

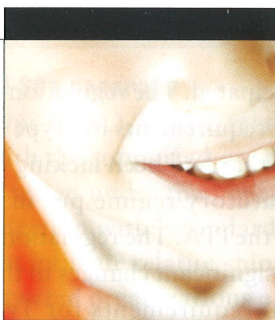
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ESTATE PLANNING

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Type III Supporting
Organizations

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Compliance Tips for Type III Supporting Organizations

Substantial statutory and regulatory changes have made meeting the requirements of a Type III supporting organization even more challenging and complex than ever.

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The “Type III supporting organization” (SO),¹ which first came into existence as a result of the enactment of Section 509(a)(3) under the Tax Reform Act of 1969, is one of the most complex and difficult to understand forms of Section 501(c)(3) tax-exempt organizations. The legislative history to Section 509(a)(3) indicates that the reason for the creation of SOs was so that the Milton Hershey School Trust, which supports the Milton Hershey School, would be classified as a public charity, even though it would otherwise be considered a private foundation because it does not receive public support sufficient for it to be classified as a public charity.²

Although a Type III SO may often bear a striking resemblance to a private foundation, particularly in the case of a charitable trust whose sole purpose is to make payments to one or more publicly supported organizations,³ a Type III SO is classified as a public charity

and is therefore not subject to the strict and burdensome tax regime, chock-full of potential excise tax penalties, applicable to private foundations.⁴ Over the years, both Congress and the IRS have struggled with the treatment of Type III SOs, particularly in light of their perceived abuses, from considering eliminating them altogether to subjecting them to rules more akin to private foundations.⁵

After years of debate and dialogue, including congressional hearings on the subject,⁶ the Pension Protection Act of 2006 (“PPA”) made a vast array of changes to Type III SOs that were intended to curb perceived abuses, while con-

tinuing to bestow public charity status on these entities. This new statutory framework did not, however, contain a precise set of rules defining the new requirements for Type III SO status, as the PPA opted instead to direct the Department of the Treasury and the IRS to issue regulations to provide such guidance. As a result, after the enactment of the PPA, there was uncertainty as to whether existing Type III SOs, including charitable trusts, could continue to qualify as Type III SOs and what measures such entities should take in order to maintain their status in a post-PPA Type III SO tax regime.

Indeed, as a result of such uncertainty, many existing charitable trusts that were historically classified as Type III SOs opted simply to convert, albeit sometimes erroneously, to private foundation status, rather than chance running afoul of the new requirements.⁷ Pending the issuance of the regulations required by the PPA, the IRS

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took steps to provide interim guidance on the new requirements applicable to Type III SOs in the form of an advanced notice of proposed rulemaking and proposed regulations.⁸ Although these measures were not effective until either final or temporary regulations were promulgated, they provided an indication of the changes to come, gave taxpayers time to prepare for such changes, and allowed for taxpayer comment before temporary or final regulations were issued.

More than six years after the enactment of the PPA (and more than three years after the issuance of the proposed regulations), the IRS issued both temporary and final regulations providing guidance on Type III SOs,⁹ although the Preamble to the regulations indicates that additional guidance in this area

is anticipated. The regulations clarify the requirements for Type III SO status that had been lacking under the statutory regime put in place under the PPA. The regulations also make significant changes to the historical requirements for Type III SO status and add complexity to an already complicated tax regime, presenting substantial challenges to organizations seeking to achieve or maintain such status. This article addresses the requirements for an organization to qualify for Type III SO status in a post-PPA tax regime, as implemented by the temporary and final regulations issued by the Treasury and the IRS.

Overview of SOs

An SO is one of the most complex, technical, and least understood of all Section 501(c)(3) tax-exempt

organizations.¹⁰ It has also been one of the most controversial and scrutinized tax-exempt organizations. An SO is excluded from the definition of a private foundation and is, therefore, classified as a public charity, essentially on a derivative basis by virtue of its support of, and relationship with, the one or more public charities that it supports. An SO can be formed as a nonprofit corporation or as a charitable trust and is a separate and distinct legal entity from the charities it supports. In order to qualify as an SO, the organization must meet each of the following three statutory requirements under Section 509(a)(3):¹¹

1. The organization must be organized, and at all times thereafter operated, exclusively for the benefit of, to per-

¹ As discussed hereinafter, there are three types of SOs depending on the relationship of the SO with the one or more publicly supported organizations it supports. The Type III SO has the most attenuated relationship with its supported organizations and, as a result, is subjected to significantly more complex rules so as to ensure that it will further the charitable purposes of, and be held accountable to, its supported organizations.

² See Congressional Records of 12/6/1969 (page S 15982).

³ For purposes of Section 509(a)(3) and references hereinafter to such term, the term "publicly supported organization" means a public charity described in Section 509(a)(1) or (2). It is possible for a Section 4947(a)(1) nonexempt charitable trust to be treated as a Type III SO even though it has neither obtained nor seeks to obtain exemption from tax as an organization classified under Section 501(c)(3). IRM 7.26.15.3.

⁴ Chapter 42 of the Internal Revenue Code subjects private foundations to a wide array of excise tax provisions under Sections 4941 through 4945. In addition, contributions to private foundations are subject to less favorable income tax treatment under Section 170. Under the PPA, certain Type III SOs, and organizations making grants to such Type III SOs, are subject to certain private foundation rules.

⁵ The scrutiny of SOs, as well as their continued viability, came to the limelight in a 4/25/2005, New York Times front-page article, entitled "Big Tax Break Often Bypasses Idea of Charity." The article, which presented a highly critical view of SOs, was followed by a joint press release issued by Senator Charles Grassley (R-Iowa), then Chairman of the Senate Finance Committee, and Senator Max Baucus (D-Mont.), then ranking Democratic member, which stated that they

planned to propose reforms "to stop the use of supporting organizations for generous tax breaks rather than charitable purposes." In a written statement to the Senate Finance Committee dated 4/5/2005 regarding SOs, then IRS Commissioner, Mark W. Everson, stated that "[s]ome promoters in this area have encouraged individuals to establish and operate supporting organizations purportedly described in 509(a)(3) that they can control for their own benefit. There are a variety of methods of abuse, but a common theme is a 'charitable' donation of an amount to the supporting organization, and a return of the donated amount to the donor, often in the form of a purported loan that may never be repaid. For example, we have seen contributed amounts that have ultimately been returned and then used by the donor to purchase residential property. In response to their possible elimination, one large Type III SO placed an advertisement in the 3/31/2005 Chronicle of Philanthropy, which stated as follows: 'The Senate Finance Committee has targeted Type III supporting organizations for elimination under the proposed revisions to the Internal Revenue Code. Hearings may be as soon as April 5. If you would like to join a coalition of other Type III organizations to develop specific legislation to curb targeted abuses rather than complete elimination, please contact the J.A. Chapman and Leta M. Chapman Charitable Trust ... as soon as possible.'

⁶ For example, on 6/22/2004, the Senate Finance Committee held a highly publicized hearing to focus on governance and best practices of charitable organizations, which also focused on various abuses in the charitable sector, including SOs being used for noncharitable purposes. On 4/5/2004, the Senate Finance Committee held a second hearing on nonprofit organizations and charitable giving, focused on ways to strengthen

nonprofit governance and reduce various perceived improprieties in charitable giving, which was followed by a hearing by the House Ways and Means Committee on 4/20/2005.

⁷ The IRS actually recognized that following the enactment of the PPA, certain charitable trusts that were historically treated as Type III SOs erroneously converted to private foundation status and, as a result, the IRS provided guidance for such trusts to retroactively convert back to their original Type III SO status. See Fox and King, "Help for Charitable Trusts That Made Erroneous Conversions," 38 ETPL 13 (January 2011).

⁸ For an article discussing the advanced notice of rulemaking (72 Fed. Reg. 42335 (8/2/2007)) and the proposed regulations (REG-155929-06, 74 Fed. Reg. 48672 (9/23/2009)), see Fox, "Prop. Regs. Provide New Guidance for Type III Supporting Organizations," 37 ETPL 6 (March 2010).

⁹ TD 9605 (12/28/2012). The temporary regulations (Temp. Reg. 1.509(a)-4T) address the annual distribution requirements for the category of Type III SOs that are considered "non-functionally integrated," as discussed hereinafter. Because their distribution requirements in the temporary regulations differ substantially from those set forth in the earlier issued proposed regulations (which never became effective), the IRS issued the revised distribution requirements in the form of temporary regulations, allowing for additional comments. Both the temporary and final regulations, however, became effective on 12/28/2012.

¹⁰ The Treasury regulations governing SOs are extremely lengthy, detailed and complex, to the point where one court characterized these regulations as "fantastically intricate and detailed." Windsor Foundation 40 AFTR2d 77-6004 (DC Va., 1977).

form the functions of, or to carry out the purposes of one or more specified publicly supported organizations.¹²

2. To ensure that a public charity has the ability and motivation to properly oversee its activities, the organization must have one of three possible relationships with one or more publicly supported organizations which, depending on the type of relationship, results in the organization being known as a Type I, Type II, or Type III SO. The three alternative types of relationships are where the SO is (1) "operated, supervised or controlled by" (Type I); (2) "supervised or controlled in connection with" (Type II); or (3) "operated in connection with" one or more publicly supported organizations (Type III).¹³
3. The organization must not be controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946) other than foundation managers with respect to such organization and other than the one or more publicly supported organizations the organization supports.¹⁴

¹¹ As discussed further below, Type III SOs are subject to additional requirements, other than those set forth in Section 509(a)(3), whereby they must annually provide certain information to each of their supported organizations, may not have any supported organization not organized in the U.S., and may not accept donations from donors who control a supported organization.

¹² Section 509(a)(3)(A).

¹³ Section 509(a)(3)(B). In the Type I SO context, the relationship between the SO and its supported organization is comparable to that of a parent and subsidiary, in which case the SO is under the direction of, and accountable or responsible to, the one or more publicly supported organizations. For a Type II SO, there is common supervision or control by the persons supervising or controlling both the SO and the one or more publicly supported organizations, which is ordinarily met if a majority of the SO's governing board are also on the governing body of the supported organization. The Type III SO "operated in connection with" relationship is discussed below.

¹⁴ Section 509(a)(3)(C).

Type III SOs generally

The Type III SO, whose relationship with the supported organization is tested under the "operated in connection with" standard, has the least intimate relationship with its supported organizations of any type of SO. It is not subject to the control of the supported organization or its board members, but has its own independent board that has control over the SO. As a result, there is a lower threshold of supported organization participation in a Type III SO's operations.

An SO can be formed as a nonprofit corporation or as a charitable trust and is a separate legal entity from the charities it supports.

Because it has the most attenuated relationship with the supported organizations of any type of SO, the Type III SO has traditionally been subject to the most complexity and IRS scrutiny. In order to meet the "operated in connection with" requirement, a Type III SO must meet a "responsiveness test" and an "integral part test." The responsiveness test generally requires that the SO be responsive to the needs or demands of one or more of its supported organizations. The integral part test is generally met by the Type III SO maintaining a significant involvement in the operations of one or more supported organizations that are dependent on the SO for the type of support which it provides. The PPA added additional requirements that must be met in order to achieve Type III SO status, which are discussed below.

Changes to Type III SOs under the PPA

The PPA made a vast array of statutory changes to the tax regime applicable to Type III SOs, including introducing two newly created categories of Type III SOs:

1. The "functionally integrated Type III SO."
2. The "non-functionally integrated Type III SO."

The functionally integrated Type III SO meets the integral part test due to the activities of the organization—i.e., by performing the functions of, or carrying out the purposes of, its supported organizations. The non-functionally integrated Type III SO meets the integral part test by virtue of distributing funds to its supported organizations so that its activities tend to focus on grant-making, similar to a private foundation.

Whether a Type III SO is "functionally integrated" or "non-functionally integrated" is a very important distinction because many of the limitations and restrictions imposed on Type III SOs under the PPA apply only if the organization is a non-functionally integrated Type III SO. Such limitations and restrictions include:

1. Under Section 4943(f)(3), a non-functionally integrated Type III SO is subject to the Section 4943 excess business holdings rule.
2. Under Section 4942(g)(4)(A)(i), grants by a private foundation to a non-functionally integrated

ed Type III SO are not considered qualifying distributions.

3. Under Section 4945(d)(4)(A)(ii), grants by a private foundation to a non-functionally integrated Type III SO are a taxable expenditure unless expenditure responsibility is exercised with respect to the grant.
4. Under Section 4966(c)(2) and (d)(4), an excise tax is imposed under Section 4966(a) with respect to distributions from a donor-advised fund to a non-functionally integrated Type III SO unless expenditure responsibility is exercised with respect to the distribution.

In addition, no charitable deduction is permitted for income, gift, and estate tax purposes for a contribution to a donor-advised fund of a non-functionally integrated Type III SO.¹⁵

Hence, the functionally integrated Type III SO is more attractive from a tax standpoint. In addition to the creation of the two new categories of Type III SOs, as further described below, the PPA made the following changes to the requirements for Type III SO classification by:

1. Removing an alternative test historically available for charitable trusts as a means of meeting the responsiveness test, thereby requiring such trusts to meet the general responsiveness test that otherwise applies to all Type III SOs.
2. Requiring the IRS to set a new annual payout requirement for non-functionally integrated Type III SOs to ensure that such organizations pay a significant amount to their supported organizations.
3. Imposing a notification requirement, whereby a Type III SO must annually provide

to each of its supported organizations such information as the IRS may require.

4. Prohibiting a Type III SO from supporting any supported organization not organized in the U.S.
5. Prohibiting a Type III SO 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 III SO.

Meeting the requirements post-PPA

Under the PPA, as implemented by the temporary and final regulations issued by the Treasury and the IRS, in order to be classified as a Type III SO, the organization must:

- Be organized and operated exclusively for the benefit of one or more specified domestic publicly supported organizations.
- Meet both a "responsiveness test" and an "integral part test," with the nature of the integral part test dependent on whether the organization is functionally integrated or non-functionally integrated.
- Not be controlled directly or indirectly by one or more disqualified persons (as defined in Section 4946) other than foundation managers with respect to such organization and other than the one or more publicly supported organizations the organization supports.
- Meet annual notification requirements with respect to each of the one or more publicly supported organizations it supports.
- Not receive contributions from persons with direct or

indirect control of any supported organization.

Organized and operated exclusively for the benefit of one or more domestic publicly supported organizations. As is the case with all SOs, a Type III SO must be organized, and at all times thereafter operated, exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more specified publicly supported organizations described in Section 509(a)(1) or (2).¹⁶ There is no limitation on the number of publicly supported organizations a Type III SO may support.

An Advanced Notice of Proposed Rulemaking (ANPRM) issued by the IRS on 8/2/2007, which described the regulations that the IRS anticipated issuing to implement the PPA changes to Type III SOs, proposed a limitation on the number of supported organizations a non-functionally integrated Type III SO could support, generally limiting the supported organizations to no more than five. In response to comments asking that such limitation not be imposed, the subsequently issued regulations do not contain any such limitation.

An organization may not qualify as a Type III SO if it supports any supported organization organized outside of the U.S.¹⁷ Thus, U.S. "friends" organizations that are

¹⁵ Section 170(f)(18) (income tax); Section 2522(c)(5) (gift tax); and Section 2055(e)(5) (estate tax). For a further discussions of these limitations and restrictions put in place under the PPA, see Fox, "Charitable Limitations and Reforms of the Pension Protection Act," 33 ETPL 3 (December 2006).

¹⁶ Section 509(a)(2); Reg. 1.509(a)-4(f)(5). Note that in the case of a Type III SO, the governing document must designate each of the specified supported organizations by name, except where there has been a historic and continuing relationship between the Type III SO and the publicly supported organization and, by reason of such relationship, there has developed a substantiality of interest between such organizations. Regs. 1.509(a)-4(d)(1) and (d)(2)(iv).

¹⁷ Section 509(f)(1)(B)(i).

formed to support a specific foreign charity can no longer qualify as Type III SOs, although such an organization can generally qualify as a public charity under Section 509(a)(1), assuming that it receives sufficient public support.

Responsiveness test. Whether a Type III SO is functionally integrated or non-functionally integrated, it must meet a "responsiveness test," so as to ensure that it is responsive to the needs or demands of a supported organization.¹⁸ To do this, (1) the Type III SO must have a specified relationship with a supported organization and (2) by virtue of such relationship, the officers, directors, or trustees of the supported organization must be considered to have a "significant voice" in the operations of the Type III SO.

Under the regulations, the Type III SO need meet the responsiveness test only with respect to at least one supported organization,¹⁹ although the Preamble to the regulations states that the Treasury and the IRS intend to propose regulations requiring that a non-functionally integrated Type III SO meet the responsiveness test with respect to each of their supported organi-

zations. Until such regulations are issued, however, the responsiveness test need be met with respect to one supported organization, regardless of the number of supported organizations of a Type III SO.

Requisite relationship. A Type III SO has the requisite relationship with respect to a supported organization only if any of the following are satisfied:

1. One or more officers, directors, or trustees of the SO are elected or appointed by the officers, directors, trustees, or membership of the supported organization.
2. One or more members of the governing body of the supported organization are also officers, directors, or trustees of, or hold other important offices in, the SO.
3. The officers, directors, or trustees of the SO maintain a close and continuous working relationship with the officers, directors, or trustees of the supported organization.

In the case of a SO that was supporting or benefiting a supported organization before 11/20/1970, additional facts and circumstances, such as a historic and continuing relationship between the organizations, may be also taken into account to establish compliance with the responsiveness test.²⁰

Significant voice requirement. A Type III SO meets the significant voice requirement only if the officers, directors, or trustees of the SO have a significant voice in:

1. The investment policies of the SO.
2. The timing of grants.
3. The manner of making grants.
4. The selection of grant recipients by such SO, and in otherwise directing the use of the income or assets of the SO.²¹

Responsiveness test for charitable trusts. Consistent with the elimination of the alternative responsiveness test historically applicable to charitable trusts, the regulations do not adopt a special rule for charitable trusts.²² Thus, charitable trusts, including those having institutional trustees, must meet the same responsiveness test applicable to all other Type III SOs. The regulations make it clear, however, that notwithstanding the elimination of the alternative responsiveness test historically available for charitable trusts, a charitable trust may under certain circumstances be able to meet the responsiveness test applicable to all other Type III SOs.

In addition, the Preamble to the regulations states that as "a general matter, the Treasury Department and the IRS anticipate that charitable trusts will be able to demonstrate that they satisfy the responsiveness test in a variety of ways, and whether a supported organization has a close and continuous relationship with, or a significant voice in directing the use of the income or assets of, a supporting organization will be determined based on all the relevant facts and circumstances." The Preamble also indicates that the Treasury and the IRS intend to issue proposed regulations clarifying the responsiveness test in the context of a trust instrument that specifies the recipients, timing, manner, and amount of grants.

The regulations provide the following specific example that illustrates factors demonstrating how a trust can be responsive to the needs of its supported organization:²³

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 (Trustee) is a bank. Under the trust instrument, X supports M, a private university described in section 509(a)(1). The trust instrument

¹⁸ Reg. 1.509(a)-4(i)(1)(ii).

¹⁹ Reg. 1.509(a)-4(i)(3)(i) ("A supporting organization meets the responsiveness test if it is responsive to the needs or demands of a supported organization.").

²⁰ Reg. 1.509(a)-4(i)(3)(v).

²¹ Reg. 1.509(a)-4(i)(1)(iii).

²² Prior to the PPA, under a special alternative test available only to charitable trusts, the regulations provided that the responsiveness test was also met where (1) the SO 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 supported organization has the power to enforce the trust and compel an accounting under state law. Thus, even where a charitable trust did not meet the general responsiveness test because a supported organization lacked a significant voice over its operations, provided the charitable trust met the alternative responsiveness test, it nonetheless was considered to be responsive to its supported organizations.

²³ Reg. 1.509(a)-4(i)(3)(iv), Example 1.

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 or telephonic meetings during which they discuss M's projected needs and ways in which M would like X to use its income and invest its assets. Additionally, Trustee communicates regularly with that 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 ... with respect to M.

This example shows the importance attached to regular communication and interaction between a charitable trust and a supported organization in establishing that the trust meets the responsive test, including such things as the trustee of the SO:

- Instituting regular meetings with their supported organizations, whether face-to-face or telephonically.²⁴
- Having regular discussions regarding the needs of the supported organizations.
- Taking into account and, where deemed appropriate, following the recommendations of the supported organizations in connection with the operations of the SOs, including with respect to such things as investment of assets, the timing of payments to the supported organizations, and other matters pertaining to the operations of the SOs.

Although the example in the regulations involves a charitable trust, there is no reason it could not be applied to a nonprofit corporation for purposes of determining whether the responsiveness test is met in that context. In the absence of regular communication and

interaction between an SO and its supported organization, the responsiveness test will not be met, as illustrated by the following example in the regulations:²⁵

Y is an organization described in section 501(c)(3) and is a trust under State law. The trustee of Y (Trustee) is a bank. 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.

Integral part test. The application of the integral part test depends on whether the Type III SO is functionally integrated or non-functionally integrated. A functionally integrated Type III SO meets the integral part test due to the activities of the organization—i.e., by directly performing the functions of, or carrying out the purposes of, its supported organizations. A non-functionally integrated Type III SO meets the integral part test by virtue of distributing funds to a supported organization, not by conducting activities.

Functionally integrated Type III SOs. A functionally integrated Type III SO is one that engages in activities “substantially all” of which (1) “directly further” the exempt purposes of one or more support-

ed organizations by performing the functions or carrying out the purposes of the supported organization and (2) but for the involvement of the SO, would normally be engaged in by the supported organization.²⁶ In this context, the activities must be conducted by the SO itself, rather than by a supported organization.²⁷

The regulations do not provide a definition of “substantially all,” indicating only that in determining whether the “substantially all” requirement is met, “all pertinent facts and circumstances will be taken into consideration.”²⁸

The regulations provide that holding title to or managing tax exempt-use assets are activities that directly further the exempt purposes of a supported organization.²⁹ On the other hand, the regulations clarify that fundraising, making grants (whether to the supported organization or to third parties), and investing and managing non-exempt-use assets (such as investments) are not considered to directly further the exempt purposes of a supported organization.³⁰ The following are examples where the integral part test is met by an SO carrying on activities that further the exempt purpose of its supported organization:³¹

1. V, an organization described in Section 501(c)(3), is organized and operated as an SO to L, a

²⁴ The example in the final regulations clarify that face-to-face meetings are not a requirement, as opposed to the example in the proposed regulations that made no indication that such meetings could be held telephonically.

²⁵ Reg. 1.509(a)-4(i)(3)(iv), Example 1.

²⁶ Regs. 1.509(a)-4(i)(4)(i) and (ii). The only definition of a “functionally integrated Type III SO” in the Code is found at Section 4943(f)(5)(B), for purposes of subjecting Type III SOs to the excess business holdings rule of Section 4943 other than in the case of a functionally integrated Type III SO. Section 4943(f)(3)(A).

²⁷ Reg. 1.509(a)-4(i)(4)(ii)(C).

²⁸ Reg. 1.509(a)-4(i)(4)(ii)(B).

²⁹ *Id.*

³⁰ Reg. 1.509(a)-4(i)(4)(ii)(C).

³¹ Reg. 1.509(a)-4(i)(4)(v), Examples 2, 3, and 5.

³² In Reg. 1.509(a)-4(i)(4)(v), Example 4, the making of scholarships by an organization to students of a private secondary school did not meet the integral part test because the organization did not provide the scholarships “as part of an active program in which it maintains a significant involvement,” given that its activities were basically limited to investing assets and disbursing funds to the scholarship recipients selected by the school.

³³ Regs. 1.509(a)-4(i) and (iii).

³⁴ Reg. 1.509(a)-4(i)(4)(v), Example 1.

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 maintaining these buildings, which L continues to use, free of charge, to further its exempt purposes. But for the activities of V, L would hold and maintain the buildings. V satisfies the integral part test.

2. O is a local nonprofit food pantry described in Section 501(c)(3). O collects donated food from local growers, grocery stores, and individuals and distributes this food free of charge to poor and needy people in O's community. O is organized and operated as an SO to eight churches of a particular denomination located in O's community, each of which is described in Section 509(a)(1). All of O's activities directly further the exempt purposes of the eight supported organizations. Additionally, but for the activities of O, the churches would normally operate food pantries themselves. O satisfies the integral part test.
3. J, an organization described in Section 501(c)(3), is organized as an SO 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 conducting general grant-making activities, G also engages in activities to beautify and maintain local parks. Substantially all of J's activities consist of maintaining all of the local parks in the area of community foundation G

by performing 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 meets the integral part test.

No charitable deduction is permitted for income, gift, and estate tax purposes for a contribution to a donor-advised fund of a non-functionally integrated Type III SO.

The making or awarding of grants, scholarships, or other payments to individual beneficiaries who are members of the charitable class benefited by a supported organization are treated as direct activities, but only if (1) the recipients are selected on an objective and nondiscriminatory basis consistent with the private foundation rules in Reg. 53.4945-4(b); (2) the officers, directors, or trustees of the supported organization have a significant voice in the timing of the payments, the manner of making them, and the selection of recipients; and (3) the making or awarding of such payments is part of an active program of the SO that directly furthers the exempt purposes of the supported organization and in which the SO maintains a significant involvement consistent with that required in the case of a private operating foundation under Reg. 53.4942(b)-1(b)(2)(ii).³²

Other types of functionally-integrated Type III SOs. The regulations provide for two other types of functionally integrated Type III SOs. One is the parent of each of its supported organizations provided, however, that the SO 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, directly or indirectly, by the governing body, members of the governing body, or officers (acting in their official capacity) of the SO.³³ As an example, the regulations provide that the parent organization of a healthcare system would be a functionally integrated Type III SO where it engages in the overall coordination and supervision of the healthcare system and appoints all board members of each hospital and outpatient clinic in the system.³⁴

The other type of functionally integrated Type III SO is one that supports a "governmental supported organization and otherwise

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meets the requirements of” Reg. 1.509(a)-4(i)(C). No guidance is provided in this area, however, as the regulations have reserved Reg. 1.509(a)-4(i)(4)(i)(C) for subsequent guidance on this issue. The 2009 proposed regulations provided a governmental entity exception under which a Type III SO that supports one (and only one) supported organization whose assets are subject to the appropriations process of a federal, state, local, or Indian tribal government may treat making grants to the supported organization and investing and managing non-exempt-use assets on behalf of the supported organization as direct furtherance activities, as long as a substantial part of the SO’s total activities are otherwise direct furtherance activities.

Several commenters requested that this governmental entity exception be expanded to allow SOs to support more than one supported organization. For instance, commenters recommended that a Type III SO be allowed to qualify for this exception if it supports (1) up to five governmental supported organizations; (2) not only a governmental entity but also other supported organizations that are responsive to, and have a substantial operational connection with, that governmental entity; or (3) a governmental system, such as a parent and subsidiary units. The Preamble to the regulations state that the “Treasury Department and the IRS are continuing to consider these comments regarding the governmental entity exception and intend to issue proposed regulations in the near future that will provide guidance on how supporting organizations can qualify as functionally integrated by supporting a governmental entity.”

In the interim, on 12/23/2013, the IRS issued Notice 2014-4,³⁵ providing a transitional rule for qualifying as a functionally integrated

Type III SO by supporting a governmental supported organization. Under this interim guidance, until the earlier of the date final regulations are published or the first day of the organization’s third tax year beginning after 2013, a Type III SO will be treated as functionally integrated, if it: (1) supports “at least one” supported organization that is a governmental entity to which the SO is responsive and (2) engages in activities for or on behalf of the governmental supported organization that perform the functions of, or carry out the purposes of, that governmental supported organization and that, but for the involvement of the SO, would normally be engaged in by the governmental supported organization itself.

The use of the phrase “at least one” in this Notice indicates that, contrary to the 2009 proposed regulations, more than one governmental entity can be supported by a Type III SO. The Notice specifically states, however, that this “transitional rule is not intended to sig-

nal what future proposed regulations will require with respect to qualifying as functionally integrated by supporting a governmental entity and that ‘No Type III supporting organization will qualify as functionally integrated by reason of satisfying this transitional rule once final regulations ... are published.’

Non-functionally integrated Type III SOs. If an organization does not qualify as functionally integrated, it must meet a separate integral part test to qualify as a non-functionally integrated Type III SO. This would be the case where the Type III SO’s activities consist of making distributions of money to the supported organization, such as in the case of a charitable trust making distributions to designated charities. A non-functionally integrated Type III SO must meet both a minimum payout requirement³⁶ and an attentiveness requirement.³⁷

Minimum payout requirement for non-functionally integrated Type III SOs. The rules have changed since the enactment of the PPA.

³⁵ 2014-2 IRB 274.

³⁶ Regs. 1.509(a)-4(i)(5)(i)(A) and 1.509(a)-4(i)(5)(ii).

³⁷ Regs. 1.509(a)-4(i)(5)(i)(A) and 1.509(a)-4(i)(5)(iii). Note that there is an alternative integral part test for a trust (whether or not exempt from taxation under Section 501(a)) that on 11/20/1970 met and continues to meet certain requirements set forth in Regs. 1.509(a)-4(i)(9)(i) through (i)(9)(vi), in which case the trust will be deemed to meet the integral part test required for a Type III SO without having to meet a minimum payout or attentiveness requirement.

³⁸ Rev. Rul. 76-208, 1976-1 CB 161.

³⁹ The Joint Committee on Taxation stated that with respect to the pre-PPA distribution regime applicable to Type III SOs, there is a “concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations.” Staff of the Joint Committee on Taxation, “Technical Explanation of H.R. 4, the Pension Protection Act of 2006,” page 360, note 571.

⁴⁰ Section 1241(d)(1) of the PPA required the Treasury to promulgate new regulations to require such non-functionally integrated Type III SOs “to make distributions of a percentage of either income or assets to supported organ-

izations ... in order to ensure that a significant amount is paid to such organizations.”

⁴¹ Temp. Regs. 1.509(a)-4T(i)(5)(ii)(B) and (C). The distributable amount for the first tax year an organization is treated as a non-functionally integrated Type III SO is zero.

⁴² Temp. Reg. 1.509(a)-4T(i)(8). In adopting a payout rate set at less than the 5% rate applicable to private foundations, the Preamble to the regulations stated that the Treasury and the IRS considered the relationship between a Type III SO and its supported organization in determining the appropriate payout rate for a non-functionally integrated Type III SO. Note that there is a “reasonable cause exception” under Reg. 1.509(a)-4(i)(5)(ii)(F) which, if met, will not result in loss of Type III SO status where the organization fails to meet the minimum distribution requirement in a given tax year.

⁴³ Reg. 1.509(a)-4(i)(7).

⁴⁴ Reg. 1.509(a)-4(i)(6).

⁴⁵ Although the regulations do not specifically indicate as such, presumably, similar to private foundations, the reasonable and necessary administrative expenses of the Type III SO itself should count towards the distribution requirement. See Section 4942(g)(1)(A) (treating reasonable and necessary administrative expenses of a private foundation as qualifying distributions that are applied against a private foundation’s 5% annual distribution requirement under Section 4942).

⁴⁶ Reg. 1.509(a)-4(i)(11)(ii)(B).

Background on payout requirement prior to the PPA. Prior to the PPA, the integral-part test for a Type III SO required the 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 organizations to the operations of the Type III SO.
3. Pay a substantial amount of the total support of the Type III SO to those supported organizations that meet the attentiveness requirement.

For purposes of these rules, the phrase “substantially all of its income” means at least 85% of adjusted net income.³⁸ Some donors establishing Type III SOs historically contributed non-income-producing assets, so that under the traditional 85% income distribution requirement, a significant amount of money was not going to supported organizations.³⁹ The PPA directed the IRS to promulgate new regulations on a payout requirement for non-functionally integrated Type III SOs to ensure that these SOs pay a significant amount to their supported organizations.⁴⁰

In advance of the issuance of proposed regulations on the distribution requirement, the ANPRM provided that a non-functionally integrated Type III SO would be required to make an annual payout equal to the annual payout required by a private nonoperating foundation—generally, 5% of the fair market value of its investment assets. Many commentators stated that the private foundation 5% payout requirement contained in the ANPRM was too high and would erode an organization’s

assets over time. The commentators asserted that a Type III SO provides long-term consistent support to specific organizations, while private foundations may pay out to whomever they choose. Further, the commentators stated that an SO maintains a governance relationship with its supported organizations in a way that a private foundation does not.

Under the regulations, the Type III SO need meet the responsiveness test only with respect to at least one supported organization.

Commentators argued that because of these differences, the private foundation payout requirement should not be imposed on an SO. Imposing a 5% payout, these commentators contended, would jeopardize the ability of SOs to provide the kind of consistent, reliable, long-term support supported organizations have come to expect. Despite the many comments arguing against a 5% distribution requirement, consistent with the ANPRM, the proposed regulations set the distribution requirement for non-functionally integrated Type III SOs at 5% of the fair market value of the non-exempt-use assets of the SO, although this requirement never became effective.

As discussed below, in response to the many comments received on the topic, the temporary regulations that were subsequently issued ultimately rejected a 5% payout requirement. They opted instead to impose a substantially lesser payout requirement for non-functionally integrated Type III SOs.

Distribution requirements in a post-PPA tax regime as implemented by regulations. Under the regulations issued by the IRS implementing the distribution regime under the PPA, the required annual minimum distribution requirement, known as the “distributable amount,” for a tax year of a Type III SO is generally equal to the greater of (1) 85% of its adjusted net income (determined by applying the principals of Section 4942(f)) for the immediately preceding tax year or (2) 3.5% of the fair market value of its noncharitable use assets for the immediately preceding tax year;⁴¹ determined by applying the principles applicable to private nonoperating foundations under Section 4942.⁴² Distributions in excess of the annual distributable amount may be carried over for five subsequent years with the distributable amount in that later year first reduced by any excess amount carried over, with the oldest excess amount applied first.⁴³

The amount of a distribution made by a Type III SO to a supported organization includes the cash distributed or the fair market value of property distributed as of the date the distribution is made, determined solely on a cash basis.⁴⁴ According to Reg. 1.509(a)-4(i)(6), distributions by the Type III SO that count toward its distribution requirement “shall include, but not be limited to” the following:

- Any amount paid to the supported organization to accomplish the supported organization’s exempt purposes.
- Any amount paid to perform a direct activity of the supported organization, but only to the extent that such amount exceeds any income derived from such activity.
- Any reasonable and necessary administrative expenses of the

supported organization to accomplish its exempt purposes (which do not include investment-related expenses).⁴⁵

- Any amount to acquire an exempt-use asset.
- Any amount set aside for a specific project that accomplishes the exempt purposes of a supported organization.

The Preamble to the regulations provide that the Treasury and the IRS intend to propose regulations that will more fully describe the expenditures (including expenditures for administrative and additional charitable activities) that do and do not count toward the distribution requirement. The Preamble also notes that the regulations do not address whether program-related investments, which count toward satisfying a private foundation's distribution requirement under Section 4942, should count toward the distribution requirement of non-functionally integrated Type III SOs, although it indicates that future proposed regulations will clarify this issue.

Although the minimum distribution requirements went into effect on 12/28/2012, under the transitional rules provided under the regulations, a Type III SO in existence on 12/28/2012 that met, and continues to comply with, the existing regulations for Type III SOs, need not meet such requirements until its second tax year beginning after 12/28/2012.⁴⁶ For example, a Type III SO having a calendar tax year need not meet the requirements until its tax year beginning on 1/1/2014. The minimum distribution amount should still be calculated for the first tax year following 12/28/2012 because an excess distribution for that year may be carried forward to the following year.⁴⁷

Attentiveness requirements. In order to meet the attentiveness requirement, the Type III SO must distribute at least one-third of its annual distributable amount to one or more supported organizations that are "attentive" to the operations of the Type III SO and to which the Type III SO is responsive.⁴⁸ For this purpose, a supported organization is considered "attentive" to the operations of the Type III SO during a tax year if, in that year:⁴⁹

1. The Type III SO distributes to the supported organization 10% or more of the supported organization's total support (or, in the case of a particular department or school of a university, hospital, or church, the total support of the department or school) received during the supported organization's last tax year ending before the beginning of the Type III SO's tax year.
2. The amount of support received from the Type III SO is necessary to avoid the interruption of a particular function or activity of the supported organization. The support is considered necessary if the Type III SO or the supported organization earmarks the sup-

port for a particular program or activity of the supported organization, even if such program or activity is not the supported organization's primary program or activity, as long as such program or activity is at least 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 Type III SO, and the purpose to which the funds are put, the support received from the Type III SO is a sufficient part of a supported organization's total support (or, in the case of a particular department or school of a university, hospital, or church, the total support of the department or school) to ensure attentiveness.

Normally, the attentiveness of a supported organization is influenced by the amounts received from the SO. 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

⁴⁷ *Id.* In addition, a Type III SO that meets the "but for" test under the pre-12/28/2012 regulations (Reg. 1.509(a)-4(i)(3)(ii)) in its tax year that includes 12/28/2012, but not in its first year beginning after 12/28/2012, is treated during that first tax year as a non-functionally integrated Type III SO with a distributable amount equal to zero for purposes of meeting the integral part test. Reg. 1.509(a)-4(i)(11)(ii)(C). The final regulations also provided transitional relief to a non-functionally integrated Type III SO organized before 9/24/2009, that commenced judicial proceedings before 6/26/2013, that were necessary to reform its governing or other instrument to allow it to meet the minimum distribution requirement. During any tax year in which such a judicial proceeding is pending, the SO is excepted from the distribution requirement to the extent it is prevented from meeting the requirement by one or more mandatory provisions in its governing instrument or other instrument that prohibits distributions from capital or corpus. The transitional relief applied only if the governing or other instrument at issue was executed (and the mandatory provisions

were in effect) before 9/24/2009, the date the 2009 proposed regulations were published in the Federal Register, and if the judicial proceeding is not subject to any unreasonable delay for which the SO is responsible. Beginning with the first tax year following the termination of a judicial proceeding, the non-functionally integrated Type III SO is subject to the minimum distribution requirement regardless of the outcome of the judicial proceeding. Reg. 1.509(a)-4(i)(11)(E).

⁴⁸ Reg. 1.509(a)-4(i)(5)(iii)(A).

⁴⁹ Regs. 1.509(a)-4(i)(5)(iii)(B)(1), (2), and (3). In determining whether a supported organization will be considered attentive to the operations of a Type III SO, any amount received that is held by the supported organization in a donor-advised fund is disregarded. Reg. 1.509(a)-4(i)(5)(iii)(C).

⁵⁰ Reg. 1.509(a)-4(i)(5)(iii)(B)(3).

⁵¹ Section 509(a)(3)(C). As a result of this requirement, unlike in the case of a private foundation, a founder of a Type III SO, and his or her relatives, cannot be in a control position.

whether the amount received from the SO is sufficient to ensure the attentiveness of the supported organization to the operations of the SO (including attentiveness to the nature and yield of the SOs 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 Type III SO under state law.⁵⁰

Example. 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 a publicly supported organization described in Section 509(a)(1). O meets the responsiveness test only as to V. Each year, O distributes its annual distributable amount in equal amounts to each of the five universities. Accordingly, O distributes only one-fifth of its distributable amount to a supported organization to which O is also responsive (V). Because O does not distribute at least one-third of its annual distributable amount to supported organizations that are both attentive to the operations of O and to which O is responsive, O does not meet the attentiveness requirements.

Type III SOs cannot be controlled by disqualified persons. A Type III SO may not be controlled directly or indirectly by one or more disqualified persons, as defined in Section 4946, including substantial contributors; their family members; and corporations, partnerships, or trusts in which interests of more than 35% is owned by disqualified persons.⁵¹ For this purpose, a disqualified person does not include foundation managers or organizations, which are public charities under Section 509(a)(1) or (2).

Reg. 1.509(a)-4(j)(1) provides that an organization is considered controlled if the disqualified persons (other than those specifically excluded as indicated above), by aggregating their votes or positions of authority, "may require such organization to perform any act which significantly affects its operations or may prevent such organization from performing such act." This includes, but is not limited to, the right of any substantial contributor or his or her spouse to designate annually the recipients, from among the publicly supported organizations, of the income attributable to his or her contribution to the SO. The regulations further provide that an SO is considered to

be controlled directly or indirectly by one or more disqualified persons if the voting power of such persons is 50% or more of the total voting power of the organization's governing body or if one or more of such persons have the right to exercise veto power over the actions of the organization.

Notwithstanding the foregoing, an organization is permitted to establish to the satisfaction of the Commissioner that disqualified persons do not directly or indirectly control it. Reg. 1.509(a)-4(j)(2) gives an example where notwithstanding that the majority of a religious organization's board of directors are substantial contributors, the organization will not be disqualified under

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Section 509(a)(3)(C) where a representative of the church, such as a bishop or other official, has control over the policies and decisions of the organization.

Type III SOs cannot receive contributions or gifts from persons with direct or indirect control over a supported organization. Prior to the PPA, the control exercised over a supported organization by a contributor to a Type III SO was not relevant to the determination of SO status under Section 509(a)(3). To curb perceived abuses, under Section 509(f)(2), as added by the PPA, if a Type III SO accepts any gift or contribution from a person who directly or indirectly controls, either alone or together with one or more specified related persons,⁵² the governing body of a supported organization, the Type III SO will no longer qualify as a SO under Section 509(a)(3).⁵³

The meaning of the term "control" is not defined under the PPA or the regulations, although the regulations have reserved a section for subsequent guidance on this issue⁵⁴ and the Preamble to the regulations state the "Treasury Department and the IRS agree that a definition of control for these purposes would be beneficial and intend to issue proposed regulations in the near future that will provide such a definition."⁵⁵ Because it results in its conversion to private foundation status, a Type III SO must be particularly diligent in not accepting any contribution from a donor who is in direct or indirect control of a supported organization of the SO, although without a clear definition of control for this purpose, Type III SOs may be put in a position where they have to decline a contribution from a would-be contributor associated with a supported organization.

Annual notification requirement to each supported organization. All Type III SOs, whether functionally or non-functionally integrated, must annually provide the following documents to each of its supported organizations:

1. A written notice addressed to a principal officer⁵⁶ of the supported organization describing the type and amount of all of the support the SO provided to the supported organization during the SO's immediately preceding tax year.
2. A copy of the SO's most recently filed Form 990 (the name and address of any contributor may be redacted from the return).
3. A copy of the SO's controlling governing documents, including its articles of incorporation, unless such documents have been previously provided and not subsequently amended.⁵⁷ The documents required for any tax year are required to be postmarked or electronically transmitted by the last day of the fifth calendar month following the close of that tax year (May 31 for calendar tax years).⁵⁸

Because the due date for the provision of these documents is not tied to the due date of Form 990, only the most recently filed Form 990 is required to be provided. For example, for a Type III SO that is on a calendar tax year, the documentation required to be provided to each supported organization by 5/31/2014 for the tax year 2013 need not include the 2013 Form 990, which is generally due by 5/15/2014, if such Form 990 is put on extension and is filed after 5/31/2014. In this situation, only the 2012 Form 990 need be submitted by 5/31/2014.

Conclusion

In seeking to curb perceived abuses and ensure that Type III SOs will further the charitable purposes of their supported organizations and be held accountable to such organizations, the post-PPA requirements, as implemented by temporary and final regulations, have made an already complex tax regime even more complicated. Notwithstanding the added complexity, the rules for qualification as a Type III SO in a post-PPA tax regime have been clarified and those organizations seeking to achieve or maintain such status must understand and comply with these rules in order to be treated as public charities, rather than private foundations. Because more guidance is anticipated to be issued by the Treasury and the IRS in this area, Type III SOs should closely monitor any changes that might affect their continuing qualification. ■

⁵² Related persons includes those persons described in Sections 509(f)(2)(b)(ii) and (iii), generally consisting of family members (as described in Section 4958(f)(4)) and a 35% controlled entity (as described in Section 4958(f)(3)). Contributions from related persons also cause the loss of the SO status of a Type III SO. Section 509(f)(2)(b).

⁵³ Note that Section 509(f)(2) also applies to a Type I SO, but does not apply to a Type II SO.

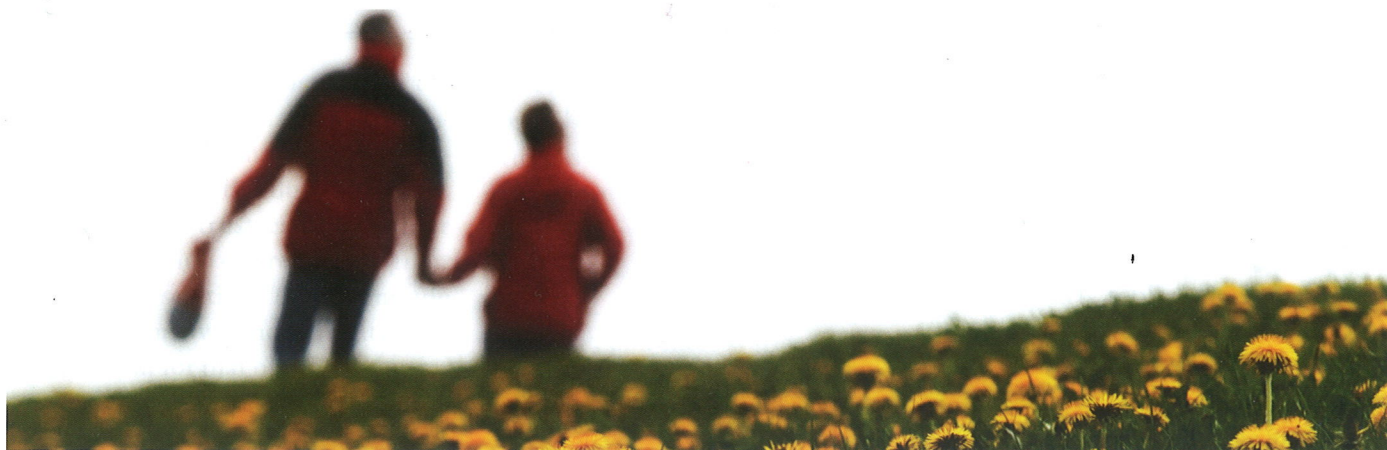
⁵⁴ Reg. 1.509(a)-4(f)(5)(ii).

⁵⁵ The Joint Committee on Taxation Technical Explanation provides that "it is intended that indirect control includes the ability to exercise effective control. For example, if a person made a gift to a supporting organization and a combination of such person, a person related to such person, and such person's personal attorney were members of the five-member board of a supported organization of the supporting organization, the organization would be treated as being indirectly controlled by such person. Board membership alone does not establish direct or indirect control. Staff of the Joint Committee on Taxation, "Technical Explanation of H.R. 4, the Pension Protection Act of 2006," page 361.

⁵⁶ A principal officer includes, but is not limited to, a person who, regardless of title, has ultimate responsibility for implementing the decisions of the governing body of a supported organization; supervising the management, administration, or operation of the supported organization; or managing the finances of the supported organization. Reg. 1.509(a)-4(i)(2)(iv).

⁵⁷ Regs. 1.509(a)-4(i)(2)(A), (B), and (C).

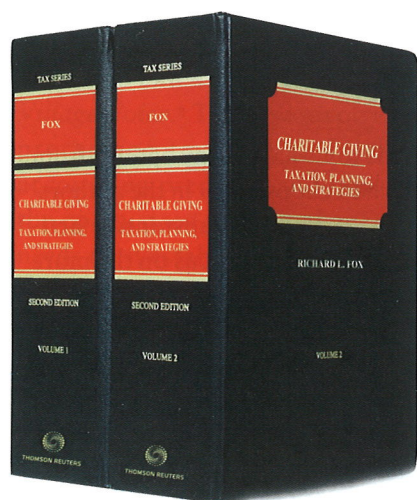
⁵⁸ Reg. 1.509(a)-4(i)(2)(iii).



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