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## New Payout Requirements for Non-functionally Integrated Type III Supporting Organizations: Comment Period for Proposed Regulations Closes March 28, 2013

On December 28, 2012, the Treasury Department issued final, temporary, and proposed regulations regarding Type III supporting organizations (“Type III SOs”), effective that day. The final and temporary regulations, including the substantial preamble, are [here](#). The temporary and proposed portions of the new regulations, available [here](#), address the calculation of the annual payout requirement for non-functionally integrated Type III SOs, which differs from that in the 2009 proposed regulations. Treasury will accept public comment on the new proposed regulations through **March 28, 2013**.

**Type III Supporting Organizations and the New Regulations: Background.** All Internal Revenue Code (“IRC”) section 509(a)(3) supporting organizations derive public charity status from their relationship with one or more IRC section 509(a)(1) or (2) public charities:

- › Type I SOs are operated, supervised, or controlled by their supported organization(s) (“parent/subsidiary” relationship);
- › Type II SOs are under common control with their supported organization(s) (“sibling” relationship);
- › Type III SOs are “operated in connection with” one or more of their supported organizations.

In the [2006 Pension Protection Act](#), in response to perceived abuses of Type III SO status, Congress established two sub-categories: “functionally integrated” Type III SOs, which carry out the functions of their supported organizations, and “non-functionally integrated” Type III SOs, which most typically make grants to their supported organizations. Believing that non-functionally integrated Type III SOs would otherwise remain vulnerable to abuse, Congress imposed significant additional requirements on this new sub-category of SOs and on private foundations and donor-advised funds making grants to them. The 2009 proposed regulations interpreted these new requirements and restrictions.

**Effect of New Regulations on Functionally Integrated Type III SOs: Few Surprises.** For most functionally integrated Type III SOs, the 2009 proposed regulations accurately presaged the 2012 final regulations; deviations were minor and anticipated. However, the 2012 final regulations eliminated the provision of the 2009 proposed regulations regarding functional integration with a government entity, reserving this discussion for future proposed regulations.

**Effect of New Regulations on Non-functionally Integrated Type III SOs: New Payout Calculation.** Similarly, the 2009 proposed regulations provided non-functionally

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integrated Type III SOs with fair warning of most of the new requirements and restrictions to be imposed on them, with at least one critical exception. Before the promulgation of the new regulations, any Type III SO that did not meet the definition of “functionally integrated” was required annually to distribute substantially all (at least 85%) of its income to one or more of its supported organizations. The 2009 regulations replaced this 85% income-based test with a proposed 5% asset-based annual payout similar to that required of private foundations. In the new regulations, in response to substantial concerns from the public, Treasury replaced the proposed 5% payout requirement with an alternative test:

Each year, a non-functionally integrated Type III SO must distribute **the greater of:**

- (1) **85% of its adjusted net income** (which generally excludes long-term capital gains) and
- (2) **3.5% of the fair market value of its non-exempt-use assets.**

This payout requirement and the valuation rules used to determine fair market value for this purpose compose the temporary and proposed regulations that remain open for public comment until March 28, 2013.

**Other Guidance Forthcoming.** All Type III SOs should be aware that Treasury intends to issue additional proposed regulations that will address other matters, which include:

- › Clarification of the responsiveness test to require a Type III SO to be responsive to **all** of its supported organizations;
- › Request for additional examples of responsiveness;
- › Definition of “parent” to determine when a Type III SO qualifies as the functionally integrated parent of a supported organization;
- › Definition of “control” for purposes of the prohibition on contributions from a donor that “controls” a supported organization;
- › Clarification regarding what will count towards the payout requirement, including whether expenditures meeting the definition of program-related investments are counted.