

IRS Issues Regulations on Type III Supporting Organizations

Effective December 28, 2012, the IRS published final [regulations](#) on the qualification requirements for “Type III” supporting organizations (SOs), and issued temporary regulations that establish a payout requirement for “non-functionally integrated” Type III SOs. The new regulations are relevant not only for SOs and their supported charities, but also for private foundations and donor-advised funds that make grants to Type III SOs.

SOs are public charities, as opposed to private foundations, because they are organized and operated exclusively to support one or more other public charities. Type III SOs are subject to less control by their supported charities than the Type I and II varieties, and, after the enactment of the Pension Protection Act of 2006, became subject to particularly strict regulation (for a summary of proposed regulations on Type III SOs released in 2009, see our [prior Alert](#)). The Pension Protection Act created two categories of Type III SOs: functionally integrated and non-functionally integrated. Functionally integrated SOs generally perform a specific function or carry on a particular activity for their supported charities (e.g., serving as a coordinating parent entity for a health care system) while non-functionally integrated SOs tend to focus on grant-making activities.

This alert highlights several key aspects of these detailed and complex regulations.

New Payout Requirements for Non-Functionally Integrated Type III SOs

Under the new regulations, non-functionally integrated SOs (NFI SOs) must annually distribute to, or for the use of, their supported charities an amount equal to the *greater* of 85 percent of adjusted net income or 3.5 percent of the fair market value of the SO’s non-exempt-use assets (calculated based on the immediately preceding taxable year). This distributable amount may include reasonable and necessary administrative expenses, although the regulations indicate that any such expenses must be for the purpose of accomplishing the supported charities’ exempt purposes, and do not include investment expenses. NFI SOs whose assets consist predominantly of non-readily marketable securities should be aware that the IRS, despite receiving several comments on the need for transition relief to allow for liquidation of such assets, expressly opted not to include any such relief in the regulations. The payout requirements went into effect December 28, 2012, although the final regulations provide transition relief for certain organizations in existence on the effective date that met, and continue to comply with, the existing regulations for Type III SOs. In all cases, however, starting with their second taxable year beginning after December 28, 2012, all NFI SOs must meet the new payout requirement as set forth in the final and temporary regulations.

Notification to Supported Charities

The final regulations specify that a Type III SO must annually provide each of its supported charities with certain materials, including governing documents, a written notice describing the type and amount of support provided to the supported charity, and a copy of the SO’s most recently filed IRS Form 990. The required notification documents must be postmarked or electronically submitted by the last day of the fifth calendar month following the close of the SO’s tax year. The IRS rejected requests to align the notification requirement with the deadline for filing of Form 990, with extensions. Therefore, if an SO’s Form 990 is on extension at the time of the notification deadline, the “most recently filed Form 990” is the Form 990 for the SO’s second preceding taxable year. For Type III SOs in existence on December 28, 2012, the due date

for the first notification to supported charities is the later of the last day of the fifth calendar month following the close of the SO's tax year or the due date for the Form 990 for that tax year, including extensions.

Effective Limit May be Imposed on Number of Supported Charities

Although the final regulations do not place a numerical limit on the number of charities an NFI SO may support, the IRS has indicated it intends to propose additional regulations specifically requiring that an NFI SO meet the "responsiveness" test with respect to each of its supported charities. The practical effect of this rule could be to limit how many organizations an NFI SO can support, since the responsiveness test generally requires that a supported charity have some level of involvement in the selection of the officers or directors of the SO. An SO with multiple supported charities may find it difficult to comply with this requirement.

Additional Guidance on How Trusts Can Satisfy Responsiveness Test

One of the significant changes made by the Pension Protection Act was to eliminate a special rule that permitted charitable trusts to qualify as Type III SOs with relative ease. As a result, charitable trusts seeking to maintain Type III SO status have been required to satisfy the "responsiveness" test, which generally requires enough involvement by a supported charity in the SO's management or governance to demonstrate a "significant voice" in the financial, investment, and grant-making affairs of the SO. The 2009 proposed regulations provided an example whereby a charitable trust met this requirement by holding quarterly face-to-face meetings with representatives of its supported charity regarding distributions from the trust, investment of the trust's assets, and the needs of the supported charity. In response to concerns by commenters that holding in-person meetings could be burdensome for charitable trustees, the example has been clarified to provide that such meetings may take place by telephone.

More Guidance Promised

Functionally Integrated SOs – Definition of Parent

Some functionally integrated SOs qualify for this status based on carrying on an activity that would be conducted by the supported charity itself "but for" the SO's existence. Others qualify for this status based on being the parent entity of each supported charity. The IRS intends to issue additional proposed regulations elaborating on the definition of "parent" based on a determination that the current definition is insufficiently specific. The new definition will specifically address the power to remove and replace officers, directors, and trustees of the SO.

Restrictions on Gifts from Certain Persons – Definition of Control

Among other rules, the Pension Protection Act and the final regulations prohibit a Type I or Type III SO from accepting a gift or contribution from a person who, alone or together with certain related persons, directly or indirectly controls the governing body of a supported organization of the SO. In response to requests for clarification of the meaning of "control" the IRS has indicated its intent to issue proposed regulations in the near future.

Effective Date and Comment Period for Temporary Regulations

The final and temporary regulations are effective December 28, 2012, although the regulations include certain transition rules for Type III SOs in existence on December 28, 2012. Comments on the temporary

regulations on the payout requirement for NFI III SOs will be accepted until March 18, 2013.

For more information on any of the regulations discussed above, please contact your usual Ropes & Gray attorney.

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