a)-4(i)(6)(ii).*

\(^{27}\) *See Reg. § 1.509(a)-4(i)(6)(iii).*

\(^{28}\) *See Reg. § 1.509(a)-4(i)(6)(iv).*

\(^{29}\) *See Reg. § 1.509(a)-4(i)(6)(v).*
functionally integrated Type III supporting organization’s annual distribution requirement.30

Summary of the Proposed Regulations

The Proposed Regulations set forth clarifications and additional requirements applicable to Type III supporting organizations, including (i) clarification of the application of the responsiveness requirements to Type III supporting organizations that support more than one supported organization; (ii) additional requirements for how a Type III supporting organization meets the integral part test necessary for qualification as functionally integrated by reason of either being (A) a parent supporting organization to one or more supported organizations, or (B) a supporting organization to a governmental entity; and (iii) clarification of the annual minimum distribution requirement for a non-functionally integrated Type III supporting organization.

1. Clarification of Responsiveness Test for Type III Supporting Organizations with Multiple Supported Organizations.

Consistent with language in the Preamble to the 2012 Regulations, the Proposed Regulations clarify that a Type III supporting organization is required to be responsive to each of its supported organizations in order to meet the responsiveness test.31 In the Preamble to the Proposed Regulations, Treasury and Service have noted that limiting the responsiveness test to fewer than all of the supported organizations could result in the supported organizations having the necessary oversight and accountability over less than all of a supporting organization’s operations.32

In addition, an example has been included in the Proposed Regulations to demonstrate one way in which a Type III supporting organization that supports multiple supported organizations may satisfy the responsiveness test.33 In particular, the example shows that a supporting organization may, with respect to each of its supported organizations, demonstrate that it has one of the three alternative relationships set forth in Regulation section 1.509(a)-4(i)(3)(ii) with each supported organization and is not required to have the same kind of relationship with all of its supported organizations.34


34 See id.
2. Clarification of Integral Part Test for Functionally Integrated Type III Supporting Organizations For Parent Supporting Organizations to Supported Organizations and Supporting Organizations to Governmental Entities.

a. Parent Supporting Organizations to Supported Organizations.

The Proposed Regulations add a new requirement that a Type III supporting organization must meet to qualify as functionally integrated by reason of being the parent of supported organizations. Specifically, in order for a Type III supporting organization to qualify as the parent of each of its supported organizations, and hence be functionally integrated, the supporting organization and the supported organizations must be part of an integrated system, such as a hospital system, and the supporting organization must engage in activities typical of the parent of an integrated system.\(^{35}\) The Proposed Regulations further provide that examples of activities typical of the parent of an integrated system of supported organizations include (but are not limited to) coordinating the activities of the supported organizations and engaging in overall planning, policy development, budgeting and resource allocation for the supported organizations.\(^{36}\) Treasury and the Service have requested comments on what activities are typical of the parent of an integrated system and whether additional activities should be explicitly listed as examples.

The Proposed Regulations retain the requirement from the 2012 Regulations that a majority of the officers, directors or trustees of each supported organization must be appointed or elected, directly or indirectly, by the governing body, members of the governing body or officers (acting in their official capacities) of the supporting organization.\(^{37}\) In the Preamble to the Proposed Regulations, Treasury and the Service have clarified that the use of the phrase “appointed or elected, directly or indirectly” means the supporting organization can qualify as functionally integrated by reason of being the parent of a second-tier (or lower) subsidiary.\(^{38}\) Furthermore, Treasury and the Service have clarified, in the Preamble to the Proposed Regulations, that the parent organization must not only have the power to appoint or elect a majority of the officers, directors or trustees of each supported organization but also have the power to remove and replace such officers, directors or trustees or otherwise have an ongoing power to appoint or elect individuals to those positions with reasonable frequency.\(^{39}\) Finally,


\(^{36}\) See id.

\(^{37}\) See id.

\(^{38}\) See Notice of Proposed Rulemaking, “Requirements for Type I and Type III Supporting Organizations,” 81 Fed. Reg. 8446, 8450 (February 19, 2016). The Preamble provides the following example of how a supporting organization could be the parent of a lower-tier subsidiary: the directors of supporting organization A appoint a majority of the directors of supported organization B, which in turn appoints a majority of the directors of supported organization C, the directors of supporting organization A will be treated as appointing the majority of the directors of both supported organization B and supported organization C.

\(^{39}\) See id.
Treasury and the Service have requested comments on whether this provision of the Proposed Regulations should be amended to provide further clarification on this point.\textsuperscript{40}

\textbf{b. Supporting Organizations to Governmental Entities.}

The Proposed Regulations provide that a Type III supporting organization may be treated as functionally integrated by supporting one or more “governmental supported organizations,” so long as (i) one or more governmental supported organizations are the only organizations supported; (ii) if more than one governmental supported organization is supported, all of the governmental supported organizations either (A) operate within the same geographic region,\textsuperscript{41} or (B) work in close coordination or collaboration with one another to conduct a service, program or activity that the supporting organization supports;\textsuperscript{42} and (iii) a “substantial part” of the supporting organization’s total activities are activities that “directly further” the exempt purposes of its governmental supported organization(s).\textsuperscript{43} Under the Proposed Regulations, whether a particular activity “directly furthers” the exempt purposes of a governmental supported organization is evaluated under the same standard set forth in the first alternative for satisfying the integral part test for a functionally integrated Type III supporting organization.\textsuperscript{44} This means that, generally speaking, fundraising, grant-making and managing non-exempt use (\textit{i.e.}, investment) assets are not qualifying activities for a supporting organization to a governmental supported organization.\textsuperscript{45} However, Treasury and the Service highlight in the Preamble to the Proposed Regulations that the use of the words “substantial part” rather than the words “substantially all” in the Proposed Regulations gives some flexibility to Type III supporting organizations to governmental supported organizations to qualify as functionally integrated even if an insubstantial part of their activities consist of fundraising, grant-making and managing investment assets.\textsuperscript{46}

The Proposed Regulations define a “governmental supported organization” as a supported organization that is (i) a governmental unit described in section 170(c)(1) or (ii) an organization described in sections 170(c)(2) and 170(b)(1)(A) (other than a private foundation described in section 170(b)(1)(A)(vi) and a public charity described in section 509(a)(2) or (a)(3)) that is an instrumentality of one or more governmental units

\textsuperscript{40} See id.
\textsuperscript{42} The Proposed Regulations state that this requirement is met if “the supporting organization maintains on file a letter from each of the governmental supported organizations (or a joint letter from all of them) describing their collaborative or cooperative efforts with respect to the particular service, program, or activity.” See Prop. Reg. § 1.509(a)-4(i)(4)(iv)(D), 81 Fed. Reg. 8453, 8454 (2016).
\textsuperscript{45} See Reg. § 1.509(a)-4(i)(4)(ii)(A).
\textsuperscript{46} See Notice of Proposed Rulemaking, “Requirements for Type I and Type III Supporting Organizations,” 81 Fed. Reg. 8446, 8451 (February 19, 2016).
described in section 170(c)(1). In the Preamble to the Proposed Regulations, Treasury and the Service have noted that a governmental unit described in section 170(c)(1) includes all of the agencies, departments and divisions of the governmental unit, which are collectively treated as one governmental supported organization. Treasury and the Service have requested comments on the proposed definition of a governmental supported organization.

Furthermore, the Proposed Regulations contain a special rule for existing Type III supporting organizations that support both governmental entities and non-governmental entities to qualify as functionally integrated. Under this special rule, a Type III supporting organization in existence on February 19, 2016 is treated as functionally integrated so long as (i) it supports one or more governmental supported organizations and not more than one other supported organization that is not a governmental supported organization; (ii) each of its supported organizations is designated by the supporting organization by name in its articles of organization (or otherwise meets the requirements for designating supported organizations to a Type III supporting organization set forth in Regulation section 1.509(a)-4(d)(4)) on or before February 19, 2016; and (iii) a substantial part of the supporting organization’s total activities are activities that “directly further” (as discussed above) the exempt purposes of the governmental supported organization(s).

3. Integral Part Test for Non-Functionally Integrated Type III Supporting Organizations: Clarification of Annual Distribution Requirement.

The Proposed Regulations now make exclusive the formerly non-exclusive list of distributions that count towards a non-functionally integrated Type III supporting organization’s annual distribution requirement in the 2012 Regulations; in other words, the Proposed Regulations limit distributions that count towards the requirement to only the five categories of distributions specified in Regulation section 1.509(a)-4(i)(6)(i) through (v) (and summarized above).

In addition, the Proposed Regulations clarify that reasonable and necessary administrative expenses paid to accomplish the exempt purposes of the supported organization(s) that count towards the distribution requirement do not include expenses incurred in the conduct of fundraising activities. However, under an exception in the Proposed Regulations, reasonable and necessary expenses incurred to solicit

51 See id.
contributions that are received directly by a supported organization do count, but only to the extent that the amount of such expenses does not exceed the amount of contributions actually received by the supported organization as a result of the solicitation, as substantiated in writing by the supported organization. 54

Finally, the Preamble to the Proposed Regulations states that Treasury and the Service do not believe that program-related investments made by a non-functionally integrated Type III supporting organization should count towards the annual distribution requirement.55

Comments on the Proposed Regulations

1. Responsiveness Test for Type III Supporting Organizations with Multiple Supported Organizations.

We are in agreement that a Type III supporting organization must be responsive to each of its supported organizations. In particular, we find helpful the additional example included in the Proposed Regulations that clarifies that a Type III supporting organization may have a different qualifying relationship with each of its supported organizations and still satisfy the responsiveness test.

2. Integral Part Test for Functionally Integrated Type III Supporting Organizations.

a. Parent Supporting Organization to Supported Organizations.

We have the following comments with respect to the provisions in the Proposed Regulations setting forth the requirements that a Type III supporting organization must satisfy in order to meet the integral part test and be considered functionally integrated by virtue of being the parent of each of its supported organizations.

We have also included here a recommendation that the definition of “control” under Proposed Regulation section 1.509(a)-4(f)(5)(ii) exclude the control that a parent supporting organization exercises over its supported organizations for purposes of the prohibition against a Type I and Type III supporting organization accepting gifts or contributions from a donor that controls a supported organization.

i. Authority of Parent.

The Preamble to the Proposed Regulations notes that Treasury and the Service interpret the authority of a functionally integrated parent supporting organization to “appoint or elect, directly or indirectly,” a majority of the officers, directors or trustees of its supported organizations to encompass two additional points: (a) first, a supporting

organization can qualify not only as the parent of its direct subsidiary but also as the parent of a second-tier or lower subsidiary, and (b) second, a parent supporting organization must not simply have the power to appoint or elect officers, directors or trustees, but must also have the authority to remove and replace such officers, directors, or trustees, or otherwise have an ongoing power to exercise such appointment or election authority with reasonable frequency. We agree with these interpretations, but think that further clarification in the Regulations with respect to these two additional points, either by including the language from the Preamble directly in the Regulations or some alternative language addressing the same points, would be helpful. We recommend that Treasury and the Service expressly address both issues in the final Regulations.

ii. Typical Activities of a Parent of an Integrated System.

The Preamble also states that a parent supporting organization must be part of an integrated system with its supported organizations (such as in a hospital system) and provides a few examples of what activities typical of a parent supporting organization in an integrated system would include, such as activity coordination, overall planning, policy development, budgeting and resource allocation. We are in favor of including additional examples of activities that are typical of a parent of an integrated system. Such examples might include financial planning and forecasting, legal services, human resources, information management, billing and collection services, marketing, and community outreach and education. Relatedly, we recommend that the final Regulations provide additional examples other than a hospital system that reflect the type of “integrated systems” that may have a qualifying functionally integrated parent supporting organization. Such examples might include affiliated continuing care retirement communities, residential rehabilitation facilities, or private schools and universities.

iii. Definition of “Control” for Purposes of the Prohibition against Type I and Type III Supporting Organizations Accepting Contributions from “Controlling” Donors under Section 509(f)(2).

We recommend that Proposed Regulation section 1.509(a)-4(f)(5)(ii) be revised to address what we believe to be an unintended consequence of the prohibition under section 509(f)(2) and Regulation section 1.509(a)-4(f)(5) against Type I and Type III supporting organizations accepting gifts or contributions from a donor who controls a supported organization. We believe that the prohibition should not apply to contributions from a parent organization that is a supporting organization to its lower-tier affiliates that are Type I or Type III supporting organizations, and that applying the prohibition to contributions from the parent organization in such circumstances could seriously impede the flow of funds among section 501(c)(3) organizations in an integrated system.

Under section 509(f)(2), a Type I or Type III supporting organization is prohibited from accepting any gift or contribution from any person who directly or

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57 See id.
indirectly controls the governing body of a supported organization, either alone or together with any family members of such person, or from an entity in which such persons own more than 35% of the interests. For these purposes, a “person” includes both individuals and legal entities. The definition of “person” excludes organizations described in sections 509(a)(1),(2) and (4), but it does not exclude supporting organizations under section 509(a)(3). A Type I or Type III supporting organization that accepts such a contribution will fail to qualify as a supporting organization and will instead be classified as a private foundation, unless it can demonstrate that it qualifies as a public charity on another basis.

The 2015 Regulations specifically contemplate that a supporting organization that is the parent of all of the supported organizations in an integrated system may qualify as a functionally integrated Type III supporting organization. A supporting organization is the parent of a supported organization if the supporting organization “exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and a majority of the officers, directors, or trustees of the supported organization is appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacity) of the supporting organization.” A Type II supporting organization may also be a parent of an integrated system, if the control or management of the supporting organization is vested in the same persons that control or manage the supported organizations.

The supported organizations in an integrated group in which a supporting organization is the parent may themselves have other Type I and Type III supporting organizations that support them. For example, the supporting organization parent of a hospital system may be the sole member of several supported organizations that operate hospitals, and each of those hospital supported organizations may have a lower-tier supporting organization that holds endowment or engages in activities in support of the hospital organization. The parent organization will generally appoint a majority of the directors or trustees of the supported organizations, or, in the case of a Type II supported organizations, a majority of the parent board will also constitute a majority of the supported organization’s board. This means that for purposes of section 509(f)(2), the parent organization controls the governing body of its supported organizations, which are also supported organizations to the lower-tier Type I and Type III supporting organizations within the integrated system. This in turn means that any allocation of funds from the parent to the Type I and Type III supporting organizations could be a gift or contribution from a controlling donor that would cause the Type I and Type III supporting organizations to fail to qualify as supporting organizations.

58 See I.R.C. § 7701(a)(1).
60 See Reg. § 1.509(a)-4(f)(5)(i).
61 See Reg. § 1.509(a)-4(i)(4)(i)(B).
62 See Reg. § 1.509(a)-4(i)(4)(iii).
63 See Reg. § 1.509(a)-4(h)(1).
We believe that the policy reasons for prohibiting Type I and Type III supporting organizations from accepting gifts from donors who control their supported organizations do not apply to situations in which the donor is the supporting organization parent of an integrated system. Accordingly, we recommend that the final Regulations address this unintended result by excluding from the definition of control for purposes of section 509(f)(2) at Proposed Regulation section 1.509(a)-4(f)(5)(ii) the control exercised by a parent supporting organization over its supported organizations.

b. Supporting Organizations to Governmental Entities.

We have several comments to the provisions in the Proposed Regulations that relate to Type III supporting organizations that support governmental entities.

i. Definition of Governmental Supported Organization.

We endorse the definition of “governmental supported organization” included in the Proposed Regulations, which provides that a governmental supported organization is (a) a governmental unit described in section 170(c)(1) or (b) an organization described in sections 170(c)(2) and 170(b)(1)(A) (other than in clauses (vii) and (viii)) that is an instrumentality of one or more governmental units described in section 170(c)(1). The definition is significantly clearer than the definition included in the 2009 Regulations.

ii. Number and Type of Supported Organizations.

We agree with the provision in the Proposed Regulations that allows a functionally integrated Type III supporting organization to support more than one governmental supported organization.\(^64\) We also agree with Treasury and the Service that limiting functionally integrated Type III supporting organizations that wish to support multiple governmental supported organizations to supporting governmental supported organizations that are located within the same geographic region or that work in close coordination or collaboration with each other is reasonable, as such a limitation provides additional certainty that the governmental supported organizations will maintain appropriate oversight over their supporting organizations.\(^65\)

We recommend, however, that the language in Proposed Regulation section 1.509(a)-4(i)(4)(iv)(A)(1)(ii), which refers to close *coordination or collaboration*, be made consistent with the language in Proposed Regulation section 1.509(a)-4(i)(4)(iv)(D), which refers to close *cooperation or coordination*. We do not have a view as to which formulation is preferable, but for the sake of clarity we recommend that the provisions use consistent language.

Further, we suggest that Treasury and the Service reconsider in the final Regulations, the provision that a Type III supporting organization that supports a

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\(^65\) See id.
governmental supported organization will not be functionally integrated if it also supports more than one non-governmental supported organization.\(^{66}\)

For example, a Type III supporting organization that functions as part of a public-private partnership may engage in activities that directly further the purposes of a governmental supported organization, while also directly furthering the purposes of other supported organizations which, while operating within the same geographic region or working in close coordination or collaboration with a governmental supported organization, are not themselves governmental supported organizations. Consider, for example, a Type III supporting organization that supports a network of public parks in a city (e.g., via providing regular clean-up and repairs at such public parks). The supporting organization may support a governmental supported organization – the city, which is responsible for the upkeep of the public parks – as well as a number of publicly supported charities, each of which operates to preserve or beautify a specific public park. In such a case, the activities of the various non-governmental supported organizations are concentrated in the same geographic region as the governmental supported organization (i.e., the city) and the supported organizations work in collaboration to conduct a specific activity (i.e., upkeep of public parks). We do not see a concern with permitting the supporting organization also to support more than one non-governmental supported organization where such supported organizations further exempt purposes substantially similar to those of the governmental supported organization, so long as such non-governmental supported organizations operate in the same geographic region or work in close coordination or collaboration (or close cooperation or coordination) with the governmental supported organization. (This assumes that substantially all of the supporting organization’s activities are activities that “directly further” the exempt purposes of its governmental supported organization.\(^{67}\)

Accordingly, we recommend that Treasury and the Service provide, in the final Regulations, that a Type III supporting organization that supports a governmental supported organization and more than one non-governmental supported organization may qualify as functionally integrated, so long as (a) it conducts activities that perform the functions of and carry out the purposes of its governmental supported organization and (b) its non-governmental supported organizations operate in the same geographic region or work in close coordination or collaboration (or close cooperation or coordination) with that governmental supported organization.

\(^{66}\) Although the Proposed Regulations contain a provision under which existing supporting organizations that support a governmental supported organization as well as a non-governmental supported organization may continue to qualify as functionally integrated, that provision is limited to \textit{existing} supporting organizations that have only one non-governmental supported organization. \textit{See} Prop. Reg. § 1.509(a)-4(i)(4)(iv)(E), 81 Fed. Reg. 8453, 8454 (2016).

iii. Fundraising, Grant-making & Managing Non-Exempt-Use Assets.

The Preamble to the Proposed Regulations notes that two commenters to the 2009 Regulations stated that fundraising, grant-making and managing non-exempt use (i.e., investment) assets should be considered activities that directly further the exempt purposes of a governmental supported organization. The Proposed Regulations did not adopt the comments. The Preamble to the Proposed Regulations states that in providing that a Type III supporting organization will be considered functionally integrated if a substantial part, but not substantially all, of its total activities directly furthers the exempt purposes of its governmental supported organization(s), the Proposed Regulations permit a Type III supporting organization sufficient flexibility to engage in some fundraising, grant-making or management activities on behalf of its governmental supported organization(s). For the reasons set forth below, we agree with the commenters.

Treasury and the Service expressed a concern in the Preamble to the Proposed Regulations that a Type III supporting organization should qualify as functionally integrated only if the supporting organization conducts activities that perform the functions of or carry out the purposes of its supported organizations (i.e., activities that “directly further” those functions or purposes), as opposed to providing financial support for the activities carried out by the supported organization (i.e., through fundraising, grant-making and managing investment assets). The Preamble states that there should not be a different definition of “directly further” that applies only to supporting organizations that support governmental supported organizations. While we understand the desire for consistency, in our view there is a critical difference between Type III supporting organizations that support governmental supported organizations and Type III supporting organizations that support non-governmental supported organizations that makes applying a different definition of “directly further” not only reasonable but also desirable from a policy perspective.

Specifically, fundraising is often a critical activity of Type III supporting organizations that support governmental supported organizations. By fundraising for a governmental supported organization and granting the funds raised to the governmental supported organization from time to time, a supporting organization keeps the funds raised separate from the accounts of the governmental supported organization. This can help to ensure that a governmental supported organization remains well-funded, because the funds raised, held and granted by the supporting organization will be protected from changes in budgeting or re-allocation of funds across governmental units. Budgets for governmental units may change frequently, e.g., as a result of a change in personnel.

70 See id.
71 See id.
following an election, to make up for shortfalls in other areas of government, etc. Fundraising for non-governmental supported organizations does not present the same issues. The case for permitting Type III supporting organizations of governmental supported organizations to include fundraising on behalf of, and grantmaking to, a governmental supported organization as activities that directly further the functions or purposes of the governmental supported organization is much more compelling than for Type III supporting organizations that support non-governmental supported organizations. We recommend that Treasury and the Service reconsider this issue and include, in the final Regulations, fundraising, grant-making and managing investment assets as activities that “directly further” the functions and purposes of governmental supported organizations.

iv. “Substantial Part.”

As discussed above, the Proposed Regulations provide that a Type III supporting organization will be considered functionally integrated if a “substantial part” of its total activities directly furthers the exempt purposes of its governmental supported organization(s). Neither the Preamble to the Proposed Regulations nor the Proposed Regulations themselves defines a “substantial part” for these purposes, however.

The Code and the Regulations apply a “substantial part” standard in other contexts involving tax-exempt organizations. For example, a public charity must receive a substantial part of its support from a governmental unit or from direct or indirect contributions from the general public, and no substantial part of the activities of a public charity may consist of carrying on propaganda or otherwise attempting to influence legislation. There is no consistent definition in the Code or Regulations of what constitutes a “substantial part,” however. If Treasury and the Service retain the “substantial part” requirement in the final Regulations, we recommend that Treasury and the Service consider providing in the final Regulations a clear definition of what constitutes a “substantial part” of a supporting organization’s activities for these purposes.

3. Integral Part Test for Non-Functionally Integrated Type III Supporting Organizations.

We are endorse the provision in the Proposed Regulations that allows a non-functionally integrated Type III supporting organization to count fundraising expenses incurred to solicit contributions received directly by a supported organization towards its annual distribution requirement. Many non-functionally integrated Type III supporting

\[72 \text{ See id.}\]

\[73 \text{ See I.R.C. § 170(b)(i)(A)(vi).}\]

\[74 \text{ See I.R.C. § 501(c)(3).}\]

\[75 \text{ For example, for purposes of section 170(b)(1)(A)(vi), Regulation section 1.170A-9(f)(1)(ii) provides that 33 1/3% of an organization’s support is considered a “substantial part,” while there is no bright line rule as to what constitutes a “substantial part” for purposes of the lobbying activity limitation of section 501(c)(3).}\]
organizations are formed expressly to solicit (and receive) contributions for their supported organizations. Under the exception, the fundraising expenses count towards the non-functionally integrated Type III supporting organization’s annual distribution requirement only if (a) the amount of those expenses does not exceed the amount of contributions actually received by the supported organization, and (b) the supported organization substantiates the amount of contributions actually received in writing. However, as explained in further detail below, there are several aspects of how the exception will work in practice that we want to bring to the attention of Treasury and the Service.

First, as noted above, non-functionally integrated Type III supporting organizations are often formed to solicit, and also receive, contributions on behalf of their supported organizations. This is often done to segregate those contributions from the supported organization’s operating assets. We recommend that Treasury and the Service consider addressing, in the final Regulations, the situation in which a non-functionally integrated Type III supporting organization embarks on a fundraising campaign on behalf of a supported organization pursuant to which the supporting organization, for the sake of convenience, receives contributions on behalf of the supported organization and is contractually obligated to remit those contributions to the supported organization within a reasonable time period of receipt. We propose that the final Regulations provide that contributions which are received as a matter of convenience by a non-functionally integrated Type III supporting organization in connection with a fundraising solicitation for a supported organization be deemed as contributions received directly by the supported organization so long as (a) the supporting organization is contractually obligated to remit the contributions to the supported organization and (b) the contributions are actually distributed to the supported organization within a reasonable time period (e.g., 90 days).

In addition, we recommend that Treasury and the Service consider addressing, in the final Regulations, how the exception will apply in the case of fundraising events and campaigns where the solicitation activity of the non-functionally integrated Type III supporting organization occurs (and expenses are incurred) late in one fiscal year but direct contributions from the solicitation may not be received by the supported organization until sometime during the next fiscal year. We propose that under those circumstances, the final Regulations provide that the expenses incurred by the non-functionally integrated Type III supporting organization in the first fiscal year count towards the supporting organization’s distribution requirement for that year, so long as the corresponding contributions are received by the supported organization within a reasonable time period following the end of that fiscal year (e.g., 90 days).

Furthermore, we recommend that Treasury and the Service consider addressing, in the final Regulations, how a supported organization will “track” contributions for purposes of demonstrating that contributions have been received directly from solicitation activity of a non-functionally integrated Type III supporting organization (rather than solicitation activity of the supported organization). That tracking process may get complicated, for example, when both the supporting organization and the supported organization are soliciting contributions simultaneously. Treasury and the Service could
consider, for example, providing in the final Regulations that a supported organization may allocate contributions received by the supported organization between the supporting organization and the supported organization based on that portion of the total solicitation budget funded by the supported organization and the supporting organization (i.e., such that if the supported organization paid for 60% of a particular solicitation campaign and its supporting organization paid for the remaining 40% of such campaign, the supported organization would allocate 40% of the contributions received to the supporting organization for tracking purposes).

Finally, we recommend that Treasury and the Service clarify in the final Regulations that a writing, for purposes of the substantiation requirement, includes an electronic mail message that is maintained in the non-functionally integrated Type III supporting organization’s electronic records.

We note that the Proposed Regulations do not permit a non-functionally integrated Type III supporting organization to count a program-related investment towards its annual distribution requirement. The Preamble states that while private foundations may use program-related investments in a variety of ways to accomplish their exempt purposes and that program-related investments are treated as qualifying distributions under section 4942, “because supporting organizations must be operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of their supported organizations, they differ from private foundations.” While supporting organizations may differ from private foundations in that their purposes are restricted to furthering the purposes of their supported organizations, the Preamble does not provide a rationale for why a supporting organization that makes a program-related investment that carries out the purposes of its supported organization should not be able to count the program-related investment as a distribution to the supported organization in the same manner that a private foundation may treat a program-related investment as a qualifying distribution under section 4942. For example, a supporting organization that supports a section 501(c)(3) public charity that provides for the needs of the homeless and which makes a low-interest loan to finance the construction of homeless shelters in a manner that would qualify the loan as a program-related investment should be able to treat that loan as a distribution to the supported organization. We encourage Treasury and the Service to reconsider their position and permit, in the final Regulations, a non-functionally integrated Type III supporting organization to treat a program-related investment as a distribution that counts towards its annual distribution requirement.

Conclusion

We appreciate the opportunity to comment on the Proposed Regulations.