before the due date of the return and, thus, T had 60 calendar days to file Form 8886 with OTSA. TS and T properly disclosed the transaction in accordance with the applicable regulations under section 6011, but S did not. S's failure to disclose relates to taxable year 2010. The time to assess tax with respect to the transaction against S for 2010 remains open under section 6501(c)(10) even though TS and T disclosed the transaction.

Example 9. Section 6501(c)(10) satisfied before expiration of three-year period of limitations under section 6501(a). Same facts as *Example 8*, except that on August 27, 2012, S satisfies the requirements of paragraph (g)(5) of this section. No material advisor satisfied the requirements of paragraph (g)(6) of this section with respect to S on a date earlier than August 27, 2012. Under section 6501(c)(10), the period of time in which the IRS may assess tax against S with respect to the listed transaction would expire no earlier than August 27, 2013, one year after the date S satisfied the requirements of paragraph (g)(5). As the general three-year period of limitations on assessment under section 6501(a) does not expire until April 15, 2014, the IRS will have until that date to assess any tax with respect to the listed transaction.

Example 10. No section 6112 request. B, a calendar year taxpayer, entered into a listed transaction in 2010. B did not comply with the applicable disclosure requirements under section 6011 for taxable year 2010; therefore, section 6501(c)(10) applies to keep the period of limitations on assessment open with respect to the tax related to the transaction until at least one year after B satisfies the requirements of paragraph (g)(5) of this section or a material advisor satisfies the requirements of paragraph (g)(6) of this section with respect to B. In June 2011, the IRS conducts a section 6700 investigation of Advisor K, who is a material advisor to B with respect to the listed transaction. During the course of the investigation, the IRS obtains the name, address, and TIN of all of Advisor K's clients who engaged in the transaction, including B. The information provided does not satisfy the requirements of paragraph (g)(6) with respect to B because the information was not provided pursuant to a section 6112 request. Therefore, the time to assess tax against B with respect to the transaction for taxable year 2010 remains open under section 6501(c)(10).

Example 11. Section 6112 request but the requirements of paragraph (g)(6) are not satisfied with respect to B. Same facts as *Example 10*, except that on January 2, 2014, the IRS sends by certified mail a section 6112 request to Advisor L, who is another material advisor to B with respect to the listed transaction. Advisor L furnishes some of the information required under section 6112 and §301.6112–1 to the IRS for inspection on January 13, 2014. The list includes information with respect to many clients of Advisor L, but it does not include any information with respect to B. The submission does not satisfy the requirements of paragraph (g)(6) of this section with respect to B. Therefore, the time to assess tax against B with respect to the transaction for taxable year 2010 remains open under section 6501(c)(10).

Example 12. Section 6112 submission made before taxpayer failed to disclose a listed transaction. Advisor M, who is a material advisor, advises C, an individual, in 2010 with respect to a transaction that is not a reportable transaction at that time. C files its return claiming the tax consequences of the transaction on April 15, 2011. The time for the IRS to assess tax against C under the general three-year period of limitations for C's 2010 taxable year would expire on April 15, 2014. The IRS identifies the transaction as a listed transaction on November 1, 2013. On December 5, 2013, the IRS hand delivers to Advisor M a section 6112 request related to the transaction. Advisor M furnishes the information to the IRS on December 30, 2013. The information contains all the required information with respect to Advisor M's clients, including C. C does not disclose the transaction on or before January 30, 2014, as required under section 6011 and the regulations under section 6011. Advisor M's submission under section 6112 satisfies the requirements of paragraph (g)(6) of this section even though it occurred prior to C's failure to disclose the listed transaction. Thus, under section 6501(c)(10), the period of limitations to assess tax against C with respect to the listed transaction will end on December 30, 2014 (one year after the requirements of paragraph (g)(6) of this section were satisfied), unless the period of limitations remains open under another exception.

Example 13. Transaction removed from the category of listed transactions after taxpayer failed to disclose. D, a calendar year taxpayer, entered into a listed transaction in 2011. D did not comply with the applicable disclosure requirements under section 6011 for taxable year 2011; therefore, section 6501(c)(10) applies to keep the period of limitations on assessment open with respect to the tax related to the transaction until at least one year after D satisfies the requirements of paragraph (g)(5) of this section or a material advisor satisfies the requirements of paragraph (g)(6) of this section with respect to D. In 2016, the IRS removes the transaction from the category of listed transactions because of a change in law. Section 6501(c)(10) continues to apply to keep the period of limitations on assessment open for D's taxable year 2011.

Example 14. Taxes assessed with respect to the listed transaction. (i) F, an individual, enters into a listed transaction in 2009. F files its 2009 Form 1040 on April 15, 2010, but does not disclose his participation in the listed transaction in accordance with section 6011 and the regulations under section 6011. F's failure to disclose relates to taxable year 2009. Thus, section 6501(c)(10) applies to keep the period of limitations on assessment open with respect to the tax related to the listed transaction for taxable year 2009 until at least one year after the date F satisfies the requirements of paragraph (g)(5) of this section or a material advisor satisfies the requirements of paragraph (g)(6) of this section with respect to F.

(ii) On July 1, 2014, the IRS completes an examination of F's 2009 taxable year and disallows the tax consequences claimed as a result of the listed transaction. The disallowance of a loss increased F's adjusted gross income. Due to the increase of F's adjusted gross income, certain credits, such as the child tax credit, and exemption deductions were disallowed or reduced because of limitations based on adjusted gross income. In addition, F now is liable for the alternative minimum tax. The examination also uncovered that F claimed two deductions on Schedule C to which F was not entitled. Under section 6501(c)(10), the IRS can timely issue a statutory notice of deficiency (and assess in due course) against F for the deficiency resulting from (1) disallowing the loss, (2) disallowing the credits and exemptions to which F was not entitled based on F's increased adjusted gross income, and (3) being liable for the alternative minimum tax. In addition, the IRS can assess any interest and applicable penalties related to those adjustments, such as the accuracy-related penalty under sections 6662 and 6662A and the penalty under section 6707A for F's failure to disclose the transaction as required under section 6011 and the regulations under section 6011. The IRS cannot, however, pursuant to section 6501(c)(10), assess the increase in tax that would result from disallowing the two deductions on F's Schedule C because those deductions are not related to, or affected by, the adjustments concerning the listed transaction.

(9) *Effective/applicability date.* The rules of this paragraph (g) apply to taxable years with respect to which the period of limitations on assessment did not expire before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**. However, taxpayers may rely on the rules of this paragraph (g) for taxable years with respect to which the period of limitations on assessment expired before the date of publication of the Treasury decision. If an individual does not choose to rely on the rules of this paragraph (g), Rev. Proc. 2005–26, 2005–1 C.B. 965, will continue to apply to taxable years with respect to which the period of limitations on assessment expired on or after April 8, 2005, and before the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on October 6, 2009, 8:45 a.m., and published in the issue of the Federal Register for October 7, 2009, 74 F.R. 55127)

Notice of Proposed Rulemaking

Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated

REG–155929–06

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations regarding the requirements to qualify as a Type III supporting organization that is operated in connection with one or more supported organizations. The regulations reflect changes to the law made by the Pension Protection Act of 2006. The regulations will affect Type III supporting organizations and their supported organizations.

DATES: Written or electronic comments and requests for a public hearing must be received by December 23, 2009.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–155929–06), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–155929–06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC, or sent electronically via the Federal eRulemaking Portal at *http://www.regulations.gov/* (IRS REG–155929–06).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Philip T. Hackney or Don R. Spellmann at (202) 622–1124; concerning submissions of comments and requests for a public hearing, Richard A. Hurst at (202) 622–7180 (not toll-free numbers) or *Richard.A.Hurst@irscounsel.treas.gov.*

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by November 23, 2009. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in Prop. Reg. §1.509(a)–4(i)(2). The collection of information flows from section 509(f)(1)(A), which requires a Type III supporting organization to provide to each of its supported organizations such information as the Secretary may require to ensure that the Type III supporting organization is responsive to the needs or demands of its supported organization(s). The likely recordkeepers are Type III supporting organizations.

Estimated total annual reporting burden: 8,400 hours.

Estimated average annual burden hours per recordkeeper: Two hours.

Estimated number of recordkeepers: 4,200.

Estimated frequency of collection of such information: Annual.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by 26 U.S.C. 6103.

Background

An organization described in section 501(c)(3) of the Internal Revenue Code (Code) is classified as either a private foundation or a public charity. To be classified as a public charity, an organization must meet the requirements of section 509(a)(1), (2), (3), or (4). Organizations described in section 509(a)(3) are known as supporting organizations. Such organizations achieve their status by providing support to one or more organizations described in section 509(a)(1) or (2), which in this context are referred to as supported organizations.

To meet the requirements of section 509(a)(3), an organization must satisfy an organizational test, an operational test, a relationship test, and a disqualified person control test. The organizational and operational tests require that the supporting organization be organized and at all times thereafter operated exclusively for the benefit of, to perform the functions of, or to conduct the purposes of one or more supported organizations. The relationship test requires the supporting organization to establish one of three types of relationships with one or more supported organizations. Finally, the disqualified person control test requires that the supporting organization not be controlled directly or indirectly by certain disqualified persons. Although each of these tests is a necessary requirement for an organization to establish that it qualifies as a supporting organization, this notice of proposed rulemaking (NPRM) focuses primarily on the relationship test.

Three Types of Supporting Organizations

Treas. Reg. §1.509(a)–4(f)(2) provides that a supporting organization must maintain one of three types of structural or operational relationships with its supported organization(s). A supporting organization that is operated, supervised or controlled by one or more supported organizations is commonly known as a Type I supporting organization. The relationship of a Type I supporting organization with its supported organization(s) is comparable to that of a corporate parent-subsidiary relationship. A supporting organization that is supervised or controlled in connection with one or more supported organizations is commonly known as a Type II sup-

porting organization. The relationship of a Type II supporting organization with its supported organization(s) is comparable to a corporate brother-sister relationship. A supporting organization that is operated in connection with one or more supported organizations is commonly known as a Type III supporting organization. This NPRM focuses primarily on Type III supporting organizations.

Qualification Requirements for Type III Supporting Organizations Prior to Enactment of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780 (2006)) (PPA)

Prior to the enactment of the PPA, the regulations under section 509(a)(3) generally provided that an organization is "operated in connection with" one or more supported organizations if it meets a "responsiveness test" and an "integral part test."

Responsiveness Test

Treas. Reg. §1.509(a)–4(i)(2)(i) provides that an organization meets the responsiveness test if the organization is responsive to the needs or demands of its supported organizations. Treas. Reg. §1.509(a)–4(i)(2)(ii) provides three ways that a supporting organization may demonstrate responsiveness to a supported organization: (1) the supported organization appoints or elects one or more of the officers, directors, or trustees of the supporting organization; (2) one or more members of the governing body of the supported organization serve as officers, directors, or trustees of, or hold other important offices in, the supporting organization; or (3) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the supported organization. In all three cases, the relationship must result in the supported organization having a significant voice in the investment policies of the supporting organization, the timing and the manner of making grants, the selection of the grant recipients of the supporting organization, and direction over the use of the income or assets of the supporting organization.

The existing regulations also provide an alternative means for charitable trusts to satisfy the responsiveness test. Under Treas. Reg. §1.509(a)–4(i)(2)(iii), a supporting organization is responsive if: (1) it is a charitable trust under State law, (2) each specified supported organization is a named beneficiary under the charitable trust's governing instrument, and (3) each beneficiary organization has the power to enforce the trust and compel an accounting under State law.

In the case of an organization that was supporting one or more supported organizations before November 20, 1970, Treas. Reg. §1.509(a)–4(i)(1)(ii) provides that additional facts and circumstances, such as a historic and continuing relationship between the supporting organization and its supported organization(s), also may be taken into account to establish compliance with the responsiveness test.

Integral Part Test

Treas. Reg. §1.509(a)–4(i)(3)(i) provides that a supporting organization meets the integral part test by maintaining a significant involvement in the operations of one or more supported organizations that are dependent upon the supporting organization for the type of support which it provides. Under the existing regulations, there are two alternative ways to meet the integral part test: (1) the "but for" test under Treas. Reg. §1.509(a)–4(i)(3)(ii); or (2) the "attentiveness" test under Treas. Reg. §1.509(a)–4(i)(3)(iii).

Treas. Reg. §1.509(a)–4(i)(3)(ii) states that the "but for" test is satisfied if "the activities engaged in [by the supporting organization] for or on behalf of the supported organizations are activities to perform the functions of, or to carry out the purposes of, such organizations, and, but for the involvement of the supporting organization, would normally be engaged in by the supported organizations themselves."

The "attentiveness" test under Treas. Reg. §1.509(a)–4(i)(3)(iii) requires a supporting organization to: (1) make payments of substantially all of its income to or for the use of one or more supported organizations, (2) provide enough support to one or more supported organizations to ensure the attentiveness of such organization(s) to the operations of the supporting organization; and (3) pay a substantial amount of the total support of the supporting organization to those supported organizations that meet the attentiveness requirement. Rev. Rul. 76–208, 1976–1 C.B. 161 (see §601.601(d)(2)(ii)(*b*)), provides that the phrase "substantially all of its income" in Treas. Reg. §1.509(a)–4(i)(3)(iii) means at least 85 percent of adjusted net income.

PPA Changes to Qualification Requirements for Type III Supporting Organizations

The PPA made five changes to the requirements an organization must meet to qualify as a Type III supporting organization:

(1) It removed the alternative test for charitable trusts as a means of meeting the responsiveness test;

(2) It required the Secretary of the Treasury to set a new payout requirement for organizations that are not functionally integrated (generally, those organizations that met the integral part test by satisfying the attentiveness test under the existing regulations) to ensure that such organizations pay a "significant amount" to their supported organizations;

(3) It provided that a Type III supporting organization must annually provide to each of its supported organizations such information as the Secretary may require to ensure that the supporting organization is responsive to the needs or demands of its supported organization(s);

(4) It prohibited a Type III supporting organization from supporting any supported organization not organized in the United States; and

(5) It prohibited a Type I or Type III supporting organization from accepting a gift or contribution from a person who, together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type I or Type III supporting organization.

Notice 2006–109

On December 18, 2006, the Treasury Department and the IRS released Notice 2006–109, 2006–2 C.B. 1121, (see §601.601(d)(2)(ii)(*b*)), which alerted taxpayers to the new supporting organization rules enacted by the PPA; provided interim guidance, including reliance standards for private foundations making grants to supporting organizations; and solicited

comments regarding the new supporting organization requirements. Fifteen comments and numerous phone calls were received in response to the request for comments contained in Notice 2006–109.

Advanced Notice of Proposed Rulemaking (ANPRM)

On August 2, 2007, the Treasury Department and the IRS issued an ANPRM titled "Payout Requirements for Type III Supporting Organizations that Are Not Functionally Integrated" (Reg–155929–06, 72 FR 148). The ANPRM described proposed rules to implement the PPA changes to the Type III supporting organization requirements, and solicited comments regarding those proposed rules.

In the ANPRM, the Treasury Department and the IRS proposed that all Type III supporting organizations would be required to meet the responsiveness test under Treas. Reg. §1.509(a)–4(i)(2)(ii). In addition, the Treasury Department and the IRS proposed that Type III supporting organizations that are functionally integrated would be required to meet: (A) the "but for" test in existing Treas. Reg. §1.509(a)–4(i)(3)(ii); (B) an expenditure test resembling the section 4942(j)(3)(A) qualifying distributions test for private operating foundations; and (C) an assets test resembling the section 4942(j)(3)(B) alternative assets test for private operating foundations. However, the Treasury Department and the IRS indicated that an exception would be provided for certain Type III supporting organizations that oversee or facilitate the operation of an integrated system, such as certain hospital systems. The ANPRM stated that such organizations would be classified as functionally integrated as long as they satisfied the responsiveness and "but for" tests under the existing regulations.

The ANPRM proposal provided that a non-functionally integrated Type III supporting organization would be required to make an annual payout equal to the annual payout required from a private non-operating foundation (generally, five percent of the fair market value of non-exempt-use assets). The Treasury Department and the IRS also proposed a limitation on the number of supported organizations a non-functionally integrated Type III supporting organization could support.

The IRS received over 40 comments and numerous phone calls in response to the ANPRM. After consideration of all comments received, the Treasury Department and the IRS are issuing this NPRM regarding the new qualification requirements for Type III supporting organizations. The major areas of comment in response to the ANPRM are discussed in the preamble under Explanation of Provisions.

Explanation of Provisions

Summary of Proposed Criteria to Qualify as a Type III Supporting Organization

The proposed regulations provide that every Type III supporting organization must: (1) satisfy the notification requirement set forth under Prop. Reg. §1.509(a)–4(i)(2); (2) meet the responsiveness test set forth under Prop. Reg. §1.509(a)–4(i)(3); and (3) demonstrate that it is an integral part of one or more supported organizations. A Type III supporting organization demonstrates that it is an integral part of a supported organization by satisfying either the requirements for functionally integrated Type III supporting organizations set forth in Prop. Reg. §1.509(a)–4(i)(4), or the requirements for non-functionally integrated Type III supporting organizations set forth in Prop. Reg. §1.509(a)–4(i)(5). Further, as set forth in Prop. Reg. §1.509(a)–4(i)(10), a Type III supporting organization may not support a supported organization that is organized outside of the United States. Finally, as set forth in Prop. Reg. §1.509(a)–4(f)(5), Type I and Type III supporting organizations are prohibited from accepting a gift or contribution from a person who, together with certain related persons, directly or indirectly controls the governing body of a supported organization of the Type I or Type III supporting organization.

Requirement to Notify Supported Organizations

Prop. Reg. §1.509(a)–4(i)(2) implements section 509(f)(1)(A) of the Code, which provides that a Type III supporting organization must provide to each of its supported organizations such information as the Secretary may require to ensure that the supporting organization is responsive to the needs or demands of the supported organization.

The Treasury Department and the IRS requested comments in the ANPRM on the type of information a Type III supporting organization should be required to provide to its supported organizations. One commentator recommended that the proposed regulations adopt a recommendation of the Panel on the Nonprofit Sector, which suggested requiring Type III supporting organizations to provide annually to their supported organizations: (1) a copy of governing documents, including those filed with Form 1023, "*Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code*," and any updates; (2) a copy of Form 990, "*Return of Organization Exempt From Income Tax*;" and (3) an annual report of activities, including a narrative, financial detail, and a description of the support provided (including how it was calculated or determined) and a projection of support to be provided in the subsequent year. Panel on the Nonprofit Sector, Strengthening Transparency, Governance, Accountability of Charitable Organizations (June 2005), at 45.

Another commentator recommended that the proposed regulations require only that the Form 990 be distributed to the "lead" supported organization. This commentator argued that any additional requirement would impose too much additional administrative burden and cost on the charitable sector. The comment also suggested allowing the notification to be provided electronically.

The proposed regulations require that each taxable year, a Type III supporting organization must provide to each of its supported organizations: (A) a written notice addressed to a principal officer of the supported organization identifying the supporting organization and describing the amount and type of support it provided to the supported organization in the past year; (B) a copy of the supporting organization's most recently filed Form 990; and (C) a copy of the supporting organization's governing documents, including any amendments. Copies of governing documents need only be provided once. The proposed regulations provide that the required notice and documents may be delivered by electronic media. Organizations

must satisfy the notification requirement to qualify as a Type III supporting organization and should retain proof of delivery in their records.

Responsiveness Test

The proposed regulations provide that all Type III supporting organizations, including those organized as charitable trusts, must meet the responsiveness test under existing Treas. Reg. §1.509(a)–4(i)(2)(ii).

The ANPRM proposed to apply the responsiveness test to all Type III supporting organizations and to remove the special rule for charitable trusts. In response to the ANPRM, commentators argued that the PPA did not require imposition of the general responsiveness test on charitable trusts, and that the test could be difficult to satisfy because of state-law fiduciary requirements on trusts. Thus, a commentator recommended the development of an alternate charitable trust test based on facts and circumstances.

One commentator recommended exempting trusts managed by institutional trustees from the responsiveness test. The commentator stated that institutional trustees employ strict rules to manage trusts, thereby making abuse of these trusts highly unlikely. Another commentator recommended transition relief for trusts in existence on the date the PPA was enacted similar to that provided in Treas. Reg. §1.509(a)–4(i)(4) for trusts established before November 20, 1970, which would apply to a trust with a lengthy and continuous history of distributions, and no discretion to vary the beneficiaries or the amount of distributions.

The proposed regulations require that all Type III supporting organizations demonstrate the necessary relationship between its officers, directors or trustees and those of the supported organization, and show that this relationship results in the officers, directors or trustees of the supported organization having a significant voice in the operations of the supporting organization. The proposed regulations do not adopt a special rule for trusts.

The Treasury Department and the IRS believe that requiring charitable trusts to meet the responsiveness test set forth in these proposed regulations is consistent with Congress' intent in the PPA. The Treasury Department and the IRS expect that some charitable trusts will be able to demonstrate that they meet the requirements of the responsiveness test. The proposed regulations provide examples that illustrate factors that could lead to a conclusion that a supporting organization organized as a trust is responsive to the needs of a supported organization. Additionally, the Treasury Department and the IRS request comments regarding a specific responsiveness rule for trusts that would be consistent with the existing responsiveness test and the Congressional intent behind section 1241 of the PPA, which removed the alternative trust test in the regulations.

Integral Part Test — Functionally Integrated Type III Supporting Organizations

The proposed regulations provide that a Type III supporting organization is functionally integrated if it either: (1) engages in activities substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s) and that, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s); or (2) is the parent of each of its supported organizations.

The ANPRM proposed requiring an organization to meet not only the "but for" test under existing Treas. Reg. §1.509(a)–4(i)(3)(ii), but also two additional tests — an expenditure test and an assets test — in order to qualify as a functionally integrated Type III supporting organization. In general, commentators said that the additional tests were unduly restrictive and more burdensome than those proposed for non-functionally integrated Type III supporting organizations. These commentators argued that the ANPRM's expenditure test was arbitrary and that Congress did not authorize the Secretary to impose a payout requirement on functionally integrated organizations. Many commentators highlighted differences between a Type III supporting organization and a private operating foundation that warrant treating these types of organizations differently, including the fact that a supporting organization is dedicated to specific organizations and that those specified organizations rely on the supporting organization for consistent support.

Many commentators recommended exempting certain types of organizations from the proposed requirements for functionally integrated Type III supporting organizations, such as long-standing supporting organizations and supporting organizations that support governmental agencies, religious organizations, and grant-making organizations. Several commentators recommended that the proposed regulations take into account the historic and continuing relationship of "long-standing" organizations with their supported organizations. Additionally, many commentators requested an exemption for supporting organizations of governmental entities, contending that these organizations are not subject to abuse because of their connection to a governmental entity. These commentators argued that supporting organizations choose a Type III structure to ensure that funds are dedicated long-term to a specific purpose, and removed from the appropriation process of the government.

In formulating the criteria in the proposed regulations, the Treasury Department and the IRS also noted the suggestion in the Joint Committee on Taxation's Technical Explanation of the PPA that "substantially all of the activities of [a functionally integrated Type III supporting organization] should be activities in direct furtherance of the functions or purposes of supported organizations." Staff of the Joint Committee on Taxation, Technical Explanation of H.R. 4, The "Pension Protection Act of 2006" (Aug. 3, 2006), at 360 n.571 (Technical Explanation). In the Technical Explanation, the Joint Committee on Taxation also expressed concern that "the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations." Technical Explanation at 360 n.571.

The Treasury Department and the IRS believe that a sufficient nexus exists between a supporting organization and its supported organization(s) where the supporting organization engages in activities that directly further the exempt purposes of the supported organization(s) and that would otherwise be conducted by the sup-

ported organization itself. Accordingly, the proposed regulations provide that a Type III supporting organization is functionally integrated if it either: (1) engages in activities (a) substantially all of which directly further the exempt purposes of the supported organization(s) to which it is responsive by performing the functions of, or carrying out the purposes of, such supported organization(s) and (b) that, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s); or (2) is the parent of each of its supported organizations. The Treasury Department and the IRS request comments on how guidance might clarify the application of the "substantially all" test in this context. The proposed regulations do not adopt the expenditure test and the assets test described in the ANPRM.

The proposed regulations provide that a supporting organization directly furthers the exempt purposes of its supported organization by holding or managing exempt-use assets but does not directly further such exempt purposes by fundraising, grantmaking, or investing and managing non-exempt-use assets. The Treasury Department and the IRS believe that fundraising, grantmaking, and investing and managing non-exempt-use assets do not alone establish a sufficient nexus between a supporting organization and its supported organization. Further, the Treasury Department and the IRS believe that an organization that does not engage in activities that directly further a exempt purpose will achieve a sufficient nexus with its supported organization(s) only if it distributes a significant amount to its supported organizations, as Congress directed in the PPA.

The Treasury Department and the IRS recognize the unique circumstances of a governmental entity whose assets are subject to the appropriations process of a federal, state, local or Indian tribal government and that therefore organizes a Type III supporting organization to remove assets from the appropriations process of the government. The proposed regulations therefore provide an exception under which a supporting organization that supports a single governmental entity may treat investing and managing non-exempt-use assets as activities that directly further an exempt purpose, so long as a substantial part of the supporting organization's total activities directly furthers the exempt purposes of such governmental entity.

The proposed regulations specifically require that a functionally integrated Type III supporting organization's activities directly further the exempt purposes of those supported organizations with respect to which the supporting organization meets the responsiveness test under Prop. Reg. §1.509(a)–4(i)(3). The Treasury Department and the IRS request comments on this requirement.

The proposed regulations provide that a supporting organization will be treated as the parent of a supported organization if the supporting organization exercises a substantial degree of direction over the policies, programs, and activities of the supported organization, and the majority of the officers, directors, or trustees of the supported organization is appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers of the supporting organization acting in their official capacity. Thus, the supporting organization could qualify as a parent of a second-tier (or lower) subsidiary. The classification of a parent supporting organization as functionally integrated is intended to apply to supporting organizations that oversee or facilitate the operation of an integrated system, such as hospital systems.

The proposed regulations provide examples that illustrate the requirements for functionally integrated Type III supporting organizations.

Integral Part Test-Non-Functionally Integrated Type III Supporting Organizations

The proposed regulations provide that a Type III supporting organization is non-functionally integrated if it satisfies a distribution requirement equal to five percent of the fair market value of non-exempt-use assets and an attentiveness requirement.

Section 1241(d)(1) of the PPA directed the Secretary of the Treasury to promulgate new regulations on a payout requirement for non-functionally integrated Type III supporting organizations, based on income or assets, in order to ensure that these supporting organizations pay a significant amount to their supported organizations. The ANPRM proposal required an annual payout of five percent of the fair market value of non-exempt-use assets. Many commentators said that this payout rate was too high and would erode an organization's assets over time. The commentators said that a Type III supporting organization provides long-term consistent support to specific organizations, while private foundations may pay out to whomever they choose. Further, a supporting organization maintains a governance relationship with its supported organization(s) in a way that a private foundation does not. Commentators argued that because of these differences, the private foundation payout requirement should not be imposed on a supporting organization. Imposing a five percent payout, these commentators contend, would jeopardize the ability of supporting organizations to provide the kind of consistent, reliable, long-term support supported organizations have come to expect.

Commentators suggested a number of alternative payout rates. Many of them also recommended allowing an averaging of assets over a period of years for purposes of calculating the payout amount.

The ANPRM proposed to limit the number of organizations a non-functionally integrated Type III supporting organization can support to no more than five. The ANPRM further provided that Type III supporting organizations in existence before the date regulations are proposed may support more than five organizations, as long as the supporting organization pays 85 percent of its support to organizations to which the supporting organization is responsive.

Many commentators asked that the proposed regulations not include the limitation on the number of supported organizations a non-functionally integrated Type III supporting organization can support, arguing that such a rule is arbitrary. In particular, commentators pointed out that the original Senate bill associated with supporting organizations, contained in the Tax Increase Prevention and Reconciliation Act of 2005, Public Law 109–222 (120 Stat. 345 (2005)), limited the number of organizations a supporting organization could support to five, but that Congress ultimately did not enact such a limitation.

One commentator suggested that the proposed regulations adopt a rule that one-third of a non-functionally integrated

Type III supporting organization's required distribution must go to a supported organization that is attentive to the supporting organization and to which the supporting organization is responsive.

Commentators recommended providing a transition period for the payout requirement to allow organizations sufficient time either to modify governing instruments or to sell assets.

A number of commentators suggested that the proposed regulations exempt Type III supporting organizations that (1) have no continuing involvement of donors or their family in the governance of the organization; and (2) before the date of enactment of PPA, had distributed to or for the benefit of its supported organizations an amount equal to or greater than the amounts transferred to the organization for which charitable deductions were allowed.

Under the proposed regulations, to qualify as a non-functionally integrated Type III supporting organization, an organization must meet a distribution requirement and an attentiveness requirement. The proposed regulations set the distribution requirement for non-functionally integrated Type III supporting organizations at five percent of non-exempt-use assets, and retain the concept of attentiveness that is in the current regulations. The proposed regulations do not adopt the five organization limit described in the ANPRM.

Distribution Requirement

To satisfy the distribution requirement of Prop. Reg. §1.509(a)–4(i)(5)(ii), a Type III supporting organization that is not functionally integrated must distribute, with respect to each taxable year, to or for the use of its supported organizations, amounts equaling or exceeding five percent of the aggregate fair market value of its non-exempt-use assets (the annual distributable amount), on or before the last day of such taxable year. The annual distributable amount is determined based on asset values measured over the preceding taxable year. Thus, for example, a Type III supporting organization that is not functionally integrated would determine its annual distributable amount for its 2012 taxable year, which must be distributed on or before the last day of the organization's 2012 taxable year, based on asset values measured over its 2011 taxable year. A Type III supporting organization that is not functionally integrated is not required to distribute any amount in its first year of existence.

The proposed regulations generally draw from the regulations under section 4942 for principles on valuation, timing, and carryovers. However, the proposed regulations do not permit set-asides, which count towards a private foundation's distribution requirement under section 4942(g)(2). While Congress statutorily provided that set-asides constitute qualifying distributions for private foundations, Congress made no such statutory provision for supporting organizations. Rather, in the PPA, it directed that a payout requirement be implemented for non-functionally integrated Type III supporting organizations that would result in a prompt, robust flow of support to supported organizations. The Treasury Department and the IRS request comments on whether set-asides are necessary and consistent with Congressional intent in determining whether Type III supporting organizations that are not functionally integrated have distributed their annual distributable amount.

The proposed regulations also provide a slightly different rule regarding the carryover of excess distributions than is applicable to private foundations. Under section 4942(i), a private foundation that distributes more than its distributable amount may carry forward that excess amount for five years. However, when calculating qualifying distributions in a future year under section 4942, amounts paid out in the future year count first towards the required distributable amount, and any amount carried forward is not "used" in the future year to the extent that the organization made qualifying distributions in that future year. These proposed regulations reverse the ordering rule and first count any excess amount carried forward toward the non-functionally integrated Type III supporting organization's annual distributable amount, followed by amounts paid out in the later year.

The proposed regulations provide a reasonable cause exception for failure to meet the distribution requirement applicable to non-functionally integrated Type III supporting organizations. Under the exception, an organization that fails to meet the distribution requirement will not be classified as a private foundation in the taxable year for which it fails to meet such distribution requirement, if the organization establishes to the satisfaction of the Secretary that: (1) the failure was due solely to an incorrect valuation of assets, a ministerial error, or unforeseen events or circumstances that are beyond the organization's control; (2) the failure was due to reasonable cause and not to willful neglect; and (3) the distribution requirement is met within 180 days after the date the incorrect valuation or ministerial error was or should have been discovered, or 180 days after the organization is first able to make its required payout notwithstanding the unforeseen event or circumstances. The reasonable cause exception applies only to the distribution requirement of Prop. Reg. §1.509(a)–4(i)(5)(ii), and not to the attentiveness requirement of Prop. Reg. §1.509(a)–4(i)(5)(iii). The Treasury Department and the IRS request comments regarding the reasonable cause exception for the distribution requirement.

The proposed regulations also provide for an emergency temporary reduction in the annual distributable amount. Under Prop. Reg. §1.509(a)–4(i)(5)(ii)(D), the Secretary may provide by publication in the Internal Revenue Bulletin for a temporary reduction in the annual distributable amount in the case of a disaster or emergency.

The Treasury Department and the IRS are aware that some supporting organizations impacted by the distribution requirement contained in these proposed regulations may be heavily invested in assets that are not readily marketable. The Treasury Department and the IRS request comments regarding the need for a transition rule for non-functionally integrated Type III supporting organizations whose assets, as of the effective date of these regulations, consist predominantly (in any event more than one-half) of assets that are not readily marketable.

Attentiveness Requirement

These proposed regulations modify the attentiveness requirement in existing Treas. Reg. §1.509(a)–4(i)(3)(iii) to provide that an organization must distribute one-third or more of its annual distributable amount to one or more supported organizations that are attentive to

the supporting organization and with respect to which the supporting organization meets the responsiveness test under Prop. Reg. §1.509(a)–4(i)(3).

The proposed regulations provide that to demonstrate that a supported organization is attentive, a supporting organization must either: (1) provide 10 percent or more of the supported organization's total support; (2) provide support that is necessary to avoid the interruption of the carrying on of a particular function or activity of the supported organization; or (3) provide an amount of support that based on all the facts and circumstances is a sufficient part of a supported organization's total support.

Consequences of Failure to Meet Requirements

A Type III supporting organization that fails to meet the requirements of these proposed regulations, once they are published as final or temporary regulations, will be classified as a private foundation. Once classified as a private foundation, the section 507 rules regarding termination of private foundation status apply. The Treasury Department and the IRS request comments on whether exceptions or special rules under section 507 are needed for Type III supporting organizations that are reclassified as private foundations as a result of the changes in the PPA.

Transition and Other Relief Provisions

Responsiveness Test

The proposed regulations continue to provide that additional facts and circumstances, such as a historic and continuing relationship with a supported organization, may be taken into account in establishing compliance with the responsiveness test for organizations that were operating prior to November 20, 1970.

Integral Part Test

The proposed regulations provide a transition rule for Type III supporting organizations in existence on the date these regulations are published in the **Federal Register** as final or temporary regulations. Under the transition rule, such organizations that met and continue to meet the requirements of existing Treas. Reg. §1.509(a)–4(i)(3)(ii) (*i.e.*, an organization that meets the integral part test by satisfying the "but for" test) will be treated as meeting the requirements of a functionally integrated Type III supporting organization set forth in Prop. Reg. §1.509(a)–4(i)(4) until the first day of the organization's first taxable year beginning after the date these proposed regulations are published as final or temporary regulations.

The proposed regulations also provide that Type III supporting organizations in existence on the date these regulations are published in the **Federal Register** as final or temporary regulations that met and continue to meet the requirements of existing Treas. Reg. §1.509(a)–4(i)(3)(iii) will be treated as meeting the requirements of a non-functionally integrated Type III supporting organization set forth in Prop. Reg. §1.509(a)–4(i)(5) until the first day of the organization's second taxable year beginning after the date these proposed regulations are published as final or temporary regulations. Such organizations will be required to value their assets in accordance with Prop. Reg. §1.509(a)–4(i)(8) in the first taxable year beginning after final or temporary regulations are published, and to meet all of the requirements of Prop. Reg. §1.509(a)–4(i)(5)(i) in the second taxable year beginning after the publication of these regulations as final or temporary regulations and for all succeeding taxable years.

For example, if the Treasury Department and the IRS publish these regulations as final or temporary regulations any time in 2010, a calendar-year non-functionally integrated Type III supporting organization must: (1) in 2010, meet all of the requirements of existing Treas. Reg. §1.509(a)–4(i)(3)(iii) (*i.e.*, distribute to its supported organizations substantially all of its income in accord with the existing regulations); (2) in 2011, meet all of the requirements of current Treas. Reg. §1.509(a)–4(i)(3)(iii) and value its assets according to Prop. Reg. §1.509(a)–4(i)(8); and (3) in 2012, meet all of the requirements of Prop. Reg. §1.509(a)–4(i)(5)(i), including the distribution requirement.

The proposed regulations also retain the exception from the integral part test for pre-November 20, 1970 trusts that meet certain other requirements found in current Treas. Reg. §1.509(a)–4(i)(4).

The Treasury Department and the IRS request comments on whether additional transition relief is needed.

The proposed regulations eliminate current Treas. Reg. §1.509(a)–4(i)(1)(iii), which provides an exception from the integral part test if an organization can establish that: (1) it met the payout requirement under current Treas. Reg. §1.509(a)–4(i)(3)(iii)(a) for any five-year period; (2) it cannot meet such payout requirement for its current taxable year solely because the amount received by one or more of the supported organizations is no longer sufficient to satisfy the attentiveness requirement; and (3) there has been a historic and continuing relationship of support between such organizations between the end of the five-year period and the taxable year in question. The Treasury Department and the IRS believe that the breadth of this exception is inconsistent with Congress' intent in mandating a payout requirement in the PPA.

Regulations under Section 4943

This NPRM also includes proposed regulations under section 4943 that provide two transition rules to address excess business holdings for Type III supporting organizations affected by the PPA. The PPA applied the section 4943 excess business holdings excise tax to non-functionally integrated Type III supporting organizations. However, it provided that in calculating the "present holdings" of Type III supporting organizations in existence on August 17, 2006 (the date of enactment of the PPA), the transition rules that applied to private foundations in 1969, when section 4943 was first enacted, would apply. These transition rules effectively allow affected organizations additional time to dispose of certain business holdings.

The proposed regulations provide transition relief to a private foundation that qualified as a Type III supporting organization under section 509(a)(3) immediately before August 17, 2006, and that was reclassified as a private foundation under section 509(a) on or after August 17, 2006, solely as a result of the rules enacted by Section 1241 of the PPA. Thus, under the proposed regulations, the present holdings of such private foundations will be determined using the same rules that apply

to Type III supporting organizations under section 4943(f)(7).

In addition, the Treasury Department and the IRS believe that pre-November 20, 1970 trusts that are exempted from the integral part test under current regulations and these proposed regulations should not be subject to the excess business holdings excise tax that applies to non-functionally integrated Type III supporting organizations. Therefore, the proposed regulations under section 4943 provide that a Type III supporting organization created as a trust before November 20, 1970, that meets the requirements of current Treas. Reg. §1.509(a)–4(i)(4) and Prop. Reg. §1.509(a)–4(i)(9), will be treated as a "functionally integrated Type III supporting organization" for purposes of section 4943(f)(3)(A).

Reliance on Prior Guidance

In Notice 2006–109, the Treasury Department and the IRS provided guidance to private foundations regarding determinations of the public charity status of a section 501(c)(3) organization when making grants. In particular, because a grant to a non-functionally integrated Type III supporting organization is not considered a qualifying distribution under section 4942, and is considered a taxable expenditure unless expenditure responsibility is exercised under section 4945, the notice provided criteria for determining whether a Type III supporting organization is functionally integrated and allowed private foundations to rely on those criteria for purposes of sections 4942 and 4945. Commentators to the ANPRM requested that the Treasury Department and the IRS permit private foundations to continue to rely on the guidance in Notice 2006–109 on private foundation grantmaking until the IRS issues determination letters addressing functionally integrated status.

Private foundations can continue to rely on the grantor reliance standards of section 3.0 of Notice 2006–109 until these proposed regulations are published as final or temporary regulations.

In addition, the IRS stated in a September 24, 2007 memorandum from the Director of Exempt Organizations Rulings and Agreements that it would issue functionally integrated Type III supporting organization determinations to organizations that meet the requirements for functionally integrated organizations set forth in the ANPRM. As of the date of the publication in the **Federal Register** of this notice of proposed rulemaking, the IRS will issue a functionally integrated Type III supporting organization determination only to organizations that meet the requirements of Prop. Reg. §1.509(a)–4(i)(4). An organization that received a determination that it qualified as a functionally integrated Type III supporting organization under the ANPRM can continue to rely on such determination letter until final or temporary regulations are published in the **Federal Register**, so long as the organization continues to meet the requirements of either the ANPRM or Prop. Reg. §1.509(a)–4(i)(4). An organization that receives a determination that it is a functionally integrated Type III supporting organization under either the ANPRM or these proposed regulations will be required to meet the requirements established in final or temporary regulations as of the first taxable year beginning after final or temporary regulations are published in the **Federal Register**.

Effective Date

The proposed regulations will apply to taxable years beginning after the date these rules are published in the **Federal Register** as final or temporary regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that this regulation will not impact a substantial number of small entities. Based on IRS Statistics of Income data for 2005, there are over 1.4 million organizations that qualify as exempt from federal income tax under section 501(c)(3). Approximately 13,000 of the 1.4 million exempt organizations reported as supporting organizations; approximately 4,200 supporting organizations reported as Type III supporting organizations; and it is expected that some fraction of the 4,200 Type III supporting organizations may be classified as non-functionally integrated Type III supporting organizations. Thus, the number of organizations affected by this regulation will not be substantial. The collection of information in this regulation that is subject to the Regulatory Flexibility Act will impose a minimal burden upon the affected organizations. All of the information required to be delivered is information that the organization is already required to maintain. Further, the distribution requirement in Prop. Reg. §1.509(a)–4(i)(5)(ii) for non-functionally integrated Type III supporting organizations does not have a significant economic impact. A non-functionally integrated Type III supporting organization that fails to satisfy the distribution requirement of Prop. Reg. §1.509(a)–4(i)(5)(ii) would be reclassified as a private non-operating foundation and as such, would be required under section 4942 to distribute amounts equal to five percent of the aggregate fair market value of non-exempt-use assets. In addition, as a private non-operating foundation, the organization would be subject to additional regulatory requirements and excise taxes that do not apply to non-functionally integrated Type III supporting organizations. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Code, this regulation has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Request for Comments

Before these proposed regulations are adopted as final or temporary regulations, consideration will be given to any written (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for

the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of these proposed regulations are Philip T. Hackney and Don R. Spellmann, Office of the Chief Counsel (Tax-Exempt and Government Entities). However, other personnel from the Treasury Department and the IRS participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 53 are proposed to be amended as follows:

Part 1—Income Taxes

Par. 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.509(a)–4 is amended by:

1. The term "publicly supported organization" is removed and replaced by the term "supported organization" wherever it appears.

2. Paragraphs (a)(5) and (i) are revised.

3. New paragraphs (a)(6) and (f)(5) are added.

The revisions and additions read as follows:

§1.509(a)–4 Supporting organizations.

(a) * * *

(5) For purposes of this section, the term "supporting organization" means either an organization described in section 509(a)(3) or an organization seeking section 509(a)(3) status, depending upon its context.

(6) For purposes of this section, the term "supported organization" means an organization described in section 509(a)(1) or (2)—

(i) For whose benefit the supporting organization is organized and operated, or

(ii) With respect to which the supporting organization performs the functions, or carries out the purposes.

* * * * *

(f) * * *

(5) *Organizations controlled by donors.* An organization shall not be considered to be operated, supervised, or controlled by, or operated in connection with, one or more supported organizations, if such organization accepts any gift or contribution from any person (other than an organization described in section 509(a)(1), (2) or (4)) who—

(i) Directly or indirectly controls, either alone or together with persons described in paragraph (f)(5)(ii) or (iii) of this section, a supported organization supported by such supporting organization;

(ii) Is a member of the family (determined under section 4958(f)(4)) of an individual described in paragraph (f)(5)(i) of this section; or

(iii) Is a 35-percent controlled entity (as defined in section 4958(f)(3) by substituting "persons described in paragraph (f)(5)(i) or (ii) of this section" for "persons described in subparagraph (A) or (B) of paragraph (1)" in paragraph (A)(i) thereof).

* * * * *

(i) *Meaning of "operated in connection with"*—(1) *General Rule.* Except as otherwise provided in paragraphs (f)(5) and (i)(10) of this section, a supporting organization is operated in connection with one or more supported organizations only if it satisfies—

(i) The notification requirement in paragraph (i)(2) of this section;

(ii) The responsiveness test, which is set forth in paragraph (i)(3) of this section; and

(iii) The integral part test, which is set forth in paragraphs (i)(4) and (i)(5) of this section. An organization is an integral part of a supported organization if it is significantly involved in the operations of the supported organization and the supported organization is dependent upon the supporting organization for the type of support the supporting organization provides. An organization can demonstrate that it is an integral part of a supported organization only if it satisfies either the requirements for functionally integrated Type III supporting organizations set forth in paragraph (i)(4) of this section or the requirements for non-functionally integrated Type III supporting organizations set forth in paragraph (i)(5) of this section.

(2) *Notification requirement.* Each taxable year, the supporting organization must provide to each of its supported organizations—

(i) A written notice addressed to a principal officer of the supported organization indicating the type and amount of support provided by the supporting organization to the supported organization in the past year;

(ii) A copy of the supporting organization's most recently filed Form 990, "*Return of Organization Exempt From Income Tax*," or other return required to be filed under section 6033; and

(iii) A copy of the supporting organization's governing documents, including its charter or trust instrument and bylaws, and any amendments to such documents. Copies of governing documents need not be provided in a given year if such documents have previously been provided and have not subsequently been amended.

(iv) *Electronic media.* Notification may be provided by electronic media.

(v) *Due date.* The required notifications shall be postmarked or electronically transmitted by the last day of the 5th month after the close of the supporting organization's tax year.

(3) *Responsiveness test.* (i) A supporting organization meets the responsiveness test if it is responsive to the needs or demands of a supported organization. Except as provided in paragraph (i)(3)(v) of this section, a supporting organization is responsive to the needs or demands of a supported organization if it satisfies the requirements of paragraphs (i)(3)(ii) and (i)(3)(iii) of this section.

(ii) A supporting organization satisfies the requirements of this paragraph (i)(3)(ii) if:

(A) One or more officers, directors, or trustees of the supporting organization are elected or appointed by the officers, directors, trustees, or membership of the supported organization;

(B) One or more members of the governing bodies of the supported organization are also officers, directors, or trustees of, or hold other important offices in, the supporting organization; or

(C) The officers, directors, or trustees of the supporting organization maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization.

(iii) By reason of paragraphs (i)(3)(ii)(A), (i)(3)(ii)(B), or (i)(3)(ii)(C)

of this section, the officers, directors or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing of grants, the manner of making them, and the selection of recipients by such supporting organization, and in otherwise directing the use of the income or assets of such supporting organization.

(iv) *Examples*. The provisions of this paragraph (i)(3) may be illustrated by the following examples:

Example (1). X, an organization described in section 501(c)(3), is a trust created under the last will and testament of Decedent. The trustee of X is a bank (Trustee). Under the trust instrument, X supports M, a private university described in section 509(a)(1). The trust instrument provides that Trustee has discretion regarding the timing and amount of distributions consistent with the Trustee's fiduciary duties. Representatives of Trustee and an officer of M have quarterly face to face meetings, at which they discuss M's projected needs for the university and ways in which M would like X to use its income and invest its assets. Additionally, Trustee communicates regularly with the officer of M regarding X's investments and plans for distributions from X. Trustee provides the officer of M with quarterly investment statements, the information required under paragraph (i)(2) of this section, and an annual accounting statement. Based on these facts, X meets the responsiveness test of this paragraph (i)(3).

Example (2). Y is an organization described in section 501(c)(3) and is organized as a trust under state law. The trustee of Y is a bank, Trustee. Y supports charities P, Q and R, each an organization described in section 509(a)(1). Y makes annual cash payments to P, Q and R. Once a year, Trustee sends to P, Q, and R the cash payment, the information required under paragraph (i)(2) of this section, and an accounting statement. Trustee has no other communication with P, Q or R. Y does not meet the responsiveness test of this paragraph (i)(3).

(v) *Exception for Pre-November 20, 1970 Organizations*. In the case of a supporting organization that was supporting or benefiting a supported organization before November 20, 1970, additional facts and circumstances, such as a historic and continuing relationship between the organizations, may be taken into account, in addition to the factors described in paragraph (i)(3)(ii) of this section, to establish compliance with the responsiveness test.

(4) *Integral part test — functionally integrated Type III supporting organization*—(i) *General rule*. A supporting organization meets the integral part test as a functionally integrated Type III supporting organization if it satisfies either paragraph (i)(4)(i)(A) or paragraph (i)(4)(i)(B) of this section.

(A) The supporting organization engages in activities:

(*1*) substantially all of which directly further the exempt purposes of the supported organization(s) to which the supporting organization is responsive, by performing the functions of, or carrying out the purposes of, such supported organization(s); and

(*2*) that, but for the involvement of the supporting organization, would normally be engaged in by the supported organization(s).

(B) The supporting organization is the parent of each of its supported organizations. For purposes of the integral part test, a supporting organization is the parent of a supported organization if the supporting organization exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and a majority of the officers, directors, or trustees of the supported organization is appointed or elected, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacity) of the supporting organization.

(ii) "*Directly further*." Holding title to exempt-use property and managing exempt-use property are activities that directly further the exempt purposes of the supported organization within the meaning of paragraph (i)(4)(i)(A) of this section. Except as provided in paragraph (i)(4)(iii) of this section, fundraising, investing and managing non-exempt-use property, and making grants (whether to the supported organization or to third parties) are not activities that directly further the exempt purposes of the supported organization within the meaning of paragraph (i)(4)(i)(A) of this section.

(iii) *Governmental Entity Exception*. A supporting organization may treat the investment and management of non-exempt-use assets and the making of grants directly to a supported organization as activities that directly further the exempt purposes of a supported organization if:

(A) Such activities are conducted on behalf of a supported organization whose assets are subject to the appropriation process of a federal, state, local or Indian tribal government for purposes or programs unrelated to the exempt purposes of the supported organization;

(B) The supporting organization supports only one supported organization; and

(C) A substantial part of the supporting organization's total activities directly furthers the exempt purpose(s) of its supported organization and are activities other than fundraising, grantmaking, and investing and managing non-exempt-use assets.

(iv) *Examples*. The provisions of this paragraph (i)(4) may be illustrated by the following examples. In each *example*, the supporting organization meets the requirements of paragraphs (i)(2) and (i)(3) of this section.

Example 1. N, an organization described in section 501(c)(3), is the parent organization of a healthcare system consisting of two hospitals (Q and R) and an outpatient clinic (S), each of which is described in section 509(a)(1), and a taxable subsidiary (T). N is the sole member of each of Q, R, and S. Under the charter and bylaws of each of Q, R, and S, N appoints all members of the board of directors of each corporation. N engages in the overall coordination and supervision of the healthcare system's exempt subsidiary corporations Q, R, and S in approval of their budgets, strategic planning, marketing, resource allocation, securing tax-exempt bond financing, and community education. N also manages and invests assets that serve as endowments of Q, R and S. Based on these facts, N qualifies as a functionally integrated Type III supporting organization under paragraph (4)(i)(B) of this section.

Example 2. V, an organization described in section 501(c)(3), is organized as a supporting organization to L, a church described in section 509(a)(1). L transferred to V title to the buildings in which L conducts religious services, Bible study and community enrichment programs. Substantially all of V's activities consist of holding and managing these buildings. But for the activities of V, L would normally engage in these same activities. Based on these facts, V satisfies the activities and but for requirements of paragraph (4)(i)(A) of this section and therefore qualifies as a functionally integrated Type III supporting organization.

Example 3. O is a nonprofit publishing organization described in section 501(c)(3). It does all of the publishing and printing for the eight churches of a particular denomination located in a particular geographic region, each of which is described in section 509(a)(1). Control of O is vested in a five-man Board of Directors, which includes an official from one of the churches and four lay members of the congregations of that denomination. The officers of O maintain a close and continuing working relationship with each of the eight churches for whom it publishes and prints materials and as a result of such relationship, each of the eight churches has a significant voice in the operations of O. O does no other printing or publishing. O publishes all of the churches' religious as well as secular tracts and materials. All of O's activities directly further the exempt purposes of supported organizations to which it is responsive. Additionally, but for the activities of O, the churches would normally publish these materials themselves. Based on these facts, O qualifies as a functionally in-

tegrated Type III supporting organization under paragraph (4)(i)(A) of this section.

Example 4. M, an organization described in section 501(c)(3), was created by B, an individual, to provide scholarships for students of a private secondary school, U, an organization described in section 509(a)(1). U establishes the scholarship criteria, publicizes the scholarship program, solicits and reviews applications, and selects the scholarship recipients. M invests its assets and disburses the funds for scholarships to the recipients selected by U. Based on these facts, M is not a functionally integrated Type III supporting organization.

Example 5. J, an organization described in section 501(c)(3), is a supporting organization to community foundation G, an organization described in section 509(a)(1). In addition to maintaining field-of-interest funds, sponsoring donor advised funds, and general grant-making activities, G also engages in activities to beautify and maintain local parks. J's activities consist of maintaining all of the local parks in the area of community foundation G by activities such as establishing and maintaining trails, planting trees and removing trash. But for the activities of J, G would normally engage in these efforts to beautify and maintain the local parks. Based on these facts, J qualifies as a functionally integrated Type III supporting organization under paragraph (4)(i)(A) of this section.

Example 6. W, an organization described in section 501(c)(3), is organized as a supporting organization to Z, a public university in state D described in section 509(a)(1). Z is the sole named supported organization in W's articles of incorporation. Under the laws of state D, assets under Z's control are subject to the appropriation process for any state D purpose by an action of the state D legislature. Z transfers the intellectual property developed by Z's science department to W for patenting and licensing, including making the property available to the public. The royalties generated by the licenses are shared among Z, the original researcher, and W. W invests and manages its share of the royalties and other income generated by the patenting and licensing of the intellectual property to build an endowment to support Z. W also conducts further research on scientific processes developed at Z and makes the results of this research available to the public. W's research activities make up a substantial part of W's total activities. But for the activities of W, Z would normally conduct the research engaged in by W and manage the royalties from the intellectual property generated at Z. W's activities of investing and managing its share of royalties and other income are not considered activities that directly further the exempt purposes of Z under paragraph (i)(4)(ii) of this section. However, because Z's assets are subject to the appropriation process of state D for purposes unrelated to Z's exempt purposes, Z is W's sole supported organization, and a substantial part of W's activities directly further Z's exempt purposes, W qualifies for the exception in paragraph (i)(4)(iii) of this section. Accordingly, based on these facts, W qualifies as a functionally integrated Type III supporting organization under paragraph (4)(i)(A) of this section.

Example 7. P, an alumni association described in section 501(c)(3), was formed to promote a spirit of loyalty among graduates of Y University, a public university in state E described in section 509(a)(1), and to effect united action in promoting the general welfare of Y. Y is the sole named supported organization in P's articles of incorporation. Under the laws of state E, Y's assets are subject to the appropriation process for any state E purpose. P manages an endowment created by gifts from the alumni. A special committee of Y's governing board meets with P and makes recommendations as to the allocation of P's program of gifts and scholarships to the university and its students. More than a substantial part of P's activities, however, consist of maintaining records of alumni and publishing a bulletin to keep alumni aware of the activities of the university. But for the activities of P, Y would normally engage in these same activities. P's endowment management activities are not considered activities that directly further the exempt purposes of Y under paragraph (i)(4)(ii) of this section. However, because Y's assets are subject to the appropriation process of state E for purposes unrelated to Y's exempt purposes, Y is P's sole supported organization, and a substantial part of P's activities directly further Y's exempt purposes, P qualifies for the exception in paragraph (i)(4)(iii) of this section. Accordingly, based on these facts, P qualifies as a functionally integrated Type III supporting organization under paragraph (4)(i)(A) of this section.

(5) *Integral part test — non-functionally integrated Type III supporting organization*—(i) A supporting organization meets the integral part test as a non-functionally integrated Type III supporting organization if it satisfies either:

(A) The distribution requirement of paragraph (i)(5)(ii) of this section and the attentiveness requirement of paragraph (i)(5)(iii) of this section; or

(B) The pre-1970 trust requirements of paragraph (i)(9) of this section.

(ii) *Distribution requirement*. (A) The supporting organization must distribute, with respect to each taxable year, to or for the use of one or more supported organizations, amounts equaling or exceeding the supporting organization's annual distributable amount for such year, as defined in paragraph (i)(5)(ii)(B) of this section, on or before the last day of such taxable year.

(B) *Annual distributable amount*. Except as provided in paragraphs (i)(5)(ii)(C) and (i)(5)(ii)(D) of this section, the annual distributable amount for a taxable year is:

(*1*) five percent of the excess of the aggregate fair market value of all non-exempt-use assets (determined under paragraph (i)(8) of this section) over the acquisition indebtedness with respect to such non-exempt-use assets, determined under section 514(c)(1) without regard to the taxable year in which the indebtedness was incurred; increased by

(*2*) amounts received or accrued as repayments of amounts which were taken into account by the organization to meet the distribution requirement imposed in paragraph (i)(5)(ii)(A) of this section for any taxable year; increased by

(*3*) amounts received or accrued from the sale or other disposition of property to the extent that the acquisition of such property was taken into account by the organization to meet the distribution requirement imposed in paragraph (i)(5)(ii)(A) of this section for any taxable year; and reduced by

(*4*) the amount of taxes imposed on the supporting organization for such taxable year under subtitle A of the Code.

(C) *First taxable year of existence*. The annual distributable amount for the first taxable year an organization is treated as a non-functionally integrated Type III supporting organization is zero.

(D) *Emergency temporary reduction*. The Secretary may provide by publication in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) for a temporary reduction in the annual distributable amount in the case of a disaster or emergency.

(E) *Reasonable cause exception*. An organization that fails to meet the distribution requirement of paragraph (i)(5)(ii) of this section will not be classified as a private foundation in the taxable year for which it fails to meet such distribution requirement, if the organization establishes to the satisfaction of the Secretary that:

(*1*) The failure was due solely to an incorrect valuation of assets, a ministerial error, or unforeseen events or circumstances that are beyond the organization's control,

(*2*) The failure was due to reasonable cause and not to willful neglect, and

(*3*) The distribution requirement is met within 180 days after the date the incorrect valuation or ministerial error was or should have been discovered, or 180 days after the organization is first able to make its required payout notwithstanding the unforeseen event or circumstances.

(iii) *Attentiveness requirement*. (A) *General rule*. A non-functionally integrated Type III supporting organization must distribute one-third or more of its annual distributable amount to one or more supported organizations that are attentive to the operations of the supporting organization and to which the supporting organization is responsive under paragraph (i)(3) of this section.

(B) Except as provided in paragraph (i)(5)(iii)(C) of this section, a supported organization is attentive to the operations of the supporting organization if the supporting organization distributes annually to such supported organization an amount of support that represents a sufficient part of the supported organization's total support. A supporting organization must meet the requirements of paragraphs (i)(5)(iii)(B)(*1*), (i)(5)(iii)(B)(*2*), or (i)(5)(iii)(B)(*3*) of this section to demonstrate that it is attentive. If a supporting organization makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the department or school shall be substituted for the total support of the beneficiary organization.

(*1*) The supporting organization distributes annually to the supported organization an amount that is 10 percent or more of the supported organization's total support.

(*2*) The amount of support received from the supporting organization is necessary to avoid the interruption of the carrying on of a particular function or activity. The support is necessary if the supporting organization or the supported organization earmarks the support for a particular program or activity, even if such program or activity is not the supported organization's primary program or activity so long as such program or activity is a substantial one.

(*3*) Based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and supporting organization and the purpose to which the funds are put, the amount of support is a sufficient part of a supported organization's total support. Normally the attentiveness of a supported organization is motivated by reason of the amounts received from the supporting organization. Thus, the more substantial the amount involved, in terms of a percentage of the supported organization's total support, the greater the likelihood that the required degree of attentiveness will be present. However, in determining whether the amount received from the supporting organization is sufficient to ensure the attentiveness of the supported organization to the operations of the supporting organization (including attentiveness to the nature and yield of such supporting organization's investments), evidence of actual attentiveness by the supported organization is of almost equal importance. A supported organization is not considered to be attentive solely because it has enforceable rights against the supporting organization under state law.

(C) *Distribution to donor-advised fund does not establish attentiveness*. Notwithstanding paragraphs (i)(5)(iii)(A) and (i)(5)(iii)(B) of this section, a supported organization will not be considered attentive to the operations of a supporting organization with respect to any amount received from the supporting organization that is held by the supported organization in a donor advised fund described in section 4966(d)(2).

(iv) Paragraph (5)(iii)(B)(*2*) of this section is illustrated by *examples 1* and *2* and paragraph (5)(iii)(B) of this section is illustrated by *examples 3* and *4*:

Example 1. K, an organization described in section 501(c)(3), annually pays over an amount equal to five percent of its assets to L, a museum described in section 509(a)(2). K meets the responsiveness test described in paragraph (i)(3) of this section with respect to L. In recent years, L has earmarked the income received from K to underwrite the cost of carrying on a chamber music series consisting of 12 performances a year that are performed for the general public free of charge at its premises. The chamber music series is not L's primary activity. L could not continue the performances without K's support. Based on these facts, K meets the requirements of paragraph (i)(5)(iii)(B)(*2*) of this section.

Example 2. M, an organization described in section 501(c)(3), pays annually an amount equal to five percent of its assets to the Law School of N University, an organization described in section 509(a)(1). M meets the responsiveness test described in paragraph (i)(3) of this section with respect to N. M has earmarked the income paid over to N's Law School to endow a chair in International Law. Without M's continued support, N could not continue to maintain this chair. Based on these facts, M meets the requirements of paragraph (i)(5)(iii)(B)(*2*) of this section.

Example 3. R is a charitable trust created under the will of B, who died in 1969. R's purpose is to hold assets as an endowment for S, a hospital, T, a university, and U, a national medical research organization (all organizations described in section 509(a)(1) and specifically named in the trust instrument), and to distribute all of the income each year in equal shares among the three named beneficiaries. Each year, R pays an amount equal to five percent of its assets to each of S, T, and U. Such payments are less than one percent of each organization's total support. Based on these facts, R does not meet the attentiveness requirement of paragraph (i)(5)(iii)(B). However, because B died prior to November 20, 1970, R could, upon meeting all of the requirements of paragraph (i)(9) of this section, be considered as meeting the requirements of paragraph (i)(5)(i)(B) of this section.

Example 4. O is an organization described in section 501(c)(3). O is organized to support five private universities, V, W, X, Y and Z, each of which is described in section 509(a)(1). O meets the responsiveness test under paragraph (i)(3) of this section only as to V. Each year, O distributes five percent of the fair market value of its non-exempt-use assets in equal amounts to the five universities. O distributes annually more than 10 percent of the total annual support of V and W. Based on these facts O does not meet the requirements of paragraph (i)(5)(iii) of this section. Although both V and W are attentive to the operations of O under paragraph (i)(5)(iii)(B)(*1*) of this section, O is only responsive to V. Accordingly, O distributes only one-fifth (*i.e.*, less than the required one-third) of its annual distributable amount to supported organization(s) that are both attentive to O and to which O is also responsive under paragraph (i)(3) of this section.

(6) *Distributions*. For purposes of this paragraph (i)(6), the amount of a distribution made to a supported organization is the fair market value of such property as of the date such distribution is made. The amount of a distribution will be determined solely on the cash receipts and disbursements method of accounting described in section 446(c)(1). Distributions that count toward the distribution requirement imposed in paragraph (i)(5)(ii)(A) of this section shall include:

(i) any amount paid to a supported organization to accomplish its exempt purposes,

(ii) any amount paid to acquire an asset used (or held for use) to carry out the exempt purposes of the supported organization(s), and

(iii) any amount expended by the supporting organization for reasonable and necessary administrative expenses.

(7) *Carryover of excess amounts*—(i) *In general*. If with respect to any taxable year, an excess amount, as defined in paragraph (i)(7)(ii) of this section, is created, such excess amount may be used to reduce the annual distributable amount in any of the five taxable years immediately following the taxable year in which the excess amount is created (the "carryover period"). An excess amount created in a taxable year cannot be carried over beyond the succeeding five taxable years. With respect to any taxable year to which an excess amount is carried over, in determining whether an excess amount is created in that taxable year, the annual distributable amount is reduced first to the extent of any excess amounts carried over and then to the extent of distributions made in that taxable year.

(ii) *Excess amount*. An excess amount is created for any taxable year beginning after the effective date of these regulations if the total distributions made by a supporting organization to its supported organization(s) for such taxable year exceeds the supporting organization's annual distributable amount for such taxable year, as defined in paragraph (i)(5)(ii)(B) of this section, determined without regard to this paragraph.

(8) *Valuation of assets*—(i) *General rules*. (A) For purposes of determining the organization's annual distributable amount, as defined in paragraph (i)(5)(ii)(B) of this section, the determination of the fair market value of the non-exempt-use assets shall be made in the year preceding the year of the required distribution under paragraph (i)(5)(ii)(A) of this section. The aggregate fair market value of all non-exempt-use assets of a supporting organization is the sum of:

(*1*) The average of the fair market values on a monthly basis of securities for which market quotations are readily available (within the meaning of paragraph (i)(8)(iii)(A)(*1*) of this section);

(*2*) The average of the supporting organization's cash balances on a monthly basis (less the same amount of cash balances excluded under paragraph (i)(8)(i)(C)(*2*)(i*v*) of this section) from the computation of the annual distributable amount); and

(*3*) The fair market value of all other assets (except those assets described in paragraph (i)(8)(i)(B) or paragraph (i)(8)(i)(C) of this section) for the period of time during the taxable year for which such assets are held by the supporting organization.

(B) *Certain assets excluded*. For purposes of this paragraph, the non-exempt-use assets taken into account in determining the annual distributable amount described in paragraph (i)(5)(ii)(B) of this section shall not include the following:

(*1*) Any future interest (such as a vested or contingent remainder, whether legal or equitable) of a supporting organization in the income or corpus of any real or personal property, other than a future interest created by the supporting organization after August 17, 2006, until all intervening interests in, and rights to the actual possession or enjoyment of, such property have expired, or, although not actually reduced to the supporting organization's possession, until such future interest has been constructively received by the supporting organization, as where it has been credited to the supporting organization's account, set apart for the supporting organization, or otherwise made available so that the supporting organization may acquire it at any time or could have acquired it if notice of intention to acquire had been given;

(*2*) The assets of an estate until such time as such assets are distributed to the supporting organization or, due to a prolonged period of administration, such estate is considered terminated for Federal income tax purposes by operation of Treas. Reg. §1.641(b)–3(a);

(*3*) Any present interest of a supporting organization in any trust created and funded by another person;

(*4*) Any pledge to the supporting organization of money or property (whether or not the pledge may be legally enforced); and

(*5*) Any assets used (or held for use) to carry out the exempt purposes of the supported organization(s).

(C) *Assets used (or held for use) to carry out the exempt purposes of the supported organization(s)*—(*1*) *In general*. For purposes of paragraph (i)(8)(i)(B)(*5*) of this section, an asset is "used (or held for use) to carry out the exempt purposes of the supported organization(s)" only if the asset is actually used by the supporting organization in activities that carry out the exempt purposes of its supported organization(s), or if the supporting organization owns the asset and establishes to the satisfaction of the Commissioner that its immediate use for such exempt purpose is not practical (based on the facts and circumstances of the particular case) and that definite plans exist to commence such use on behalf of its supported organization(s) within a reasonable period of time. Consequently, assets that are held for the production of income or for investment (for example, stocks, bonds, interest-bearing notes, endowment funds, or, generally, leased real estate) are not being used (or held for use) to carry out the exempt purposes of the supported organization(s), even though the income from such assets is used to carry out such exempt purposes. Whether an asset is held for the production of income or for investment rather than used (or held for use) by the supporting organization to carry out the exempt purposes of the supported organization(s) is a question of fact. For example, an office building used for the purpose of providing offices for employees engaged in the management of endowment funds is not being used (or held for use) by the supporting organization to carry out the exempt purposes of the supported organization(s). However, where property is used both to carry out the exempt purposes of the supported organization(s) and for other purposes, if the former use represents 95 percent or more of the total use, such property shall be considered to be used exclusively to carry out an exempt purpose of the supported organization(s). If the use of such property to carry out the exempt purposes of the supported organization(s) represents less than 95 percent of the total use, reasonable allocation between such use and other use must be made for purposes of this paragraph. Property acquired by the supporting organization to be used to carry out the exempt purposes of the supported organization(s) may be considered as used (or held for use) to carry out such exempt purposes even though the property, in whole or in part, is leased for a limited period of time during which arrangements are made for its conversion to the use for which it was acquired, provided such income-producing use of the property does not exceed a reasonable period of time. Generally, one year shall be deemed to be a reasonable period of time for purposes of the immediately preceding sentence. Where the income-producing use continues beyond a reasonable period of time, the property shall not be deemed to be used by the supporting organization to carry out the exempt purposes of the supported organization(s), but, instead, as of the time the income-producing use becomes unreasonable, such property shall be treated as disposed of within the meaning of paragraph (i)(5)(ii)(B)(*3*) of this section to the extent that the acquisition of the property was taken into account by the organization to meet the distribution requirement imposed in paragraph (i)(5)(ii)(A) of this section for any taxable year. If, subsequently, the property is used by the supporting organization to carry out the exempt purposes of the supported organization(s), a distribution to its supported organization(s) in the amount of its then fair market value, determined in accordance with the rules contained in this

paragraph (i)(8), shall be deemed to have been made as of the time such exempt purpose use begins.

(*2*) *Illustrations*. Examples of assets that are "used (or held for use) to carry out the exempt purposes of the supported organization(s)" include, but are not limited to, the following:

(*i*) Administrative assets, such as office equipment and supplies that are used by employees or consultants of the supporting organization, to the extent such assets are devoted to and used directly in the administration of the supporting organization's activities that carry out the exempt purposes of the supported organization(s).

(*ii*) Real estate or the portion of a building used by the supporting organization directly in its activities to carry out the exempt purposes of the supported organization(s).

(*iii*) Physical facilities used in the supporting organization's activities to carry out the exempt purposes of the supported organization(s), such as paintings or other works of art owned by the supporting organization that are on public display, fixtures and equipment in classrooms, and research facilities and related equipment, which under the facts and circumstances serve a useful purpose in the conduct of such exempt purpose activities.

(*iv*) The reasonable cash balances necessary to cover current administrative expenses and other normal and current disbursements directly connected to the supporting organization's activities to carry out the exempt purposes of the supported organization(s). The reasonable necessary cash balances will generally be deemed to be an amount, computed on an annual basis, equal to one and one-half percent of the fair market value of all of the supporting organization's assets, other than assets used or held for use to carry out the exempt purposes of the supported organization(s), without regard to this paragraph (i)(8)(i)(C)(*2*)(*iv*). However, if the Commissioner is satisfied that under the facts and circumstances an amount in addition to such one and one-half percent is necessary for payment of such expenses and disbursements, then such additional amount may also be excluded from the amount of assets described in paragraph (i)(5)(ii)(B) of this section. All remaining cash balances, including amounts necessary to pay any tax imposed by section 511 or section 4943, are to be included in the assets described in paragraph (i)(5)(ii)(B) of this section.

(*v*) Any property leased by the supporting organization in carrying out the exempt purposes of its supported organization(s) at no cost (or at a nominal rent) to the lessee, such as the leasing of renovated apartments to low-income tenants at a low rental as part of the lessor-supporting organization's program for rehabilitating a blighted portion of the community.

(ii) *Valuation of assets — timing*. For purposes of determining the annual distributable amount for a taxable year, the supporting organization's assets are to be valued over the preceding taxable year.

(iii) *Valuation of assets*—(A) *Certain securities*. (*1*) For purposes of this paragraph, a supporting organization may use any reasonable method to determine the fair market value on a monthly basis of securities for which market quotations are readily available, as long as such method is consistently used.

(*2*) For purposes of this paragraph, market quotations are readily available if a security is:

(*i*) Listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign national or regional exchange;

(*ii*) Regularly traded in the national or regional over-the-counter market, for which published quotations are available; or

(*iii*) Locally traded, for which quotations can readily be obtained from established brokerage firms.

(*3*) For purposes of this paragraph, if the supporting organization can show that the value of securities determined on the basis of market quotations as provided by paragraph (i)(8)(iii)(A)(*2*) of this section, does not reflect the fair market value thereof because:

(*i*) The securities constitute a block of securities so large in relation to the volume of actual sales on the existing market that it could not be liquidated in a reasonable time without depressing the market;

(*ii*) The securities are securities in a closely held corporation and sales are few or of a sporadic nature; and/or

(*iii*) The sale of the securities would result in a forced or distress sale because the securities could not be offered to the public for sale without first being registered under the Securities Act of 1933 or because of other factors, then the price at which the securities could be sold as such outside the usual market, as through an underwriter, may be a more accurate indication of value than market quotations. On the other hand, if the securities to be valued represent a controlling interest, either actual or effective, in a going business, the price at which other lots change hands may have little relation to the true value of the securities. No decrease in the fair market value of any given class of securities determined on the basis of market quotations as provided by paragraph (i)(8)(iii)(A)(*2*) of this section shall be allowed except as authorized by this paragraph, and no such decrease shall in the aggregate exceed 10 percent of the fair market value of such class of securities so determined on the basis of market quotations and without regard to this paragraph.

(*4*) In the case of securities described in paragraph (i)(8)(iii)(A)(*2*) of this section, that are held in trust for, or on behalf of, a supporting organization by a bank or other financial institution that values such securities periodically by use of a computer, a supporting organization may determine the correct value of such securities by use of such computer pricing system, provided the Commissioner has accepted such computer pricing system as a valid method for valuing securities for Federal estate tax purposes.

(B) *Cash*. In order to determine the amount of a supporting organization's cash balances, the supporting organization shall value its cash on a monthly basis by averaging the amount of cash on hand as of the first day of each month and as of the last day of each month.

(C) *Common trust funds*. If a supporting organization owns a participating interest in a common trust fund (as defined in section 584) established and administered under a plan providing for the periodic valuation of participating interests during the fund's taxable year and the reporting of such valuations to participants, the value of the supporting organization's interest in the common trust fund based upon the average of the valuations reported to the supporting organization during its

taxable year will ordinarily constitute an acceptable method of valuation.

(D) *Other assets.* (*1*) Except as otherwise provided in paragraph (i)(8)(iii)(D)(*2*) of this section, the fair market value of assets other than those described in paragraphs (i)(8)(iii)(A) through (i)(8)(iii)(C) of this section, shall be determined annually. Thus, the fair market value of securities other than those described in paragraph (i)(8)(iii)(A) of this section shall be determined in accordance with this paragraph (i)(8)(iii)(D)(*1*). If, however, a supporting organization owns voting stock of an issuer of unlisted securities and has, or together with disqualified persons or another supporting organization has, effective control of the issuer (within the meaning of §53.4943–3(b)(3)(ii)), then to the extent that the issuer's assets consist of shares of listed securities issues, such assets shall be valued monthly on the basis of market quotations or in accordance with section 4942(e)(2)(B), if applicable. Thus, for example, if a supporting organization and a disqualified person together own all of the unlisted voting stock of a holding company that in turn holds a portfolio of securities of issues that are listed on the New York Stock Exchange, in determining the net worth of the holding company, the underlying portfolio securities are to be valued monthly by reference to market quotations for their issues unless a decrease in such value is authorized in accordance with section 4942(e)(2)(B). Such determination may be made by employees of the supporting organization or by any other person without regard to whether such person is a disqualified person with respect to the supporting organization. A valuation made pursuant to the provisions of this paragraph, if accepted by the Commissioner, shall be valid only for the taxable year for which it is made. A new valuation made in accordance with these provisions is required for the succeeding taxable year.

(*2*) If the requirements of this paragraph are met, the fair market value of any interest in real property, including any improvements thereon, may be determined on a five-year basis. Such value must be determined by means of a certified, independent appraisal made in writing by a qualified person who is neither a disqualified person with respect to, nor an employee of, the supporting organization. The appraisal is certified only if it contains a statement at the end thereof to the effect that, in the opinion of the appraiser, the values placed on the assets appraised were determined in accordance with valuation principles regularly employed in making appraisals of such property using all reasonable valuation methods. The supporting organization shall retain a copy of the independent appraisal for its records. If a valuation made pursuant to the provisions of this paragraph in fact falls within the range of reasonable values for the appraised property, such valuation may be used by the supporting organization for the taxable year for which the valuation is made and for each of the succeeding four taxable years. Any valuation made pursuant to the provisions of this paragraph may be replaced during the five-year period by a subsequent five-year valuation made in accordance with the rules set forth in this paragraph (i)(8)(iii)(D)(*2*), or with an annual valuation made in accordance with paragraph (i)(8)(iii)(D)(*1*) of this section, and the most recent such valuation of such assets shall be used in computing the supporting organization's annual distributable amount. A valuation made in accordance with this paragraph must be made no later than the last day of the first taxable year for which such valuation is applicable. A valuation, if properly made in accordance with the rules set forth in this paragraph, will not be disturbed by the Commissioner during the five-year period for which it applies even if the actual fair market value of such property changes during such period.

(*3*) For purposes of this paragraph (i)(8)(iii)(D)(*3*), commonly accepted methods of valuation must be used in making an appraisal. Valuations made in accordance with the principles stated in the regulations under section 2031 constitute acceptable methods of valuation. The term "appraisal," as used in this paragraph (i)(8)(iii)(D)(*3*), means a determination of fair market value and is not to be construed in a technical sense peculiar to particular property or interests therein, such as, for example, mineral interests in real property.

(E) *Definition of "securities".* For purposes of this paragraph (i)(8)(iii)(E), the term "securities" includes, but is not limited to, common and preferred stocks, bonds, and mutual fund shares.

(F) *Valuation date.* (*1*) In the case of an asset that is required to be valued on an annual basis as provided in paragraph (i)(8)(iii)(D)(*1*) of this section, such asset may be valued as of any day in the supporting organization's taxable year to which such valuation applies, provided the supporting organization follows a consistent practice of valuing such asset as of such date in all taxable years.

(*2*) A valuation described in paragraph (i)(8)(iii)(D)(*2*) of this section may be made as of any day in the first taxable year of the supporting organization to which such valuation is to be applied.

(G) *Assets held for less than a taxable year.* For purposes of this paragraph (i)(8)(iii)(G), any asset described in paragraph (i)(8)(i)(A) of this section that is held by a supporting organization for only part of a taxable year shall be taken into account for purposes of determining the supporting organization's annual distributable amount for such taxable year by multiplying the fair market value of such asset (as determined pursuant to paragraph (i)(8) of this section) by a fraction, the numerator of which is the number of days in such taxable year that the supporting organization held such asset and the denominator of which is the number of days in such taxable year.

(9) *Exception to integral part test for certain trusts.* A trust (whether or not exempt from taxation under section 501(a)) that on November 20, 1970, met and continues to meet the requirements of paragraphs (i)(9)(i) through (i)(9)(v) of this section, shall be treated as meeting the requirements of the integral part test (whether or not it meets the requirements of paragraph (i)(4) or paragraph (i)(5) of this section) if for taxable years beginning after October 16, 1972, the trustee of such trust makes annual written reports to all of the beneficiary supported organizations with respect to such trust setting forth a description of the assets of the trust, including a detailed list of the assets and the income produced by such assets. A trust organization that meets the requirements of this paragraph may request a ruling that it is described in section 509(a)(3) in such manner as the Commissioner may prescribe.

(i) All the unexpired interests in the trust are devoted to one or more purposes described in section 170(c)(1) or (2)(B) and a deduction was allowed with respect to such interests under sections

170, 545(b)(2), 556(b)(2), 642(c), 2055, 2106(a)(2), 2522, or corresponding provisions of prior law (or would have been allowed such a deduction if the trust had not been created before 1913);

(ii) The trust was created prior to November 20, 1970, and did not receive any grant, contribution, bequest or other transfer on or after such date. For purpose of this paragraph (i)(9)(ii), a split-interest trust described in section 4947(a)(2) that was created prior to November 20, 1970, was irrevocable on such date, and that becomes a charitable trust described in section 4947(a)(1) after such date shall be treated as having been created prior to such date;

(iii) The trust is required by its governing instrument to distribute all of its net income currently to a designated beneficiary supported organization. Where more than one beneficiary supported organization is designated in the governing instrument of a trust, all of the net income must be distributable and must be distributed currently to each of such beneficiary organizations in fixed shares pursuant to such governing instrument. For purposes of this paragraph (i)(9)(iii), the governing instrument of a charitable trust shall be treated as requiring distribution to a designated beneficiary organization where the trust instrument describes the charitable purpose of the trust so completely that such description can apply to only one existing beneficiary organization and is of sufficient particularity as to vest in such organization rights against the trust enforceable in a court possessing equitable powers;

(iv) The trustee of the trust does not have discretion to vary either the beneficiaries or the amounts payable to the beneficiaries. For purposes of this paragraph (i)(9)(iv), a trustee shall not be treated as having such discretion where the trustee has discretion to make payments of principal to the single section 509(a)(1) or (2) organization that is currently entitled to receive all of the trust's income or where the trust instrument provides that the trustee may cease making income payments to a particular charitable beneficiary in the event of certain specific occurrences, such as the loss of exemption under section 501(c)(3) or classification under section 509(a)(1) or (2) by the beneficiary or the failure of the beneficiary to carry out its charitable purpose properly; and

(v) None of the trustees would be disqualified persons within the meaning of section 4946(a) (other than foundation managers under section 4946(a)(1)(B)) with respect to the trust if such trust were treated as a private foundation.

(10) *Foreign supported organizations*. A supporting organization is not operated in connection with one or more supported organizations if it supports any supported organization organized outside of the United States.

(11) *Transition rules*—(i) A Type III supporting organization in existence on the effective date of these regulations that met and continues to meet the requirements of Treas. Reg. §1.509(a)–4(i)(3)(ii), as in effect prior to the date these regulations are published as final or temporary regulations, will be treated as meeting the requirements of paragraph (i)(4)(i) of this section until the first day of the organization's first taxable year beginning after the date these regulations are published as final or temporary regulations.

(ii) A Type III supporting organization in existence on the effective date of these regulations that met and continues to meet the requirements of Treas. Reg. §1.509(a)–4(i)(3)(iii), as in effect prior to the date these regulations are published as final or temporary regulations, will be treated as meeting the requirements of paragraph (i)(5)(i) of this section until the first day of its second taxable year beginning after the effective date of these regulations. Beginning in the first taxable year beginning after the effective date of these regulations, such organizations must value their assets according to paragraph (i)(8) of this section. Beginning in the second taxable year beginning after the effective date of these regulations (and in all succeeding taxable years), these organizations must meet all of the requirements of paragraph (i)(5)(i) of this section.

(iii) For the first taxable year after the effective date of these regulations, the annual distributable amount for Type III supporting organizations that are not functionally integrated is zero.

(12) *Effective/applicability date*. These regulations are effective on the date of publication of the Treasury decision adopting these rules as final or temporary regulations.

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Part 53—FOUNDATION AND SIMILAR EXCISE TAXES

Par. 3. The authority citation for part 53 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 4. In §53.4943–11, section heading is revised and paragraphs (f) and (g) are added to read as follows:

§53.4943–11 Effective/Applicability date.

* * * * *

(f) Special transitional rule for private foundations that qualified as Type III supporting organizations before August 17, 2006. The present holdings of a private foundation that qualified as a Type III supporting organization under section 509(a)(3) immediately before August 17, 2006, and that was reclassified as a private foundation under section 509(a) on or after August 17, 2006, solely as a result of the rules enacted by section 1241 of the Pension Protection Act of 2006, Public Law 109–280 (120 Stat. 780), will be determined using the same rules that apply to Type III supporting organizations under section 4943(f)(7).

(g) Special transitional rule for Type III supporting organizations created as trusts before November 20, 1970. A trust that qualifies as a Type III supporting organization under section 509(a)(3) and meets the requirements of Treas. Reg. §1.509(a)–4(i)(9) will be treated as a "functionally integrated Type III supporting organization" for purposes of section 4943(f)(3)(A).

Linda E. Stiff,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on September 23, 2009, 8:45 a.m., and published in the issue of the Federal Register for September 24, 2009, 74 F.R. 48672)

Notice of Proposed Rulemaking

Clarification of Controlled Group Qualification Rules

REG–135005–07

AGENCY: Internal Revenue Service (IRS), Treasury.