

On December 23, 2013, the IRS issued a transition test for certain Type III supporting organizations in Notice 2014-4. This new guidance provides clarity for those organizations that support a governmental organization and for funders of such governmental organizations. This update reviews the federal tax law developments.

General Background

Organizations that are operated exclusively for religious, charitable, scientific and other limited purposes may qualify as exempt from federal income tax under Internal Revenue Code (Code) Section 501(c)(3). All Code Section 501(c)(3) organizations are then further classified as either a private foundation or a public charity. In general, public charity status is more desirable than private foundation status because a private foundation is subject to self-dealing and other restrictions, minimum distribution requirements and excise taxes on its investment income.

In general, all Code Section 501(c)(3) organizations are classified as private foundations unless an exception applies. One such exception is for "supporting organizations" that work exclusively with another federal tax-exempt entity that is not a private foundation in support of the exempt mission of the other tax-exempt entity. For example, a supporting organization might assist a public school or university in teaching or providing materials to students, which is a task normally taken on by the school or university.

Organizations that are "operated in connection with" their supported organization are called Type III supporting organizations. The Code divides Type III organizations into (1) those that are "functionally integrated" and (2) those that are not.

On December 28, 2012, the Department of the Treasury (Treasury Department) and the IRS published Treasury Decision 9605 containing final and temporary regulations that set forth the requirements to qualify as a functionally integrated Type III supporting organization (2012 Regulations). However, the Treasury Department and the IRS reserved, for future guidance, the specific requirements for organizations that support a governmental organization to meet the functionally integrated requirement.

Grants and Donor Advised Funds

Type III organizations sometimes receive grants from private foundations and sponsoring organizations that maintain donor advised funds. Such grants and funds are subject to strict requirements when made to Type III organizations that are not functionally integrated. Such grants made to "functionally integrated" Type III organizations are not subject to those requirements. In this regard, the Treasury Department and the IRS previously issued [IRS Notice 2006-109](#) and [Revenue Procedure 2011-33](#), which together provided that grantors may reasonably rely on the opinion of legal counsel in determining if the Type III organization is "functionally integrated".

Transition Guidance

On December 23, 2013, the IRS published [IRS Notice 2014-4](#) setting forth transitional guidance for Type III supporting organizations. The Notice provides that, until the earlier of (1) the date final regulations are published or (2) the first day of the organization's third taxable year beginning after December 31, 2013, a Type III supporting organization will be treated as functionally integrated if it:

- (1) Supports at least one supported organization that is a governmental entity to which the supporting organization is "responsive" within the meaning of Treasury Regulations under Code Section 509(a) (those regulations generally require an overlap or close relationship between the officers or directors of the two organizations); and
- (2) Engages in activities for or on behalf of the governmental supported organization described in paragraph (1) that perform the functions of, or carry out the purposes of, that governmental supported organization and that, but for the involvement of the supporting organization, would normally be engaged in by the governmental supported organization itself.

Importantly, with respect to grants from private foundations and donor advised funds after December 28, 2012, the opinion of legal counsel must be based on either (i) the 2012 Regulations (which contain a different, more general, test) or (ii) IRS Notice 2014-4 when determining whether the Type III supporting organization is functionally integrated. Overall, the transition guidance appears aimed at preserving the existing nature of the relationships between most public universities and secondary schools and their supporting organizations and that donations to those supporting organizations by private foundations and donor advised funds should be subject to the less restrictive rules.

For more information, please consult a Squire Sanders advisor below.

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