

Supporting Organization Provisions Of The Pension Protection Act Of 2006

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Summarized below are the main provisions of Public Law 109-280, the Pension Protection Act of 2006 (the “Act”), relating to section 509(a)(3) supporting organizations. (Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986 as amended.) Except as otherwise noted, these provisions are generally effective for contributions, transactions, and tax years beginning after the date of enactment

A. Definitions

1. *Types Of Supporting Organization.* Section 509(a)(3)(B) was revised to specify the three types of supporting organization relationship previously defined only in the Regulations (and informally referred to as Type I, II, and III supporting organizations). These relationships are:
 - a. *Type I*—the supporting organization is “operated, supervised or controlled by” its supported organization(s)
 - b. *Type II*—the supporting organization is “supervised or controlled in connection with” its supported organization(s)
 - c. *Type III*—the supporting organization is “operated in connection with” its supported organization(s)

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(See also new Code sections 4966(d)(4)(B), 4942(g)(4)(B) and 4943(f)(5), which incorporate the previously informal classification as Type I, Type II, and Type III supporting organizations into the Code.)

2. *Functionally Integrated Type III Supporting Organization.* Section 4943(f) (added by the Act) defines a “functionally integrated type III supporting organization” as a type III supporting organization which is not required to meet the payout requirement of the integral part test in the regulations because it performs the functions or carries out the purposes of its supported organization(s). §4943(f)(5)(B).
 - a. The term functionally integrated Type III supporting organization should be understood as currently defined in regulations. However, the JCT’s explanation of the Act notes that Congress is concerned that “the current regulatory standards [for being considered functionally integrated] are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations.” Joint Committee on Taxation, *Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006*, JCX-38-06, p.360, note 571 (Aug. 3, 2006) (hereinafter “*JCT Explanation*”). The *JCT Explanation* further notes that when the Treasury Secretary revisits the payout requirements in new regulations (as directed by the Act), he has the discretion to determine whether any type III supporting organizations should be exempt from a payout requirement, or, if the exemption is retained, how standards for such exemption should be strengthened.

B. Type III Supporting Organization Qualification

1. In order to qualify as a *type III* supporting organization, the organization:
 - a. Must provide each supported organization with information as required by the Treasury Secretary annually. §509(f)(1)(A). This information could include copies of the supporting organization’s governing documents (and any changes made to them), copies of its Forms 990 and 990-T, and an annual report (including a description of the support provided, how it was calculated and a projection of the next year’s support). Failure to provide sufficient information will be considered a factor in determining whether the current law “responsiveness test” is met. *JCT Explanation*, p.362.
 - b. May *not* support non-U.S. organizations (effective the first day of the third taxable year after the date of enactment for organizations which currently support foreign entities). §509(f)(1)(B).
 - c. Must maintain a “close and continuous working relationship” with officers or board members of the supported organization(s) such that it is responsive to the needs or demands of the supported organization, even if organized as a trust. Although the language of the statute is not entirely clear, it appears to eliminate the “trust option” alternative for meeting the “responsiveness test” in current Treas. Reg. §1.509(a)-4(i)(2)(iii), thus requiring trusts to meet either the alternative responsiveness test in current Treas. Reg. §1.509(a)-4(i)(2)(ii) or some yet-to-be determined “close and continuous relationship” test for trusts. The *JCT Explanation*, however, seems to imply that trusts will be required to meet *both* the current “trust option” *and* some version of the “close and continuous relationship” test. *JCT Explanation*, p.362. For existing trusts, this provision is effective one year after the date of enactment. Act, §1241(c), (e)(2).

C. Donors Cannot Control Supported Organizations

1. Under new section 509(f)(2), a *type I or type III* supporting organization will fail to qualify (or lose its status as a supporting organization if it accepts a contribution from:
 - a. A donor (except a public charity that is not a supporting organization) who, alone or together with family members or 35 percent owned entities noted below, directly or indirectly controls a supported organization. (Employees of 35 percent controlled entities will likely be considered when determining whether a supported organization is indirectly controlled. *See* Rev. Rul. 80-207, 1980-2 C.B. 193);
 - b. A family member of such a donor (determined under §4958(f)(4)); or
 - c. An entity 35 percent controlled by either of the foregoing. (Defined with reference to section 4958(f)(3) and potentially including 35 percent controlled charities.)
2. A type II supporting organization that accepts a contribution from any of the above-described persons will not lose its supporting organization status, but it will become subject to the private foundation excess business holdings rules in section 4943, as described below. §4943(f)(3)(B).

D. Expanded Excess Benefit Transactions For All SOs

1. Disqualified persons of a supporting organization will be treated as disqualified persons of its supported organization(s) for section 4958 purposes. §4958(f)(1)(D).
2. Effective after July 25, 2006, *all loans* by a supporting organization to disqualified persons (*excluding* public charities that are not supporting organizations) and *all grants, loans, compensation, or other similar payments* made by a supporting organization to substantial contributors, their family members, or entities 35 percent controlled by either will be considered excess benefit transactions and the *full amount* of the loan, compensation, or other payment will be considered the “excess benefit amount.” Thus, if a supporting organization makes such a payment to a substantial contributor, the substantial contributor will be liable for an excise tax under section 4958 equal to 25 percent of the full amount of the payment (not just the excess benefit, if any) and the payment will have to be returned to the supporting organization. §4958(c)(3).
 - a. For purposes of this provision, a substantial contributor is defined as any person, other than a public charity that is not a supporting organization, who gives an organization more than \$5,000 if such amount is more than two percent of the total contributions received by the organization through the end of the year in which the contribution was received. In the case of a trust, it also means the creator of the trust. Rules similar to 507(d)(2)(B) and (C) apply. Note that unlike the definition of substantial contributor in the 4958 regulations, a donor’s status as a substantial contributor depends on contributions over the life of the organization, not just the past five years. §4958(c)(3)(C).
 - b. The legislation does not define “other similar payments.” However, the *JCT Explanation* of the Act indicates that the term includes payments “in the nature of a grant, loan or payment of compensation, such as an expense reimbursement,” but that it does not include payments “made

pursuant to a bona fide sale or lease of property with a substantial contributor.” *JCT Explanation*, p.358.

- c. Although this provision applies to loans and payments made after July 25, 2006, IRS Notice 2006-109, 2006-51 I.R.B. 1121 (Dec. 4, 2006), provides that the IRS will not consider a payment an excess benefit transaction if:
 - i. The payment is made on or before August 17, 2007; *and*
 - ii. The payment is made pursuant to a binding written contract in effect on August 17, 2006, that remained binding and unmodified at all times thereafter and through the date of the payment; *or*
 - iii. The payment was made for services rendered or goods delivered on or before December 31, 2006, pursuant to an employment arrangement or other legal obligation that was in existence on August 17, 2006, and was unmodified through the payment date.

E. Payout Requirement For Type III SOs.

1. The Act requires the Treasury Secretary to promulgate new regulations requiring *type III* supporting organizations (*except* functionally integrated type III supporting organizations) to pay out annually a percentage of assets or income to or for the use of supported organizations to “ensure that a significant amount is paid to such organizations.” Act §1241(d).

F. Excess Business Holdings Rules Extended To SOs

1. The excess business holdings rules of section 4943, which generally prohibit a private foundation and its disqualified persons from together owning more than 20 percent of a business enterprise, now apply to *type III* supporting organizations (*except* functionally integrated type III supporting organizations). These rules also apply to *type II* supporting organizations that accept contributions from a donor who directly or indirectly controls a supported organization (unless the donor is a *public charity* that is not a supporting organization), from a family member of such a donor, or from an entity controlled by either of the foregoing. §4943(f).
2. The definition of a “disqualified person” of a supporting organization for purposes of application of section 4943 to supporting organizations is quite broad. §4943(f)(4). Included are:
 - a. Persons in a position to exercise substantial influence over the affairs of the organization, their family members, or entities 35 percent controlled by either;
 - b. Substantial contributors to the supporting organization, their family members, and entities 35 percent controlled by either;
 - c. Any organization that is effectively controlled by the same person(s) as the supporting organization; or
 - d. Any organization that received substantially all of its funds from:
 - i. An officer, director, or trustee of the supporting organization;

- ii. A substantial contributor to the supporting organization; or
 - iii. The owner of more than 20 percent of the interests in a substantial contributor to the supporting organization.
3. Certain Type III holdings at the direction of a state attorney general are exempt from application of these rules and the Treasury Secretary may exempt the holdings of other Type IIIs if such holdings are consistent with the organization's exempt purpose. §4943(f)(2),(f)(6).
 4. This provision is effective for tax years beginning after enactment. Transition rules apply, allowing organizations that currently have business holdings to retain up to a 35 percent interest in the business and to take up to 35 years to decrease their percentage ownership to allowed levels. §4943(f)(7).

G. Restrictions On DAF And Private Foundation Funding

1. *Donor Advised Fund (DAF) Distributions.* DAFs cannot make distributions to *type III* supporting organizations (*except* functionally integrated type III supporting organizations) *unless* the sponsoring organization exercises expenditure responsibility for the distribution. Similarly, *unless* the sponsoring organization exercises expenditure responsibility, distributions cannot be made from a DAF to a *type I*, *type II*, or *functionally integrated type III supporting organization* if the donor or advisor of the DAF directly or indirectly controls a supported organization of such organization (or if the Treasury Secretary determines by regulation that the distribution would be inappropriate). §4966.
 - a. Although not specifically referenced, the §4945(h) private foundation expenditure responsibility rules may provide some guidance for complying with this provision.
2. *Sponsoring DAFs.* The Act practically prohibits type III supporting organizations that are not functionally integrated from being sponsoring organizations for DAFs by denying a charitable deduction to donors who contribute to DAFs held by such supporting organizations. §§170(f)(18); 2055(e)(5); 2522(c)(5).
3. *Private Foundation Grants.* Non-operating private foundations cannot count as qualifying distributions any grants to *type III* supporting organizations (*except* functionally integrated type III supporting organizations) or to any *type I*, *type II*, or *functionally integrated type III supporting organization* if a disqualified person of the private foundation directly or indirectly controls either the supporting organization or any of its supported organizations (or if the Treasury Secretary determines by regulation that the distribution would be inappropriate). §4942(g)(4). In addition, private foundations must *exercise expenditure responsibility* over any such grant that does not count as a qualifying distribution or the grant will be a taxable expenditure, subject to penalty and correction. §4945(d)(4). The *JCT Explanation*, p.363, states that “[a]ny amount that does not count as a qualifying distribution under this rule is treated as a taxable expenditure under section 4945.” However, this does not seem to correspond with the text of the legislation, which treats any such amount as a taxable expenditure only if the foundation does not exercise expenditure responsibility for it.
4. *Due Diligence For Foundation And DAF Grants.* Notice 2006-109, 2006-51 I.R.B. 1121 (Dec. 4, 2006), provides that grantors may rely on a grantee's current IRS exemption letter or information from the IRS Business Master File (available at www.irs.gov) to establish whether the grantee is or is not a sup-

porting organization described in §509(a)(3). The Notice also provides guidance on how a supporting organization's type may be established.

- a. To establish that a grantee is a type I or type II supporting organization, a grantor may rely on a *written representation from the grantee*, signed by an officer, director or trustee, that states the grantee's organization type, describes how its officers, directors, or trustees are selected, and references the relevant provisions of the grantee's governing documents, *provided that* the grantor also collects and reviews copies of the grantee's governing documents and the documents are not inconsistent with the grantee's written representation.
- b. To establish that a grantee is a functionally integrated type III supporting organization, a grantor may rely on a *written representation* similar to that described above, but which also identifies the supported organizations with which the grantee is functionally integrated, *provided that* the grantor collects and reviews, and finds nothing inconsistent with the grantee's written representation in:
 - i. The governing documents of the grantee (and, if relevant, of the supported organizations) and any other documents setting forth the grantee's relationship with its supported organizations; and
 - ii. Written representations signed by an officer, director, or trustee of each supported organization with which the grantee is functionally integrated describing the activities of the grantee and confirming that, but for the involvement of the grantee, the supported organization would normally be engaged in the grantee's activities itself.
- c. As an alternative to relying on a grantee's written representation and the collected documents, the Notice provides that a grantor may instead rely on a reasoned written opinion of counsel of either the grantor or the grantee concluding that the grantee is a type I, type II, or functionally integrated type III supporting organization.
- d. In addition, the Notice indicates that grantors may also need to obtain a list of a grantee's supported organizations to determine whether any of these organizations are controlled either by foundation-disqualified persons or by the donor or donor advisor of the DAF (and any related parties).

H. Exclusion From IRA Rollover Incentive

1. The Act provides for an exclusion from income of up to \$100,000 for distributions from the individual retirement account ("IRA") of a donor that has reached age 70½ directly to a public charity (*except* for distributions to supporting organizations or for donor-advised funds). This exclusion is available only for 2006 and 2007. §408(d)(8).

I. Information Returns

1. Effective for taxable years *ending* after the date of enactment:

- a. The Secretary no longer has discretion to exempt supporting organizations from the obligation to file information returns. Thus, even small supporting organizations (with gross receipts under \$25,000) will generally have to file a Form 990 (or Form 990-EZ). §6033(a)(3)(B).
 - i. The *JCT Explanation*, p.359, indicates that the Act requires all supporting organizations, regardless of their gross receipts, to file an annual information return. However, supporting organizations to religious organizations that normally have not more than \$5,000 of gross receipts annually are still exempt from filing under a statutory exemption in section 6033(a)(3)(C)(iv).
 - b. Each supporting organization's annual Form 990 must indicate what type of supporting organization it is, list the organization(s) it supports, and certify that it is not controlled, directly or indirectly, by one or more disqualified persons (other than entity managers and public charities). §6033(l).
2. Although the Act contains no specific requirements or restrictions regarding who may be on a supporting organization's governing board (as it does with respect to credit counseling organizations), the *JCT Explanation* of the Act indicates that Congress intended that supporting organizations be able to certify that the majority of their governing bodies are composed of individuals who either have special expertise in the particular field in which the supporting organization operates or represent the particular community served by the supported public charities. *JCT Explanation*, p.359.

J. Treasury Report To Congress

1. *Within one year of enactment*, the Treasury Secretary is required to report to the Senate Finance Committee and the House Ways and Means Committee regarding its study of the organization and operation of DAFs and supporting organizations. Act, §1226. The Act specifically indicates that the Treasury's study should consider:
 - a. Whether the current tax deductions for contributions to DAFs and supporting organizations are appropriate considering the use of the contributed assets and any benefits received by donors;
 - b. Whether DAF sponsoring organizations should have a payout requirement;
 - c. Whether a donor's retention of rights or privileges with respect to property transfers to a DAF or supporting organization (e.g., to advise regarding investment or distributions) is consistent with treatment of such transfers as completed gifts; and
 - d. Whether other forms of charities or charitable contributions are subject to these issues.
2. In Notice 2007-21, the Service invited public comments on these issues to be submitted by April 9, 2007.

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