IRS Publishes Long-Awaited Final Regulations for Type III Supporting Organizations

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On Dec. 21, 2012, more than three years after publishing proposed regulations in 2009, the IRS and the
Treasury Department issued final and temporary regulations (T.D. 9605) regarding the changes made
to Type III supporting organizations under the Pension Protection Act of 2006 (the 2006 Act). Most
significantly, the IRS withdrew portions of the 2009 proposed regulations that provided for a 5 percent
distribution requirement for non-functionally integrated Type III supporting organizations similar to
the distribution requirements that apply to private foundations. The withdrawn portion of the
regulations was replaced with temporary regulations, which serve as the text of the new proposed
regulations, requiring non-functionally integrated Type III supporting organizations to meet a
distribution requirement equal to the greater of 85 percent of the organization’s adjusted net income or
3.5 percent of the fair market value of the organization’s non-exempt-use assets.

The final and temporary regulations, making some changes to the 2009 proposed regulations (in
addition to the changes to the payout requirements for non-functionally integrated Type III supporting
organizations), include guidance regarding:

• The types of information that a Type III supporting organization must provide to the
  organization(s) it supports under the new notification requirement.
• The elimination of the special rule that allowed certain charitable trusts to meet the responsiveness
test for classification as a Type III supporting organization.
• The retention of certain transitional rules allowing certain charitable trusts in existence before
  Nov. 20, 1970, to qualify as Type III supporting organizations.
• The criteria that must be satisfied for a Type III supporting organization to be “functionally
  integrated” (i.e., engaging in activities substantially all of which directly further the exempt
  purposes of the supported organization(s) to which it is responsive) and the types of activities that
  “directly further” the exempt purposes of a supported organization.
• The exception for a supporting organization that is the parent of, and exercises a substantial degree
  of control over, each of its supported organizations.
• The distribution requirement and attentiveness requirement for “non-functionally integrated” Type
  III supporting organizations.

OVERVIEW OF SUPPORTING ORGANIZATIONS

A supporting organization is a tax-exempt organization described in Internal Revenue Code section
501(c)(3) that supports one or more tax-exempt 501(c)(3) organizations described in Internal Revenue
Code sections 509(a)(1) or 509(a)(2) (hereinafter referred to as “public charities,” “publicly supported
organizations” or “supported organizations”). For tax purposes, the supporting organization receives
the favorable tax treatment afforded to public charities, without being required to meet the strenuous
public support tests that must be met by some section 509(a)(1) organizations and all section 509(a)(2)
organizations, because of the close relationship between the supporting organization and its supported
organization(s).

To be classified as a supporting organization, an organization must meet three requirements. Under the
organizational and operational tests, the organization must be organized and at all times thereafter
operated exclusively for the benefit of, to perform the functions of or to carry out the purposes of one
or more public charities. The “relationship” test requires that the organization be operated, supervised
or controlled by or in connection with one or more public charities. And the organization must not be
controlled directly or indirectly by one or more disqualified persons (other than foundation managers)
within the meaning of Internal Revenue Code section 4946.
**Organizational Test**
The organizational test requires that the organization be organized for the benefit of, to perform the functions of or to carry out the purposes of one or more public charities. To meet the organizational test, the organization’s articles of organization must limit the purposes of the organization to benefiting, performing the functions of or carrying out the purposes of one or more public charities; not expressly empower the organization to engage in any activities that are not in furtherance of benefiting, performing the functions of or carrying out the purposes of one or more public charities; designate by class or purpose or by name the public charities on whose behalf the organization is to be operated; and not expressly empower the organization to operate to support or benefit any organization other than those specified in the articles of organization.

The degree of specificity with which the supported organization must be designated depends upon the type of relationship between the supporting organization and the supported public charity or charities. The permissible types of relationships are described below in more detail. Generally, if the organization is “operated, supervised or controlled by” or “supervised or controlled in connection with” the supported public charity or charities, the supported public charity or charities can be specified by name, class or purpose. If the supporting organization is “operated in connection with” one or more public charities, the supported organization as a general rule must be specified by name.

**Operational Test**
The operational test requires that the organization be “operated exclusively” to support one or more specified public charities. An organization will meet this operational test only if it engages solely in activities that support or benefit the specified public charity or charities. Permissible activities may include making payments to or for the use of, or providing services or facilities for, individual members of the charitable class benefited by the supported public charities. The organization will not meet the operational test if any part of its activities is not in furtherance of a purpose other than supporting or benefiting the specified public charity or charities. It is not necessary to meet the operational test that the organization pay over its income to the supported public charity or charities. Instead, it may meet the operational test by using its income to carry on an independent activity or program that supports or benefits the specified public charity or charities.

**Relationship Test**
The organization must have one of three types of relationships with the public charity or charities it is to support. The organization must be either (a) operated, supervised or controlled by the public charity or charities it supports; (b) supervised or controlled in connection with the public charity or charities it supports; or (c) operated in connection with the public charity or charities it supports. Any relationship must ensure that the organization will be responsive to the needs or demands of the public charity or charities it supports and will constitute an integral part of, or maintain a significant involvement in, the operations of the public charity or charities it supports.

*Operated, Supervised or Controlled by Test (Type I Supporting Organization).* The distinguishing feature of a Type I supporting organization is the presence of a substantial degree of direction by the public charity or charities over the conduct of the supporting organization. This relationship test is the one most commonly used to establish supporting organization status and is most appropriate for organizations that have a close, primary relationship with the public charity to be supported. Essentially, this type of relationship is comparable to that of a parent and subsidiary in which the subsidiary is under the direction of and accountable or responsible to the parent. The operated, supervised or controlled by test is met if a majority of the officers, directors or trustees of the
supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity or the membership of one or more public charities.

**Supervised or Controlled in Connection With Test (Type II Supporting Organization).** The distinguishing feature of a Type II supporting organization is the presence of common supervision or control among the governing bodies of the organizations involved, such as the presence of common directors. The Type II relationship is usually used by an existing public charity that for fundraising or other reasons desires to establish another charitable organization to carry out certain activities. The supervised or controlled in connection with test requires common supervision or control by the persons supervising or controlling both the supporting organization and the public charity or charities to ensure that the supporting organization will be responsive to the needs and requirements of the public charity or charities. This relationship test is met by establishing that the control or management of the supporting organization is vested in the same persons that control or manage the public charity or charities it supports. This type of relationship is similar to that of “brother-sister” corporations in the for-profit corporate context.

**Operated in Connection With Test (Type III Supporting Organization).** The distinguishing feature of a Type III supporting organization is that the supporting organization is responsive to, and significantly involved in the operations of, the public charity or charities that it supports. The operated in connection with test is the most flexible type of relationship that can exist between the supporting organization and the public charity or charities it supports. But it is also the most subjective test, and therefore it can be more difficult to establish that the requirements of the test are met. Under this test, it is not necessary that the supporting organization be controlled by the supported public charity or charities. Rather, there must be sufficient ties between the supporting organization and the public charity or charities it supports. To meet this relationship test, the supporting organization must establish that it satisfies a responsiveness test and an integral part test.

- **Responsiveness Test.** The responsiveness test is designed to ensure that the supporting organization will be responsive to the needs or demands of the supported public charity or charities. The responsiveness test is satisfied if: (1) one or more officers, directors or trustees of the supporting organization are elected or appointed by the officers, directors, trustees or membership of the publicly supported organizations; (2) one or more members of the governing bodies of the publicly supported organizations are also officers, directors or trustees of, or hold other important offices in, the supporting organization; or (3) the officers, directors or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors or trustees of the publicly supported organizations; and (4) by reason of either (1), (2) or (3) above, the officers, directors or trustees of the publicly supported organizations have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making grants and the selection of recipients by the supporting organization, and in otherwise directing the use of the income or assets of the supporting organization. Because of the changes made by the 2006 Act, the responsiveness test can no longer be met solely because the supporting organization is a charitable trust under state law and each specified publicly supported organization is a named beneficiary under the terms of the charitable trust’s governing instrument and has the power to enforce the trust and compel an accounting under applicable state law.

- **Integral Part Test.** To meet the integral part test, the supporting organization must maintain a significant involvement in the operations of one or more publicly supported organizations. Furthermore, the publicly supported organizations must be dependent upon the supporting organization for the type of support the supporting organization provides. Before the issuance of
the final regulations in December 2012, the integral part test could be satisfied in one of two ways. The first alternative contemplated that the supporting organization would carry on its own activities in furtherance of the purposes of the publicly supported organization or organizations it supports. The integral part test would be satisfied if the activities engaged in for or on behalf of the publicly supported organizations were activities to perform the functions of, or to carry out the purposes of, such organizations and, but for the involvement of the supporting organization, would normally be engaged in by the publicly supported organizations themselves. This alternative was referred to as the “but for” alternative. Alternatively, the integral part test could be satisfied if the supporting organization made payments of substantially all its income to or for the use of one or more publicly supported organizations, and the amount of support received by one or more of such publicly supported organizations was sufficient to ensure the attentiveness of such organizations to the operations of the supporting organization. This alternative was referred to as the “substantially all income” alternative. For purposes of this alternative, “substantially all” meant 85 percent or more. Also, a substantial amount of the total support of the supporting organization had to go to those publicly supported organizations that met this attentiveness requirement. As a general rule, the amount of support received by a publicly supported organization had to represent a sufficient part of the organization’s total support so as to ensure such attentiveness.

**ADDITIONAL REQUIREMENTS FOR TYPE III SUPPORTING ORGANIZATIONS UNDER THE 2006 ACT**

The 2006 Act imposed additional requirements on Type III supporting organizations.

**Notification**

For each tax year beginning after Aug. 17, 2006, a Type III supporting organization must provide each supported organization with such information as the IRS may require to ensure that the supporting organization is responsive to the needs of the supported organization. This information is intended to include a copy of the supporting organization’s governing documents and any amendments thereto, the Form 990, the Form 990-T if any and an annual report. These requirements became effective upon issuance of the final regulations on Dec. 28, 2012.

**Foreign Organizations**

A Type III supporting organization cannot support an organization that is not organized in the United States. (This rule does not apply until the first day of the organization’s third tax year beginning after Aug. 17, 2006, for existing organizations operated in connection with a foreign organization.)

**Distribution Requirements**

The 2006 Act directed the IRS to issue new regulations on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations that will require these organizations to make distributions of either a percentage of either income or assets to supported organizations in order to ensure that a “significant amount” is paid to such organizations. A functionally integrated Type III supporting organization is defined as a Type III supporting organization that is not required under regulations to be issued by the IRS to make payments to supported organizations because the activities of the organization are related to performing the functions of, or carrying out the purposes of, such supported organizations.
Application of the Responsiveness Test to Certain Charitable Trusts

The 2006 Act eliminated a special rule that allowed certain charitable trusts to meet the responsiveness test for classification as a Type III supporting organization. Before the 2006 Act, a charitable trust could satisfy the responsiveness test if it was a charitable trust under state law, each supported organization was a named beneficiary under the terms of the charitable trust’s governing instrument, and the supported organization(s) had the power to enforce the trust and compel an accounting under applicable state law.

PROVISIONS OF THE FINAL AND TEMPORARY REGULATIONS ON THE 2006 ACT CHANGES AFFECTING TYPE III SUPPORTING ORGANIZATIONS

The final and temporary regulations, which are generally effective as of Dec. 28, 2012, the date of publication in the Federal Register, address the relationship test as it applies to Type III supporting organizations following the enactment of the 2006 Act. This relationship test for a Type III supporting organization mandates that a Type III supporting organization be “operated in connection with” one or more public charities and must meet three requirements: a notification requirement, a responsiveness test and an integral part test. A Type III supporting organization that fails to meet these requirements and otherwise fails to meet the requirements of any other provisions for classification as a public charity will be reclassified as a private foundation.

Annual Notification to Supported Organizations

A Type III supporting organization must provide certain information to its supported organization(s) to ensure that the organization is responsive to the supported organization’s needs. The final regulations require that a Type III supporting organization annually provide the following information to each of its supported organizations:

- Written notice addressed to a principal officer of the supported organization identifying the supporting organization and describing the amount and type of support it provided to it during the taxable year immediately preceding the taxable year in which the written notice is provided (and during any other taxable year ending after Dec. 28, 2012, for which support information has not previously been provided).
- A copy of the supporting organization’s most recently filed Form 990 or other return required to be filed under federal tax law as well as any return for any other taxable year of the supporting organization ending after Dec. 28, 2012, that has not been previously provided to the supported organization, but the organization may redact the names and addresses of any contributors in the copy provided, consistent with the Form 990 public disclosure rules.
- A copy of the supporting organization’s governing documents, including its articles of organization and bylaws, if any, and any amendments to such documents, unless previously provided to the supported organization.

The required notice, which may be provided by electronic media, must be postmarked or electronically transmitted by the last day of the fifth month after the close of the supporting organization’s tax year. Recognizing that organizations frequently obtain an extension for filing their annual returns, the final regulations clarify that the return to be included in the notification is the one most recently filed. The preamble to the final regulations contains the following example: “[I]f a Type III supporting organization reporting on a calendar year basis has not filed its 2013 Form 990 by May 31, 2014, because it requested an extension, it can satisfy the Form 990 portion of its notification requirement for
2013 (which it needs to meet by May 31, 2014) by providing a copy of the 2012 Form 990 that it filed in 2013."

The final regulations define a “principal officer” as the person who, regardless of title, has ultimate responsibility for (a) implementing the decisions of the governing body of the supported organization; (b) supervising the management, administration or operation of the supported organization; or (c) managing the finances of the supported organization (such as a CFO or treasurer).

The final regulations also provide transitional relief for supporting organizations already in existence by allowing the first required notification for its taxable year that includes Dec. 28, 2012, to be given by the later of the last day of the fifth month after the close of that taxable year or the due date, including extensions, for the Form 990 for that taxable year. Thus, if a calendar year Type III supporting organization puts its 2012 Form 990 on extension until Nov. 15, 2013, it will not be required to satisfy its notification requirement until Nov. 15, 2013. But if the return for 2012 is not placed on extension, it will be required to provide the required notification by May 31, 2013.

**Responsiveness Test**

The responsiveness test for classification as a Type III supporting organization remains largely unchanged and requires that the supporting organization be responsive to the needs or demands of a supported organization. The final regulations confirm the 2006 Act’s elimination of the alternative responsiveness test for charitable trusts.

This responsiveness test requires that the officers, directors or trustees of the supported organization(s) have a significant voice in (but not control of) the supporting organization’s investment policies, the timing of grants, the manner of making grants, the selection of recipients and direction of the use of the income or assets of the supporting organization. This significant voice must occur by one of three relationships between the supporting organization and the supported organization:

- One or more officers, directors or trustees of the supporting organization are elected or appointed by the officers, directors, trustees or membership of the supported organization;
- One or more members of the governing body of the supported organization are also officers, directors or trustees of, or hold other important offices in, the supporting organization; or
- The officers, directors or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors or trustees of the supported organization.

The final regulations offer examples as set forth below, intended to show how a charitable trust may meet the responsiveness test following the elimination of the alternative responsiveness test for charitable trusts. The final regulations modified Example 1 as previously set forth in the proposed regulations to include not only face-to-face meetings, but also telephonic meetings, in response to comments received.

**Example 1.** X, an organization described in section 501(c)(3), is a trust created under the last will and testament of Decedent. The trustee of X (Trustee) is a bank. Under the trust instrument, X supports M, a private university described in section 509(a)(1). The trust instrument provides that Trustee has discretion regarding the timing and amount of distributions consistent with the Trustee’s fiduciary duties. Representatives of Trustee and an officer of M have quarterly face-to-face or telephonic meetings during which they discuss M’s projected needs and ways in which M would like X to use its income and invest its assets. Additionally, Trustee
 communicates regularly with that officer of M regarding X’s investments and plans for distributions from X. Trustee provides the officer of M with quarterly investment statements, the information required under paragraph (i)(2) of this section and an annual accounting statement. Based on these facts, X meets the responsiveness test … with respect to M.

Example 2. Y is an organization described in section 501(c)(3) and is a trust under State law. The trustee of Y (Trustee) is a bank. Y supports charities P, Q, and R, each an organization described in section 509(a)(1). Y makes annual cash payments to P, Q, and R. Once a year, Trustee sends to P, Q, and R the cash payment, the information required under [the notification requirement] of this section, and an accounting statement. Trustee has no other communication with P, Q, or R. Y does not meet the responsiveness test ….

In the preamble to the final regulations, the IRS stated that it intends to issue proposed regulations in the near future that amend the responsiveness test by clarifying that Type III supporting organizations must be responsive to all their supported organizations and further that it intends to request comments regarding examples of how to satisfy the responsiveness test. The IRS is also considering how a supported organization can still be deemed to have a significant voice over a trust that has a governing instrument specifying the recipients, timing, manner and amount of grants, and the IRS intends to issue proposed regulations in the near future that will provide further clarification of this issue.

The final regulations continue to allow supporting organizations that were in existence before Nov. 20, 1970, to use additional facts and circumstances, such as a historic and continuing relationship between the supporting and supported organizations, to satisfy the responsiveness test.

Integral Part Test

The final regulations make significant revisions to the integral part test to reflect the changes made by the 2006 Act. The 2006 Act created two categories of Type III supporting organizations, those that are “functionally integrated” and those that are not (referred to as “non-functionally integrated”). Significantly, a functionally integrated Type III supporting organization will not be subject to the distribution requirement discussed below.

Functionally Integrated Type III Supporting Organizations. On Aug. 2, 2007, the IRS issued an Advance Notice of Proposed Rulemaking (Advance Notice) defining a functionally integrated Type III organization as one that is not required to make payments to supported organizations because the activities of the organization are related to performing the functions, or carrying out the purposes of, such supported organizations. See 72 Fed. Reg. 42335 (Aug. 2, 2007).

Under the Advance Notice, the definition of a functionally integrated Type III supporting organization encompassed organizations that met the “but for” prong of the integral part test as set forth in the former supporting organization regulations and an expenditure test and an assets test similar to those that apply for determining if an organization is a private operating foundation under Internal Revenue Code section 4942.

The final regulations provide that a Type III supporting organization is functionally integrated if it:

• Meets the “but for” test;
• Is the parent of each of its supported organizations; or
• Supports a governmental supported organization.
The final regulations provide additional guidance on what activities directly further the exempt purposes of a supported organization for purposes of the but for test, as well as the definition of a “parent.” Rules regarding organizations that support a governmental supported organization, which were included in the proposed regulations in 2009, have been eliminated, however, and reserved for future guidance. The IRS stated in the preamble to the final regulations that this guidance will be issued sufficiently in advance of the beginning of the full implementation of the functional integration rules under the transitional rules discussed below to enable Type III supporting organizations to determine whether they are functionally integrated.

“But For” Test. The final regulations confirm that a Type III supporting organization may be considered “functionally integrated” if it engages in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s) and which, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s). The final regulations do not include an expenditure or assets test.

Under the final regulations, in determining whether “substantially all” of the supporting organization’s activities directly further the supporting organization’s exempt purposes, all pertinent facts and circumstances will be considered.

Activities “directly further” the exempt purposes of the supported organization(s) only if they are conducted by the supporting organization and not by the supported organization. Holding title to and managing exempt-use property are activities that directly further the supported organization’s exempt purposes. Fundraising, making grants (to either the supported organization or third parties), and investing and managing non-exempt-use property are not activities that directly further the supported organization’s exempt purposes. The payment of grants, scholarships or other payments to individual beneficiaries who are members of the charitable class benefited by the supported organization, however, is treated as an activity that directly furthers the exempt purposes of the supported organization if:

- The individual grantees are selected on an objective and nondiscriminatory basis;
- The officers, directors or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making payments and the selection of the grantees; and
- The making or awarding of such individual grants is part of an active program of the supporting organization that directly furthers the exempt purposes of the supported organization and in which the supporting organization maintains significant involvement within the meaning of the private foundation minimum distribution regulations.

Finally, the final regulations also add to the “but for” test a requirement that a functionally integrated Type III supporting organization’s activities must directly further the exempt purposes of the supported organizations to which it is responsive under the responsiveness test.

Under transitional rules set forth in the final regulations, a Type III supporting organization can qualify as functionally integrated under the “but for” test set forth in the former supporting organization regulations until the first day of its second taxable year beginning after Dec. 28, 2012. Thus, an organization on a calendar year tax year may be considered to be functionally integrated under the old “but for” test until Jan. 1, 2014. Beginning on Jan. 1, 2014, however, it will have to meet the new requirements set forth in the final regulations in order to be considered functionally integrated.
Parent Test. The final regulations also provide that a Type III supporting organization will be functionally integrated if it is the “parent” of each of its supported organizations. To be a “parent,” the Type III supporting organization must oversee or facilitate the operation of an integrated system, such as a hospital system, by exercising a substantial degree of direction over the policies, programs and activities of the supported organization. In addition, a majority of the officers, directors or trustees of the supported organization must be appointed or elected, directly or indirectly, by the officers, governing body or members of the governing body of the supporting organization. The IRS, however, believing this definition of “parent” to be “insufficiently specific,” intends to issue proposed regulations in the near future to provide a new definition specifically addressing the power to remove and replace officers, directors and trustees.

Non-Functionally Integrated Type III Supporting Organizations. The 2006 Act introduced the concept of a “non-functionally integrated” Type III supporting organization and directed the Treasury to issue regulations imposing a distribution requirement on these organizations and requiring them to meet an attentiveness requirement. Under the final regulations, an organization that otherwise meets the requirements of the responsiveness test as a Type III supporting organization but does not meet the integral part test for a functionally integrated Type III supporting organization may meet the integral part test and be considered non-functionally integrated if it satisfies either (a) a distribution requirement and an attentiveness requirement or (b) the requirements for a pre-Nov. 20, 1970, trust.

Distribution Requirement. The proposed regulations issued in 2009 had imposed a 5 percent distribution requirement on non-functionally integrated Type III supporting organizations. The final regulations continue to impose a distribution requirement on these organizations, but reserved for future guidance the distributable amount. The IRS issued temporary regulations simultaneously with the final regulations that define the distributable amount as the greater of (a) 85 percent of the organization’s adjusted net income as determined under the private foundation minimum distribution rules of Internal Revenue Code section 4942 for the taxable year immediately preceding the taxable year of the required distribution and (b) the organization’s “minimum asset amount” for the immediately preceding taxable year, reduced by the amount of any taxes imposed on the supporting organization during the immediately preceding taxable year. An organization’s “minimum asset amount” is defined as 3.5 percent of the excess of the aggregate fair market value of the supporting organization’s non-exempt-use assets in that immediately preceding taxable year over the acquisition indebtedness with respect to such non-exempt-use assets increased by:

- amounts received or accrued during the immediately preceding taxable year as repayments of amounts that were taken into account in a prior year to meet the minimum distribution requirement;
- amounts received or accrued during the immediately preceding taxable year from the sale or other disposition of property to the extent that the acquisition of such property was taken into account by the organization to meet the minimum distribution requirement for a prior year; and
- any amount “set aside” to the extent it is determined during the immediately preceding taxable year that such set-aside is not necessary for the purposes for which it was set aside and such set-aside was taken into account by the organization to meet the distribution requirement in a prior year.

The temporary regulations also set forth rules for the valuation of non-exempt-use assets and provide that the value is to be determined under the private foundation minimum distribution rules of Internal Revenue Code section 4942. The value of the non-exempt-use assets may not be reduced by any set-aside. Non-exempt-use assets are all assets of the supporting organization other than:
any future interest of the supporting organization in the income or corpus or any real or personal
property, until all intervening interests in, and rights to the actual possession or enjoyment of, such
property have expired, or, although not actually reduced to the supporting organization’s
possession, until such future interest has been constructively received by the supporting
organization, or otherwise made available so that the supporting organization may acquire it at any
time or could have acquired it if notice of intention to acquire had been given;
• the assets of an estate until such time as such assets are distributed to the supporting organization,
or due to a prolonged period of administration, such estate is considered terminated for federal
income tax purposes;
• any present interest of the supporting organization in any trust created by and funded by another
person;
• any pledge to the supporting organization of money or property (whether or not the pledge may be
legally enforced); and
• exempt-use assets, which are assets used or held for use to carry out the exempt purposes of the
supporting organization’s supported organization(s) by either the supporting organization or one
or more supported organizations, but only if the supporting organization makes the asset available
to the supported organization(s) at no cost or nominal rent to the supported organization(s).

The provisions of the temporary regulations defining the distributable amount and the minimum asset
amount and setting forth the rules for valuing non-exempt-use assets are effective as of Dec. 28, 2012,
and expire on or before Dec. 21, 2015.

The distributable amount must be distributed to or for the use of one or more supported organizations
on or before the last day of the taxable year. Subject to certain transitional rules, the distributable
amount for the first year in which an organization is treated as a non-functionally integrated Type III
supporting organization is zero. In the case of a disaster or emergency, the IRS may, by publication in
the Internal Revenue Bulletin, provide for a temporary reduction in the distributable amount.

The final regulations include guidance on what distributions count toward the distribution requirement
and add provisions requested by commentators that allow certain set-asides to count toward the
distribution requirement similar to the private foundation rules as well as certain expenditures on
activities that directly further the exempt purposes of the supported organization(s). Generally, the
amount of a distribution is the amount of cash distributed or the fair market value of property
distributed as of the date of distribution. The amount of distributions is determined solely on the cash
receipts and disbursements method of accounting. Distributions that count include, but are not limited
to:

• Any amount paid to a supported organization to accomplish the supported organization’s exempt
purposes.
• Any amount paid by the supporting organization to perform an activity that directly furthers the
exempt purposes of the supported organization(s) within the meaning of the integral part test for
functionally integrated Type III supporting organizations, but only to the extent such amount
exceeds any income derived by the supporting organization from the activity.
• Any reasonable and necessary administrative expenses paid to accomplish the exempt purposes of
the supported organization(s), which do not include expenses incurred in the production of
investment income.
• Any amount paid to acquire an “exempt-use” asset.
• Any amount “set aside” for a specific project that accomplishes the exempt purposes of a
supported organization to which the supporting organization is responsive, with the set-aside
counting toward the distribution requirements for the taxable year in which the set-aside is made but not when actually paid, if at the time of the set-aside the supporting organization:

- Obtains a written statement from each supported organization whose exempt purposes the set-aside accomplishes, signed under the penalties of perjury by a principal officer of the supported organization, stating that the supported organization approves the project as one that accomplishes one or more of its exempt purposes and also approves the supporting organization’s determination that the project is one that can be better accomplished by the set-aside rather than an immediate payment of funds;
- Establishes to the satisfaction of the IRS, by meeting the approval and information requirements set forth in the private foundation set-aside rules of Internal Revenue Code section 4942 and by providing the statement described above from the supported organization(s), that the amount set aside will be paid within 60 months after the set-aside and that the project is one that can be better accomplished by the set-aside rather than an immediate payment of funds; and
- Evidences the set-aside by the entry of a dollar amount on the books and records of the supporting organization as a pledge or obligation to be paid at a future date or dates within 60 months of the set-aside.

The IRS indicates in the preamble to the final regulations that it intends to propose regulations in the near future that will more fully describe the expenditures (including expenditures for administrative and additional charitable activities) that do and do not count toward the distribution requirement. In addition, the IRS is considering whether rules similar to the private foundation program-related investment provisions should be included and intends to provide further clarification in future proposed regulations.

Like the private foundation minimum distribution rules, any excess distributions can be carried forward to reduce the distributable amount in any of the five taxable years immediately following the taxable year in which the excess distribution is made. An excess created in a taxable year can be carried forward for only five taxable years. There is an excess amount for any taxable year beginning after Dec. 28, 2012, if the total distributions made in that taxable year that count toward the distribution requirement exceed the supporting organization’s distributable amount for that taxable year. With respect to any taxable year to which an excess is carried over, in determining whether there is an excess distribution in that taxable year, the distributable amount is first reduced by any excess amounts carried over (with the oldest excess amounts applied first) and then by any distributions made in that taxable year.

If a non-functionally integrated Type III supporting organization fails to meet its distribution requirement, it will not be reclassified as a private foundation for the taxable year in which this occurs if the organization can establish to the satisfaction of the IRS that:

- The failure was due solely to unforeseen events or circumstances that are beyond the organization’s control, a clerical error or an incorrect valuation of assets;
- The failure was due to reasonable cause and not due to willful neglect; and
- The distribution requirement is satisfied within 180 days after the organization is first able to distribute its distributable amount notwithstanding the unforeseen events or circumstances or 180 days after the date the incorrect valuation or clerical error was or should have been discovered.
Attestiveness Test. The final regulations also require that a non-functionally integrated Type III supporting organization distribute one-third or more of its distributable amount to one or more supported organizations that are attentive to the operations of the supporting organization and to which the supporting organization is responsive. A supported organization is considered to be attentive to the supporting organization if at least one of the following requirements is met:

- The supporting organization provides 10 percent or more of the supported organization’s total support (or, in the case of a particular department or school of a university, hospital or church, the total support of the department or school) received during the supported organization’s last taxable year ending before the beginning of the supporting organization’s taxable year.
- The amount of support received from the supporting organization is necessary to avoid the interruption of a particular function or activity of the supported organization. The amount of the support is necessary if the supporting or supported organization earmarks the support for a particular program or activity of the supported organization, even if such program or activity is not the supported organization’s primary program or activity, as long as such program is a substantial one.
- Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and the supporting organization, and the purpose to which the funds are put, the amount of support received from the supporting organization is a sufficient part of a supported organization’s total support (or, in the case of a particular department or school of a university, hospital or church, the total support of the department or school) to ensure attentiveness. Under the requirement of the attentiveness of the supported organization to the operations of the supporting organization (including the nature and yield of the supporting organization’s investments), evidence of actual attentiveness is of almost equal importance to the amount paid in terms of a percentage of the total support. But a supported organization will not be considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

Any distributions by the supporting organization to a donor-advised fund held by the supported organization are disregarded in determining whether the supported organization will be attentive. Also, the preamble to the final regulations makes it clear that grants to organizations other than the supported organization will not ensure the attentiveness of the supported organization. Type III supporting organizations are generally not permitted to make grants to organizations other than their supported organizations and may not satisfy the attentiveness test by making distributions to third-party organizations.

Alternative Integral Part Test for Pre-Nov. 20, 1970, Trusts. The final regulations continue to allow certain trusts created before Nov. 20, 1970, to meet the integral part test by meeting certain requirements. These rules apply to both trusts that are exempt from taxation because they are organizations described in Internal Revenue Code section 501(c)(3) as well as charitable trusts within the meaning of Internal Revenue Code section 4947(a)(1). Trusts that meet the requirements of this special rule are not required to meet the new distribution and attentiveness requirements described above, but will be classified as non-functionally integrated Type III supporting organizations. To qualify for this classification, a trust must have met as of Nov. 20, 1970, and continue to meet, the requirements set forth below.

- For taxable years beginning after Oct. 16, 1972, the trustee must make annual written reports to all the trust’s supported organizations, setting forth a description of the trust’s assets, including a detailed list of the assets and income produced by such assets.
• All the unexpired interests in the trust are devoted to one or more purposes described in Internal Revenue Code section 170(c)(1) or (c)(2)(B) and a deduction was allowed with respect to such interests under Internal Revenue Code sections 170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), 2522 or corresponding provisions of prior law (or would have been allowed had the trust not been created before 1913).

• The trust was created before Nov. 20, 1970, and did not receive any grant, contribution, bequest or other transfer on or after that date. (A split-interest trust that was created before Nov. 20, 1970, was irrevocable on that date, and becomes a charitable trust after such date is treated as having been created before Nov. 20, 1970.)

• The trust is required by its governing instrument to distribute all its net income currently to a designated beneficiary (supported organization). If there is more than one beneficiary designated in the trust instrument, all the net income of the trust must be distributable and be distributed currently to each of the beneficiaries in fixed shares under the terms of the trust instrument.

• The trustee of the trust does not have discretion to vary either the beneficiaries or the amounts payable to them. If the trust has only one beneficiary to whom all the net income is distributable, this requirement will still be met even if the trustee has discretion to pay principal to the supported organization in addition to the mandatory income distributions. In addition, the trust instrument may also provide for discontinuance of the income distributions in the event of certain specific occurrences, such as the loss of the beneficiary’s exempt status under Internal Revenue Code section 501(c)(3) or its classification as a public charity under Internal Revenue Code section 509(a)(1) or (2) or the failure of the beneficiary to carry out its charitable purpose properly.

• None of the trustees would be disqualified persons within the meaning of the private foundation rules (other than as foundation managers) if the trust were a private foundation.

As was the case under prior rules, a charitable trust may request a ruling that it meets the requirements of special rule for pre-Nov. 20, 1970, charitable trusts and is properly classified as a non-functionally integrated Type III supporting organization, but is not required to do so.

**Transitional Rules.** A Type III supporting organization that is in existence on Dec. 28, 2012, and that met and continues to meet the former “substantially all income” test of the former regulations will be treated as meeting the distribution requirement imposed by the final regulations until the first day of its second taxable year beginning after Dec. 28, 2012. But to determine if there is an excess distribution in the first taxable year beginning after Dec. 28, 2012, the distributable amount is the amount described in the temporary regulations (i.e., the greater of 85 percent of the organization’s adjusted net income and its minimum asset amount). If an organization had been meeting the former “but for” test so that it was classified as functionally integrated, it may transition to a non-functionally integrated Type III supporting organization. In this case, its distribution requirement for its first taxable year beginning after Dec. 28, 2012, will be zero. But to determine if there is an excess distribution in the first taxable year beginning after Dec. 28, 2012, for such a transitioning organization, the distributable amount is the amount described in the temporary regulations (i.e., the greater of 85 percent of the organization’s adjusted net income and its minimum asset amount).

Recognizing that the governing instruments of some Type III supporting organizations that are non-functionally integrated under the final regulations may limit the amount that can be distributed to the supported organization(s), the IRS provides transitional relief in the final regulations to these organizations if created before Sept. 24, 2009, and judicial proceedings that are necessary to reform the governing instrument are commenced within 180 days after the Dec. 28, 2012, publication of the final regulations to reform the governing instrument to permit the supporting organization to meet the
distribution requirement. During any taxable year in which such a judicial proceeding is pending, the non-functionally integrated Type III supporting organization is not required to meet the distribution requirement to the extent one or more mandatory provisions of its governing instrument prevent it from meeting the distribution requirement by prohibiting distributions of corpus. The exception is available as long as the governing instrument was executed before Sept. 24, 2009, and the judicial proceeding is not subject to any unreasonable delay for which the supporting organization is responsible. Beginning with the first taxable year after the termination of the judicial proceeding, the non-functionally integrated Type III supporting organization must satisfy the distribution requirement under the final regulations regardless of the outcome of the judicial proceeding.

**Support of Foreign Organizations**
The final regulations confirm the provisions of the 2006 Act and provide that a supporting organization will not be operated in connection with one or more supported organizations if it supports any supported organization organized outside the United States.

**Effective Date**
Both the final and temporary regulations are effective and applicable on Dec. 28, 2012. Transitional relief where granted has been addressed above.

**ADDITIONAL PROVISIONS OF THE 2006 ACT AFFECTING SUPPORTING ORGANIZATIONS**

**Limits on Contributors**
Type I and Type III supporting organizations cannot receive contributions from certain persons. These persons include (1) a person who directly or indirectly controls (either alone or with other persons described in (2) or (3) following) the governing body of the supported organization; (2) a family member of a person described in (1); and (3) a 35 percent controlled entity. The final regulations issued on Dec. 28, 2012, confirm this rule. In addition, in response to comments, the IRS has stated that it intends to issue proposed regulations in the near future defining “control” for purposes of this rule for comment.

**Excess Benefit Transactions**
Because they are not private foundations, supporting organizations are subject to the intermediate sanctions or excess benefit transaction rules, which provide penalty excise taxes on “excess benefit transactions” under Internal Revenue Code section 4958. The 2006 Act expands the application of these taxes to supporting organizations and provides that an excess benefit transaction automatically includes (i) any grant, loan, compensation or other payment, such as an expense reimbursement, made by a supporting organization to a substantial contributor or his family members and entities 35 percent controlled by such persons and (ii) any loan provided by a supporting organization to a disqualified person (which would include a director of the organization). A person who is a disqualified person with respect to a supporting organization will also be a disqualified person with respect to the supported organization. These rules apply to all types of supporting organizations.

**Application of Excess Business Holdings Rules to Supporting Organizations**
Before the enactment of the 2006 Act, supporting organizations were sometimes used as a vehicle to hold family business interests in situations where the private foundation excess business holdings rules would have prevented a family foundation from doing so. The 2006 Act applies the private foundation excess business holdings rules of Internal Revenue Code section 4943 to certain supporting
organizations, including non-functionally integrated Type III supporting organizations and Type I or Type II supporting organizations if the supported organization is controlled by the supporting organization’s donors. The private foundation excess business holdings rules provide that the amount of holdings of the organization in a business enterprise, when combined with the holdings of disqualified persons, cannot exceed 20 percent. Any holdings in excess of this amount are subject to an excise tax. These rules apply the broader definition of disqualified person, however, that is found under the excess benefit transaction rules of Internal Revenue Code section 4958.

The 2006 Act offers some relief from the application of these rules. The IRS may exempt any qualified supporting organization from the application of these rules if it determines that the excess business holdings of such organization are consistent with the purpose or function constituting the basis for its exemption under Internal Revenue Code section 501. The provisions also adopt certain transitional rules that had applied to private foundations after the enactment of Internal Revenue Code section 4943 in 1969 to allow a period of time to dispose of these excess business holdings. While these transitional rules are complex, it appears that existing holdings of a supporting organization holding 95 percent or more of the voting stock in the business enterprise may be held for up to 20 years without imposition of an excise tax.

The final regulations add similar transitional relief for private foundations that were classified as Type III supporting organizations immediately before Aug. 17, 2006, but became private foundations under changes made by the 2006 Act. In addition, pre-Nov. 20, 1970, charitable trusts that continue to meet the requirements under the final regulations for classification as non-functionally integrated Type III supporting organizations under the special integral part test for pre-Nov. 20, 1970, charitable trusts will be treated as functionally integrated Type III supporting organizations for purposes of the excess business holding rules.

**Distributions from Nonoperating Private Foundations and Donor-Advised Funds to Supporting Organizations**

The 2006 Act excludes from the definition of a “qualifying distribution,” for purposes of the minimum distribution rules applicable to private foundations, any amount paid by a private foundation that is not an operating foundation to a Type III supporting organization that is not a functionally integrated Type III supporting organization or to a Type I or Type II supporting organization if a disqualified person with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. The IRS may determine, by regulation, that other distributions to supporting organizations should be excluded from the definition of qualifying distributions as well. The 2006 Act also amended the taxable expenditure rules applicable to private foundations to provide that any distribution to a Type III supporting organization that is not a functionally integrated Type III supporting organization is a taxable expenditure unless the private foundation exercises expenditure responsibility with respect to the grant. Similar expenditure responsibility requirements apply to grants from a donor-advised fund to a Type III supporting organization that is not functionally integrated.

**McGuireWoods Nonprofit & Tax-Exempt Organizations Group**

Our nonprofit and tax-exempt organizations lawyers provide advice and guidance that enable charities and other nonprofits to operate efficiently and effectively in today’s increasingly complicated, regulated and competitive environment.
McGuireWoods Private Wealth Services

The McGuireWoods private wealth services team stands ready to help clients and their advisors obtain estate planning results that benefit themselves and their families from both a tax and non-tax perspective. Private Wealth Services has been ranked by Chambers and Partners, the international rating service for lawyers, as one of the top wealth management practices in the United States for several years. Our professionals throughout the United States and in London are dedicated to estate planning and the analysis of related tax and fiduciary issues.

McGuireWoods Education Practice

Our education attorneys represent public and private colleges and universities. This representation includes statutory and regulatory compliance and investigation work relating to the Higher Education Act of 1965 and federal student aid programs. It also includes issues relating to NCAA investigations, faculty tenure, financing expansion, low-income housing, 501(c)(3) and other tax issues, student lending compliance and investigations, intellectual property, students and academics, housing, governance, endowment management, and construction.