

PROPOSED REGULATIONS FOR TYPE III SUPPORTING ORGANIZATIONS

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On 9/24/09, the IRS released long-awaited proposed regulations regarding Type III supporting organizations and how the terms “functionally integrated” and “non-functionally integrated” will be interpreted.¹ The proposed regulations take the place of guidance included in the 8/2/07 advance notice of proposed rulemaking.²

Supporting organizations generally

Supporting organizations are organizations that are described in Section 501(c)(3) and that, because of their relationships to other Section 501(c)(3) organizations, qualify as public charities rather than private foundations.³ Each supporting organization must meet an organizational test, an operational test, a relationship test, and a disqualified person test.⁴

For a supporting organization to satisfy the requisite relationship test, the Code and the regulations thereunder require that the organization have one of three types of relationships with the organization it supports. The relationship of a Type I supporting organization with its supported organization generally is analogous to that of a parent and subsidiary, and the relationship of a Type II supporting organization and its supported organization is comparable to a brother-sister relationship.⁵ The relationship of a Type

III supporting organization to its supported organization(s), however, is looser, requiring only that the supporting organization be operated “in connection with” its supported organization. Because this relationship is not as direct as the relationship required of a Type I or a Type II supporting organization, regulations are needed to clarify the scope of the relationship required.

Responsiveness test—currently. To satisfy the Type III supporting organization relationship test, the regulations currently require that an organization satisfy both a “responsiveness test” and an “integral part test.”⁶ The responsiveness test generally requires that (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 supported organization(s); (2) one or more members of the governing body of the supported organization(s) is also an officer, director, or trustee of, or holds another important office 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 supported organization(s); *and* (4) by reason of the three preceding requirements, the officers, directors, or trustees of the supported organization(s) have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, the selection of

There are important developments and new planning considerations for supporting organizations.

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recipients by the supporting organization, and in otherwise directing the use of the income or assets of the supporting organization.⁷

Prior to the Pension Protection Act of 2006, a separate responsiveness test applied to supporting organizations organized as charitable trusts under state law. Pursuant to that earlier test, the responsiveness test was satisfied if (1) each specified supported organization was a named beneficiary under the charitable trust's governing instrument *and* (2) the beneficiary organization had the power to enforce the trust and compel an accounting under state law.⁸

Integral part test—currently. The existing integral part test requires that a Type III supporting organization maintain significant involvement in the operations of its supported organization(s) and that the supported organization(s) in turn be dependent upon the supporting organization for its support.⁹ A supporting organization generally satisfies the integral part test if the activities in which it engages for or on behalf of its supported organization(s) are 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 [supported organization(s)] themselves.”¹⁰ This is referred to commonly as the “but for” test. As an alternative to the “but for” test, a Type III supporting organization currently may satisfy the integral part test by making distributions of either (1) substantially all of its income (which has been interpreted by the Service to mean at least 85% of its income¹¹) to or for the use of its supported organization(s) (a substantial amount of which must go to supported organization(s) that are attentive to the supporting organization) or (2) an amount that is necessary to prevent the interruption of a particular function or activity of the supported organization(s).¹²

Disqualified person test. As is the case with Type I and Type II supporting organizations, a Type III supporting organization must satisfy the “disqualified person test.” That test provides that a supporting organization may not be controlled directly or indirectly by disqualified persons (other than foundation managers and public charities described in Section 509(a)(1) or (2)).¹³

Pension Protection Act requirements affecting all supporting organizations

The Pension Protection Act of 2006 (the “Act”) imposed new requirements and restrictions on *all* supporting organizations. For example, automatic excess benefit transactions under the intermediate sanctions rules now include a variety of financial transactions between a supporting organization and its disqualified persons,¹⁴ and the definition of a “disqualified person” for purposes of the standard excess benefit transaction rules was expanded so that a disqualified person of the supporting organization now is treated as a disqualified person of the supported organization.¹⁵ Further, certain supporting organizations now are treated as private foundations rather than as public charities for purposes of the excess business holding rules and penalty taxes.¹⁶ Every supporting organization now is required to file an annual information return, regardless of the amount of the organization's gross receipts, and the organization must indicate on such return whether it is a Type I, Type II, or Type III supporting organization. Finally, the organization must identify its supported organizations on its annual return, and certify annually that it is not controlled by one or more disqualified persons.¹⁷

The Act also imposed new restrictions on the basic qualifications of certain supporting organizations. To qualify as supporting organizations, Type I

¹ The proposed regulations also include guidance regarding how the excess business holdings rules of Section 4943 will apply to certain supporting organizations; those provisions are not discussed in this article.

² 72 Fed. Reg. 42335 (8/2/07). The proposed regulations can be read in their entirety at www.irs.gov/pub/irs-tege/rp2009_32.pdf.

³ Section 509(a)(3).

⁴ Reg. 1.509(a)-4(a). The organizational and operational tests remain unchanged by the proposed regulations and are not discussed in this article.

⁵ See Reg. 1.509(a)-4(g)(1)(i) (describing the requirements of the Type I supporting organization relationship); Reg. 1.509(a)-4(h)(1) (describing the requirements of the Type II supporting organization relationship).

⁶ Reg. 1.509(a)-4(i)(1).

⁷ Reg. 1.509(a)-4(i)(2)(ii).

⁸ Reg. 1.509(a)-4(i)(2)(iii). Special rules related to pre-1970 supporting organizations are not discussed here.

⁹ Reg. 1.509(a)-4(i)(3)(i).

¹⁰ Reg. 1.509(a)-4(i)(3)(ii).

¹¹ Rev. Rul. 76-208, 1976-1 CB 161.

¹² Reg. 1.509(a)-4(i)(3)(iii).

¹³ Section 509(a)(3)(C).

¹⁴ Section 4958(c)(3) (identifying, for example, the entire amount of a loan from a supporting organization to one of its disqualified persons as an excess benefit transaction, regardless of the commercial reasonableness of the loan).

¹⁵ Section 4958(f)(1)(D).

¹⁶ Section 4943(f) (subjecting non-functionally integrated Type III supporting organizations and certain Type II supporting organizations to the excess business holdings rules).

¹⁷ Section 6033(a)(l).

¹⁸ Section 509(f)(2).

¹⁹ Sections 4942(g)(4)(C), 4943(f)(5)(B).

²⁰ Section 509(f)(1)(B).

²¹ Section 4942(g)(4)(A)(i).

²² Section 4945(d)(4).

²³ Pension Protection Act of 2006, P.L. 109-280, § 1241(c), 120 Stat. 780, 1103.

²⁴ *Id.* at § 1241(d)(1).

²⁵ 72 Fed. Reg. 42335 (8/2/07).

and Type III supporting organizations now must refrain from accepting contributions from persons (other than from organizations described in Section 509(a)(1), (2), or (4)) who directly or indirectly control their supported organizations, from family members of such persons, and from entities that are controlled by such persons.¹⁸

Pension Protection Act requirements affecting Type III supporting organizations

In addition to new requirements for all supporting organizations, the Act created new limitations that specifically affect Type III supporting organizations. First, two sub-categories of Type III supporting organizations have been created: “functionally integrated” and “non-functionally integrated.”¹⁹ The Code also now provides that a Type III supporting organization may support only entities that are organized in the U.S.²⁰ Further, a non-operating private foundation may not treat a grant to a non-functionally integrated Type III supporting organization as going toward the foundation’s 5% minimum distribution requirement,²¹ and a grant by *any* private foundation to a non-functionally integrated Type III supporting organization will be treated as a taxable expenditure unless the private foundation exercises expenditure responsibility with respect to the grant.²² A private foundation accordingly may make a grant to a non-functionally integrated Type III supporting organization if it exercises expenditure responsibility with respect to the grant, but the grant will not count towards the foundation’s minimum distribution requirement.

With respect to a Type III supporting organization that is organized as a charitable trust, the Act specified that the trust will not meet the responsiveness test set forth in the existing regulations simply by giving the supported organization(s) the power to enforce the terms of the trust under state law, as the existing regulations had allowed.²³

Finally, the Act directed the Service both to consider minimum distribution requirements for Type III supporting organizations and to issue regulations that define a “functionally integrated” Type III supporting organization. The Service issued the proposed regulations in part to satisfy the latter congressional order, but only after having tested the waters with an advanced notice.²⁴

Advanced notice of proposed rulemaking

On 8/2/07, the Service issued an advanced notice of proposed rulemaking (the “Advance Notice”) that included proposed definitions of “functionally integrated” and “non-functionally integrated” Type III supporting organizations.²⁵ The Advance Notice crafted its definitions by relying heavily on the existing Type III supporting organization regulations and by supplementing them with significant parts of the tests applicable to private operating foundations.

The Advance Notice provided that a Type III supporting organization would be “functionally integrated” if it satisfied four tests:

1. A responsiveness test.
2. A “but for” test.
3. An expenditure test.
4. An assets test.

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The responsiveness test proposed in the Advance Notice mirrored the one already in the regulations, except that, consistent with the Pension Protection Act, it did not include any special provision for charitable trusts. The Advance Notice's "but for" test adopted part of the "integral part test" in the current regulations and provided that a supporting organization would satisfy the new "but for" test if "the activities engaged in [by the supporting organization] for or on behalf of the [supported organizations] are 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."

The expenditure test proposed in the Advance Notice was similar to an existing private operating foundation requirement. The expenditure test would have required a functionally integrated Type III supporting organization to use substantially all (i.e., 85%) of the lesser of (1) its adjusted net income or (2) 5% of the aggregate fair market value of all its assets (other than assets used, or held for use, directly in supporting the charitable programs of the supported organizations) directly for the active conduct of its supported organization's exempt purposes.

The assets test proposed in the Advance Notice also would have been similar to rules currently applicable to private operating foundations. The assets test would have required a supporting organization to devote at least 65% of the aggregate fair market value of all its assets directly for the active conduct of activities that directly further its supported organization's exempt purposes.

For Type III supporting organizations that did not meet these four tests and therefore failed to qualify as functionally integrated, the Advance Notice proposed that such supporting organizations be required to meet the responsiveness test and satisfy an annual payout requirement in order to qualify as non-functionally integrated and avoid private foundation status. The payment requirement would have required a non-functionally integrated Type III supporting organization to distribute annually to or for the use of its supported organization(s) an amount equal to 5% of the aggregate fair market value of its assets (other than assets used or held for use directly in the support of

the charitable programs of its supported organization), *i.e.*, the same amount required to be distributed by private nonoperating foundations. The Advance Notice also would have limited a non-functionally integrated Type III supporting organization generally to no more than five supported organizations.

The Service received numerous comments in response to the proposed definitions and rules set forth in the Advance Notice. Comments focused particularly on the perceived arbitrary limit on the number of organizations that a non-functionally integrated Type III supporting organization could support, the appropriateness of using the private operating foundation guidelines in the supporting organization context, and the ability of charitable trusts to meet the existing responsiveness test.²⁶

Proposed regulations

The Service released proposed regulations on 9/24/09 that reflected changes based on some, but not all, of the comments. Under the proposed regulations, all supporting organizations must continue to satisfy an organizational test, an operational test, a disqualified person control test, and a relationship test. The proposed regulations focus particularly on Type III supporting organizations, however, by requiring each Type III supporting organization to satisfy three criteria as part of the relationship test: (1) a notification requirement, (2) a responsiveness test, (3) and an integral part test.²⁷ The proposed regulations also create specific definitions for "functionally integrated" and "non-functionally integrated" Type III supporting organizations as part of the revised integral part test.²⁸

Notification requirement. The notification requirement set forth in the proposed regulations requires a Type III supporting organization to provide each of the following to each of its supported organizations annually:

- A written notice addressed to a principal officer of the supported organization identifying the amount and type of support provided by the supporting organization to the supported organization in the past year.
- A copy of the supporting organization's most recently filed Form 990 (or, if applicable, Form 990-EZ).

²⁶ See, e.g., 74 Fed. Reg. 48672, 48673-48679 (9/24/09) (discussing the comments received in response to the Advance Notice).

²⁷ Prop. Reg. 1.509(a)-4(i)(1).

²⁸ Prop. Regs. 1.509(a)-4(i)(4), (5).

²⁹ Prop. Reg. 1.509(a)-4(i)(2).

³⁰ Prop. Regs. 1.509(a)-4(i)(3)(ii), (iii); compare with Reg. 1.509(a)-4(i)(2)(ii) for similarities. There are exceptions to the standard re-

sponsiveness test requirements for supporting organizations that were in existence prior to 11/20/70. Prop. Reg. 1.509(a)-4(i)(3)(v).

³¹ Prop. Reg. 1.509(a)-4(i)(3)(iv).

³² A charitable trust in existence on 11/20/70 can satisfy an alternate integral part test not available to other supporting organizations. Prop. Reg. 1.509(a)-4(i)(9).

³³ Prop. Reg. 1.509(a)-4(i)(4)(i)(A).

³⁴ Prop. Reg. 1.509(a)-4(i)(4)(i)(B).

- A copy of the supporting organization's governing documents, including any amendments (copies of the governing documents should be provided initially and then only if amended).

The required notification can be provided electronically (e.g., via e-mail). Regardless of the method of delivery, the Type III supporting organization should retain proof of delivery in its records. The notification must be made by the last day of the fifth month after the close of the supporting organization's tax year.²⁹

Responsiveness test. Next, the proposed regulations require all Type III supporting organizations, including those organized as charitable trusts with institutional trustees, to meet the basic responsiveness test set forth in the existing regulations without any special rule for charitable trusts. This means that the supported organization must have a significant voice in the supporting organization's investment policies, grant making, and use of assets. It also means that one of the following arrangements must exist:

- The supported organization must appoint or elect one or more officers, directors, or trustees of the supporting organization.
- One or more members of the supported organization must also be an officer, director, or trustee of, or hold another important office in, the supporting organization.
- The officers, directors, or trustees of the supporting organization must maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization.³⁰

The proposed regulations include an example of how a charitable trust with an institutional trustee can meet this responsiveness test. In that example, a charitable trust supports a private university. A bank serves as the trustee of the charitable trust. The trustee meets with representatives of the private university on a quarterly basis to discuss the university's needs, the ways in which the charitable trust can support the university, and the ways in which the charitable trust should invest its assets. The bank communicates regularly with the university regarding the charitable trust's investments and planned distributions and provides the university with copies of relevant accounting and investment statements. Based on these facts, the example concludes that the charitable trust meets the responsiveness test. In contrast, the proposed regulations provide an example of a charitable trust with an institutional trustee that failed to meet the responsiveness test when it made annual cash payments and provided the required annual notifications to its beneficiaries without any other communications.³¹

Integral part test. Finally, the proposed regulations require that a Type III supporting organization meet an integral part test by complying with either the "functionally integrated" or "non-functionally integrated" definition.³²

Functionally integrated. A Type III supporting organization can meet the "functionally integrated" definition set forth in the proposed regulations if it engages in activities (1) substantially all of which "directly further" the exempt purposes of its supported organization(s) to which it is responsive *and* (2) that, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s).³³ (In a limited exception, the proposed regulations would treat a supporting organization that is the parent of each of its supported organizations for corporate governance purposes as functionally integrated.³⁴ This is a structure most commonly seen in the context of health care systems.)

For purposes of this definition, holding title to and managing exempt-use property "directly furthers" the exempt purposes of the supported organization, but fundraising, investing and managing non-exempt-use property, and making grants (whether to the supported organization or to third parties) do not.³⁵ The proposed regulations provide an important but limited exception: The investment and management of non-exempt-use assets and the making of grants to a supported organization are sufficient to satisfy the "functionally integrated" definition if the supporting organization supports a single government entity whose assets are subject to government appropriation.³⁶

Non-functionally integrated. An organization that fails to satisfy the "functionally integrated" definition still can meet the integral part test if it satisfies the "non-functionally integrated" definition. A supporting organization may qualify as a non-functionally integrated Type III supporting organization if it satisfies an annual distribution requirement and an attentiveness requirement.³⁷

Distribution requirement. To satisfy the distribution requirement set out in the proposed regulations, a non-functionally integrated Type III supporting organization must distribute its "annual distributable amount" to or for the use of its supported organization(s) each year.³⁸ The annual distributable amount is equal to roughly 5% of the fair market value of the supporting organization's non-exempt-use assets and is calculated in a manner similar to the method used

³⁵ Prop. Reg. 1.509(a)-4(i)(4)(ii).

³⁶ Prop. Reg. 1.509(a)-4(i)(4)(iii).

³⁷ Prop. Reg. 1.509(a)-4(i)(5)(i). Special rules apply to pre-1970 trusts and are not discussed here.

³⁸ Prop. Reg. 1.509(a)-4(i)(5)(ii).

to calculate a private foundation's minimum distribution requirement.³⁹ Assets used (or held for use) in carrying out the exempt purposes of the supported organization are excluded from the calculation of the annual distributable amount.⁴⁰ One important difference between the private foundation rules and the rules set out in the proposed regulations is that a non-functionally integrated Type III supporting organization's annual distributable amount for any year can be reduced by the amount of any excess distribution made during the prior five-year period, before taking into account distributions made in the current year.⁴¹

Distributions that count toward the annual distributable amount include:

- Any amount paid to a supported organization to accomplish its exempt purposes.
- Any amount paid to acquire an asset used (or held for use) to carry out the exempt purposes of a supported organization.
- Any amount expended by the supporting organization for reasonable and necessary administrative expenses.

Significantly, and unlike what is required by the rules governing the annual distribution requirements of private foundations, this means that a non-functionally integrated Type III supporting organization cannot count charitable set-asides towards its distribution requirement. The Service has indicated that the reason for this difference is that while the applicable private foundation statute permits certain set-asides to be counted toward a private foundation's annual distribution requirement, no such statutory authority exists with respect to supporting organizations.⁴²

The proposed regulations are ambiguous regarding whether a non-functionally integrated Type III supporting organization can count distributions "for the benefit of" its supported organization(s) towards its annual distribution requirement. The basic distribution requirement states that a non-functionally in-

tegrated Type III supporting organization must make annual distributions "to or for the use of" its supported organization(s).⁴³ The description of which distributions count toward the annual distributable amount, however, states that only distributions "to" a supported organization are counted toward the distribution requirement. This leaves unclear whether a non-functionally integrated Type III supporting organization can satisfy its annual distribution requirement by, for example, paying expenses on behalf of its supported organization, making grants to other supporting organizations of the same supported organization, or making distributions to individuals in the charitable class intended to be benefited by the supported organization.⁴⁴

The proposed regulations set out valuation rules that are consistent with the valuation rules applicable to private foundations. Accordingly, the aggregate fair market value of all non-exempt-use assets for purposes of calculating the annual distributable amount generally is equal to the sum of the following:

- The average of the fair market values on a monthly basis of the supporting organization's securities for which market quotations are readily available.
- The average of the supporting organization's cash balances on a monthly basis.
- The fair market value of all other assets for the period during the tax year for which such assets are held by the supporting organization.⁴⁵

Attentiveness requirement. To meet the attentiveness prong of the "non-functionally integrated" definition, a Type III supporting organization must distribute one-third or more of its annual distributable amount to one or more supported organizations that (1) are attentive to the operations of the supporting organization *and* (2) to which the supporting organization is responsive.⁴⁶ To demonstrate that the one-third distribution is made to a supported organization(s) that is attentive to the operations of

³⁹ Prop. Reg. 1.509(a)-4(i)(5)(ii)(B). Thus, the annual distributable amount equals (1) 5% of the excess of the aggregate fair market value of all non-exempt-use assets over the acquisition indebtedness with respect to such non-exempt-use assets, increased by (2) amounts received or accrued as repayments of amounts that were taken into account previously by the organization to meet an annual distribution requirement, increased by (3) amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was taken into account previously by the organization to meet an annual distribution requirement, and reduced by (4) the amount of taxes imposed on the supporting organization for such tax year.

⁴⁰ Prop. Reg. 1.509(a)-4(i)(8)(i)(C). Assets used or held for use to carry out the supported organization's exempt purposes include (1) administrative assets that are devoted to and used directly in the supporting organization's activities that carry out the exempt purposes of the supported organization(s); (2) real estate or the portion of a building used by the supporting organization directly in its activities to carry out the exempt purposes of the supported organization(s); (3) physical facilities used in the supporting orga-

nization's activities to carry out the exempt purposes of the supported organization(s), such as paintings or other works of art owned by the supporting organization that are on public display, fixtures and equipment in classrooms, and research facilities and related equipment, which under the facts and circumstances serve a useful purpose in the conduct of such exempt purpose activities; and (4) the reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected to the supporting organization's activities to carry out the exempt purposes of the supported organization(s). Prop. Reg. 1.509(a)-4(i)(8)(i)(C)(2).

⁴¹ Prop. Reg. 1.509(a)-4(i)(7). In contrast, Section 4942 requires a private foundation to count its current-year distributions toward the minimum distribution requirement before counting any excess carry forwards from prior years.

⁴² Prop. Reg. 1.509(a)-4(i)(6). Section 4942(g)(2) permits private foundations to count certain set-asides for charitable purposes toward the annual distribution requirement.

⁴³ Prop. Reg. 1.509(a)-4(i)(5)(ii).

the supporting organization, one of the following must be true:

- The supporting organization must distribute annually to the supported organization an amount that is 10% or more of the supported organization's total support.
- The amount of support received by the supported organization from the supporting organization must be necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization. The support is deemed necessary if the supporting organization or the supported organization earmarks the support for a particular program or activity, provided that such program or activity is a substantial one (but not necessarily the primary one) for the supported organization.
- 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 supporting organization, and the purpose to which the funds are put, the amount of support must be a sufficient part of a supported organization's total support. A supported organization is not considered to be attentive solely because it has enforceable rights against the supporting organization under state law.⁴⁷

Distributions by a supporting organization to a donor-advised fund held by the supported organization will not demonstrate compliance with the attentiveness requirement.⁴⁸

Effective date and transition rules

The proposed regulations will become effective on the date of publication as final or temporary regulations in the Federal Register and generally will apply to tax years beginning after that date. The Service has requested comments on the proposed regulations through 12/23/09, and therefore final or temporary regulations are not likely to be published until 2010 at the earliest. This means that if the proposed regulations are published as final or temporary in February 2010, they will not apply to an existing supporting organization that operates on a calendar year basis until 2011.⁴⁹

The proposed regulations provide transitional relief to existing Type III supporting organizations. A Type III supporting organization that on the effective date of the proposed regulations meets the "but for" test in the existing regulations will be treated as meeting the new "functionally integrated" definition until the first day of the organization's first tax year beginning after the effective date.⁵⁰ A Type III supporting organization that meets the alternative prong of the integral part test in the existing regulations on the effective date of the proposed regulations, however, will be treated as meeting the new "non-functionally integrated" definition until the first day of its *second* tax year beginning after the effective date of the proposed

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regulations. Beginning in the first tax year after the effective date, the organization must value its assets pursuant to the requirements in the proposed regulations so that, beginning in the second tax year after the effective date, the organization is able to calculate and distribute its annual distributable amount appropriately. For the first tax year of a non-functionally integrated Type III supporting organization after the effective date of the proposed regulations, the annual distributable amount will be zero.⁵¹

Planning considerations

The proposed regulations present several planning opportunities for supporting organizations, the organizations they support, and practitioners.

First, supporting organizations that are organized as charitable trusts under state law and that have institutional trustees (such as banks or trust companies) should review their current practices with respect to communications with their supported organizations. As the examples in the proposed regulations suggest, a charitable trust can meet the responsiveness test if the trustee engages in regular and meaningful communications with the supported organization(s) regarding the timing and amount of distributions to the supported organization and the investment of the supporting organization's assets.

⁴⁴ Prop. Reg. 1.509(a)-4(f)(6); see Reg. 1.509(a)-4(e)(1) for a description of the ways in which such distributions may be permitted within the operational test that applies to all supporting organizations.

⁴⁵ Prop. Reg. 1.509(a)-4(f)(8)(i)(A).

⁴⁶ Prop. Reg. 1.509(a)-4(f)(5)(iii).

⁴⁷ Prop. Reg. 1.509(a)-4(f)(5)(iii)(B). Special rules apply if a supporting organization supports only a particular department or school of a hospital, university, or church.

⁴⁸ Prop. Reg. 1.509(a)-4(f)(5)(iii)(C).

⁴⁹ However, the Service will begin applying the provisions of the proposed regulations immediately to organizations in the process of applying for recognition of exemption.

⁵⁰ Prop. Reg. 1.509(a)-4(f)(1)(i).

⁵¹ Prop. Reg. 1.509(a)-4(f)(1)(i), (iii).

Next, all Type III supporting organizations should begin to develop procedures designed to satisfy the notification requirement in the proposed regulations. It may be advisable to incorporate the required notifications into the supporting organization's regular compliance calendar, remembering that the notification must be provided no later than the last day of the fifth month following the close of the supporting organization's tax year (e.g., May 31st for a calendar-year supporting organization).

Type III supporting organizations that have been created primarily to raise funds, hold and manage investment assets, or make grants on behalf of their supported organizations, can qualify as "non-functionally integrated" under the proposed regulations and therefore should begin to evaluate how the annual distribution requirement will affect their operations. A supporting organization that exists solely to invest and manage assets on behalf of its supported organization, for example, currently may operate pursuant to a carefully crafted spending and distribution policy that permits annual distributions in amounts less than the 5% that will be required under the proposed regulations. This type of supporting organization should consider, in collaboration with its supported organization, whether it would be advisable to amend its existing policy to comply with the proposed regulations or whether it may be possible to restructure in a way that allows it to qualify as Type I or Type II supporting organization (and consequently avoid the annual distribution requirement).

Finally, in publishing the proposed regulations, the Service stated that until temporary or final regu-

lations are published, private foundations may continue to rely on the guidance set out in section 3.0 of Notice 2006-109 in connection with making grants to supporting organizations. That guidance generally permits a grant-making private foundation to rely on information contained in the Internal Revenue Service Business Master File or in a grantee's current determination letter in determining whether the grantee is a public charity. In addition, the private foundation may rely upon certain written representations of the grantee, or a reasoned, written opinion of legal counsel, in determining whether the grantee is a Type I, Type II, or functionally integrated Type III supporting organization (since neither the Master File nor most existing determination letters list supporting organization type).

Conclusion

The proposed regulations significantly change the manner in which Type III supporting organizations may be organized and operated. Failure to understand the specific application of the proposed regulations to a particular Type III supporting organization may result in the supporting organization's loss of public charity status and its reclassification as a private foundation. Because the proposed regulations could become effective as early as 2010, organizations should immediately begin to evaluate the likely impact of the proposed regulations on their current practices and operations. Where possible, organizations should take steps now to avoid undesired consequences. ■