Payout Requirements for Non-Functionally Integrated Type III Supporting Organizations -- Comments Requested by the IRS

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Dear NCNG Esquire:

What’s this I hear about new and potentially draconian IRS rules applicable to Type III non-functionally integrated supporting organizations?

On August 2, 2007 and again on October 1, 2007, the Internal Revenue Service published advance notice of a proposed rulemaking that would (1) require Type III non-functionally integrated supporting organizations (“NFISO III”) to annually pay out approximately 5% of their assets to supported public charities and (2) limit the number of publicly supported charities that NFISO IIIs may support. The notice is in response to the Pension Protection Act of 2006 (“PPA”).

The PPA states that NFISO IIIs should be required to make annual distributions of a percentage of either income or assets to supported organizations. Indicating a preference for the asset test, the new rules would provide that the familiar qualifying distribution requirement applicable to private non-operating foundations under Section 4942 of the Internal Revenue Code also applies to NFISO IIIs. A private non-operating foundation generally is subject to excise tax if it fails to make qualifying distributions each year equal to the minimum investment return (typically 5%).

In addition, the rules also would limit the number of publicly supported organizations that may be supported by NFISO IIIs. The maximum number would be five. The cap would not apply to existing NFISO IIIs that...
distribute at least 85% of the new payout requirement (see preceding paragraph) to or for the use of certain supported organizations. The notice of proposed rulemaking specifically requests comments from affected NFISO IIIs on this requirement and, in particular, potential transitional rules for existing NFISO IIIs.

The purpose of these regulations is to strengthen the connection between NFISO IIIs and the public charities they support, thereby increasing the NFISO III’s accountability to supported organizations and reducing the potential for abuse. Keep in mind that this announcement is merely a proposal to propose rules. The task of the nonprofit sector now is to provide feedback to the Internal Revenue Service about the wisdom and efficacy of these rules on or before October 31, 2007.