



## **Kiss or Kill?: Decision Time Approaches for Type III Supporting Organizations As the IRS Issues Proposed Regulations**

by Patrick J. Downey

### **Background**

The Internal Revenue Code (the Code) creates two classes of 501(c)(3) tax exempt charitable organizations – private foundations and public charities. An organization must first qualify for tax exemption under 501(c)(3) before its classification as a public charity or private foundation becomes an issue. The law presumes that a 501(c)(3) is a private foundation unless it establishes that it meets one of the exceptions provided by the Code. Private foundations are more highly regulated than most public charities. They are also subject to certain excise taxes that generally do not apply to public charities. The Code classifies supporting organizations as public charities.

A supporting organization is a 501(c)(3) organization that is 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. A supporting organization cannot be controlled directly or indirectly by major donors or parties related to its major donors. A supporting organization must have and maintain one of three statutorily described

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relationships with one or more of the charities that it supports. It is the nature of a supporting organization's relationship with its supported organizations that results in its designation as a Type I, Type II or Type III supporting organization. The specific requirements of these relationships are established by regulation.

Congress and the IRS had long-standing concerns that the supporting organization public charity classification was the subject of abuse. Their concerns mostly were directed at the type of supporting organization that practitioners had termed Type III supporting organizations (supporting organizations that are "operated in connection with" one or more supported organizations). This is the most attenuated supporting organization-supported organization relationship. Under the pre-PPA regulations, Type III's were required to satisfy a responsiveness test and an integral part test.

In 2006, Congress passed the Pension Protection Act (PPA) which established new rules for supporting organizations to address some of those perceived abuses. The PPA codified the practitioner's designation of supporting organizations as Type I, Type II or Type III supporting organizations. The PPA also created two categories of Type III supporting organizations – "functionally integrated" and "non-functionally integrated."

In 2007, the Department of Treasury provided advanced notice of the rules that were under consideration to implement the PPA's changes in the law governing Type III supporting organizations and requested comments on those proposed rules. The Treasury recently promulgated Prop. Regs. 1.509(a)-4 and Prop. Regs. 53.4943-11. The proposed regulations include a number of changes from the rules described in the 2007 announcement. Although Treasury has requested comment on several outstanding issues, the proposed regulations provide existing Type III's with a clearer picture of the regulatory regime they soon will be living under. Despite the PPA's changes to the Code, the specific requirements that a supporting organization must satisfy to be classified as a Type III supporting organization are set forth mainly in the proposed regulations.

### **The PPA's Changes To Type III Status**

The PPA revised the Code to require that Type III's supply their supported organizations with information that is intended to ensure they are responsive to their supported organizations. The Code grants the Treasury Secretary the authority to specify the information that a Type III will be required to provide to satisfy this annual requirement. Type III's no longer are able to support organizations that are not organized in the United States. The PPA revised the Code to provide that Type III's will not be treated as being operated in connection with a particular supported organization if they accept a gift or contribution from any person that directly or indirectly controls the governing body of such supported organization or from certain persons or entities related to such a person. Accepting such a gift or contribution likely would result in the loss of the supporting organization's public charity status.

### **The Proposed Regulations**

The proposed regulations establish three requirements for Type III supporting organizations: the notification requirement, the responsiveness test and the integral part test.



Under the notification requirement, a Type III must provide a principal officer of each of its supported organizations with a notice of the type and amount of support it provided in the past year, a copy of its most recently filed Form 990 and a copy of its governing documents on or before the last day of the fifth month following the end of its fiscal year. The Type III will not have to provide copies of its governing documents if they were previously provided and have not subsequently been amended.

The responsiveness test requires that Type III supporting organizations be responsive to the needs or demands of a supported organization. The pre-PPA regulations provided a separate responsiveness test for charitable trusts. The proposed regulations eliminate the separate test for charitable trusts and all Type III's are required to satisfy the same test. Under the responsiveness test, one or more of the officers, directors or trustees of the Type III must maintain one of three relationships with the officers, directors or trustees of its supported organizations. The supported organization, by virtue of that relationship, must have a significant voice in the investment policies of the Type III, the timing of grants, the manner of making them, the selection of the grant recipients and in otherwise directing the use of the Type III's income or assets.

Finally, under the integral part test Type III supporting organizations must show they are involved significantly in the operations of a supported organization and the supported organization is dependent upon the supporting organization for that support. The proposed regulations establish separate integral part tests for functionally integrated and non-functionally integrated Type III's.

### **The Integral Part Test for Functionally Integrated Type III's**

A functionally integrated Type III will satisfy the integral part test if it engages in activities substantially all of which directly further the exempt purposes of its supported organizations by performing their functions or carrying out their purposes which otherwise would have been undertaken by the supported organizations. Holding title to and managing exempt-use property are activities that directly further the exempt purposes of a supported organization. Fundraising, investing and managing non-exempt-use property and making grants generally are not activities that directly further exempt purposes. The proposed regulations do not include the expenditure and assets tests that were discussed in the 2007 notice.

A functionally integrated Type III also will satisfy the integral part test if it is the parent of its supported organizations. The parent-subsidiary relationship is established if the Type III exercises a substantial degree of direction over the policies, programs and activities and a majority of the officers, directors or trustees of the supported organization is, directly or indirectly, appointed or elected by the governing body of the supporting organization or its members or officers acting in their official capacity.

### **The Integral Part Test for Non-Functionally Integrated Type III's**

To satisfy the integral part test, a non-functionally integrated Type III generally will be compelled to satisfy a distribution requirement and an attentiveness requirement. Trusts that were established before November 20, 1970, may not be obligated to satisfy the integral part test if they satisfy a separate set of requirements set forth in the regulations.

To satisfy the distribution requirement, a non-functionally integrated Type III must annually distribute a certain amount to or for the use of its supported organizations on or before the last day of its fiscal year. That amount is termed its annual distributable amount. The amount of a distribution is its fair market value on the date it is dispensed. The supporting organization can carry forward the amount by which its annual distribution exceeds its annual distributable amount for a period of five years. The regulations provide extensive rules that are to be used to calculate the annual distributable amount.

Under the attentiveness requirement, a non-functionally integrated Type III must distribute at least one-third of its annual distributable amount to one or more supported organizations that are attentive to its operations and to which it is responsive. A supported organization is attentive to the operations of a supporting organization if the supporting organization annually distributes to the supported organization a sufficient part of its total support. A supported organization is attentive to a supporting organization if the supporting organization annually provides it with 10% or more of its total support. Attentiveness also is present if the amount of support provided by the supporting organization is necessary to avoid the interruption of a particular function or activity. Finally, attentiveness can be shown if all the facts and circumstances establish that the support provided by the supporting organization is a sufficient part of its total support.

### Conclusion

Existing Type III supporting organizations will be expected to satisfy the requirements set forth in the regulations beginning with their first taxable year after the regulations are published in the *Federal Register* as final or temporary regulations. A Type III supporting organization that fails to satisfy these requirements will be classified as a private foundation. Type III supporting organizations should review their operations to determine whether they will be able to and want to maintain their status as a Type III supporting organization and examine their other options. Please contact Patrick J. Downey if you would like Eastman & Smith to assist you with your review.



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