



## **Analysis of Type III Supporting Organization Regulations Issued December 28, 2012**

On December 28, 2012, the Treasury Department and IRS issued [final and temporary regulations](#) on Type III supporting organizations. Simultaneously, [proposed regulations](#) were issued regarding payout for Type III non-functionally integrated supporting organizations. This analysis focuses on the areas specifically addressed by the issued regulations but, for general background on all three types of supporting organizations, see the supporting organization section at [www.cof.org/ppa](http://www.cof.org/ppa).

### **Summary**

The Pension Protection Act of 2006 imposed new rules on the operation of Type III supporting organizations and segregated such organizations into two categories: functionally related and non-functionally integrated. Type III supporting organizations are public charities that obtain their public charity status because of a specific relationship with one or more organizations described in section 509(a)(1) or 509(a)(2). Supported organizations are generally other public charities or government units. Compared to other types of supporting organizations, Type III supporting organizations operate with the greatest degree of independence from the organization(s) they support. Typically, a supported organization appoints one member of the governing board of the supporting organizations and institutes other procedures designed to ensure that the supporting organization is responsible to it.

On September 24, 2009, the Treasury Department issued proposed regulations addressing Type III supporting organizations. The Council's analysis of and comments on those proposed regulations are available under the "PPA Update" section at [www.cof.org/ppa](http://www.cof.org/ppa). On December 28, 2012, the Treasury Department issued final regulations addressing the responsiveness and integral part test for Type III functionally integrated and non-functionally integrated supporting organizations, the notice requirements for all Type III supporting organizations, and several other provisions changed by the Pension Protection Act. The regulations regarding the payout calculation for non-functionally integrated Type III supporting organizations were issued as temporary and proposed regulations to allow an opportunity to comment. Comments are due March 28, 2013.

In addition to Type III supporting organizations themselves, these regulations will be of interest to community foundations and other public charities serving as supported organizations. These will also be of interest to private foundations and sponsoring organizations of donor advised funds making grants to Type III supporting organizations and trying to determine whether a potential Type III supporting organization is functionally integrated or non-functionally integrated.

### **Annual Notice Requirement**

The final regulations provide that any Type III supporting organization must provide to each of its supported organizations the following information for each taxable year:

- A written notice addressed to a principal officer of the supported organization describing the amount and type of support provided to the supported organization during the previous

taxable year. The principal officer is someone who has ultimate responsibility for implementing the decisions of the governing body of the supported organization; supervising the management, administration, or operation of the supported organization; or managing the finances of the supporting organization.

- A copy of the supporting organization's most recently filed Form 990 or a link to the document. Note that the names and addresses of contributors on Schedule B of Form 990 may be redacted in the version provided to the supported organization.
- A copy of the supporting organization's governing documents (e.g., articles of incorporation, bylaws) including any amendments. If the documents have been previously provided to the supported organization and not subsequently amended, the supporting organization does not have to provide these documents.

In terms of timing, the final regulations state that these documents must be postmarked or electronically transmitted by the last day of the fifth calendar month following the close of the supporting organization's taxable year. For example, if a supporting organization is on a calendar tax year, the documents would need to be postmarked or transmitted to each supported organization by May 31 of each year and report on support provided in the previous tax year. Note that this notice requirement is not subject to extension. If the supporting organization has filed an extension for its Form 990, it should simply submit the most recently filed version to the supported organization in order to meet the annual notice requirement.

The final regulations do provide some transition relief so that Type III supporting organizations may have time to prepare their initial notice to their supported organizations. For the initial notification only, Type III supporting organizations currently in existence have until the later of the last day of the fifth calendar month following the close of the supporting organization's taxable year or the due date for the Form 990 for that taxable year, including extensions.

## **Responsiveness Test**

All Type III supporting organizations must meet a responsiveness test. To meet the responsiveness test, a supporting organization must have one of three defined relationships with its supported organizations and these relationships must give the supported organization "a significant voice" in the supporting organization's investment policies, its grantmaking, and in "otherwise directing the use of the income or assets of such supporting organization." (Treas. Reg. § 1.509(a)-4(i)(2)(ii).) The three relationships are:

- One or more of the supporting organization's directors, officers, or trustees are selected by the officers, directors, trustees, or membership of the supported organization
- One or more members of the governing boards of the supported organizations are also officers, directors, or trustees of, or hold other important offices in the supporting organization
- 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 organizations

The PPA modified the responsiveness test by removing a special rule that had allowed charitable trusts to meet this test if their supported organizations had the power to enforce the trust and compel an accounting under state law, but allowed a one-year grace period for existing trusts. Like the proposed regulations, the final regulations do not include any new way for charitable trusts to meet the

responsiveness test so a trust would have to meet the responsiveness test in one of the three ways outlined above. For most, this will mean meeting the “close and continuing working relationship test,” as they will not have a trustee that is appointed by, or is an officer, director, or trustee of, the trust’s supported organizations.

The proposed regulations offer an example of a trust that meets the responsiveness test and one that does not. In Example 1, a trust with a bank trustee supports a university. The trustee has discretion with respect to the timing and amount of distributions from the trust to the university and meets quarterly face to face or telephonically with an officer of the university to discuss the university’s projected needs and how the university would like the supporting organization to use its income and invest its assets. The trustee bank also provides regular communications to the university about investments and plans for distributions, including quarterly investment statements and an annual accounting, in addition to the notice required of all Type III supporting organization. The trust in Example 1 meets the responsiveness test due to the close and continuous working relationship between the trustee and an officer of the university.

By contrast, the bank trustee in Example 2 makes annual cash payments to three public charities named in the trust document. Each year, the trustee sends each supported organization its distribution, the required notice, and an annual accounting. With no other communications between the trustee and the supported organizations, the charitable trust in Example 2 does not meet the responsiveness test.

It is worth noting that although there are frequent meetings between the trustee in Example 1 and the supported organization that include discussions concerning the supported organization’s needs and its preferences with respect to investment, nothing in the example requires that the trustee’s investments and distributions be in accordance with the university’s preferences. The preamble to the final regulations clarifies that a supported organization should have the ability to influence the supporting organization's decisions but not necessarily control the supporting organization's decisions.

Besides offering the two examples by way of guidance, the final regulations also state that supporting organizations that were in existence before November 20, 1970, may be able to show additional facts and circumstances “such as a historic and continuing relationship” between the supporting organization and its supported organization that will be deemed to meet the responsiveness test.

The preamble to the final regulations states that the Treasury Department and IRS intend to issue proposed regulations in the near future to amend the responsiveness test by clarifying that Type III supporting organizations must be responsive to all of their supported organizations and will request comments on additional examples of how to satisfy the responsiveness test. Future proposed regulations will also address how a supported organization can have a significant voice in the situation where trust instruments specify the recipients, timing, manner, and amount of grants.

## **Integral Part Test**

In addition to the responsiveness test, all Type III supporting organizations must meet a test commonly referred to as the “integral part” test. There were previously two basic ways to meet this test:

- The supporting organization could perform a function that but for its existence, the supported organization would otherwise perform for itself (the “but for” test)
- It could pay substantially all its income to the supported organization

The final regulations replace these tests with more detailed tests described below. Further, the Pension Protection Act and the final regulations break Type III supporting organizations into two categories based on how the supporting organization meets the integral part test. These two categories are functionally integrated and non-functionally integrated.

**Integral Part Test for Functionally Integrated Type III Supporting Organization.** Like the proposed regulations, the final regulations incorporated a tighter “but for” test for those organizations seeking functional integration status. To meet the integral part test and qualify as a Type III supporting organization, the supporting organization is required to either:

- Demonstrate that substantially all its activities directly further the exempt purposes of the supported organizations with respect to which it meets the responsiveness test
- Be the parent of each of its supported organizations

Further, Treasury and the IRS reserved a section to address how Type III supporting organizations can qualify as functionally integrated by supporting a government entity. The 2009 proposed regulations included a section addressing that topic but the final regulations omitted the substance of that section with a note in the preamble that they expect to issue proposed regulations on the topic. Based on their comments, these proposed regulations are expected to be released in 2013.

Substantially all activities directly further exempt purposes of the supported organization(s)

To demonstrate that substantially all of its activities directly further the exempt purposes of the supported organizations with respect to which it meets the responsiveness test, the supporting organization must perform the functions or carry out the purposes of those supported organizations, and, but for the involvement of the supporting organization, its activities must be ones that normally would be engaged in by the supported organization.

The final regulations simply state that the definition of “substantially all” will be determined based on all pertinent facts and circumstances. The phrase “directly further” is defined to include activities carried out by the supporting organization itself. The regulations are specific that holding title to and managing property that the supported organization uses in carrying out its charitable purposes (“exempt-use property”) does directly further the exempt purposes of a supported organization. However, the final regulations state explicitly that fundraising, investing, and managing non-exempt use property, and making grants, whether to the supported organization or to third parties, do not. Of note, the final regulations added one exception regarding grantmaking to individuals that was not in the proposed regulations.

For grants, scholarships, or other payments to individuals to be considered an activity that directly furthers the exempt purposes of the supported organizations, the following elements must be met:

- The individual beneficiaries must be members of the charitable class benefited by a supported organization.
- The individuals must be selected on an objective and nondiscriminatory basis.
- The officers, directors, or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making them, and the selection of recipients.
- The awarding of the payments is part of an active program of the supporting organization that directly furthers the exempt purposes of the supporting organization and the supporting

organization maintains significant involvement. For the definition of significant involvement, the regulations look to the regulations on the subject for private operating foundations. Very generally, those regulations provide that if the exempt purpose of the supporting organization is the relief of poverty or human distress, grants to ameliorate conditions of a poor or distressed class directly made by the supporting organization and supervised and directed by salaried or voluntary personnel would qualify as significant involvement. Similarly, if the supporting organization has developed specialized skills, expertise, or involvement in a particular area; maintains personnel who supervise or conduct programs to support the foundations work; and, as part of such programs, makes grants to individuals to further their involvement in the supporting organization's area of interest, the supporting organization would be considered to have significant involvement.

The final regulations do not include any significant changes from the examples used in the proposed regulations. The examples illustrate the basic requirements for functional integration status, one of which involves a community foundation. Supporting organizations that achieve functional integration in these examples are:

Example 2: A supporting organization that holds title to and manages property used by a church for worship, religious education, and community enrichment.

Example 3: A nonprofit food pantry collects food from local growers, stores, and individuals and distributes it free of charge to those in need in the community. The food pantry is a supporting organization to the eight churches in a particular geographic region. The supporting organization's board includes an official from one of the churches. The other board members are drawn from the churches' congregations.

Example 5: A supporting organization maintains local parks and recreation areas by establishing and maintaining trails, planting trees, and removing trash. Its supported organization, a community foundation, engages in activities to beautify and maintain local parks in addition to maintaining field of interest funds, sponsoring donor advised funds, and general grantmaking activities.

In contrast to this:

Example 4: A supporting organization created by an individual donor provides scholarships to students at a private secondary school. The school, not the supporting organization, established the criteria for awarding the scholarships, publicized the program, solicited and reviewed applications, and selected the recipients. The supporting organization invested its assets and disbursed funds to the students the school selected. This supporting organization does not provide the scholarships as part of an active program in which it maintains significant involvement and is not functionally integrated because neither investment management nor grantmaking – the supporting organization's only activities – are deemed by the regulations to directly further the school's exempt purposes.

It is interesting to note that Example 4 was the only example that described how the supporting organization came into existence, suggesting that creation by an individual, rather than by the supported organization or organizations, may be a negative factor in assessing functional integration status.

Example 3 is based on Example 1 in the current regulations (Treas. Reg. § 1.509(a)-4(i)(5)) but makes some changes to the facts. The existing example does not specify the number of churches that are supported, nor does it locate them in the same geographic area, while the proposed example limits the number of churches to eight, all in the same geographic region. The drafters may have felt these changes were necessary in order to demonstrate that the supporting organization had a close and continuing working relationship with the seven churches that did not have representation on the supporting organization's board. Without this relationship, the supporting organization would have met the responsiveness test only for the church with representation on its board and so would have failed the integral part test as not providing substantially all its activities in support of that one church.

#### Supporting organization is parent of supported organization(s)

The final regulations do not change an exception included in the proposed regulations under which a supporting organization can be functionally integrated if it is the parent of each of its supported organizations; it exercises a substantial degree of control over the supported organizations' policies, programs and activities; and it elects or appoints, directly or indirectly, the officers, directors, or trustees of the supported organizations. This exception, which at first glance seems contrary to the concept of a supporting organization, reflects the structure of some nonprofit health care systems and had been approved by the IRS in a series of private letter rulings issued in connection with reorganizations of health care systems. Example 1, a supporting organization that is the parent in a health care system, illustrates this exception.

The preamble of the final regulations does state that the Treasury Department and IRS have determined that the definition of "parent" they are using for purposes of this section is insufficient so will be issuing proposed regulations providing a new definition of parent.

**Integral Part Test for Non-Functionally Integrated Type III Supporting Organizations.** Type III supporting organizations that cannot meet the above tests must meet the integral part test by distributing income to, or for the use of, their supporting organizations and by meeting an attentiveness test.

Distribution Test: The most significant change between the 2009 proposed regulations and the regulations issued in December 2012 is the distribution requirement for non-functionally integrated Type III supporting organizations. Because of the significant change, the portion of the regulations regarding the calculation of the payout requirement was issued in temporary and proposed form rather than final form.

Under previous law, a Type III supporting organization not meeting the "but for" test was required to distribute substantially all of its income. Substantially all was considered to mean 85 percent or more of its income. The 2009 proposed regulations proposed replacing that test with a 5 percent payout requirement similar to that of a private foundation. The preamble to the 2012 regulations states that, because non-functionally integrated Type III support organizations must adhere to different requirements and restrictions than private foundations, including, but not limited to, a prohibition on disqualified persons controlling the supporting organization, the likelihood that substantial contributors to such supporting organizations will be able to use the supporting organization's assets to further their own interests is significantly reduced. That, coupled with the relationship required between the supporting organization and its supported organization, led the Treasury Department and IRS to propose a lower payout than that of private non-operating foundations.

The distributable amount or “payout” required under the temporary regulations for a Type III non-functionally integrated supporting organization is the greater of (1) 85 percent of its adjusted net income or (2) 3.5 percent of the fair market value of the supporting organization's non-exempt-use assets in the immediately preceding taxable year. A Type III non-functionally integrated supporting organization must annually distribute this amount to or for the use of one or more supported organizations on or before the last day of the taxable year. The temporary rules cross-reference those for private operating foundations for the purpose of valuation of assets. Excess distributions may be carried forward for up to five years to be applied to a future year's payout obligation.

Distributions that count toward fulfilling the required annual payout include:

- Amounts paid to the supported organization for its exempt purposes
- Amounts paid to perform activities directly furthering the exempt purposes of the supported organization to the extent such amounts paid exceed any income produced by the activity
- Reasonable and necessary administrative expenses paid to accomplish the exempt purposes of the supported organization except investment expenses
- Amounts paid to acquire assets used or held for use to carry out the exempt purposes of the supported organization
- Amounts set aside for a specific project meeting certain rules described below

The addition of set-asides as qualifying distributions was also a significant change from the proposed regulation. The final regulations provide that a supporting organization may count a set-aside toward its payout requirement if the supporting organization obtains approval from the IRS by demonstrating that the project is one that can be better accomplished by the set-aside than by an immediate payment of funds and that the set-aside amount will be paid for the project within 60 months of the set-aside. In addition, a principal officer of the supported organization must sign a statement under penalty of perjury that the project accomplishes the exempt purposes of the supported organization and the supported organization approves the determination that the project is better served by the set-aside.

Identical to the proposed regulations, the final regulations provide a “reasonable cause” exception to the payout requirement that is broader than the comparable one for private foundations in that a failure to make payout may be excused if it is caused by “unforeseen events or circumstances” or “ministerial error” in addition to mistakes in valuing assets, the option for private foundations. As with private foundations, the failure must be due to reasonable cause and not willful neglect. Finally, the mistake must be corrected within 180 days after the date on which the incorrect valuation or ministerial error was discovered or within 180 days of when the organization is first able to make the required payout notwithstanding the unforeseen event or circumstance.

The final regulations also provide for an emergency temporary reduction in the payout amount on publication of a notice by the secretary of the treasury in the case of a disaster or emergency. The preamble to the final regulations notes that it is the intention that a time of great financial distress would be included in this provision as written.

Because part of the reason for lowering the payout requirement was due to the relationship between the supporting organization and its supported organizations, the Treasury Department and IRS intend to propose regulations requiring that non-functionally integrated Type III supporting organizations

meet the responsiveness test with respect to each of their supporting organizations. In addition, they intend to issue proposed regulations that more fully describe the expenditures that do and do not count toward the distribution requirements. Finally, the preamble states that the Treasury Department and IRS are considering whether program-related investments should count toward the distribution requirement.

Attentiveness Test: The final regulations track the proposed regulations in modifying the attentiveness test to require that a Type III non-functionally integrated supporting organization distribute at least one-third of its annual distributable amount to those supported organizations that are attentive to it and with respect to which they meet the responsiveness test. This requirement will substantially limit the ability of Type III supporting organizations to support many different supported organizations since they often will meet the responsiveness test for only one.

The final regulations also provide that to demonstrate attentiveness, these supporting organizations must do one of the following:

- Provide 10 percent or more of the supported organization's total support in the immediately preceding taxable year (or of the total support for a school or department of a university, hospital, or church)
- Provide support that is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization
- Provide an amount of support that based on all the facts and circumstances is a sufficient part of a supported organization's total support

The preamble to the final regulation takes the position that grants to organizations other than the supported organization will not ensure the attentiveness of a supported organization so will not count toward satisfying the attentiveness test. Additionally, the final regulations codify a result reached in *Lapham Foundation v. Comm'r*, 389 F.3d 606 (6th Cir. 2004) holding that supporting organizations cannot meet the attentiveness test by distributions to a donor advised fund at a supported organization.

The final regulations continue an existing exemption from the integral part test for certain pre-November 20, 1970, charitable trusts. However, as with the proposed regulations, the final regulations eliminate an existing exemption for supporting organizations that have met the current distribution requirement for a five-year period, but have become unable to meet the attentiveness test only because the amount paid out is no longer sufficiently large, if there is a historic and continuing relationship of support between the two organizations.

The final regulations offer four examples to illustrate the working of the revised integral part test for Type III supporting organizations that are not functionally integrated. The first three are based on examples in the existing regulations and are modified only as necessary to incorporate the new distribution requirement and the requirement that at least one-third of that distribution be to a supported organization with respect to which the supporting organization meets the responsiveness test.

The supporting organizations in Examples 1, 2, and 3 all meet the revised integral part test. In each example the supporting organization distributes an amount that equals or exceeds the distributable amount so the focus is the attentiveness test. In Example 1, a supporting organization meets the



integral part test by distributing an amount that equals or exceeds the distributable amount to a museum to pay for a series of free chamber music performances. Although the chamber series is not one of the museum's primary activities, it could not continue it without the support provided by the supporting organization. In Example 2, the supporting organization provides the resources to support a chair in international law at a university's law school and that support is necessary to maintain the chair. Both supporting organizations meet the integral part test. The supporting organization in Example 3, which meets its distribution test through payments to three supported organizations, would fail the attentiveness test because the support provided to each is less than 1 percent of the total support. However, the organization continues to be a Type III supporting organization because it meets the requirements for the grandfather provision for pre-November 20, 1970, charitable trusts.

Example 4 is a new example that illustrates the requirement that the supporting organization provide at least one-third of its support to a supported organization to which it is responsive. The supporting organization supports five private universities, but meets the responsiveness test for only one. Each year, the supporting organization distributes an amount that equals its distributable amount in equal shares to the five and that support is more than 10 percent of the annual support of two, including the one to which it is responsive. However, the supporting organization fails the integral part test. To have met the test, it would have needed to provide one-third of the distributable amount to the one supported organization to which it was responsive.

Transition Rules for the Integral Part Test. A supporting organization meeting the distribution requirement in effect prior to December 28, 2012, will be treated as meeting the new payout requirement until the first day of its second taxable year beginning after December 28, 2012. However, non-functionally integrated Type III supporting organizations will need to value their assets during the first taxable year in order to calculate the payout for the second taxable year. If such a supporting organization wishes to carry over payout from its first taxable year, it would be required to calculate the payout obligation under the new rules for its first taxable year after December 28, 2012, as only amounts distributed above that calculation would be eligible to be carried over to future years.

Supporting organizations that met and continue to meet the original "but for" test, but not the test as revised, will continue to be functionally integrated until the first day of their second taxable year beginning after December 28, 2012. For example, if an organization with a calendar taxable year met the previous "but for" test and continues to meet that test but cannot meet the test for functional integration contained in the final regulations, it will be treated as functionally integrated until January 1, 2014. After that time, it would be treated as non-functionally integrated and subject to the payout requirement described below.

However, if a supporting organization that met the original "but for" test on December 28, 2012, but not on the first day of its next taxable year after December 28, 2012, it will be treated as a non-functionally integrated Type III supporting organization but will have a distribution requirement of zero for the initial tax year. However, when calculating the carryover for future years, the supporting organization may carry forward only the amount above what they would have had to pay out if their payout was calculated using the normal methods found in the temporary regulations.

Finally, if a non-functionally integrated Type III supporting organization organized prior to September 24, 2009, has governing or other instruments that prohibit distributions from corpus and begins judicial proceedings prior to June 26, 2013, to reform its instruments to meet the payout requirement, its

distribution requirement is exempt from the payout requirement to the extent it cannot meet such requirement under its current instruments. This transition relief generally continues during any taxable year in which the judicial proceeding is pending. The final regulations do not provide any special transition relief for supporting organizations with assets that are not readily marketable.

## Miscellaneous Provisions

**Excess Business Holdings.** The final regulations contain a provision unchanged from the proposed regulation that extends transition relief to private foundations that were Type III supporting organizations on the date of enactment of the PPA. These private foundations will have the benefit of transition relief that allows extra time to dispose of excess holdings. The PPA had allowed Type III supporting organizations the same transition relief that Congress granted to private foundations in 1969 when it imposed the excess business holdings rule on them. However, the PPA failed to take into account the need for similar relief for entities that lost their supporting organization status as a consequence of the enactment of the PPA.

**Prohibition on Supported Organizations Not Organized in the United States.** The final regulations also contain final implementing regulations prohibiting a Type III supporting organization from supporting any supported organization not organized in the United States. This rule was effective in 2006 and the transition period for existing organizations has already expired.

**Prohibition on Gifts from Controlling Donors.** The PPA provided that a Type I or Type III supporting organization would lose its status as a supporting organization if it accepted a gift from a person who, together with certain related persons, directly or indirectly controls the governing body of a supported organization. Related persons are defined as a member of the family or a 35-controlled entity [4958(f)]. The final regulations provide that this prohibition does not extend to gifts from a section 509(a)(1), 509(a)(2), or 509(a)(4). In other words, gifts from public charities other than supporting organizations are not subject to this rule.

The preamble to the regulations states that Treasury intends to issued proposed regulations on the definition of “control” for the purpose of this provision in the near future.

## Next Steps

As mentioned above, the Treasury Department and IRS are accepting comments regarding the temporary and proposed regulations regarding payout for non-functionally integrated Type III supporting organizations. The comments are due March 28, 2013. In addition, the Treasury Department and IRS are expecting to issue additional proposed regulations affecting Type III supporting organizations. While the timing is unclear, the regulations issued in December 2012 indicate that some of those additional proposed regulations may be released sometime in 2013.