

Alert 10-084

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## Tax Alert

## Are Your Charitable Trusts Supporting Organizations? Should They Be? A Trust Officer's Road Map to Type III Supporting Organizations

What has changed? Why should bank trust departments be concerned?

It has been more than three years since the Pension Protection Act of 2006 ("PPA") changed the requirements for Type III supporting organization ("Type III SO") status—the primary means by which tax-exempt charitable trusts qualify as public charities. As of August 17, 2007, charitable trusts that failed to satisfy the new requirements for Type III SO status automatically became private foundations. The Internal Revenue Service (the "Service") recently issued proposed regulations clarifying the requirements for Type III SOs, which should be adopted shortly. The Service has also recently issued procedures for charitable trusts seeking classification as Type III SOs under the new rules.

These tax law developments are taking place at a time that many bank trust officers and wealth managers find themselves undertaking responsibility for large numbers of charitable trusts formerly administered by another institutional fiduciary as a result of the recent flurry of bank mergers and consolidations. Trust officers may therefore be uncertain as to whether many of the charitable trusts they administer do or can qualify as supporting organizations under the new rules, or whether they should comply with the private foundation rules.

Why is supporting organization status an important option for charitable trusts?

All organizations that are qualified as tax-exempt under section 501(c)(3) of the Internal Revenue Code (the "Code"), including charitable trusts, are presumed to be private foundations unless they can demonstrate that they meet one of the tests for qualification as a public charity. Private foundations are subject to a 2 percent tax on investment income; strict self-dealing provisions that may prohibit advantageous arrangements between the trust and the trustee institution; a mandatory annual payout requirement equal to 5 percent of investment asset value; limitations on business holdings; and prohibitions on jeopardizing investments and lobbying expenditures; as well as limitations on grantmaking to non-public charities and private individuals. As a result of these onerous private foundation requirements, public charity status is generally considered to be the more advantageous classification for entities exempt from tax under section 501(c)(3).

Charitable trusts generally lack the diversity of support and types of activities necessary to qualify for most types of public charity status, but they may be able to qualify as a public charity by reason of being a supporting organization of one or more publicly supported charities or governmental entities ("supported organizations"). In order to so qualify, a trust

must be "operated, supervised, or controlled by or in connection with" one or more supported organizations. Donors rarely establish charitable trusts that are controlled by their supported organizations or are subject to common control along with their supported organizations. As a result, charitable trusts that qualify as supporting organizations most often qualify as Type III SOs on the basis that they "operate in connection with" supported organizations specified in their trust instrument. The remainder of this bulletin summarizes the requirements for charitable trust Type III SO status since enactment of the PPA, and provides some practical guidance for trust officers seeking to assess the impact of the new Type III SO rules on the trusts they administer.

## Which charitable trusts most likely qualify for Type III SO status under the new requirements?

A charitable trust should qualify for Type III SO status if the trust satisfies all of the following requirements:

- The trust establishes that it is responsive to one or more of its supporting organizations (the "Responsiveness Test"). A trust can do so if the trustee institution, through the efforts of the responsible trust officer, demonstrates a close, continuous working relationship with the officers and directors of its supported organizations by engaging in regular meetings and correspondence with an officer of one or more of its "supported organizations" concerning the timing and priorities of its grantmaking and the management of its investments, so that the supported organizations may be deemed to have a "significant voice" in the grantmaking and investment activities of the trust.
- The trust annually expends at least 5 percent of its investment asset value on grants and reasonable trust administration costs (the "Distribution Test").
- The trust provides at least one-third of its total 5 percent distributions to or for the benefit of a supported organization to which the trust is responsive (see above), and the trust is able to demonstrate that such payments are significant enough to the supported organization that the supported organization is attentive to the trust's activities (the "Attentiveness Test"). A trust can demonstrate that its support is significant enough to guaranty the supported organization's attentiveness through any one of the following means:
  - The trust distributes annually to the supported organization an amount that is 10 percent or more of the supported organization's total support, or 10 percent or more of the total support for the particular program or division of the supported organization for which the trust designates its payments.
  - The support the trust provides is "necessary" to avoid the interruption in carrying on a particular function or activity of the supported organization. The trust's support will be considered "necessary" if the trust or the supported organization earmarks the support for a particular program or activity, even if such program or activity is not the supported organization's primary program or activity, so long as such program or activity is a substantial one.
  - Based on the consideration of all pertinent factors, including the number of the trust's supported organizations, the length and nature of the relationship between the supported organization and trust, and the purpose to which the funds are put, the amount of support the trust provides is a sufficient part of the supported organization's total support. Evidence of the supported organization's actual attentiveness to the trust is nearly as important as the amount of support the trust provides to the supported organization.
- Note that in each year after the new regulations are adopted, the trust must also provide to each of its supported organizations the following notifications ("Notification Requirement"): (1) a written notice addressed to a principal officer of the supported organization indicating the type and amount of support provided by the trust to the

supported organization in the past year; (2) a copy of the trust's most recently filed IRS Form 990; and (3) a copy of the trust's governing documents, including its charter or trust instrument and bylaws, and any amendments to such documents. After the first year of notice, the annual notice need only include governing documents if the trust has amended them in the past year.

## What practical steps can a trust officer take so that a trust will satisfy these requirements?

- **Tips for Satisfying the Responsiveness Requirement.** Increase the amount and frequency of information-sharing with one or more of the trust's supported organizations to establish a close, continuous working relationship. The proposed regulations provide an example of how a charitable trust with a bank as its sole trustee can demonstrate that its beneficiary-supported organization, a private university, has a significant voice in the trust's grantmaking and investment activities. The trust instrument provides that the bank trustee has discretion regarding the timing and amount of the trust's charitable distributions. However, representatives of the trustee and an officer of the university hold quarterly face-to-face meetings at which they discuss the university's projected needs and the ways in which the university would like the trust to use its income and invest its assets. The trustee representative also communicates regularly with the university's officer concerning the trust's investments and distribution plans. Additionally, the trustee provides the officer with quarterly investment statements and other information as mandated by the new notification requirement noted above. Taking and carefully documenting these simple steps, which do not require any amendment to the trust instrument, is sufficient to satisfy the responsiveness requirement.<sup>1</sup> Documentation may include minutes of meetings, email exchanges, and policies that demonstrate a close, continuous working relationship with a supported organization.
- **Tips for Satisfying the Distribution Requirement.** In determining whether the trust satisfies the requirement to annually pay out at least 5 percent of its investment assets, be sure to include the costs of reasonable trust administration.
- **Tips for Satisfying the Attentiveness Test.** If a trust has multiple supported organizations, the trust need not satisfy the attentiveness test for every charitable beneficiary. Focus on the supported organization, or the supported organization program or activity for which the trust's distributions have the greatest impact, and determine whether it is possible to satisfy both the responsiveness test and the attentiveness test for this particular supported organization. The trustee (if such designation is within the trustee's discretion) or the supported organization may also earmark the trust's support for a program or activity of the supported organization to help establish that the trust's annual support is significant and necessary for the conduct of such program. Consider working with the supported organization to establish the evidence of attentiveness necessary to achieve Type III SO status. Type III SO status for the trust eliminates the section 4940 tax, and thus preserves more funds for the benefit of the supported organization. As a result, most supported organizations should be amenable to taking steps that help to establish their attentiveness to a Type III SO trust.

## What if a trust does not satisfy the requirements listed above?

The trust is a private foundation. It should be filing an annual Form 990-PF, paying the 2 percent tax on its investment income required by section 4940 of the Code, and distributing at least 5 percent of the value of its investment assets to charitable beneficiaries and for reasonable trust administration in accordance with section 4942 of the Code. [Note that the 5 percent distribution requirement will apply regardless of the spending limitations set forth in the trust instrument. For example, if the trust instrument limits the trust's spending to "income only," the trust is still required to satisfy the 5 percent distribution requirement, and generally state law automatically reforms the trust so as to require such distributions.]

For each year in which the trust fails to satisfy these requirements, the trust may be liable for

additional excise taxes, interest, and late filing penalties, which will continue to accrue unless and until the trust corrects these failures. Because these tax liabilities are compounding, they can become very significant, even for small trusts. In some cases, such liabilities may even wipe out the entire trust. Charitable beneficiaries of a trust may allege that an institutional trustee has breached its fiduciary duties by subjecting the trust to such liabilities. In such cases, a court may require an institutional trustee to indemnify the trust for such liabilities, return trustee fees previously paid by the trust, otherwise surcharge the trustee, and/or deny the trustee compensation for its trust administration services. Accordingly, it is very important that institutional trustees identify all trusts that should be filing 990-PFs.<sup>2</sup>

## What if a trust does or can meet the new Type III SO requirements?

If the trust had a determination letter from the Service classifying it as a Type III SO prior to the passage of the PPA and if it satisfied the requirements for SO status noted above for 2008 and 2009 (and satisfied the significant voice requirement after August 17, 2007), it should be able to confirm its Type III SO status with the Service (even if it filed a Form 990-PF for 2008) and obtain a refund of section 4940 taxes paid since 2008.<sup>3</sup>

If the trust became a private foundation as of August 17, 2009 because it failed to satisfy the new Type III SO requirements, it may undertake steps to terminate its private foundation status by satisfying the Type III SO requirements listed above for a period of 60 continuous months, and notifying the Service before it commences so operating, in accordance with established Service procedures for termination of private foundation status under section 507 of the Code.

## Should all charitable trusts take steps to satisfy the new Type III SO requirements if they can?

Under the new rules, charitable trusts that satisfy the new Type III SO requirements described above will be classified as "Non-Functionally Integrated" Type III SOs.<sup>4</sup> Non-Functionally Integrated Type III SOs are subject to a number of new restrictions. Most importantly, private foundations cannot count grants to such Type III SOs in satisfying their own payout requirements, and both private foundations and donor-advised funds must exercise special oversight procedures (known as "expenditure responsibility") over grants to such SOs. As a result, while status as a Type III Non-Functionally Integrated SO is generally a more favorable status for a charitable trust than private foundation status, it may not be appropriate in the unlikely event that a particular charitable trust anticipates distributions from private foundations and donor-advised funds. For most charitable trusts, this will not be an issue.

1. Note that the Responsiveness Test is also satisfied if a supported organization appoints a trustee or officer of the trust, or if a member of the governing body of a supporting organization also serves as a trustee or officer of the trust. In practice, most charitable trusts will satisfy the Responsiveness Test by establishing a close and continuous relationship with a supporting organization, as described above.
2. Note that charitable trusts that are not exempt under section 501(c)(3), but that have only section 501(c)(3) charitable beneficiaries remaining, are subject to the same requirements under section 4947(a)(1) of the Code. For more details, see Reed Smith's Client Alert, "Beware of Liabilities Lurking in Testamentary and Charitable Trusts," published May 8, 2009, available in the Tax-Exempt Publications Library at reedsmith.com.
3. This procedure is also available to section 4947(a)(1) trusts that were treated as Type III SOs prior to the passage of the PPA and that satisfy the new Type III SO requirements.
4. Charitable trusts that do not engage in activities other than grantmaking and managing their investments will not generally qualify as "Functionally Integrated" Type III SOs. "Functionally Integrated" SOs essentially enjoy all the benefits that Type III SOs enjoyed prior to the passage of the PPA.

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