

**IRS Issues Interim Guidance on Provisions in Pension Protection Act of 2006
Relating to Supporting Organizations & Donor Advised Funds**

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On December 4, 2006, the IRS issued Notice 2006-109, providing interim guidance on requirements enacted as part of the Pension Protection Act of 2006 (“PPA”) that affect supporting organizations, donor advised funds, and private foundations that make grants to supporting organizations. The PPA was enacted on August 17, 2006. Many of the provisions dealing with exempt organizations became effective upon enactment, or apply to taxable years beginning after the date of the enactment; a few provisions apply to transactions or events occurring after July 25, 2006. The IRS issued Notice 2006-109 to address a limited number of issues that the agency believes warrant immediate guidance, and stated in the notice that it will be providing additional guidance, including regulations, under these provisions of the Act.

The Notice provides guidance on four aspects of the new rules enacted as part of the PPA:

- (1) the criteria that may be used by private foundations in making distributions to supporting organizations; the criteria for determining whether a supporting organization, or any of its supported organizations, are controlled by disqualified persons; and guidance with respect to donor advised funds that make grants to supporting organizations;
- (2) the date of applicability for the new section 4958(c)(3) excise tax on certain excess benefit transactions involving supporting organizations;
- (3) an exclusion from the definition of “donor-advised fund” for certain employer-sponsored disaster relief funds; and
- (4) clarification on how the IRS will apply the new section 4966(a) excise taxes with respect to payments made pursuant to educational grants awarded prior to the date of enactment of the PPA.

Background

Federal tax law divides section 501(c)(3) organizations into two subcategories: private foundations and organizations that are not private foundations, commonly known as public charities. Section 509(a) describes several categories of public charities. To qualify for public charity status under section 509(a)(1) or (2), an organization must receive a substantial amount of public support to fund its operations. To qualify as a public charity under section 509(a)(3),

an organization must demonstrate that it provides support to one or more publicly supported organizations that are exempt under section 501(c)(3), (4), (5) or (6), and that the “supporting organization” has a particular type of relationship with the organization(s) it supports.

Section 509(a)(3) describes three types of relationships that a supporting organization may have with its supported organizations. A “Type I” supporting organization is operated, supervised, or controlled by one or more of the publicly supported organizations. A “Type II” supporting organization is supervised or controlled in connection with one or more of the publicly supported organizations. A “Type III” supporting organization is operated in connection with one or more of the publicly supported organizations. While Section 509(a)(3) describes these three types of relationships, it does not use the “Type I, II, and III” nomenclature. The PPA added sections 4966(d)(4)(B)(i), 4966(d)(4)(B)(ii), and 4943(f)(5)(A), which define the terms “Type I supporting organization,” “Type II supporting organization,” and “Type III supporting organization,” respectively. The PPA also added section 4943(f)(5)(B), which defines a “functionally integrated Type III organization” as a Type III supporting organization that, under Treasury regulations, is not required to make payments to the group it supports because the organization’s activities are related to performing the functions of, or carrying out the purposes of the supported organization(s).

The PPA also contains a number of provisions dealing with “donor advised funds,” a term that generally has been used to describe an account that is established by one or more donors who contribute the funds to a public charity, which thereafter owns and controls the funds but which also agrees to accept nonbinding recommendations from the donor or donors regarding the use of the funds and investment decisions. Prior to the PPA, the term “donor advised fund” was not defined in the IRC. The PPA added section 4966(d)(2), which defines a “donor advised fund” as a fund or account owned and controlled by a sponsoring organization, which is separately identified by reference to contributions of a donor or donors, and with respect to which the donor, or any person appointed or designated by such donor (“donor advisor”), has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of the funds.

Among other things, the PPA:

- denies qualifying distribution treatment to grants made by private foundations to supporting organizations under certain circumstances (IRC § 4942(g)),
- prohibits certain supporting organizations from accepting gifts or contributions from certain persons associated with a supported organization (IRC § 509(f)(2));
- provides that any grant, loan, compensation, or other similar payment from a supporting organization to a substantial contributor or persons related to the substantial contributor is treated as an excess benefit transaction for purposes of the section 4958 excise tax on certain persons if they engage in one or more excess benefit transactions (IRC § 4958(c)(3));

- imposes an excise tax on a sponsoring organization that maintains donor advised funds if it makes certain distributions from a donor advised fund (IRC § 4966); and
- imposes excise taxes on certain distributions from a donor advised fund that provide more than an incidental benefit to a donor, a donor-advisor, or related persons (IRC § 4967).

Guidance for Private Foundations Making Grants to Supporting Organizations

The PPA established special rules for grants made by a private foundation to (1) a Type III supporting organization that is not functionally integrated, or (2) a Type I, Type II, or functionally integrated Type III supporting organization if one or more disqualified persons of the private foundation directly or indirectly controls the supporting organization or one of its supported organizations. For non-operating foundations, such a grant will not qualify as a qualifying distribution under section 4942. *See* IRC § 4942(g). (Section 4942 generally requires private non-operating foundations to annually distribute their “minimum investment return,” approximately five percent of a foundation’s net investment assets, and imposes a series of excise taxes on private foundations that fail to make current distributions or demonstrate that they fall within one of several exceptions to the minimum distribution requirement.) For all private foundations, grants to the above entities are treated as a taxable expenditure under section 4945 if the private foundation does not exercise expenditure responsibility with respect to the grant. *See* IRC § 4945(d)(4)(A).

Notice 2006-109 states that, until further guidance is issued, private foundations may rely on information from the IRS Business Master File (“BMF”) or the grantee’s current IRS determination letter indicating the grantee’s public charity classification in determining whether the grantee is a public charity under section 509(a)(1), (2) or (3). A private foundation may also rely on a written representation from a grantee and specified documents described in the Notice in determining whether the grantee is a Type I, Type II, or functionally integrated Type III supporting organization. Alternatively, a foundation may rely on a reasoned written opinion of counsel of either the grantor or the grantee concluding that the grantee is a Type I, Type II, or functionally integrated Type III supporting organization. In each case, the foundation must verify that the grantee is listed in the IRS’s Publication 78, *Cumulative List of Organizations described in Section 170(c)*, or obtain a copy of the current IRS determination letter recognizing the grantee as exempt from federal income tax.

The Notice states that a private foundation considering a grant to a Type I, Type II, or functionally integrated Type III supporting organization may need to obtain a list of the grantee’s supported organizations to determine whether any of the supported organizations is controlled by disqualified persons of the private. Similarly, a sponsoring organization considering a grant from a donor advised fund to such an organization may need to obtain a list of the grantee’s supported organization(s) to determine whether any of the supported organizations is controlled by the fund’s donor or donor advisor (or any related parties). The Notice provides an interim definition of “control” that may be used in making this determination and provides interim guidance for applying the new statutory definition of “functionally integrated Type III supporting

organization,” and notes that the IRS intends to issue regulations adopting standards which may or may not be the same as those set forth in the Notice.

Applicability Date for Excess Benefit Transactions by Supporting Organizations

Under section 4958(c)(3), as amended by the PPA, any grant, loan, compensation, or other similar payment by a supporting organization to a substantial contributor to the supporting organization or a person related to a substantial contributor, and any loan provided by a supporting organization to certain disqualified persons, is treated automatically as an excess benefit transaction, with the entire amount paid to the substantial contributor or disqualified person and those related to them treated as an excess benefit. The statute provides that this new rule applies to transactions occurring after July 25, 2006.

Recognizing that supporting organizations may have entered into binding contracts or other legal obligations prior to the enactment of the PPA that required payments that at the time were not necessarily considered excess benefit transactions, the Notice states that the IRS will not consider certain payments made pursuant to a written contract or other arrangement that was binding on August 17, 2006, as an excess benefit transaction, provided the contract or arrangement satisfies certain conditions described in the Notice.

Donor Advised Funds

The PPA added section 4966(c)(1)(A) to impose an excise tax on all distributions to natural persons from donor advised funds effective for taxable years beginning after August 17, 2006. The PPA authorized the IRS to exempt certain funds from treatment as donor advised funds if either (1) the fund or account is advised by a committee not directly or indirectly controlled by the donor or donor advisor (and any related parties), or (2) such fund or account benefits a single identified charitable purpose. IRC § 4966(d)(2)(C). The Notice provides that certain employers may establish disaster relief funds at a community foundation or other public charity to provide disaster relief grants to employees or their family members who are the victims of a major disaster. The Notice provides specific requirements that must be met for an employer-sponsored disaster relief fund to be excluded from the definition of donor advised fund.

Applicability Date for Educational Grants

Under new section 4966, distributions to natural persons from a donor advised fund (including certain educational grants) are subject to an excise tax. This provision applies to applicable distributions made in taxable years beginning after August 17, 2006. To address situations where a commitment may have been made to an individual with respect to an educational grant on or before the date of enactment of the PPA, the payments of which extend beyond that date, the Notice provides that section 4966(c)(1)(A) will not apply to payments made after August 17, 2006, with respect to an educational grant, if the payment is made pursuant to a grant commitment entered into on or before August 17, 2006. The Notice explains the specific requirements that must be satisfied for a commitment to be treated as being entered into on or before August 17, 2006.

Even if a commitment is treated as being entered into on or before August 17, 2006, Section 4967 may apply to any grant that otherwise fits within the criteria specified. Section 4967, which was added as part of the PPA, imposes an excise tax if a donor, donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, more than an incidental benefit. The Notice states that if a sponsoring organization makes an educational grant distribution that results in more than an incidental benefit to a donor, donor advisor, or a person related to a donor or donor advisor, the grant will be subject to excise tax.

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