

tax-exempt organizations lawflash

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IRS Issues Regulations for Type III Supporting Organizations

Type III supporting organizations should take steps to comply with new regulations and funders should review due diligence procedures for grants made to these organizations.

On December 21, 2012, the Internal Revenue Service (IRS) issued final and temporary regulations on the classification of Type III supporting organizations (SOs) as “functionally integrated” and “non-functionally integrated” in accordance with provisions added to the Internal Revenue Code by the Pension Protection Act of 2006 (PPA).¹ These regulations, which took effect on December 28, 2012, made significant changes to the proposed regulations that were published on September 24, 2009, including the requirements for functionally and non-functionally integrated Type III SOs. Type III SOs and their potential funders should familiarize themselves with the new regulations and their key features, as the regulations raise important considerations for these entities.

Background

To be classified as a public charity, rather than a private foundation, a Section 501(c)(3)² organization must be described in Section 509(a). Many public charities are described in Section 509(a)(1) or 509(a)(2) by virtue of being a specific type of organization (such as a school, church, or hospital) or the nature of their income as measured through one of two public support tests. Section 509(a)(3) organizations, called “supporting organizations,” derive their public charity status solely as a result of being 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 described in Section 509(a)(1) or 509(a)(2).

SOs must maintain one of three defined relationships with their supported organizations—these are referred to as “types.” Type I SOs are “operated, supervised, or controlled by one or more” supported organizations. Type II SOs are “supervised or controlled in connection with one or more” supported organizations. Type III SOs are “operated in connection with” one or more supported organizations.

In response to perceived tax law abuses by SOs and their donors, provisions of the PPA tighten certain rules regarding the qualification and operations of SOs, particularly Type III SOs. Among other things, the PPA draws a distinction between Type III SOs that are “functionally integrated” with their supported organizations by virtue of their carrying out activities that directly perform the functions of the supported organizations, and those that are not. The PPA subjects the latter category of “non-functionally integrated” Type III SOs to stringent new requirements, including a payout requirement and limitations on excess business holdings. It also requires private foundations and donor-advised funds to exercise expenditure responsibility on grants to non-functionally integrated Type III SOs.

Recognizing that many SOs do not have a determination letter from the IRS indicating their type, the IRS issued IRS Notice 2006-109 on December 4, 2006, in part to provide grantmakers with a safe-harbor process to make such a determination themselves. The notice allows grantmakers to rely on certain documentation provided by the

1. Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated, 77 Fed. Reg. 76,382 (Dec. 28, 2012) (to be codified at 26 C.F.R. pts. 1, 53, 602), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-31050.pdf>.

2. Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

SOs to demonstrate that they meet the “but for” requirement of Treasury Regulations section 1.509(a)-4(i)(3)(ii), which was to serve as the standard for determining functional integration until regulations were finalized.

The PPA left open several other issues with respect to the new SO rules, many of which have now been addressed by the new regulations. While the regulations are very technical and merit careful review, we have provided highlights below.

Qualifying as a Type III Supporting Organization

Under the new regulations, a Type III SO must satisfy a notification requirement, a responsiveness test, and an integral part test. The integral part test is used to determine whether the Type III SO is functionally integrated or non-functionally integrated.

Notification Requirement

A Type III SO must provide certain documents to each of its supported organizations, including a written description of the type and amount of all of the support it provided to each supported organization, its most recent Form 990, and a copy of its governing documents.

Responsiveness Test

The responsiveness test generally requires a prescribed connection between the boards of directors and officers of the SO and its supported organizations that gives each supported organization a significant voice in the investment policies and use of the SO's income and assets.

Integral Part Test for Functionally Integrated Type III SOs

A Type III functionally integrated SO can meet the integral part test through one of the three following ways:

- Conducting activities substantially all of which directly further the exempt purposes of the supported organizations
 - For this purpose, the SO must perform functions or carry out activities that would otherwise normally be performed or carried out by each supported organization.
- Being the parent of each supported organization
- Supporting a governmental supported organization.

Fundraising and Grantmaking Disfavored Activities

Under the new regulations, several types of activities commonly found in Type III SOs—fundraising, grantmaking (whether to the supported organization or to third parties), and investing and managing nonexempt use assets—are not considered to be activities that directly further the exempt purposes of a supported organization. Consequently, a Type III SO that is established to fundraise or manage an endowment for a supported organization or to make grants (with the exception of individual grants, scholarships, and other payments made under certain circumstances) will not qualify as functionally integrated unless it is the parent of the supported organization or its supported organization is a governmental unit.

Integral Part Test for Non-Functionally Integrated Type III SOs

Generally, the integral part test for a non-functionally integrated Type III SO has the following two components:

- The first component requires the SO to distribute a “distributable amount” to, or for the use of, its supported organizations each year. The distributable amount must equal the greater of 85% of adjusted gross income or 3.5% of the fair market value of nonexempt use assets. Administrative expenses, excluding investment

management fees, may count toward this distribution requirement, and SOs may take advantage of a set-aside provision.

- The second component requires that the SO be “attentive” to the supported organization, which can be demonstrated in one of the following three ways:
 - The SO distributes to its supported organization (other than to a donor-advised fund) at least 10% of such organization’s total support.
 - The SO’s support is necessary to avoid the interruption of a substantial program of the supported organization.
 - Attentiveness can also be established by facts and circumstances, such as the length and nature of the relationship, the SO’s use of funds, and the support from the SO in comparison to the supported organization’s total support.

Transition Periods

SOs in existence prior to the effective date of the new regulations may be able to take advantage of a transition relief periods with respect to compliance with the notification requirements and the integral part test or in transitioning to a non-functionally integrated Type III SO.

Future Guidance

The IRS reserved several provisions for further guidance, including the definition of “control” for purposes of these provisions, an amendment to the responsiveness test to clarify that an SO must be responsive to all of its supported organizations, the definition of “parent,” how SOs can qualify as functionally integrated by supporting a governmental entity, and what expenditures will count toward the distribution requirement.

Effect on Grantmakers and Certain Supporting Organizations

As noted above, grants to non-functionally integrated Type III SOs are disfavored for private foundations and donor-advised funds. As a result, most Type III SOs that raise funds from such sources will need to comply with the new functionally integrated Type III SO requirements or take advantage of the transition period to reclassify to another type or category of public charity.

One issue left unresolved is how donor-advised funds and private foundations should treat grants to Type III SOs that do not have an IRS classification indicating whether they are functionally integrated or not. Prior to the new regulations, in the absence of an IRS determination grantmakers could rely on the standards and procedures set forth in IRS Notice 2006-109 to determine whether an SO was functionally integrated. While the new regulations change some of the standards, the IRS has not indicated whether grantmakers can continue to rely on the procedures set forth in the notice using the new standards. We expect the IRS to release further guidance on this issue in the near future. In any case, while being mindful of the transition period, grantmakers should (1) review due diligence they have already collected on SOs before issuing new grants and (2) make necessary adjustments to due diligence for prospective SO grantees going forward.

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