

Final, Proposed and Temporary Regulations Regarding the Requirements to Qualify as a Type III Supporting Organization

January 3, 2013

Effective December 28, 2012, the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") published (i) final regulations (the "Final Regulations") that put into effect proposed regulations issued on September 24, 2009 (the "2009 Proposed Regulations"), and (ii) proposed and temporary regulations (the "Current Proposed Regulations") regarding the annual distribution requirement for non-functionally integrated Type III supporting organizations and procedures for valuing assets for purposes of the annual distribution requirement.

I. Supporting Organizations

A supporting organization is defined as an organization which is (a) 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; (b) operated, supervised or controlled by, supervised or controlled in connection with, or operated in connection with one or more public charities; and (c) not controlled directly or indirectly by any disqualified person.¹ Despite its classification as a public charity, a supporting organization is not required to meet a public support test on its own if it engages in activities to benefit or carry out the purposes of one or more supported public charities and has certain prescribed relationships (involving structural and operational controls) with those charities.

Prior to the enactment of the Pension Protection Act of 2006 (the "PPA"),² Treasury Regulations placed supporting organizations into three categories, or "types," based on the relationship between the supporting organization and its supported public charity or charities. The PPA amended the Code so that it reflects this division of supporting organizations among the three types: Type I, Type II and Type III, with Type III further subdivided into functionally integrated and non-functionally integrated categories.³

The 2009 Proposed Regulations refined the existing definitions of functionally integrated and non-functionally integrated Type III supporting organizations and included provisions requiring that every Type III supporting organization satisfy a notification requirement, meet a

¹ See Code sections 509(a)(3)(A), (B) and (C). Citations are to the Internal Revenue Code of 1986, as amended (the "Code").

² Public Law 109-280 (120 Stat. 780 (2006)).

³ See Code sections 509(a)(3)(B) and 4943(f)(3).

“responsiveness” test and demonstrate that it is an “integral part” of one or more supported public charities. Although the Final Regulations put into final form many of the provisions contained in the 2009 Proposed Regulations, certain provisions have been revised to reflect comments received in response to the 2009 Proposed Regulations.

II. The Final Regulations

A. Definition of Supported Organization

The 2009 Proposed Regulations proposed removing the term “publicly supported organization” from Treasury Regulation section 1.509(a)-4 and replacing it with the defined term “supported organization.” The defined term “supported organization” is limited to publicly supported organizations described in Code section 509(a)(1) or 509(a)(2) (i) for whose benefit a supporting organization is organized or operated or (ii) with respect to which a supporting organization performs the functions or carries out the purposes.⁴ This term is narrower than the term “publicly supported organization,” which was defined in the prior Treasury Regulations, i.e., those in place prior to the effective date of the Final Regulations (the “Prior Regulations”), as an organization described in Code section 509(a)(1) or 509(a)(2). The term “supported organization,” therefore, refers to a limited class of “publicly supported organizations” and Treasury and the IRS determined that using “supported organization” was not appropriate in every instance in the 2009 Proposed Regulations.⁵ As a result, the Final Regulations maintain the term “publicly supported organization” and use it in every paragraph of Treasury Regulation section 1.509(a)-4 other than for purposes of the provisions relating only to Type III supporting organizations in Treasury Regulation section 1.509(a)-4(i). The provisions of Treasury Regulation section 1.509(a)-4(i) refer specifically to the narrower class of “supported organizations” to describe the requirements and tests that Type III supporting organizations must meet and, therefore, retain the use of that term.

In addition, the Final Regulations clarify that the definition of “supported organization” includes (i) any supported public charity described by name in a supporting organization’s articles of incorporation or (ii) any supported public charity not designated by name in the supporting organization’s articles of incorporation if there has been a historical and continuing relationship between the supporting organization and the supported public charity and, by reason of the relationship, there has developed a substantial identity of interests between the two organizations.⁶

⁴ The PPA amended the Code to define “supported organization.” See Code section 509(f)(3).

⁵ For example, certain provisions of Treas. Reg. § 1.509(a)-4 refer to “publicly supported organizations” to illustrate relationships between organizations described in Code section 509(a)(3) and publicly supported organizations. Because certain examples do not intend to refer to a Code section 509(a)(1) or 509(a)(2) organization specifically for whose benefit a supporting organization is organized and operated or with respect to which the supporting organization performs the functions of or carries out the purposes, use of the term “publicly supported organization” remains necessary for clarity. See, for example, Treas. Reg. § 1.509(a)-4(h)(3), Example 1.

⁶ See Treas. Reg. § 1.509(a)-4(a)(6). Unless the context requires otherwise, the term “supported public charity” is used throughout this memo to refer to a “supported organization.”

B. Notification Requirement

The Final Regulations put into place, with minor changes, the notification requirement set forth in the 2009 Proposed Regulations. Pursuant to the Final Regulations, a Type III supporting organization must provide the following documents to each of its supported public charities on an annual basis on or before the last day of the fifth calendar month following the close of its taxable year: (i) a written notice to a principal officer of the supported public charity describing the type and amount of all the support it provided to the supported public charity during the supporting organization's immediately preceding taxable year; (ii) a copy of the supporting organization's Form 990 that was most recently filed as of the date the notification is provided; and (iii) a copy of the supporting organization's governing documents as in effect on the date the notification is provided, including its articles of organization and by-laws, and any amendments to those documents, unless those documents have been provided previously and not subsequently amended.⁷ All required information may be provided to the supported public charities in electronic format.⁸

In response to comments received to the 2009 Proposed Regulations, the Final Regulations clarify that the supporting organization must provide to its supported public charities its most recently filed Form 990, which is not necessarily the Form 990 for the taxable year immediately preceding the taxable year in which notice is provided.⁹ Therefore, if a supporting organization reporting on a calendar year basis provides its annual notification to its supported public charities on May 31, 2014 (the last day of the fifth month after the close of its taxable year), but has filed for and received an extension to file its Form 990 for taxable year 2013, the supporting organization may provide its Form 990 for taxable year 2012 with its notification.¹⁰ In addition, the Final Regulations provide that a supporting organization may redact the name and address of any donors from Schedule B of the Form 990 provided to its supported public charities pursuant to the notification requirement.¹¹

The Final Regulations also clarify that the information as to support provided to the supported public charities refers to support provided during the previous taxable year, as opposed to "in the past year," as was set forth in the 2009 Proposed Regulations. In addition, the "principal officer" to whom all of the information must be provided has been clarified to mean a person who, regardless of his or her title, has ultimate responsibility for managing the supported public charity's finances, supervising the management, administration or operation of the supported

⁷ See Treas. Reg. § 1.509(a)-4(i)(2)(i).

⁸ See Treas. Reg. § 1.509(a)-4(i)(2)(ii). The Preamble to the Final Regulations (the "Preamble") states that providing an internet link to the relevant Form 990, however, would be insufficient as the Form 990 does not contain all of the information required to be provided under the notification requirement. See Treas. Dec. 9605 (Dec. 28, 2012).

⁹ See Treas. Reg. § 1.509(a)-4(i)(2)(i)(B).

¹⁰ Transitional relief for Type III supporting organizations in existence on December 28, 2012 is discussed in Section IV, below.

¹¹ See Treas. Reg. § 1.509(a)-4(i)(2)(i)(B).

public charity or implementing the decisions of the supported public charity's governing body.¹²

Finally, the Preamble clarifies that the required notification must be given to each supported public charity, even in the case of a supporting organization that supports both a central organization in a group exemption as well as subordinate organizations covered by the same group exemption.

C. Responsiveness Test

As in the 2009 Proposed Regulations, the Final Regulations require that all Type III supporting organizations satisfy a responsiveness test by demonstrating one of three relationships between the officers, directors or trustees of the supporting organization and the supported public charity, with that relationship resulting in the officers, directors or trustees of the supported public charity having a significant voice in directing the use of the supporting organization's income and assets.¹³ The three relationships are: (i) one or more officers, directors or trustees of the supporting organization are elected or appointed by the officers, directors, trustees or members of the supported public charity; (ii) one or more members of the supported public charity's governing body also are officers, directors or trustees of, or hold important offices in, the supporting organization; or (iii) 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 public charity.¹⁴

The Final Regulations leave the 2009 Proposed Regulations generally unchanged. However, example 1 of the responsiveness test portion of the Final Regulations has been clarified to provide that, for a Type III supporting organization organized as a charitable trust, quarterly face-to-face or telephonic meetings between the trust's trustee and an officer of the supported public charity may demonstrate that the supporting organization meets the responsiveness test. This example included only face-to-face meetings in the 2009 Proposed Regulations. The Preamble notes that charitable trusts will be able to demonstrate satisfaction of the responsiveness test in a variety of ways, and that satisfaction of the test will be determined taking into account all relevant facts and circumstances. The Preamble also clarifies that the responsiveness test requires only that the officers, directors or trustees of the supported public charity have the ability to influence the supporting organization's decisions regarding use of the supporting organization's income or assets, and does not require that the officers, directors or trustees of the supported public charity have control over those decisions.

The Preamble states that Treasury and the IRS intend to issue proposed regulations clarifying that Type III supporting organizations must be responsive to all of their supported public charities and also intend to request additional comments regarding examples of how to satisfy the responsiveness test.

¹² See Treas. Reg. § 1.509(a)-4(i)(2)(i)(A) and Treas. Reg. § 1.509(a)-4(i)(2)(iv).

¹³ See Treas. Reg. § 1.509(a)-4(i)(3).

¹⁴ See Treas. Reg. § 1.509(a)-4(i)(3)(ii).

D. Integral Part Test – Functionally Integrated Type III Supporting Organizations

Whether a Type III supporting organization is classified as functionally integrated or non-functionally integrated depends on how the organization meets the “integral part” test. As in the 2009 Proposed Regulations, the Final Regulations provide that, to meet the integral part test as a functionally integrated Type III supporting organization, a Type III supporting organization must either (i) engage in activities substantially all of which directly further the exempt purposes of one or more supported public charities and which, but for the involvement of the supporting organization, would normally be engaged in by the supported public charities, or (ii) be the parent of each of its supported public charities.¹⁵

The Final Regulations include an important additional clause not included in the 2009 Proposed Regulations as to activities that directly further the exempt purposes of a supported public charity. Specifically, a Type III supporting organization that makes or awards grants, scholarships or other payments to individuals who are members of the charitable class benefited by its supported public charity will be treated as engaging in activities that directly further the exempt purposes of the supported public charity, provided that (i) the individual beneficiaries are selected on an objective and nondiscriminatory basis, (ii) the officers, directors or trustees of the supported public charity have a significant voice in the timing and manner of payments and the selection of recipients and (iii) the making or awarding of the payments is an active program of the supporting organization that directly furthers the exempt purposes of the supported public charity and in which the supporting organization maintains significant involvement (based on existing rules applicable to private operating foundations).¹⁶

Otherwise, the Final Regulations generally are consistent with the 2009 Proposed Regulations, except that (i) language has been added to the Final Regulations clarifying that whether substantially all of a supporting organization’s activities directly furthers the exempt purposes of a supported public charity will be determined on a facts and circumstances basis, and (ii) how a Type III supporting organization may qualify as functionally integrated with a governmental entity has been reserved. With respect to support of governmental entities, Type III supporting organizations can continue to qualify as functionally integrated by meeting the “but for” test set forth in the Prior Regulations until the first day of their second taxable year beginning after December 28, 2012.¹⁷

Of note is that the Final Regulations continue to treat fundraising, making grants and investing and managing non-exempt-use assets as activities that do not directly further the exempt purposes of a supported public charity. Therefore, Type III supporting organizations which

¹⁵ The Preamble states that Treasury and the IRS intend to issue proposed regulations in the future that will include a new definition of “parent” for purposes of the integral part test for functionally integrated Type III supporting organizations.

¹⁶ See Treas. Reg. § 1.509(a)-4(i)(4)(ii)(D) and Treas. Reg. § 53.4942(b)-1(b)(2)(ii).

¹⁷ The Preamble states that Treasury and the IRS intend to issue proposed regulations on this matter sufficiently in advance of the end of this period to enable Type III supporting organizations to determine whether or not they are functionally integrated by reason of supporting a governmental entity.

engage only in fundraising, grant-making and/or investment and management of non-exempt-use assets will not qualify as functionally integrated.

E. Integral Part Test – Non-functionally Integrated Type III Supporting Organizations - Attentiveness Requirement

In order to satisfy the integral part test, a non-functionally integrated Type III supporting organization must meet both an annual distribution requirement, discussed in further detail in Section III below, and an attentiveness requirement. The provisions in the Final Regulations as to the attentiveness requirement are substantially similar to the 2009 Proposed Regulations.

To meet the attentiveness requirement, a non-functionally integrated Type III supporting organization must distribute one-third or more of its annual distributable amount (discussed below) to one or more supported public charities that are attentive to the supporting organization's operations and to which the supporting organization is responsive (as discussed in Section II. C, above). A supported public charity is attentive to a supporting organization's operations if (i) the supporting organization distributes to the supported public charity at least 10% of the supported public charity's total support during the supported public charity's last taxable year, (ii) the amount of support received from the supporting organization is necessary to avoid interruption of a particular function or activity of a supported public charity (provided that such function or activity is a substantial function or activity of the supported public charity), or (iii) based on all pertinent factors, including the number of supported public charities, the length and nature of the relationship between the supported public charities 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 the supported public charities' total support to ensure attentiveness.¹⁸ As in the 2009 Proposed Regulations, distributions to donor-advised funds held by a supported public charity are disregarded in determining whether a supported public charity is attentive to the operations of a supporting organization.¹⁹ In addition, the Preamble clarifies that grants to organizations other than a supporting organization's supported public charities do not count towards the attentiveness requirement.

F. Termination of Private Foundation Status

Treasury and the IRS received a number of comments in response to the provisions in the 2009 Proposed Regulations relating to reclassification of a Type III supporting organization as a private foundation for failure to meet the requirements for supporting organization classification. Treasury and the IRS did not incorporate any of the comments received into the Final Regulations. In particular, the Preamble notes that the PPA revisions to the Code did not impact the timing of a Type III supporting organization's reclassification or the provisions that apply to any public charity that fails to meet one or more of the requirements necessary to retain its classification. Therefore, a Type III supporting organization that is reclassified as a private foundation still must notify the IRS before it commences a 60-month period to terminate its private foundation status and attempts reclassification as a Type III supporting organization.

¹⁸ See Treas. Reg. § 1.509(a)-4(i)(5)(iii).

¹⁹ See Treas. Reg. § 1.509(a)-4(i)(5)(iii)(C).

III. The Current Proposed Regulations

Perhaps the most significant revisions to the 2009 Proposed Regulations are to the annual distribution requirement applicable to non-functionally integrated Type III supporting organizations. Because of the substantive changes to these provisions, Treasury and the IRS issued the revised provisions as proposed and temporary regulations in order to provide an opportunity for public comment.

A. Integral Part Test for Non-functionally Integrated Type III Supporting Organizations

i. Annual Distribution Requirement

The 2009 Proposed Regulations provided that, in order to meet the integral part test, a non-functionally integrated Type III supporting organization would have to distribute annually at least 5% of the fair market value of its non-exempt-use assets, as is the current requirement for private non-operating foundations. This requirement prompted multiple comments, focusing in large part on the depletion of a supporting organization's assets as a result of the requirement and the additional requirements and restrictions to which supporting organizations are subject that do not apply to private foundations.

In response to the comments, the Current Proposed Regulations replace the 5% annual distribution requirement with a two-prong distributable amount test. Under this test, a non-functionally integrated Type III supporting organization must distribute annually a "distributable amount" equal to the greater of (i) 85% of its adjusted net income, or (ii) 3.5% of the fair market value of its non-exempt-use assets. As in the 2009 Proposed Regulations, non-exempt-use assets are measured as of the preceding taxable year.²⁰

Several provisions related to the annual distribution requirement were included in the Final (not Current Proposed) Regulations and therefore have been made final as of December 28, 2012. Specifically, the Final Regulations set forth those distributions that count towards the annual distribution requirement and continue to allow a non-functionally integrated Type III supporting organization that distributes more than its annual distributable amount during any given taxable year to carry over that excess amount for five taxable years. Significantly, the Final Regulations explicitly count amounts set aside for specific projects to accomplish the exempt purposes of a supported public charity towards a non-functionally integrated Type III supporting organization's distributable amount. To count set-asides towards its annual distributable amount, the supporting organization must (i) obtain a written statement from the supported public charity that the supported public charity approves the project for which funds are set aside, (ii) meet the IRS approval and information requirements for set-asides applicable to private foundations and (iii) evidence the set-aside in its books as an obligation to be paid within 60 months.²¹

²⁰ See Treas. Reg. § 1.509(a)-4T(i)(5)(ii).

²¹ See Treas. Reg. § 1.509(a)-4(i)(6)(v).

In addition, the Final Regulations provide that amounts paid to perform an activity that directly furthers the exempt purposes of the supported public charity that, but for the supporting organization's involvement, would normally be engaged in by the supported public charity, also may be counted towards the supporting organization's annual distributable amount, but only to the extent that expenditures on the activity exceed the revenue derived from the activity.²² The Preamble provides an example whereby a non-functionally integrated Type III supporting organization spends \$1 million operating a museum that generated \$800,000 in receipts during a taxable year. The supporting organization therefore may count the \$200,000 difference between museum expenses and receipts towards its annual distributable amount.

The Final Regulations also provide that reasonable and necessary administrative expenses paid to accomplish the exempt purposes of a supported public charity may be counted towards a non-functionally integrated Type III supporting organization's annual distributable amount, except for those expenses incurred in the production of investment income.²³ Finally, the Preamble clarifies that grants to organizations other than a supporting organization's supported public charities do not count towards a non-functionally integrated Type III supporting organization's distributable amount.

B. Valuation of Assets

The 2009 Proposed Regulations used language from the Treasury Regulation relating to the private foundation annual distribution requirement of Code section 4942 to determine how a non-functionally integrated Type III supporting organization computes the fair market value of its non-exempt-use assets in connection with determining its annual distributable amount.²⁴ Treasury and the IRS determined that cross-referencing the specific Treasury Regulation section, rather than restating language found in that section, accomplished the same result and, therefore, the Current Proposed Regulations include a cross-reference.²⁵ Although Treasury and the IRS did not intend the change to result in any substantive changes from the 2009 Proposed Regulations, the new provisions relating to valuation of assets were issued as temporary and proposed regulations to provide opportunity for public comment.

IV. Transitional Provisions

The Final Regulations provide Type III supporting organizations in existence as of December 28, 2012 with the following transitional relief:

- A Type III supporting organization must meet its notification requirement for the taxable year including December 28, 2012 by the later of the last day of the fifth calendar month following the close of that taxable year or the due date, including extensions, of its Form 990. For example, a Type III supporting organization reporting on a calendar year basis that does not have to file its 2012 Form 990

²² See Treas. Reg. § 1.509(a)-4(i)(6)(ii).

²³ See Treas. Reg. § 1.509(a)-4(i)(6)(iii).

²⁴ See Treas. Reg. § 53.4942(a)(2)(c).

²⁵ See Treas. Reg. § 1.509(a)-4T(i)(8).

until November 15, 2013 (because it was granted two three-month extensions) will have until November 15, 2013 to satisfy its notification requirement for 2012.

- A Type III supporting organization that met and continues to meet the “but for” test under the Prior Regulations will be treated as meeting the requirements of a functionally integrated Type III supporting organization until the first day of the organization’s second taxable year beginning after December 28, 2012.
- A Type III supporting organization that met and continues to meet the “payout” requirement under the Prior Regulations will be treated as meeting the requirements of a non-functionally integrated Type III supporting organization until the first day of the organization’s second taxable year after December 28, 2012, provided that the determination of any carry-over distributable amount will be based on the organization meeting the annual distribution requirement set forth in the Current Proposed Regulations during its first taxable year beginning after December 28, 2012.
- A non-functionally integrated Type III supporting organization that must reform its governing or other instruments in order make distributions out of capital or corpus to comply with the Final Regulations will be excepted from the distribution requirement, provided that it commences judicial proceedings before June 26, 2013 to revise its governing or other instrument.

V. Further Action

The Preamble and the Final Regulations reserve several additional matters not already discussed in this memo, which Treasury and the IRS note will be addressed in future proposed regulations. These reserved matters include:

- A definition of “control” for purposes of determining donors, related persons and donor-controlled entities from which a Type I or Type III supporting organization is prohibited from accepting gifts or contributions;²⁶
- Treatment of trust instruments that specify grant recipients and the timing, manner and amount of grants from supporting organizations organized as charitable trusts;
- Further detail on the types of expenditures (including for administrative purposes and additional charitable activities) that count towards or do not count towards a non-functionally integrated Type III supporting organization’s annual distributable amount; and

²⁶ Type I and Type III supporting organizations are prohibited from accepting gifts or contributions from a person who, alone or together with certain related persons, directly or indirectly controls the governing body of a supported public charity of the Type I or Type III supporting organization, or from persons related to a person possessing such control, including family members and 35% controlled entities within the meaning of Code section 4958(f). *See* Treas. Reg. § 1.509(a)-4(f)(5).

- Further detail on whether program-related investments count towards a non-functionally integrated Type III supporting organization's annual distributable amount.

Comments are due by March 18, 2013.

The Final and Current Proposed Regulations can be found at <https://www.federalregister.gov/articles/2012/12/28/2012-31050/payout-requirements-for-type-iii-supporting-organizations-that-are-not-functionally-integrated>.

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