

**KROKIDAS & BLUESTEIN**  
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**CLIENT ALERT**

**NOTICE 2014-4 PROVIDES NEW GUIDANCE FOR GOVERNMENT ENTITY  
AFFILIATES**

**Governmental Entities and Their Tax-Exempt Corporate Affiliates:**

Many of our governmental and quasi-governmental clients, including charter schools and housing authorities, have formed tax-exempt corporate affiliates. Tax-exempt corporate affiliates may be formed for a number of reasons: to take advantage of fundraising and grant opportunities; to own and develop real estate; and to obtain financing not available to government entities, such as New Markets Tax Credit financing. This Client Alert will discuss new IRS guidance as to how corporate affiliates of governmental entities may be structured to obtain optimal treatment for tax purposes and under state law.

**Structuring Tax-Exempt Corporate Affiliates:**

When a governmental entity intends to create a corporate affiliate which will apply for tax-exempt status under Section 501(c)(3) of the Internal Revenue Code, it must consider how the tax-exempt corporate affiliate will meet the “public support” tests that apply to all Section 501(c)(3) organizations. The “public support” tests require a tax-exempt organization to demonstrate either that it will have a broad base of public support, or that it will have one of several specified relationships with a publicly supported tax-exempt corporation or governmental entity which will enable it to qualify as a “supporting organization.” If a tax-exempt organization does not meet either public support test, it will be treated as a private foundation subject to numerous restrictions, including those which may preclude certain fundraising and grant opportunities, and certain investment and business relationships and activities. Private foundation status is rarely desirable.

Although some tax-exempt corporate affiliates of governmental entities qualify as publicly supported, many do not. Corporate affiliates which focus their fundraising efforts on a small number of large grants, and those which are formed for a single purpose or transaction are unlikely to qualify as publicly supported. In such cases, the corporate affiliates must be structured as “supporting organizations” in order to avoid being characterized as private foundations.

**Supporting Organizations:**

Supporting organizations must have a specified relationship with a publicly supported 501(c)(3) organization or with a governmental entity (its “supported organization”). Supporting

organizations may be structured in one of three ways. 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 serve on the boards of both the supported organization and the supporting organization). Type III supporting organizations have more attenuated relationships with their supported organizations (e.g., there may be only a single board member who overlaps with, or is appointed by, the supported organization).

### **Governmental Entity Considerations:**

State and municipal governmental entities are subject to a number of statutory requirements and restrictions which guide their operation, including the so-called Open Meeting Law, Public Records Law, Ethics Statute, Public Procurement Statute, and Designer Selection Statute. In structuring a tax-exempt corporate affiliate, governmental entities and their funders and partners may wish to consider whether to have the tax-exempt corporate affiliate treated as a governmental entity. Although all facts and circumstances must be taken into account, if the tax-exempt corporate affiliate is structured as a Type I supporting organization or a Type II supporting organization, it is more likely that the corporate affiliate will be treated as a governmental entity under the Open Meeting Law, Public Records Law, Public Procurement Law and Designer Selection Statute. In contrast, if the tax-exempt corporate affiliate is structured as a Type III supporting organization, it is less likely that these statutes will apply to the corporate affiliate in all circumstances.

### **New Type III Supporting Organization Rules:**

Temporary Treasury Regulations (the “Temporary Treasury Regulations”) issued in 2012 require Type III supporting organizations to demonstrate that they are “functionally integrated” (into the supported organization) or become subject to mandatory payout requirements, much like private foundations. The Temporary Treasury Regulations specify that organizations whose activities are limited to fundraising and managing “non-exempt-use assets” will not be considered functionally integrated. The Temporary Treasury Regulations indicate that real estate may be characterized as an “exempt-use asset” only if it is used by the supporting organization to carry out the purpose of the supported organization or if it is leased to the supported organization for no or nominal rent. Treas. Reg. 26 CFR 1.509(a)-4T(i)(8). The Temporary Treasury Regulations make it difficult to use Type III supporting organizations for fundraising or for holding debt-financed real estate, as the mandatory pay-out requirements are often inconsistent with the expectations of the government entity and its funders and lenders.

### **New Guidance for Type III Supporting Organizations of Governmental Affiliates:**

When issued, the Temporary Treasury Regulations indicated that regulations specifically applicable to Type III supporting organizations affiliated with governmental entities would follow. Although the promised regulations have not yet issued, the Internal Revenue Service recently issued Notice 2014-4, providing interim guidance which will make it easier for governmental entities to form tax-exempt corporate affiliates that qualify as functionally integrated Type III supporting organizations not subject to mandatory payout requirements.

Under Notice 2014-4, Type III supporting organizations of governmental entities are treated as a unique category, not subject to those provisions of the Temporary Treasury Regulations which subject Type III supporting organizations formed for fundraising purposes to mandatory payout requirements, and provide that Type III supporting organizations which lease property to their supported organizations must do so for nominal rent to avoid payout requirements. Notice 2014-4 will make it easier for governmental entities to create Type III supporting organizations for fundraising, real estate ownership and development, and other purposes.

**More Information:**

If you would like to review the status of your existing tax-exempt corporate affiliates, or are considering the formation of new corporate affiliates, or have any other questions, please contact Attorney Elka Sachs ([ets@kb-law.com](mailto:ets@kb-law.com)) or Sheryl Howard ([showard@kb-law.com](mailto:showard@kb-law.com)) at Krokidas & Bluestein LLP.

FA\0001\353456.1FA\0001\352653.3