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## Internal Revenue Service Issues Proposed Regulations Affecting Type I and Type III Supporting Organizations

On February 19, 2016, the IRS issued proposed regulations regarding Type I and Type III supporting organizations (Proposed Regulations). The Proposed Regulations implement amendments to Section 509(a)(3) of the Internal Revenue Code (Code), contained in the Pension Protection Act of 2006, and clarify and expand on regulations issued in 2012 and 2015. The IRS is accepting written comments and requests for a public hearing on the Proposed Regulations through May 19, 2016.

### BACKGROUND

In general, “supporting organizations” support other [tax-exempt organizations](#), typically public charities, described in 509(a)(1) or (2) of the Code. They are exempt from taxation under Section 501(c)(3) of the Code and qualify as public charities rather than private foundations (which are subject to more restrictive IRS regulations). Parent corporations of tax-exempt hospital systems often qualify as supporting organizations.

To qualify as a supporting organization, the organization must meet four tests: organizational, operational, relationship, and disqualified person control. To meet the first two tests, supporting organizations must be both organized and operated for the benefit of, to perform the functions of, or to carry out the purposes of one or more named “supported organizations.” To meet the disqualified person control test, a supporting organization must not be controlled, directly or indirectly, by one or more disqualified persons. For this purpose, disqualified persons include substantial contributors to the organization, their family members, and entities controlled by one or more substantial contributors. The term “substantial contributor” refers to any person who contributed or bequeathed more than \$5,000 to an organization in a given year, provided the amount is also more than two percent of the total contributions and bequests received by the organization during that year.

To meet the relationship test, a supporting organization must have one of three types of relationships with its supported organization(s). Type I supporting organizations are operated, supervised, or controlled by one or more supported organizations, analogous to the relationship between a parent and subsidiary corporation, with the supporting organization as the subsidiary corporation. Type II supporting organizations are supervised or controlled by the same persons or entities who control the supported organization(s). Type III supporting organizations have the most attenuated relationship to their supported organization(s) as they are operated independently from, but in connection with, the supported organization(s), rather than controlled by the supported organization. For this reason, the relationship between a Type III supporting organization and its supported organization(s) is more heavily regulated than for either Type I or Type II supporting organizations.

Because their supported organization(s) do not have direct control, Type III supporting organizations must undertake additional compliance measures to ensure that they are responsive to the needs of the supported organizations, which are accomplished by satisfying the “responsiveness” and “integral part” tests. A Type III supporting organization meets the responsiveness test by ensuring that all supported organizations have adequate representation on the supporting organization’s board and a significant voice in the supporting organization’s management and use of its assets. A Type III supporting organization satisfies the integral part test by maintaining significant involvement in the operations of its supported organizations and by providing financial support on which its supported organizations depend in order to continue their operations.

Under Section 509(f)(2) of the Code, Type I and Type III supporting organizations are prohibited from accepting contributions from persons who, alone or together, control the governing board of the supported organization(s) or from their family members or entities that they control. Accepting such contributions causes the supporting organization to lose its classification as a public charity and to be treated as a private foundation subject to a more restrictive regulatory scheme.

### **PROPOSED REGULATIONS**

The Proposed Regulations focus in large part on the relationship between Type III supporting organizations and their supported organizations, including by clarifying certain rules regarding the required degree of responsiveness and involvement of supporting organizations. They clarify that Type III supporting organizations must meet the responsiveness test with respect to every supported organization.

The Proposed Regulations also increase the minimum annual financial distribution that certain Type III supporting organizations are required to make to their supported organizations by eliminating the provision that reduces the distributable amount by the amount of unrelated business income tax imposed on a supporting organization during the immediately preceding taxable year. The regulations also revise Treasury Regulation Section 1.509(a)-4(i)(6), which sets forth the list of distributions that count toward the minimum distribution requirement. The current regulations provide that such distributions may generally include, but are not limited to, (1) amounts paid to a supported organization to accomplish the supported organization’s exempt purposes; (2) amounts paid by the supporting organization to conduct activities in direct furtherance of the supported organization’s exempt purposes, but only to the extent such amount exceeds any income derived by the supporting organization from the activity; (3) reasonable and necessary administrative expenses paid to accomplish the supported organization’s exempt purposes (excluding investment expenses); (4) amounts paid to acquire an exempt-use asset; and (5) amounts set aside for a specific project that accomplishes the exempt purposes of a supported organization. Under the Proposed Regulations, the preceding list would be exclusive rather than nonexhaustive.

Additionally, the Proposed Regulations clarify the definition of a parent organization for purposes of the “integral part” test. A subset of Type III supporting organizations satisfies the integral part test by acting as a parent organization to its supported organizations. Under the Proposed Regulations, a Type III supporting organization qualifies as the parent of its supported organizations only if both the Type III supporting organization and its supported organizations exist as part of one integrated system, such as a hospital system. The Type III supporting organization must also carry out activities typically carried out by the parent of an integrated system and appoint a majority of the board members of each of its supported organizations.

For purposes of the prohibition on Type I and Type III supporting organizations accepting contributions from persons who control a supported organization, the Proposed Regulations also clarify the meaning of the word “control.” Generally, one or more persons are considered to control the board of a supported organization if they hold 50 percent of the total voting power or have the ability to exercise veto power over the actions of the board.

### **CONCLUSION**

While the Proposed Regulations do not significantly alter the existing regulatory landscape facing

Type I and Type III supporting organizations, certain Type III supporting organizations may find it necessary to make adjustments in their operations, annual distributions, or relationships to their supported organizations. Although the Proposed Regulations serve to clarify certain terms and definitions left unclear in the current version of the regulations, the laws surrounding Type I and III supporting organizations remain a complex area to navigate.

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If you would like assistance in preparing comments on the Proposed Regulations, please contact one of the lawyers listed below.

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