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CLIENT ALERT

UPDATE ON TAX-EXEMPT “SUPPORTING ORGANIZATIONS”

The Treasury Department and the Internal Revenue Service (IRS) recently released two sets of regulations, one final and one proposed, which primarily concern tax-exempt organizations characterized as “Type III supporting organizations,” as discussed in more detail in this Alert.

Background

A “supporting organization” is an organization that is tax exempt under Section 501(c)(3) of the Internal Revenue Code and escapes classification as a private foundation because it supports one or more publicly supported tax-exempt organizations (the “supported organization”). Thus, even though the supporting organization is not publicly supported, it can avoid the many requirements and excise taxes applicable to private foundations because of its support of a publicly supported organization. A supporting organization is categorized as Type I, Type II, or Type III depending on the relationship that it has with its supported organization. Of the three types, Type III supporting organizations have the most tenuous relationships with their supported organizations, with only a single board member overlapping with, or being appointed by, the supported organization.

Type III supporting organizations are further grouped as “functionally integrated” or “non-functionally integrated.” A Type III supporting organization can qualify as functionally integrated by (i) primarily conducting activities that directly further the exempt purposes of its supported organization, (ii) serving as parent of its supported organization, or (iii) supporting a governmental entity. Any Type III supporting organization that does not qualify under one of these categories is treated as non-functionally integrated and is subject to distribution requirements similar to those that apply to private foundations.

Final Regulations – Non-Functionally Integrated, Type III Supporting Organizations:

The final regulations that became effective on December 21, 2015 concerned the requirements for non-functionally integrated, Type III supporting organizations. The final regulations provide a detailed explanation of the annual payments that non-functionally integrated, Type III supporting organizations must make to their supported organizations in order to avoid classification as a private foundation.

Proposed Regulations – Supporting a Governmental Entity:

The proposed regulations primarily provide guidance on how an organization can qualify as a functionally integrated, Type III supporting organization by supporting a governmental entity (as opposed to a publicly-supported tax-exempt organization). These regulations will go into effect when the Treasury Department publishes temporary or final regulations. The proposed regulations (i) provide guidance on the activities in which the supporting organization must engage in order to qualify as a supporting organization of a governmental supported organization and (ii) provide a transition rule for supporting organizations that have operated as Type III supporting organizations of a governmental supported organization. This guidance is as follows:

Activities: Organizations must focus their activities on activities that “directly further” the exempt purposes of their governmental supported organization, such as managing exempt-use assets (e.g., leasing property to its supported organization free of charge) or operating a program that furthers the exempt purposes of its governmental supported organization and would otherwise be conducted by the governmental supported organization itself. Fundraising, grant-making (except in limited circumstances), and managing non-exempt-use assets (e.g., leasing property to its supported organization at fair market value) are not considered activities that directly further the exempt purposes of a governmental supported organization.

Transition Rule: An organization that relied on previous guidance regarding how to qualify as a functionally integrated, Type III supporting organization of a governmental supported organization will continue to be treated as a functionally integrated, Type III supporting organization until the beginning of the organization’s first taxable year after the final regulations are published or the beginning of the organization’s second taxable year beginning after February 19, 2016, whichever is earlier.

Impact of Proposed Regulations

A Type III supporting organization that is connected to its governmental supported organization primarily by fundraising for its governmental supported organization or leasing real estate to its governmental supported organization for more than a nominal fee will likely not qualify as a functionally integrated, Type III supporting organization of a governmental supported organization under these proposed regulations or the final regulations that supersede them. Organizations that are classified as supporting organizations should review their status to determine if they may be impacted by these proposed regulations.

More Information

If you would like more information on supporting organizations, or if you need assistance in reviewing your organization’s supporting organization status, please contact Elka Sachs (ets@kb-law.com) or Judith Kim (jyk@kb-law.com) at Krokidas and Bluestein LLP.