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Nonprofit Update: IRS Proposes New Regulations for Type III Supporting Organizations

By Laura A. Lo Bianco

By way of background, the universe of organizations that qualify under Section 501(c)(3) the Internal Revenue Code of 1986, as amended (the "Code"), is divided into two classes: private foundations and public charities. Different regulatory restrictions apply to private foundations in addition to the basic rules governing all charities. In most circumstances, public charity status is preferable to private foundation status.

Some nonprofit organizations receive their public charity status by virtue of their relationship with another public charity. Such organizations are known as "supporting organizations" under Code § 509(a)(3).

Prior to the enactment of the Pension Protection Act of 2006 ("PPA"), supporting organizations were not subject to the limitations and excise taxes that are assessed against certain activities of private foundations. The PPA changed some of these rules as they apply to certain types of supporting organizations.

To qualify as a supporting organization, a nonprofit organization must meet detailed organizational, operational, relationship and disqualified persons control tests. The IRS has issued proposed regulations explaining changes made by the PPA to the rules for Type III supporting organizations. The proposed regulations would provide qualification and notification requirements for such organizations, as well as revised rules for how these organizations meet the responsiveness test and the integral part test.

Qualification Criteria

Under the proposed regulations, every Type III supporting organization would have to (1) satisfy certain notification requirements; (2) meet a responsiveness test; and (3) demonstrate that it is an integral part of one or more publicly supported organizations by satisfying either the requirements for functionally integrated Type III supporting organizations, or the requirements for non-functionally integrated Type III supporting organizations.

Under the PPA, Type III supporting organizations are prohibited from: (a) supporting a supported organization organized outside of the United States; or (b) accepting a gift or contribution from a person who, together with certain related persons, directly or indirectly controls the governing body of a supported organization.

Notification Requirements

In the past, some Type III supporting organizations were created to support a number of public charities, many of which were never made aware of that the supporting organization had identified it as a supported organization. The proposed regulations would require a Type III supporting organization to notify each supported organization of its relationship with the supported organizations and to annually provide

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information to its supported organizations regarding the support provided to it, a copy of its most recently filed Form 990 and copies of its governing documents.

Responsiveness Test

The proposed regulations would require that all Type III supporting organizations demonstrate the necessary relationship between its officers, directors or trustees and those of the supported organization, and show that this relationship results in those personnel having a significant voice in the operations of the supporting organization.

Integral Part Test - Functionally Integrated

The PPA restricted private foundations from making grants to only those Type III supporting organizations that are “functionally integrated.” The proposed regulations more specifically define a functionally integrated a Type III supporting organization, and provide examples and circumstances under which the definitional requirements may be satisfied.

Integral Part Test - Non-Functionally Integrated

Under the proposed regulations, a Type III supporting organization would be non functionally integrated if it satisfies a distribution requirement equal to five percent of the fair market value of non-exempt-use assets and an attentiveness requirement. To determine satisfaction of the distribution requirement, the proposed regulations borrow from the regulations relating to private foundation distribution requirements with some modification.

Failure to Comply with the New Rules

A Type III supporting organization that fails to meet the requirements of these proposed regulations, once they are published as final or temporary regulations, would be classified as a private foundation.

Effective Date and Transition Relief

The proposed regulations generally would apply to tax years beginning after the date the regulations are published as final or temporary regulations. The proposed regulations contain transition and other relief provisions for compliance.

Common Supporting Organization Mistakes

In representing supporting organizations, we have encountered the following common mistakes:

- Donors hold managerial positions in the supporting organization;
- Donors control the assets of the supporting organization by making investment decisions or by owning a majority interest in the supporting organization’s sole asset;
- Supporting organizations fail to make grants or conduct activities to or for the benefit of the supported organizations;
- Supporting organizations fail to initially inform and keep informed the supported organizations of its relationship and activities;
- Supported organizations do not monitor the activities of its supporting organization; and
- Supported organizations and supporting organizations do not follow their governing documents.

Conclusion

Supporting organization regulations are complex and in flux. If you find you need assistance navigating the complicated world of supporting organizations, please contact Laura Lo Bianco at (602) 916-5345; or your Fennemore Craig attorney.

Fennemore Craig's Nonprofit group now has a blog!

The Nonprofit and Tax-Exempt Organizations group at Fennemore Craig has launched the Fennemore Craig Nonprofit Law Blog. The new blog will feature recent developments in federal and state laws applicable to nonprofit and tax-exempt organizations, discussions of relevant legal issues, news updates in the nonprofit community, and other pertinent information that will assist nonprofit and tax-exempt organizations in maintaining their tax-exempt status, complying with the law, improving corporate governance practices, and achieving charitable objectives. Readers are invited and encouraged to contact members of the Nonprofit and Tax-Exempt Organizations group at Fennemore Craig with any questions or comments they may have regarding information posted on the blog. Readers can periodically check for blog updates at <http://www.fclaw.com/blogs/nonprofit> or subscribe to automatic updates via RSS feed.

Laurie A. Lo Bianco focuses her practice on corporate law and transactional matters. Her general corporate experience includes business counseling, formation of organizations, including joint ventures, non-profit corporations and limited liability companies; and maintenance of requisite organizational records. She also has experience with mergers and acquisitions; purchase, sale and lease of real property; and negotiation of contracts, including intellectual property licensing, independent contractor, employment, and equipment and service purchase contracts. She received her B.S. (1993) from Arizona State University and her J.D. with distinction, Editor Law Review, (1996) from Santa Clara University, School of Law.



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