

UNDERSTANDING THE NEW SUPPORTING ORGANIZATION PROPOSED REGULATIONS

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On 2/19/16, the U.S. Department of the Treasury (“Treasury”) released another round of supporting organization proposed regulations, dealing largely with the requirements applicable to Type III supporting organizations.¹ These proposed regulations are only the latest in a long string of rulemakings stemming from the Pension Protection Act of 2006,² and they trace their roots to the scandals at the turn of the 21st century involving supporting organization abuses.

As these proposals and the rules applicable to supporting organizations accumulate, it is useful not only to look at the scope and impact of the proposed regulations, but also to contextualize them within the history and existing regulatory framework of supporting organizations. Ultimately, each round of regulations warrants reflection on the implications of the proposals for structuring and operating supporting organizations, and careful examination of how to balance the utility and benefits of the supporting organization classification with the growing number of regulatory and ongoing compliance obligations imposed on supporting organizations.

Supporting organization background: a place in between

Supporting organizations are important, widely used, and highly regulated—albeit complex—philanthropic tools. From a practical perspective, they provide a way for donors to advance the work of public charities and maintain a high degree of donor involvement, without being subject to the onerous requirements applicable to private foundations. Among other things, supporting organizations are used to further the fundraising efforts of hospitals and universities, facilitate grant-making, and directly conduct programmatic activities. They derive their public charity status on the basis of their relationship to other public charities. The relationship between a supporting organization and the organizations it supports can take numerous forms under Section 509(a)(3), and the nature of that relationship determines the supporting organization’s “type” and, therefore, its legal and reporting obligations.

Supporting organizations date back to the passage of the Tax Reform Act of 1969.³ That act drew a distinction between private foundations and public charities, and established the legal regime currently applicable to private foundations, including distribution requirements and excise taxes.⁴ However, in establishing the supporting organization rules,

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the act also implicitly recognized that certain organizations that may not be able to qualify as public charities nonetheless substantially advance the work of public charities, such that the concerns underlying the private foundation rules might not apply and the associated regulatory regime could be unnecessary. A supporting organization was thus conceived under the act as a hybrid organization

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of sorts that, because of its connection to one or more public charities, could avoid treatment as a private foundation. In the years after their statutory genesis, supporting organizations remained a useful tool for donors and largely escaped additional regulatory attention—until the end of the last century. After reports of supporting organization abuse, Congress turned its attention to supporting organizations.⁵ This focus continued to hold, and the passage of the Pension Protection Act of 2006 included new statutory rules applicable to supporting organizations that, among other things, authorized the drafting of the proposed regulations.⁶

Supporting organizations: the regulatory framework

The rules applicable to supporting organizations are meant to ensure that a supporting organization (unlike a private foundation) is directly accountable to the organizations it supports.⁷ These rules impose a series of requirements with respect to the supporting organization's governance structure, operations, and, critically, relationship to its supported organizations in the form of four tests: (1) an organizational test, (2) an operational test, (3) a relationship test, and (4) a control test. Together, these four tests demonstrate that the supporting organization fulfills its exempt purposes by advancing the exempt purposes of one or more public charities described under Section 509(a)(1) or Section 509(a)(2).

Organizational test. The organizational test requires the supporting organization to be organized “exclusively for the benefit of, to perform the functions of, or to carry out the purposes of” one or more publicly supported organizations.⁸ To satisfy this test, the supporting organization's governing documents—including, as applicable, any

trust instrument or articles of incorporation—are required to state that the supporting organization exists for that purpose. In addition, the governing documents must specify the name or class of the supported organizations for which it provides support.⁹

Operational test. The operational test requires the supporting organization to operate “exclusively” for the benefit of its supported organizations. The supporting organization will meet this test only if it “engages *solely* in activities which support or benefit the specified publicly supported organizations.”¹⁰ Such activities can include, among other things, conducting activities that further a charitable purpose or paying over income to the supported organizations for charitable ends.¹¹

Relationship test. Under the relationship test, the supporting organization must be classified as one of three “types,” as follows:

- Type I supporting organizations are operated, supervised, or controlled by their supported organizations. This generally means that the supported organizations have the power to appoint or elect a majority of the members of the supporting organization's governing body.¹²
- Type II supporting organizations are supervised or controlled in connection with their supported organizations. This generally means that the supported organizations and the supporting organization are controlled by the same individuals, such that a majority of the members of the supporting organization's governing body also constitute a majority of the governing bodies of its supported organizations.¹³
- Type III supporting organizations are operated in connection with their supported organizations. This generally means that the supporting organization is responsive to the needs and demands of its supported organizations, and constitutes an integral part (or has significant involvement in the work) of its supported organizations. Unlike Type I and Type II supporting organizations—which are deemed to be responsive to and an integral part of their supported organizations based on the control exercised by, or in common with, their supported organizations—Type III supporting organizations are subject to a detailed notification requirement as well as certain responsiveness and integral part tests, which are the subject of the proposed regulations.¹⁴

Control test. Finally, to meet the control test, the supporting organization must not be con-

trolled directly or indirectly by one or more “disqualified persons.”¹⁵ Disqualified persons include, among others, substantial contributors to the supporting organization, the owners of more than 20% of certain entities that are substantial contributors to the supporting organization, and certain family members of such individuals or entities.¹⁶ Excluded from the definition of disqualified persons are foundation managers who are disqualified persons only as a result of being foundation managers (and not because they are also, for example, substantial contributors) and, generally, public charities.¹⁷

In addition, Type I and Type III supporting organizations may not accept a gift or contribution from any person who, alone or together with certain related persons, directly or indirectly controls the supported organization’s governing body.¹⁸ The proposed regulations would define a supporting organization as “controlled” with respect to this prohibition if the contributor, alone or by aggregating his or her votes or positions of authority with certain related persons, may require the governing body to perform any act that significantly affects its operations or may prevent the governing body from performing any such act.¹⁹

The proposed regulations—Type III supporting organization requirements. In addition to the control provisions outlined above, the majority of the proposed regulations focus on Type III supporting organizations, addressing the applicable notification requirement, responsiveness test, and integral part test, each of which is addressed below.

Notification requirement. In order to meet the notification requirement, a Type III supporting organization must provide each of its supported

organizations for each tax year with (1) a written notice addressed to a principal officer of the supported organization describing the type and amount of all the support it provided to the supported organization during the supporting organization’s immediately preceding tax year, (2) a copy of its Form 990 annual tax return, and (3) a copy of its governing documents as in effect on the date the notification is provided, including its articles of organization and bylaws (if any) and any amendments thereto, unless such documents have been previously provided and not subsequently amended.²⁰ The proposed regulations would not change the timing or substance of such notification, but instead would clarify that the supporting organization must deliver the required documents to each supported organization by the last day of the fifth month of the tax year after the tax year in which the supporting organization provided the support it is reporting.²¹

Responsiveness test. In order to meet the responsiveness test, a Type III supporting organization must be “responsive to the needs or demands of a supported organization.”²² Responsiveness is proven in two ways. First, the supporting organization’s governance must be closely tied to that of its supported organizations. This can be achieved if, for example, the officers, directors, trustees or members of the supported organizations elect the officers, directors, or trustees of the supporting organization or, more generally, if the leadership of the supporting organization maintains a “close and continuous working relationship” with the leadership of its supported organizations.²³ In addition, the supported organizations must have a “significant voice” in the operations of the sup-

¹ Requirements for Type I and Type III Supporting Organizations, REG-118867-10, 2016-10 IRB 411, 81 Fed. Reg. 8446 (2016).

² P.L. 109-280, 8/17/06. See, e.g., IRS Notice 2014-4, 2014-2 IRB 274; 80 Fed. Reg. 79,684 (2015), 77 Fed. Reg. 76,382 (2012), 77 Fed. Reg. 76,426 (2012), 74 Fed. Reg. 48,672 (2009).

³ P.L. 91-172, 12/30/69.

⁴ See Sections 4940-4946.

⁵ See “How to Succeed in Philanthropy Without Really Giving Anything,” Wall St. J., 5/29/98, available at www.wsj.com/articles/SB896325636807205500.

⁶ P. L. 109-280, 8/17/06. In the Pension Protection Act, Congress imposed a series of requirements on Type III supporting organizations, which the IRS has been implementing through the various rulemakings described above in Footnote 2 and the proposed regulations.

⁷ For example, according to the Preamble to the proposed regulations, “The Treasury Department and the IRS believe that, unless a Type III supporting organization is responsive to each of its supported organizations, the supported organizations cannot exercise the requisite level of oversight of

and engagement with the supporting organization.” 81 Fed. Reg. 8446 at 8449 (2016).

⁸ Section 509(a)(3)(A); see also Reg. 1.509(a)-4(c).

⁹ Reg. 1.509(a)-4(d). The specificity required by the regulations with respect to the name or class of supported organizations varies depending on the type of supporting organization.

¹⁰ Reg. 1.509(a)-4(e)(1) (emphasis added).

¹¹ Regs. 1.509(a)-4(e)(1)-(3).

¹² Section 509(a)(3)(B)(i); Reg. 1.509(a)-4(g).

¹³ Section 509(a)(3)(B)(ii); Reg. 1.509(a)-4(h).

¹⁴ Section 509(a)(3)(B)(iii); Reg. 1.509(a)-4(i).

¹⁵ Section 509(a)(3)(C).

¹⁶ Section 4946; Reg. 1.509(a)-4(j).

¹⁷ Section 509(a)(3)(C).

¹⁸ Section 509(f)(2); Reg. 1.509(a)-4(f)(5).

¹⁹ Prop. Reg. 1.509(a)-4(f)(5)(ii).

²⁰ Reg. 1.509(a)-4(i)(2)(i).

²¹ Prop. Regs. 1.509(a)-4(i)(2)(i), (iii).

²² Reg. 1.509(a)-4(i)(3)(i).

²³ Reg. 1.509(a)-4(i)(3)(ii).

porting organization, including with respect to its investment policies and grant making.²⁴

Practitioners had previously suggested that being responsive to multiple organizations could subject a supporting organization to a serious administrative burden, by requiring supporting organizations to manage relationships and communications with multiple public charities.²⁵ The proposed regulations would clarify that a supporting organization must be responsive to each of its supported organizations, but also would provide means for supporting organizations to be responsive in ways that are both effective and practical.²⁶ An example in the proposed regulations explains how a supporting organization can meet the responsiveness test with respect to numerous supported organizations. In the example, an organization with ten supported organizations meets the responsiveness test by (1) organizing regular face-to-face or telephonic meetings with officers of each of the supported organizations (either individually or jointly), (2) prior to such meetings, making available to each of its supported organizations up-to-date information regarding the supporting organization's activities, including its assets and liabilities, receipts and distributions, and investment policies and returns, and (3) encouraging officers of its supported organizations to be in contact with one of the supporting organization's officers if they have questions or wish to schedule additional meetings.²⁷ This provision would clarify, and perhaps simplify in some cases, the process required to satisfy the responsiveness test.

Integral part test. Type III supporting organizations are subject to a complex integral part test, the result of which determines whether the Type III supporting organization is functionally integrated with its supported organizations. As noted

above, the proposed regulations would clarify this key test, which can be vexing to practitioners:

Functionally integrated. A Type III supporting organization is considered functionally integrated if it meets one of three tests:

1. Substantially all of the supporting organization's activities must directly further the activities of its supported organizations and substantially all of such activities must be activities that would ordinarily be engaged in by the supported organizations, but for the work of the supporting organization. For these purposes, fundraising, managing non-exempt-use assets, and (except in certain cases) grant making to individuals or organizations do not constitute direct furtherance activities.²⁸
2. The supporting organization acts as the "parent" of its supported organizations. This test is met if (a) the supporting organization's governing body, members of its governing body, or its officers (acting in their official capacities) have the power to appoint or elect, directly or indirectly, a majority of the officers, directors, or trustees of each of its supported organizations and (b) the supporting organization exercises a substantial degree of direction over the policies, programs, and activities of its supported organizations.²⁹ The proposed regulations would amend the definition of the term "parent" to state that in order for a supporting organization to qualify as the parent of each of its supported organizations, the supporting organization and supported organizations must be part of an integrated system (such as a hospital system). In addition, the proposed regulations would require the supporting organization to engage in activities typical of a parent in such an integrated system, including, but not limited to, coordinating activities and engaging in overall planning, policy development, budgeting,

²⁴ Reg. 1.509(a)-4(i)(3)(iii).

²⁵ See Preamble to Prop. Regs., 81 Fed. Reg. 8446 at 8449 (2016).

²⁶ Prop. Reg. 1.509(a)-4(i)(3)(i).

²⁷ Prop. Reg. 1.509(a)-4(i)(3)(iv).

²⁸ Reg. 1.509(a)-4(i)(4)(ii).

²⁹ Reg. 1.509(a)-4(i)(4)(iii).

³⁰ Prop. Reg. 1.509(a)-4(i)(4)(iii).

³¹ Reg. 1.509(a)-4(i)(4)(iv).

³² Sections 170(c)(1)-(2), 170(b)(1)(A).

³³ Prop. Reg. 1.509(a)-4(i)(4)(iv). The proposed regulations also provide transitional relief for Type III supporting organizations in existence on or before 2/19/16 and extend certain relief previously granted under Notice 2014-4, 2014-2 IRB 274. See Prop. Reg. 1.509(a)-4(i)(4)(iv)(F).

³⁴ Prop. Reg. 1.509(a)-4(i)(4)(iv)(D).

³⁵ See Internal Revenue Service, "Supporting Organizations—Requirements and Types," www.irs.gov/charities-non-profits/charitable-organizations/supporting-organizations-requirements-and-types.

³⁶ Reg. 1.509(a)-4(i)(5)(ii).

³⁷ Reg. 1.509(a)-4(i)(5)(ii)(C).

³⁸ Reg. 1.509(a)-4(i)(5)(ii)(B).

³⁹ Prop. Reg. 1.509(a)-4(i)(5)(ii)(B). In addition, the proposed regulations would clarify the terms of the attentiveness test in light of the new requirement that a supporting organization meet the relevant supporting organization tests with respect to each of its supported organizations. See Prop. Regs. 1.509(a)-4(i)(5)(iii)(A), (D).

⁴⁰ Reg. 1.509(a)-4(i)(6).

⁴¹ Prop. Reg. 1.509(a)-4(i)(6).

and resource allocation for the supported organizations.³⁰

3. The supporting organization must support only governmental supported organizations and a substantial part (not substantially all) of the supporting organization's total activities must be activities that directly further the exempt purposes of such governmental supported organizations.³¹ The proposed regulations also would provide a long-awaited definition of "governmental supported organization," by referring to the definitions found in Section 170(c)(1), Section 170(c)(2), and Section 170(b)(1)(A). Such entities include states and certain organizations that are instrumentalities of federal or state governments, including schools and hospitals.³² In addition, the proposed regulations would clarify that a Type III functionally integrated supporting organization can support multiple governmental supported organizations if the supported organizations operate within the same geographic region or work in close collaboration or coordination with one another to conduct the programs or provide the services advanced by the supporting organization.³³ In order to satisfy the close cooperation requirement, the supporting organization must have on file a letter from each governmental supported organization (or a joint letter from all of them) describing the nature of its collaboration with such supported organization.³⁴

Non-functionally integrated. A Type III supporting organization is considered non-functionally integrated if it distributes a required amount each year to one or more of its supported organizations, and if such distributions are sufficiently important to the supported organizations to gain their attention.³⁵ Specifically, for each tax year, the supporting organization must distribute an amount equal to the greater of 85% of its adjusted net income for the tax year immediately preceding the tax year of the required distribution or a "minimum asset amount."³⁶ The minimum asset amount for the immediately preceding tax year is equal to 3.5% of the excess of the fair market value of all of the supporting organization's non-exempt-use assets in that immediately preceding tax year, over the acquisition indebtedness with respect to such non-exempt-use assets, plus certain amounts received or accrued to fulfill the distribution requirement.³⁷

The current regulations provide that the distributable amount may be reduced by the amount of the supporting organization's unrelated business income tax (UBIT) paid in the preceding tax year.³⁸ The proposed regulations, however, would eliminate this provision (and, therefore, the ability of Type III non-functionally integrated supporting organizations to reduce the distributable amount by the amount of UBIT paid).³⁹



The proposed regulations would clarify (and, in some cases, potentially limit) the types of distributions that count toward satisfaction of the distributable amount.

The proposed regulations would also clarify (and, in some cases, potentially limit) the types of distributions that count toward satisfaction of the distributable amount. Under the current regulations, distributions include, but are not limited to, (1) amounts paid by a supporting organization to a supported organization to accomplish the supported organization's exempt purposes, (2) amounts paid by a supporting organization to perform an activity that directly furthers the exempt purposes of a supported organization, but only to the extent such amount exceeds any income derived by the supported organization from the activity, (3) reasonable and necessary administrative expenses that are paid by the supporting organization to accomplish the exempt purposes of a supported organization (not including expenses related to the production of investment income), (4) amounts paid by a supporting organization to acquire exempt-use assets, and (5) amounts set aside by a supporting organization for a specific project that accomplishes the exempt purposes of a supported organization to which the supporting organization is responsive.⁴⁰ In order to eliminate uncertainty regarding which distributions are part of the distributable amount (while also effectively diminishing potential flexibility for supporting organizations), the proposed regulations would limit distributions to the above list.⁴¹

In addition, the proposed regulations would further clarify that fundraising expenses generally do not count toward the distributable amount, except for reasonable and necessary expenses incurred to solicit contributions re-

ceived directly by the supported organizations, and then only to the extent such expenses do not exceed the amount of contributions actually received by the supported organization as a result of the expenses paid by the supporting organization (as substantiated in writing by the supported organization).⁴²

Finally, the Preamble to the proposed regulations clarify that program-related investments—that is, investments made to accomplish one or more exempt purposes and for which production of income or appreciation of property is not a significant purpose—could not be counted toward the distributable amount.⁴³

Advice for supporting organizations

The issuance of the proposed regulations provides an opportunity for supporting organizations to review their internal policies and procedures, and their relationship with any supported organizations, to ensure that they are currently fulfilling, and will continue to be able to fulfill, the requirements under Section 509(a)(3) and its related regulations. In light of the proposed regulations:

- All Type I and Type III supporting organizations should ensure that they could continue to pass the control test under the proposed regulations (and should bear these rules in mind when accepting contributions).
- All Type III supporting organizations should ensure that they have procedures in place to fulfill the notification requirement and the re-

sponsiveness test with respect to all of their supported organizations.

- Type III non-functionally integrated supporting organizations should examine their annual distributions to confirm that they could continue to meet the distributable amount under the proposed regulations and, if necessary (and the proposed regulations become final), make any changes to their planned distributions in order to maintain their supporting organization status.
- Type III supporting organizations that could no longer maintain their supporting organization status under the proposed regulations should examine whether conversion to being a Type I or Type II supporting organization by modifying their governing documents in cooperation with their supported organizations may be an option.

Conclusion

The Treasury has received a number of comment letters that request clarification, and make a number of suggestions, regarding various provisions of the proposed regulations in order to improve their practical value. Indeed, while the commenters generally acknowledge the proposed regulations as important next steps, they also underscore the need for further guidance regarding compliance. Regardless of whether the suggested comments are addressed and incorporated, however, the proposed regulations will not be the final word from Congress or the Treasury on how supporting organizations operate. Continued exploration and analysis of the costs and benefits of supporting organization classification will be necessary, as will close monitoring to ensure ongoing compliance in a constantly changing regulatory landscape. ■

⁴² Prop. Regs. 1.509(a)-4(i)(6)(iii)(A)-(B).

⁴³ See Preamble to Prop. Regs., 81 Fed. Reg. 8446 at 8452 (2016). Program-related investments are generally discussed with reference to private foundations as an exception from the jeopardizing investment rules under Section 4944.