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# IRS Issues Final Regulations under IRC Section 509(a) for Type III Supporting Organizations

The Treasury Department and IRS on Oct. 13, 2023, released for publication in the Federal Register final regulations ([T.D. 9981](#)) providing guidance under Internal Revenue Code (IRC) Section 509(a) on the prohibition on certain gifts or contributions to Type I and Type III supporting organizations from persons who control a supported organization. The final regulations also include other requirements for Type III supporting organizations, such as (1) meeting the Type III responsiveness test, (2) qualifying as a functionally integrated Type III supporting organization (including a definition of a governmental supporting organization), and (3) the required annual

distributions by non-functionally integrated Type III supporting organizations.

The final regulations largely adopt proposed regulations released in 2016, with some modifications. The final regulations apply to tax years beginning on or after Oct. 16, 2023, but organizations may choose to apply them to tax years beginning on or after Feb. 19, 2016, as long as they are applied in their entirety and in a consistent manner.

## Background

An organization described in IRC Section 501(c)(3) is classified as either a private foundation or a public charity. To be classified as a public charity, an organization must be described in IRC Section 509(a)(1), (2), or (3). Organizations described in IRC Section 509(a)(3) are known as “supporting organizations.” Supporting organizations achieve their public charity status by providing support to one or more organizations described in IRC Section 509(a)(1) or (2), which, in this context, are referred to as “supported organizations.”

To be described in IRC Section 509(a)(3), an organization must satisfy an organizational test, an operational test, a disqualified person control test and one of three relationship tests. The disqualified person control test requires that a supporting organization not be controlled directly or indirectly by certain disqualified persons.

The three relationships are commonly known as:

- ▶ **Type I** (supporting organization is operated, supervised or controlled by the supported organization(s), comparable to a corporate parent-subsidiary relationship);
- ▶ **Type II** (supporting organization is supervised or controlled in connection with the supported organization(s), comparable to commonly controlled brother-sister organizations); and
- ▶ **Type III** (supporting organization is operated in connection with one or more supported organizations). Type III supporting organizations are classified as either functionally integrated, or non-functionally integrated, based on the supporting organization’s relationship with its supported organization(s).

# Final Regulations

The IRS issued proposed regulations in February 2016 that defined “control” for purposes of the prohibition on Type I or Type III supporting organizations accepting contributions from controlling donors. In addition, the proposed regulations clarified how Type III supporting organizations could satisfy the relationship test.

## Accepting Contributions from Controlling Donors

The final regulations clarify the definition of “control” for purposes of the prohibition on Type I and Type III supporting organizations receiving any gift or contribution from any person exercising direct or indirect control over the governing body. The final regulations provide that a person exercises “control” over the governing body of a supported organization if (1) that person’s voting power, either alone or with certain unrelated persons, is 50% or more of the total voting power of the governing body, or (2) those persons have veto power over the governing body’s actions. In situations where those persons do not have 50% or more of the voting power or veto power, then all pertinent facts and circumstances will be considered in determining whether they directly or indirectly control the governing body of the supported organization.

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The additional clarification of what constitutes “control” provided in the final regulations should help organizations identify potential gift/contribution transactions that might jeopardize a supporting organization’s tax-exempt status.

## Type III Relationship Test

The relationship test requires Type III supporting organizations to satisfy (1) a notification

requirement, (2) a responsiveness test and (3) the integral part test annually.

Under the notification requirement, a Type III supporting organization must provide certain information to its supported organization(s) on an annual basis to show that the supporting organization is responding to the needs or demands of the supported organization(s). The information that must be provided includes written notice to each supported organization's principal officer describing the type and amount of support the supporting organization provided in the preceding tax year. The final regulations provide that the due date for delivering this information to each supported organization is the last day of the fifth month after the end of the supporting organization's tax year in which it provided the reported support.

A Type III supporting organization meets the responsiveness test if it is responsive to the needs or demands of a supported organization. To meet the test, an organization must satisfy two elements: a relationship requirement and the significant voice requirement. Under the relationship requirement the officers, directors or trustees of the organization must have one of three specified relationships with the officers, directors or trustees of the supported organization. Under the significant voice requirement, the officers, directors or trustees of the supported organization must have a significant voice in the investment policies, timing of grants, the manner of making grants and the selection of grant recipients by the supporting organization. The final regulations adopted the responsiveness test in the proposed regulations without change.

The integral part test is satisfied by maintaining significant involvement in the operations of one or more supported organizations and providing support on which the supported organizations are dependent. The test requirements for functionally integrated and non-functionally integrated Type III supporting organizations differ. In general, a Type III supporting organization is treated as functionally integrated if it (1) engages in activities substantially all of which directly further the exempt purposes of one or more supported organizations, (2) is the parent of each of its supported organizations, or (3) supports a governmental supported organization.

The proposed regulations provided that to qualify as the parent of each of its supported organizations, the supporting organization had to be part of an integrated system with each of its supported organizations and had to engage in activities "typical of a parent" of an integrated system. The proposed regulations cited hospital systems as an example of an integrated system.

The final regulations provide that a hospital system is only one example of an integrated system (and not exclusive) and that the test is whether the structure is that of an integrated system, not whether the system is in a particular industry. They also add that a parent must direct the overall

policies, programs and activities of its supporting organizations, and that the parent, through its governing body and officers, has the power to appoint or remove a majority of the officers, directors or trustees of each of the supported organizations.

## Governmental Supported Organizations

The final regulations adopt the proposed regulations' definition of "governmental supported organization" using the existing IRC definition of "[governmental unit](#),"<sup>1</sup> with some modifications. The final regulations provide that a governmental unit includes all its agencies, departments and divisions, and that they will be treated as one governmental supported organization for these purposes.

The proposed regulations provide that a supporting organization that supports only governmental supported organizations would be considered functionally integrated if a substantial part of its total activities directly further the exempt purposes of its governmental supported organizations and, if the supporting organization supports more than one governmental supported organization, all its governmental supported organizations either (1) operate within the same geographic region or (2) work in close coordination or collaboration with each other to conduct a service, program or activity that the supporting organization supports.

To satisfy the close coordination or collaboration requirement, the proposed regulations required a supporting organization to maintain on file a letter from each of the governmental supported organizations (or a joint letter from all of them) describing their coordination or collaboration efforts with respect to the particular service, program or activity. The final regulations adopt these provisions without any substantive change.

## Integral Part Test for Non-Functionally Integrated Supporting Organizations

To meet the integral part test, a non-functionally integrated (NFI) Type III supporting organization must satisfy both a distribution requirement and an attentiveness requirement. With respect to each taxable year, an NFI Type III supporting organization must distribute to or for the use of one or more supported organizations an amount equaling or exceeding its "distributable amount." In

general, the distributable amount is equal to the greater of 85% of an organization's adjusted net income or its minimum asset amount for the immediately preceding tax year, reduced by the amount of unrelated business income tax paid by the supporting organization in the immediately preceding tax year. The proposed regulations removed the reduction of the distributable amount for this unrelated business income tax paid, and the final regulations adopt this change to the calculation of the distributable amount.

In addition, the proposed regulations provided guidance on which distributions count towards meeting the NFI Type III supporting organization distributions requirement. With respect to fundraising expenses incurred by the supporting organization, the final regulations provide that expenses the supporting organization incurs to solicit contributions count towards the distribution requirement when the resulting contributions are received directly by a supported organization, but only to the extent that the supporting organization's expenses for each solicitation do not exceed the amount of contributions a supported organization actually receives, and only if the supporting organization substantiates that those contributions were received as a result of the supporting organization's solicitation activities. This limitation applies on a solicitation-by-solicitation basis.

Finally, the final regulations follow the proposed regulations regarding a requirement that an NFI Type III supporting organization obtain written substantiation from the supported organization of the amount of contributions the supported organization actually received as a result of the supporting organization's solicitations. The final regulations clarify that the supported organization could provide this written substantiation by electronic media.

## Summary

The final regulations are generally consistent with the proposed regulations issued in 2016. In sum, they reflect a loosening of the rules for Type III supporting organizations that support governmental supported organizations and a bit of tightening of the rules for other Type III supporting organizations.

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<sup>1</sup> A governmental unit is defined as one described in IRC Section 170(c)(1) or an instrumentality of a governmental unit that (1) is described in IRC Section 170(c)(2) and (b)(1)(A), and (2) is not a private foundation or supporting organization.