

## Summary of Requirements for Type I and Type III Supporting Organizations

A Proposed Rule by the Internal Revenue Service on 2/19/2016

<http://federalregister.gov/a/2016-02858>

On February 19, 2016, the Treasury Department and the Internal Revenue Service issued proposed regulations regarding the prohibition on certain contributions to Type I and Type III supporting organizations and the requirements for Type III supporting organizations. The regulations reflect changes to the law made by the Pension Protection Act of 2006. While the proposed regulations focus primarily on the relationship test for Type III supporting organizations, Type I supporting organizations are included in the proposed regulations to ensure consistent definitions of prohibited contributions due to prohibited control by disqualified persons in both Type I and Type III supporting organizations.

In addition to Type I and Type III supporting organizations themselves, these regulations will be of interest to community foundations and other public charities serving as supported organizations. The proposed regulations will also be of interest to private foundations and sponsoring organizations of donor advised funds making grants to Type I and Type III supporting organizations.

**The Council is leading the foundation field’s review and analysis of the proposed regulations. Please share with us how supporting organizations are valuable to your foundation. Your input will be reflected in our analysis and in the comments we submit to the Treasury Department.**

### Relevant Background

#### Defining Supporting Organizations

Supporting organizations are uniquely beneficial to donors and the charitable organizations served by offering many types of charitable assistance. Distinct from a private foundation, supporting organizations allow donors the opportunity to partner directly with a public charity to fund one specific charitable organization. Their unique structure allows them to be an effective, efficient, and flexible operator; allowing charitable organizations to thrive under unique sets of challenges.

Under current law, three types of supporting organizations are classified as public charities:

“Type I” supporting organizations are akin to a subsidiary of the supported organization in that the supported organization—generally a 501(c)(3) organization—exercises a substantial degree of direction over the policies, programs, and activities of the supporting organization.

“Type II” supporting organizations, where persons supervising or controlling the supported organization exercise supervision or control over the supporting organization, are more akin to a brother-sister organization of the supported 501(c)(3).

“Type III” organizations are operated in connection with one or more 501(c)(3) organizations, and must satisfy a notification requirement, a “responsiveness test,” and an “integral part test.”

### **Working timeline of policy and regulatory actions addressing Type III supporting organizations**

- 2006: The Pension Protection Act of 2006 imposed new rules on the operation of Type III supporting organizations.
- 2009: The Treasury Department issued proposed regulations addressing Type III supporting organizations.
- 2011: Department of Treasury Report to Congress on Supporting Organizations and Donor Advised Funds
- 2012: The Treasury Department issued final regulations addressing the responsiveness and integral part test for Type III functionally integrated and non-functionally integrated supporting organizations, the notice requirements for all Type III supporting organizations, and several other provisions changed by the Pension Protection Act.
- 2014: Tax Reform Act of 2014 proposes to eliminate Type II and Type III supporting organizations. This means that organizations that support public charities would need to qualify as a supporting organization that is operated, supervised, or controlled by a publicly supported organization (i.e., a Type I supporting organization), or they would be treated as private foundations. Any new entities seeking to organize as supporting organizations would need to qualify as Type I supporting organizations to be eligible for tax-exempt status.
- 2016: The Treasury Department and the Internal Revenue Service issued proposed regulations regarding the prohibition on certain contributions to Type I and Type III supporting organizations and the requirements for Type III supporting organizations.

## **Proposed Regulations**

### **1. Restricting Gifts from Controlling Donor – Meaning of Control**

Type I and Type III supporting organizations are prohibited from accepting a gift or contribution from a person who directly or indirectly controls the governing body of a Type I or Type III supporting organization. In 2012, the Treasury reserved § 1.509(a)-4(f)(5)(ii) with the intent of defining control. The proposed regulations define “control,” in a way that is consistent with the existing regulations as it relates to disqualified persons. Under the proposed regulations, the governing body of a supported organization is considered “controlled” by a person if that person, alone or by aggregating his or her votes or position of authority with certain related persons, as described in section 509(f)(2)(B)(ii) and (iii), may require the governing body of the supported organization to perform any act that significantly

affects its operations or may prevent the governing body of the supported organization from performing any such act.

## **2. Type III Supporting Organization Relationship Test**

Section 1.509(a)-4(i)(1) provides that for each taxable year, a Type III supporting organization must satisfy a relationship test through three elements – a notification requirement, a responsiveness test, and an integral part test provided in the current regulations. The proposed regulations provide additional rules regarding the A) Notification Requirement, B) Responsiveness test

### **1) Notification Requirement**

Currently, a Type III supporting organization must provide certain documents to each of its supported organizations. The proposed regulations would clarify when these documents must be delivered. Specifically, supporting organizations must deliver the documents to each of its supported organizations by the last day of the fifth month of the taxable year after the taxable year in which the supporting organization provided the support it is reporting.

### **2) Responsiveness Test**

The proposed regulations would require organizations supported by Type III supporting organizations to demonstrate that they are responsive to and significantly involved in the operations of all (not some) of their supporting organization. Examples regarding concerns about potential administrative burdens relative to the responsiveness test, as well as how to satisfy the significant voice test requirement will be included.

### **3) Integral Part Test – Functionally Integrated Type III Supporting Organizations**

Section 1.509(a)-4(i)(1) provides that for each taxable year, a Type III supporting organization must satisfy the integral part test by maintaining significant involvement in the operations of one or more supported organization and providing support on which the supported organizations are dependent. To be functionally integrated a supporting organization must meet a three part test.

#### **a) Defining “Parent” and “Government Supported Organization”**

The proposed regulations further define supporting organizations that act as a parent of a supported organization and government supported organization.

#### **b) New Test for Government Supported Organization as Functionally Integrated**

A supporting organization that supports more than one governmental supported organization may be considered functionally integrated if all of its governmental supported organizations either:

- i) Operate within the same geographic region; or
- ii) Work in close coordination or collaboration with one another to conduct a service, program, or activity that the supporting organization supports.

In addition, the proposed regulations include a requirement that a substantial part of the supporting organization’s total activities must directly further the exempt purposes of its

governmental supported organization(s). The proposed regulations intend to use the definition of “directly further” in § 1.509(a)-4(i)(4)(ii)(C).

#### **4) Integral Part Test – Non-Functionally Integrated Type III Supporting Organizations**

Section 1.509(a)-4(i)(5)(ii) provides that, with respect to each taxable year, a supporting organization must distribute to or for the use of one or more supported organizations an amount equaling or exceeding its “distributable amount.”

Regulation § 1.509(a)-4(i)(5)(ii) will be revised to state that a supporting organization must make distributions in order to satisfy the distribution requirement, and § 1.509(a)-4(i)(6) will be revised to describe in detail an exclusive list of what distributions count towards the distribution requirement. We see a preview of what may and may not be included in that list with the following clarifications in the proposed regulations.

##### **a) Unrelated Business Income Tax**

The proposed regulations remove the provision in § 1.509(a)-4(i)(5)(ii)(B) that reduces the distributable amount by the amount of taxes subtitle A of the Code imposed on a supporting organization during the immediately preceding taxable year.

##### **b) Fundraising Expenses**

Under the proposed regulations, it is possible for fundraising expenses to count toward distribution requirement, provided they are reasonable and necessary expenses incurred by the supporting organization to solicit contributions that a supported organization receives directly from donors, but only to the extent that the amount of such expenses does not exceed the amount of contributions actually received by the supported organization as a result of the solicitation activities of the supporting organization.

##### **c) Program Related Investments**

PRIs are not treated as distributions to supported organizations