

Client Alert: New IRS Regulations Regarding Tax Exempt “Supporting Organizations”

The Internal Revenue Service has issued new regulations for tax-exempt “supporting organizations,” which became effective December 28, 2012. The new regulations include minimum payout requirements, limitations on gifts from controlling parties, and requirements for notice to the supported organizations.

The new regulations apply only to “supporting organizations” -- organizations which are tax exempt under Section 501(c)(3) of the Internal Revenue Code and which support other charities. There are three types of supporting organizations, known as Type I, Type II and Type III. Type I supporting organizations function as subsidiaries of their supported organization parents (e.g. the supported organization appoints a majority of the directors of the supporting organization). Type II supporting organizations have a “brother-sister” relationship with their supported organizations (e.g. a majority of the directors is on both organizations’ boards). Type III supporting organizations have a more tenuous connection to their supported organizations (e.g. there may be only a single board member who overlaps with, or is appointed by, the supported organization). Type III supporting organizations have a number of useful functions, but have come under increased scrutiny by the IRS, all, as discussed below.

Highlights of the New Regulations:

Gifts from Controlling Donors: Type I and Type III supporting organizations may not accept gifts from persons who control the governance of their supported organizations, or the family members and controlled entities of such persons. The IRS has promised to issue additional regulations in the near future to define the term “control” as used in the new regulations.

Payout Requirements: The new regulations require Non-Functionally Integrated Type III supporting organizations to distribute at least 3.5% of the fair market value of their non-exempt-use assets each year to the supported organization. “Non-Functionally Integrated Type III supporting organizations” are Type III supporting organizations which (a) do not serve as the parents of their supported organizations, and (b) focus on activities separate from the exempt purposes of their supported organizations such as fund-raising, grant-making, and the management or investment of other non-exempt use assets. The regulations include detailed explanations of the calculation and timing of the required payments, and require that the annual payments be substantial enough to make the supported organization pay more attention to the activities of the supporting organization. The annual payment must constitute 10% or more of the supported organization’s total support *or* the payment must provide support necessary to avoid the interruption of a particular function or activity of the supported organization *or* the payment must satisfy a facts and circumstances test. The Treasury Department is requesting comments regarding the advisability of an exception to the distribution requirement allowing a set-aside rather than a distribution for long-term capital projects or other purposes.

Notice Requirements: Type III supporting organizations must now provide annual notices to their supported organizations concerning the support provided. The notice of support

provided must include a copy of the Type III supporting organization's most recently filed Form 990, and a copy of the governing documents of the Type III supporting organization.

Benefits of Type III Supporting Organizations and Impact of New Regulations

Type III supporting organizations' autonomy from their supported organizations makes them attractive for several uses. Alumni associations and other groups wishing to support an identified charity without complete control by the charities they support may form Type III supporting organizations, as may groups wishing to support public schools (including charter schools), state universities, and other public or governmental units which qualify as charities. The looser control by the supported organizations may permit Type III supporting organizations to avoid being treated as governmental entities for purposes of Open Meeting Law, Public Records Law, and other statutes that regulate governmental entities.

More Information

If you would like more information on Type I, Type II and Type III supporting organizations or the new regulations, or have any other questions, please contact Elka Sachs (ETS@kb-law.com) or Sheryl Howard (SAH@kb-law.com) at Krokidas and Bluestein LLP.

The new regulations, 26 CFR Parts 1, 53, and 602, may be accessed at <http://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-31050.pdf>