

PROFESSIONAL TAX & ESTATE PLANNING NOTES

June 2007

Impact of the Pension Protection Act on Supporting Organizations

This article discusses the provisions of the Pension Protection Act of 2006 (the “Act”) relating to organizations that have been classified as “supporting organizations” under Code Section 509(a)(3)¹. It is the second in a series examining the charitable giving and tax-exempt organization provisions of the Act, which became law on August 17, 2006.

Supporting organizations, especially those known as Type III supporting organizations, have been the subject of scrutiny and criticism in recent years. Regulators, lawmakers, and the press have voiced suspicions that some wealthy individuals use supporting organizations more for personal tax planning purposes than for charity, citing donor control over the supporting

organization, the absence of a payout requirement and no or little actual payout in some cases, and the lack of responsiveness to the needs of the supported organization as reasons why more benefit sometimes flows to the donor than to charity.²

The Act attempts to address the problems or perceived problems generating this criticism. As explained below, some of the new rules are aimed at preventing certain persons, such as substantial contributors, from personally benefiting from their relationship with the supporting organization. Others increase the public disclosure required of supporting organizations and attempt to make supporting organizations more responsive to the needs and demands of their supported organizations.

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Background and Definitions

In general terms, a supporting organization is an entity that qualifies as a public charity because of its relationship with one or more publicly supported organizations, and thus, a supporting organization receives many of the benefits of a public charity without being subject to a public support test, as described below. For example, an entity that provides scholarships to students graduating from a particular high school or an entity that conducts research in areas of interest to a particular medical center may be a supporting organization if it meets the requirements described below. The following definitions explain some of the technical terms that are important to an understanding of supporting organizations and the relevant provisions of the Act.

Supporting organization. A supporting organization generally must be organized and operated to benefit and support one or more Code Section 509(a)(1) or (2) public charities (the “supported organizations”). In addition, a supporting organization must not be controlled by “disqualified persons,” a category that includes substantial contributors.³ Section 509(a)(1) and (2) organizations are public charities because they pass a “public support” test which generally requires that at least 1/3 of their ongoing receipts come from diverse sources, rather than a single family, company, or individual. A supporting organization is treated as a public charity, despite not meeting public support requirements, because of its relationship to one or more supported organizations. A supporting organization is further categorized as Type I, Type II, or Type III depending on the nature of its relationship with the supported organization(s).⁴ In practice, Type III supporting organizations generally are subject to the least amount of control by their supported organizations and the greatest degree of involvement by their

donors, and anecdotal evidence suggests that they may be more susceptible to abuse.

Functionally integrated Type III supporting organizations. Type III supporting organizations are subdivided into two categories, those that are “functionally integrated” with their supported organization(s) and those that are not. Broadly speaking, functionally integrated Type III supporting organizations provide support by performing activities that would otherwise be performed by the supported organization itself.⁵ For example, a Type III supporting organization that operates a printing press for a university would be functionally integrated because, if it weren’t for the supporting organization, the university would operate the printing press itself.⁶ On the other hand, Type III supporting organizations that are *not* functionally integrated provide support by making payments to or for the benefit of the supported organization.⁷

Related persons. The term “related persons” refers to certain persons who are related to a substantial contributor to a supporting organization or to a person who controls the supporting organization or its supported organization. Those related persons include family members and “35% controlled entities” (*i.e.*, entities in which a substantial contributor to the supporting organization or a person who controls the supporting organization or its supported organization or their family members own more than a 35% interest⁸). Interim guidance from the IRS clarifies that, until regulations are issued, the standard for determining whether a disqualified person controls the supporting organization or its supported organization is the standard found in Section 53.4942(a)-3(a)(3) of the Treasury Regulations.⁹ Under that standard, control exists if the disqualified persons may, by aggregating their votes or positions of authority, require or prevent an expenditure by the organization.

Provisions of the Act That Apply to All Supporting Organizations

Automatic Excess Benefit

Transaction Rules. Under prior law, supporting organizations, like other types of public charities, were subject to the excess benefit transaction rules of Code Section 4958 and the excise taxes under those rules (often called “intermediate sanctions”). The Act expands the exposure of supporting organizations to intermediate sanctions, separating out supporting organizations from other public charities.¹⁰

■ **Payments to substantial contributors and related persons.** The entire amount of a grant, loan, payment of compensation, or “other similar payment” (such as an expense reimbursement) by a supporting organization to a substantial contributor or a related person is an “automatic excess benefit transaction” that triggers the various penalty provisions of Section 4958, even if the payment is reasonable.¹¹

■ **Loans to disqualified persons.** In addition to loans to substantial contributors and their related persons, a loan to any disqualified person with respect to a supporting organization (*i.e.*, any person who was, at any time during the 5-year period ending on the date of the loan, in a position to exercise substantial influence over the supporting organization or any related person) will be an automatic excess benefit transaction.¹²

[Effective: Transactions occurring after July 25, 2006 (this date first appeared in the bill that was introduced in Congress on July 28, 2006)]

■ **Interim guidance regarding effective date.** The IRS has issued interim guidance to address situations where a supporting organization may have entered into a legal obligation to make a payment to a substantial

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contributor (or related person) or a loan to a disqualified person prior to the enactment of the Act.¹³ The IRS will not consider any payment made pursuant to a written contract, employment relationship, or other legal obligation that was in effect on August 17, 2006 as an automatic

excess benefit transaction if certain conditions are met, including that the terms of the obligation are not modified after August 17, 2006 and that payment is made by August 17, 2007.¹⁴

■ **Overlapping disqualified persons.** For Code Section 4958 purposes, a disqualified person of a supporting organization also is considered a disqualified person of the supported organization. For example, a substantial contributor to a supporting organization will be a disqualified person of the supported organization.¹⁵

[Effective: August 17, 2006]

New Disclosure Requirements. Prior to the Act, the general rule was that a public charity was not required to file a Form 990 information return with the IRS if its annual gross receipts were \$25,000 or less.¹⁶ Under the new rules, every Section 509(a)(3) supporting organization is required to file a Form 990 regardless of its gross receipts.¹⁷ On the Form 990, each supporting organization must list its supported organizations, indicate whether it is Type I, Type II, or Type III, and certify that it is not controlled by disqualified persons.¹⁸

[Effective: Forms 990 filed for tax years ending after August 17, 2006]

Grants by Private Nonoperating Foundations and Donor-Advised Funds to Supporting Organizations

■ **May not be a qualifying distribution.** A grant by a private nonoperating foundation to a supporting organ-

ization will not be a qualifying distribution that counts toward the foundation's annual payout requirement if the grant is made to:

- a Type III supporting organization that is not functionally integrated;
- or
- a Type I, Type II, or functionally integrated Type III supporting organization where a disqualified person with respect to the private foundation controls the supporting organization or its supported organization.¹⁹

The practical import of this new rule is that these categories of supporting organizations are likely to attract grants only from private nonoperating foundations that have exceeded, or plan to exceed, their payout requirement. This new rule is harsher than the comparable rule applicable to a grant by a private nonoperating foundation to another private nonoperating foundation, which permits the grant to be treated as a qualifying distribution if the grantee foundation distributes an amount equal to the grant amount within a certain period.²⁰

■ **May be a taxable expenditure.** Any grant by a private nonoperating foundation to a supporting organization that is not a qualifying distribution, as described above, will also be a taxable expenditure and subject to excise taxes, unless the foundation making the grant exercises expenditure responsibility.²¹

■ **May be a taxable distribution.** A similar grant by a donor-advised fund to a supporting organization that comes within one of the two categories described above will be a taxable distribution unless the donor-advised fund's sponsoring organization exercises expenditure

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responsibility.²² For donor-advised funds, however, the prohibition on control by the donor or donor advisor applies only to supported organizations, not to supporting organizations.

[Effective: Distributions and expenditures after August 17, 2006]

■ **Interim guidance on grants to supporting organizations.** The IRS has issued interim guidance that

allows private foundations and donor-advised funds to rely on a written representation and certain specified documents in order to determine whether a grantee is a Type I, Type II, or functionally integrated Type III supporting organization.²³ The interim guidance requires detailed information and substantiation regarding the grantee supporting organization's governance and relationship with its supported organization, which can be quite burdensome to obtain and review. Alternatively, a grantor foundation or donor-advised fund can rely on a reasoned written opinion of its counsel or the grantee's counsel.²⁴ The interim guidance also sets out the control standard for determining whether a disqualified person controls the supporting organization or its supported organization.²⁵

Study on Supporting Organizations. The Act directs the Secretary of the Treasury to undertake a study on supporting organizations and submit a report to the Senate Committee on Finance and the House Committee on Ways and Means by August 17, 2007.²⁶ The study will consider whether deductions for charitable contributions to supporting organizations are appropriate and whether the retention by donors of rights or privileges with respect to contributed assets (such as advisory rights or privileges with respect to making grants or investments) is con-

sistent with the treatment of such contributions as completed gifts.²⁷

Additional Provision of the Act That Applies to Type I and Type III Supporting Organizations

Loss of Type I or Type III Status Due to Donor Control.

A Type I or Type III supporting organization will lose its status as a supporting organization (and thus will be treated as a private foundation) if it accepts a gift or contribution from a person (other than a Section 509(a)(1) or (2) public charity) who controls the supported organization or from a related person.²⁸

[Effective: Tax years beginning after August 17, 2006]

Further Provisions of the Act That Apply to Type III Supporting Organizations

Payout Requirements. The Act directs the Secretary of the Treasury to promulgate new regulations setting out payout requirements for Type III supporting organizations that are not functionally integrated.²⁹ According to the Act, the new regulations will require each such Type III organization to distribute a percentage of either its income or assets to the supported organization(s).³⁰ This payout requirement would make most Type III supporting organizations more like private foundations than public charities.

Excess Business Holdings Rules. The excess business holdings rules of Code Section 4943, which previously applied only to private foundations, are now applicable to Type III supporting organizations that are not functionally integrated.³¹ (The excess business holdings rules also apply now to a small number of Type II supporting organizations.³²) Under the excess business holdings rules, such a Type III supporting

The excess business holdings rules of Code Section 4943, which previously applied only to private foundations, are now applicable to Type III supporting organizations that are not functionally integrated.

organization, together with its disqualified persons, generally cannot hold more than a 20% interest in a business enterprise.³³ If the supporting organization and disqualified persons together do not have effective control of an enterprise, then the limit is raised to 35%.³⁴ However, a safe harbor exists under which the supporting organization need not consider the

holdings of its disqualified persons if the supporting organization itself holds no more than a 2% interest.³⁵ In addition, if the supporting organization obtains business holdings by gift or bequest and the additional holdings would result in the supporting organization having excess business holdings, the supporting organization has five years to dispose of the excess business holdings without penalty.³⁶

■ **Disqualified persons.** For purposes of the excess business holdings rules applicable to Type III supporting organizations, the Act expands the list of “disqualified persons” beyond those persons in a position to exercise substantial influence over the supporting organization and their related persons. The list now includes, among others, substantial contributors and their related persons, and organizations controlled by persons who control the supporting organization.³⁷ This further distances the treatment of supporting organizations from that of other public charities.

It may be difficult, if not impossible, for a Type III supporting organization to know what interest in business enterprises all its disqualified persons hold, and without that knowledge a supporting organization may want to play it safe and hold no more than a 2% interest in any business enterprise, or invest only in vehicles that are not considered business enterprises because they qualify as functionally related

businesses or because at least 95% of their income is from passive sources.³⁸

Transition rules. Complex transition rules provide Type III supporting organizations with an extended period in which to reduce their business holdings to permitted levels.³⁹

[Effective: Tax years beginning after August 17, 2006]

Responsiveness to Supported Organizations. A Type III supporting organization must provide each supported organization with information enabling the supported organization to assure itself that the supporting organization is responsive to the supported organization's needs or demands.⁴⁰ The Secretary of the Treasury will determine what information will meet this requirement.⁴¹

[Effective: August 17, 2006]

Qualification of Trusts as Type III Supporting Organizations. Under current Treasury Regulations, a Type III supporting organization that is organized as a trust can qualify to be a supporting organization if it is a charitable trust under state law, the supported organization is a beneficiary of the trust, and the supported organization has the power to enforce the trust and compel an accounting.⁴² Under the Act, it will no longer be enough merely to satisfy these factors – in other words, there will no longer be a safe harbor for trusts.⁴³

[Effective: August 17, 2006, except for trusts currently relying on the Treasury Regulations, for which the change will be effective August 17, 2007]

No Foreign Organizations as Supported Organizations. A foreign organization may not be a supported organization of any Type III supporting organization.⁴⁴

The Act, however, eliminates some of the advantages of a supporting organization, especially those of Type III supporting organizations, and in several ways differentiates supporting organizations from other types of public charities.

[Effective: August 17, 2006, except that, for an existing Type III supporting organization that has a foreign organization as a supported organization, this provision will not apply until the first day of the third tax year beginning after August 17, 2006]

Conclusion

In the past, some donors have found it advantageous from a tax perspective to contribute to a newly created supporting organization. The Act, however, eliminates some of the advantages of a supporting organization, especially those of Type III supporting organizations, and in several ways differentiates supporting organizations from other types of public charities. A donor who is considering a contribution to a supporting organization should carefully consider the impact the Act may have on that decision. Likewise, existing supporting organizations, especially Type III supporting organizations, should ensure that their operations are consistent with the Act. A supporting organization that currently meets the public support requirements of Code Section 509(a)(1) or (2) may wish to avoid the limitations imposed by the Act by changing its public charity classification from a supporting organization to a publicly supported organization.⁴⁵ The Treasury Department study on supporting organizations, which is mandated by the Act, is due in August of this year, and it is likely that we have not seen the last of the changes to the law and regulations governing supporting organizations.

End Notes

- ¹ All Code Section references are to the Internal Revenue Code of 1986, as amended.
- ² See Stephanie Strom, *Big Tax Break Often Bypasses Idea of Charity*, N.Y. TIMES, Apr. 25, 2005.
- ³ Code Section 509(a)(3)(A) and (C).
- ⁴ Code Section 509(a)(3)(B).
- ⁵ Treas. Reg. Section 1.509(a)-4(i)(3)(ii).
- ⁶ See Council on Foundations Supporting Organization FAQs, *at* <http://www.cof.org/Learn/content.cfm?ItemNumber=5336&navItemNumber=5337>.
- ⁷ Treas. Reg. Section 1.509(a)-4(i)(3)(iii).
- ⁸ Code Sections 4943(f)(4)(A)(iii) and 4958(f)(3).
- ⁹ I.R.S. Notice 2006-109, Section 3 (Dec. 5, 2006).
- ¹⁰ Act Section 1242.
- ¹¹ Code Section 4958(c)(3)(A)(i)(I).
- ¹² Code Section 4958(c)(3)(A)(i)(II).
- ¹³ I.R.S. Notice 2006-109, Section 4 (Dec. 5, 2006).
- ¹⁴ *Id.*
- ¹⁵ Code Section 4958(f)(1)(D).
- ¹⁶ The Act, however, subjects Code Section 509(a)(1) or (2) public charities with gross receipts of less than \$25,000 to new electronic notification requirements.
- ¹⁷ Act Section 1245; Code Section 6033(a)(3)(B).
- ¹⁸ Code Section 6033(l).
- ¹⁹ Act Section 1244; Code Section 4942(g)(4).
- ²⁰ Code Section 4942(g)(3).
- ²¹ Code Section 4945(d)(4).
- ²² Code Section 4966(c).
- ²³ I.R.S. Notice 2006-109, Section 3 (Dec. 5, 2006).
- ²⁴ *Id.*
- ²⁵ *Id.*
- ²⁶ Act Section 1226(a) and (b).
- ²⁷ *Id.*
- ²⁸ Act Section 1241(b); Code Section 509(f)(2).
- ²⁹ Act Section 1241(d).
- ³⁰ *Id.*
- ³¹ Act Section 1243; Code Section 4943(f). There are two narrow exceptions: (i) the excess business holdings rules do not apply to a Type III supporting organization if the Secretary of the Treasury determines that the excess business holdings are consistent with the purpose or function constituting the basis for the supporting organization's exemption under Code Section 501(c)(3); and (ii) an exception exists for a Type III supporting organization that held assets as of November 18, 2005 on the direction of a state attorney general or other official with jurisdiction over the organization.
- ³² The Act makes the excess business holdings rules applicable to Type II supporting organizations where the supporting organization accepts any gift or contribution from a person (other than a Code Section 509(a)(1) or (2) public charity) who controls the supported organization or from a related person. See Act Section 1243; Code Section 4943(f)(3)(B).
- ³³ Code Section 4943(c)(2)(A). Not all businesses are business enterprises for this purpose. For example, the term "business enterprise" does not include a functionally related business or a trade or business where at least 95% of the gross income is derived from passive sources (such as interest, dividends, annuities, royalties, rent, and gains from the disposition of certain property). See Code Section 4943(d)(3).
- ³⁴ Code Section 4943(c)(2)(B).
- ³⁵ Code Section 4943(c)(2)(C).
- ³⁶ Code Section 4943(c)(6).
- ³⁷ Code Section 4943(f)(4).
- ³⁸ See Code Section 4943(d)(3).
- ³⁹ Code Section 4943(f)(7) and 4943(c)(4)-(6).
- ⁴⁰ Act Section 1241(b); Code Section 509(f)(1)(A).
- ⁴¹ *Id.*
- ⁴² Treas. Reg. Section 1.509(a)-4(i)(2)(iii).
- ⁴³ Act Section 1241(c).
- ⁴⁴ Act Section 1241(b); Code Section 509(f)(1)(B).
- ⁴⁵ I.R.S. Announcement 2006-93 (Nov. 7, 2006) provides procedures that a supporting organization should follow to change its classification to a publicly supported organization.

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