

Part III – Administrative, Procedural, and Miscellaneous

Interim Guidance Regarding Supporting Organizations and Donor Advised Funds

Notice 2006-XXXX

Section 1. PURPOSE

This Notice provides interim guidance regarding the application of certain requirements enacted as part of the Pension Protection Act of 2006, Pub. L. No. 109-208, 120 Stat. 780 (2006) (“PPA”), that affect supporting organizations, donor advised funds, and private foundations that make grants to supporting organizations.

Sections 1231, 1241, 1242, 1243, and 1244 of the PPA add sections 509(f), 4943(f), 4958(c)(3), 4966, and 4967, to the Internal Revenue Code (“Code”), and amend sections 509(a)(3)(B), 4942(g)(4), and 4945(d)(4)(A) of the Code. The amendments to section 509(a)(3) and the addition of section 509(f) prescribe requirements for supporting organizations. The addition of section 4943(f) defines the terms “Type III supporting organization” and “functionally integrated Type III supporting organization.” The amendments to sections 4942 and 4945 affect private foundations that make grants to supporting organizations under certain circumstances. The amendments to section 4958, inter alia, subject substantial contributors and persons related to them to excise taxes if they engage in certain types of transactions with supporting organizations with which they have a relationship. New section 4966 imposes an excise tax on a sponsoring organization that maintains donor advised funds if it makes certain distributions from a donor advised fund. New section 4967 imposes an excise tax on donors, donor advisors, or certain persons related to them if they benefit improperly from a distribution from a donor advised fund.

This notice provides guidance on four aspects of the application of these new provisions of the Code. First, Section 3 provides criteria for private foundations making distributions to supporting organizations that can be used to determine for purposes of sections 4942(g)(4) and 4945(d)(4) whether an organization is a Type I, Type II, or functionally integrated Type III supporting organization, and whether a supporting organization, or its supported organizations, are controlled by disqualified persons. Second, Section 4 clarifies the date of applicability for the new section 4958(c)(3) excise tax on certain excess benefit transactions involving supported organizations. Third, pursuant to the authority under new section 4966(d)(2)(C), Section 5.01 excludes certain employer-sponsored disaster relief funds from the definition of donor-advised fund. Fourth, section

5.02 clarifies how the Internal Revenue Service (“Service”) will apply the new section 4966(a) excise taxes with respect to payments made pursuant to scholarships awarded prior to the date of enactment of the PPA.

The Service and the Department of Treasury (“Treasury”) expect to issue further guidance, including regulations, under these Code sections. The rules provided in this notice apply until further guidance is issued. This notice does not affect the substantive standards for tax exemption under section 501(c)(3). This notice also invites comments from the public regarding this notice and suggestions for future guidance implementing statutory changes under the PPA.

This notice is intended to address a limited number of issues which required immediate guidance. The Service and Treasury expect to issue additional guidance on other Code sections amended or added by the PPA and welcome comments on other issues for which guidance may be needed.

Section 2. BACKGROUND

Organizations that are organized and operated exclusively for charitable, religious educational or other specified purposes are generally exempt from income tax under section 501(a) as organizations described in section 501(c)(3). Section 509(a) divides section 501(c)(3) organizations into two subcategories: private foundations and organizations that are not private foundations, which are commonly known as public charities. To be categorized as a public charity and not a private foundation, an organization must be described in section 509(a). To be described in section 509(a)(1) or (2), an organization must receive a substantial amount of public support to fund its operations. To be described in section 509(a)(3), an organization must have a particular type of structural relationship with a publicly supported section 501(c)(3), (4), (5) or (6) organization.

Private foundations are subject to a different regime of excise taxes than are public charities. For example, private foundations are subject to excise tax if they do not make at least a minimum level of qualifying distributions each year. Private foundations are also subject to excise tax if they make certain taxable expenditures. Taxable expenditures include, but are not limited to, certain grants to organizations unless the private foundation exercises expenditure responsibility with respect to the grants as required by section 4945(h) and Treas. Reg. section 1.4945-5(b).

.01 Donor Advised Funds and Supporting Organizations before the PPA

Donor Advised Funds

Prior to the PPA, the Code did not define the term donor advised fund. However, the term was commonly understood to refer to component funds of certain

community trusts. See Treas. Reg. section 1.170A-9(e)(10) and (11). The term was also commonly understood to refer to an account established by one or more donors but owned and controlled by a public charity to which such donors or other individuals designated by the donors could provide nonbinding recommendations regarding distributions from the account or investment of the assets in the account.

Supporting Organizations

Section 509(a)(3) excludes from the definition of private foundation certain organizations that support certain public charities. The Treasury regulations under section 509(a)(3) refer to these organizations as supporting organizations. To be described in section 509(a)(3), an organization must meet several tests: (1) it must be organized and operated exclusively for the benefit of specified publicly supported organizations (generally, public charities); (2) it must have one of three types of relationships with its publicly supported organizations; and (3) it must not be controlled, directly or indirectly, by disqualified persons (as defined in section 4946 other than foundation managers) with respect to such supporting organization.

In general, supporting organizations have been identified by the type of relationship they have with their publicly supported organizations. A supporting organization that is operated, supervised or controlled by one or more publicly supported organizations is commonly known as a Type I Supporting Organization. A supporting organization supervised or controlled in connection with one or more publicly supported organizations is commonly known as a Type II organization. A supporting organization that is operated in connection with one or more publicly supported organizations is commonly known as a Type III supporting organization.

.02 Donor Advised Funds Under the PPA

Definition of a Donor Advised Fund

Under new section 4966(d)(2), a donor advised fund is defined 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 donor advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of the funds.

A sponsoring organization is defined under new section 4966(d)(1) as a section 170(c) organization that is not a governmental organization (referenced in section 170(c)(1) and (2)(A)) or a private foundation and maintains one or more donor advised funds.

Pursuant to new section 4966(d)(2)(B), the term donor advised fund does not include a fund or account: (1) that makes distributions only to a single identified organization or governmental entity or (2) with respect to which a donor advises a sponsoring organization regarding grants for travel, study or similar purposes if:

(a) the donor's (or the donor advisor's) advisory privileges are performed in his capacity as a member of a committee whose members are appointed by the sponsoring organization,

(b) no combination of donors or donor advisors on the committee approving grants directly or indirectly control the committee, and

(c) all grants are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the sponsoring organization's board of directors.

Thus, a sponsoring organization that owns and controls a fund that meets these criteria may award a scholarship from the fund to a natural person without subjecting the sponsoring organization or its managers to excise taxes under new section 4966.

Taxable Distribution

New section 4966 imposes an excise tax on a sponsoring organization for each taxable distribution it makes from a donor advised fund. It also imposes an excise tax on the agreement of any fund manager of the sponsoring organization to the making of a distribution, knowing that it is a taxable distribution. The tax on taxable distributions applies to distributions occurring in taxable years beginning after August 17, 2006.

In general, under new section 4966(c), a taxable distribution is any distribution from a donor advised fund to any natural person or to any other person if (i) the distribution is for any purpose other than one specified in section 170(c)(2)(B), or (ii) the sponsoring organization maintaining the donor advised fund does not exercise expenditure responsibility with respect to such distribution in accordance with section 4945(h).

Under new section 4966(c)(2), a taxable distribution does not include a distribution from a donor advised fund to: (1) any organization described in section 170(b)(1)(A) (other than a disqualified supporting organization), (2) the sponsoring organization of such donor advised fund, or (3) any other donor advised fund.

Under new section 4966(c)(4), a disqualified supporting organization includes a Type III supporting organization that is not functionally integrated and any Type I, Type II, or functionally integrated Type III supporting organization where the

donor, or an advisor on behalf of the donor (or any related party) directly or indirectly controls a supported organization that the supporting organization supports.

Prohibited Benefit

New section 4967 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, a more than incidental benefit. The excise tax is imposed on the person who advises as to the distribution or who receives the benefit. A separate excise tax may be imposed on a fund manager who agreed to the making of the distribution. The new excise tax under section 4967 applies to taxable years beginning after August 17, 2006.

Secretarial Authority

New section 4966(d)(2)(C) grants the Secretary authority 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 any person appointed or designated by the donor for the purpose of advising with respect to distributions from the fund, or (2) such fund or account benefits a single identified charitable purpose.

.03 Supporting Organizations Under the PPA

Supporting Organization Definition

The PPA incorporates the previously informal nomenclature used to distinguish among types of supporting organizations into the statute. Thus, new section 4943(f)(5)(A) defines a Type III supporting organization as a supporting organization that is operated in connection with a section 509(a)(1) or (2) organization (i.e., a publicly supported organization).

New section 4943(f)(5)(B) defines a functionally integrated Type III supporting organization as one which is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.

New section 509(f)(2), which is effective after August 17, 2006, prohibits certain supporting organizations from accepting gifts or contributions from certain persons associated with the supported organization of such organization. This provision provides that any organization that would otherwise meet the requirements of a Type I or Type III supporting organization will be excluded under this provision if it accepts any gift or contribution from a person who

directly or indirectly controls (either alone or together with related persons) a supported organization of such supporting organization or from a family member or 35% controlled entity of such person.

New Rules Regarding Section 4958 Excess Benefit Transactions and Supporting Organizations

Section 4958 imposes an excise tax on certain persons if they engage in one or more excess benefit transactions. New section 4958(c)(3) 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, and any loan from a supporting organization to a disqualified person, is treated as an excess benefit transaction, meaning that the payee is subject to excise tax. Furthermore, the entire amount of the payment to a substantial contributor (or to related persons) would be an excess benefit subject to an excise tax under section 4958. This excise tax applies to transactions occurring after July 25, 2006.

Under new section 4958(c)(3)(C), a substantial contributor includes any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the organization, if such amount is more than 2 percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received.

.04 New Restrictions on Grants Made by Private Foundations to Supporting Organizations

The PPA amended section 4942(g) to deny qualifying distribution treatment to grants by non-operating private foundations to (1) Type III supporting organizations that are not functionally integrated and (2) to Type I, Type II, and functionally integrated Type III supporting organizations if a disqualified person of the private foundation directly or indirectly controls such supporting organization or a supported organization that the supporting organization supports. The PPA also amended Section 4945(d)(4)(A) to treat grants to the above entities by a private foundation as taxable expenditures unless the private foundation exercises expenditure responsibility with respect to the grants.

Section 3. PRIVATE FOUNDATION RELIANCE STANDARDS FOR GRANTS TO CERTAIN SUPPORTING ORGANIZATIONS

.01 Treatment of Grants from Private Foundations to Supporting Organizations

As stated in Section 2.04, the enactment of the PPA imposes certain limitations if a private foundation makes a grant 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 such supporting organization or one of its

supported organizations. Specifically, for non-operating foundations, the grant is not a qualifying distribution under section 4942. For all private foundations, the grant is a taxable expenditure under section 4945 if the private foundation does not exercise expenditure responsibility with respect to the grant.

Until further guidance is issued, for purposes of sections 4942 and 4945, a private foundation, acting in good faith, may rely on a written representation from the supporting organization and on supporting documents as described below as establishing that the supporting organization is a Type I, Type II, or functionally integrated Type III supporting organization.

- A. If the grantee provides a written representation signed by an officer, director or trustee of the grantee that it is a Type I or Type II supporting organization, that describes who selects its directors or trustees, and that references any provisions in governing documents that establish the Type I or II relationship, a private foundation, acting in good faith, may rely on the representation as establishing that the supporting organization is a Type I or II supporting organization, provided that the private foundation
 - (1) verifies that the grantee is listed in Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986*, or obtains a copy of the current IRS letter recognizing the grantee as exempt from federal income tax; and
 - (2) collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organization(s)) .

- B. If the grantee provides a written representation signed by an officer, director or trustee of the grantee that it is a functionally integrated Type III supporting organization, a private foundation, acting in good faith, may rely on the representation as establishing that the supporting organization is a functionally integrated Type III supporting organization provided that the private foundation
 - (1) verifies that the grantee is listed in Publication 78, *Cumulative List of Organizations described in Section 170(c) of the Internal Revenue Code of 1986* or obtains a copy of the current IRS letter recognizing the grantee as exempt from federal income tax;
 - (2) collects and reviews copies of governing documents of the grantee (and, if relevant, of the supported organizations) that confirm the structure necessary to be a Type III supporting organization or otherwise demonstrate the relationship of the grantee to its supported organizations;

- (3) obtains a further written representation from the grantee identifying the one or more supported organizations with which it is functionally integrated;
- (4) collects a written representation from each of the supported organizations with which it is functionally integrated describing the activities of the grantee and confirming, consistent with Section 3.02 of this notice, that but for the involvement of the grantee engaging in activities to perform the functions of, or to carry out the purposes of, the supported organization, the supported organization would normally be engaged in those activities itself; and
- (5) uses best efforts to confirm that the information collected in (2) through (4) above is consistent with the grantee's representation.

As an alternative to relying on a written representation from a grantee, a private foundation may rely on a well-reasoned opinion of counsel concluding that the grantee is a Type I, Type II, or functionally integrated Type III supporting organization. A private foundation may also rely on a well-reasoned opinion of grantee's counsel that the grantee is a Type I, Type II, or functionally integrated Type III supporting organization.

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 from the grantee in order to confirm that none of the supported organizations are controlled by disqualified persons of the private foundation. See Section 3.02, below, for the definition of control that may be used.

.02 Standards for Determining Control by a Disqualified Person and for Defining "Functionally Integrated Type III Supporting Organization"

The Service and the Treasury Department intend to issue regulations regarding the definition of "control" under section 4942(g)(4)(A) and the definition of a "functionally integrated Type III supporting organization" under section 4943(f)(5) (B). Until those regulations are issued, a private foundation may rely on the definitions provided below for purposes of sections 4942 and 4945. Although regulations may adopt different definitions from those referenced below, those regulations will apply to grants made by private foundations no sooner than the date that the regulations are proposed. The definitions set forth below will apply with respect to any grants made prior to that date.

For purposes of the private foundation reliance standards set forth in Section 3.01 of this notice, a supporting organization and a supported organization will be considered controlled by a disqualified person or persons with respect to the private foundation if any of such persons may, by aggregating their vote or

positions of authority, require the grantee to make an expenditure, or prevent the grantee from making an expenditure, regardless of the method by which the control is exercised or exercisable. See Treas Reg. section 53.4942(a)-3(a)(3).

Also, solely for purposes of a representation or opinion of counsel on which a private foundation may rely, an organization will be considered a functionally integrated Type III supporting organization if it would meet the test set forth in Treas. Reg. section 1.509(a)-4(i)(3)(ii).

Section 4. APPLICABILITY DATE FOR EXCESS BENEFIT TRANSACTIONS BY SUPPORTING ORGANIZATIONS

As stated in Section 2.03, under section 4958(c), as amended by the PPA, any grant, loan, compensation, or other similar payment by a supporting organization to a substantial contributor or a person related to a substantial contributor, and any loan provided by a supporting organization to a disqualified person (as described in section 4958(f)), is treated automatically as an excess benefit transaction, with the entire amount paid to any substantial contributor 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.

Treasury and the IRS understand that before the PPA was enacted on August 17, 2006, a supporting organization may have entered into a binding contract or other legal obligation to pay substantial contributors, or persons related to substantial contributors, for goods or services, or to provide a loan to a disqualified person. At the time the supporting organization entered into these contracts or other legal obligations, the payments required under them were not automatically considered excess benefit transactions.

To address the change to the law under the PPA, the IRS will not consider any payment made pursuant to a written contract that was binding on August 17, 2006 as an excess benefit transaction under new section 4958(c)(3), as long as (1) such contract was binding at all times after August 17, 2006 and before payment is made, (2) the contract is not modified during such period, and (3) the payment under the contract is completed on or before August 17, 2007.

Similarly, the legal obligation of a supporting organization to pay for goods or services delivered or performed by substantial contributors or persons related to substantial contributors during the current calendar year of 2006 may not have been set forth in a binding written contract in effect on August 17, 2006, but nonetheless commitments pertaining to 2006 may have been made pursuant to a legally enforceable nonwritten agreement in existence on such date. The IRS will not consider any payment made pursuant to such an agreement in order to satisfy an obligation for services performed or goods delivered on or before December 31, 2006, as an excess benefit transaction under new section 4958(c)(3), provided that such payment is made on or before August 17, 2007.

The applicability dates set forth in this section affect only liability for excise taxes under new section 4958(c)(3). Notwithstanding any relief provided in this section, if the supporting organization pays in excess of reasonable compensation for services or in excess of fair market value for goods, it jeopardizes continued tax exemption under section 501(c)(3), and the individuals receiving the payments may be subject to excise taxes under section 4958.

Section 5. DONOR ADVISED FUNDS

New section 4966(c)(1)(A) will impose an excise tax on all distributions to natural persons from donor advised funds effective for taxable years beginning after August 17, 2006. However, pursuant to the authority described in Section 2.02 above, certain funds or accounts are excepted from the definition of donor advised fund.

.01 Employer-Sponsored Disaster Relief Assistance Programs

The definition of donor advised fund in section 4966(d)(2)(A) encompasses all funds and accounts owned or controlled by a sponsoring organization separately identified with reference to the contribution of a donor or donors for which the donor, or anyone appointed by the donor, has or reasonably expects to have, advisory privileges. Section 4966(d)(2)(C) grants the Secretary the authority to exempt a fund or account (a "fund") from the definition of donor advised fund.

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 sponsoring organization may receive contributions to these funds from both the employer and its employees. If these employer-sponsored disaster relief funds are within the definition of donor advised funds, any distribution from these funds to employees or their family members would be subject to excise tax under new section 4966.

Pursuant to the authority under 4966(d)(2)(C), the IRS and Department of Treasury exclude from the definition of donor advised fund any employer-sponsored disaster relief fund that meets the following requirements:

- a. the fund serves a single identified charitable purpose, which is to provide relief from a qualified disaster within the meaning of section 139(c)(1), (2), or (3)¹;

¹ Under sections 139(c)(1), (2) and (3), a qualified disaster means a disaster that results from a terroristic or military action (as defined in section 692(c)(2)), a Presidentially declared disaster (as defined in section 1033(h)(3)), and a disaster that results from an accident involving a common carrier or from any other event which the Secretary determines to be of a catastrophic nature.

- b. the fund serves a large or indefinite class (a “charitable class”);
- c. recipients of grants from the fund are selected based on objective determinations of need;
- d. the selection of recipients of grants from the fund is made using either an independent selection committee or adequate substitute procedures to ensure that any benefit to the employer is incidental and tenuous. The selection committee is independent if a majority of the members of the committee consists of persons who are not in a position to exercise substantial influence over the affairs of the employer;
- e. no payment is made from the fund to or for the benefit of
 - (i) any director, officer, or trustee of the sponsoring organization of the fund, or
 - (ii) members of the fund’s selection committee; and
- f. the fund maintains adequate records that demonstrate the recipients’ needs for the disaster relief assistance provided.

Satisfaction of the requirements of this presumption does not affect the determination of whether any payments made from the fund might result in taxable compensation to the employees.

.02 Applicability Date for Educational Grants

As provided in Section 2.02 above, under new section 4966, distributions to natural persons from a donor advised fund may be subject to an excise tax. The PPA provides that section 4966 applies to distributions made in taxable years beginning after August 17, 2006. The excise tax applies irrespective of whether the grant is excludable from the recipient’s income under section 117.

The IRS and Department of Treasury understand that certain scholarships and fellowship grants may have been committed to an individual on or before the date of enactment, the payments of which extend beyond August 17, 2006. Pursuant to this notice, section 4966(c)(1)(A) shall not apply to an educational grant made after August 17, 2006, if the educational grant is made pursuant to a commitment entered into on or before August 17, 2006. A commitment will be considered entered into on or before August 17, 2006, if:

- a. the educational grant was awarded on an objective and nondiscriminatory basis and is reasonable in amount in light of the purposes of the educational grant;
- b. the educational grant was not awarded to, nor are payments made pursuant to that award, to a donor, donor advisor, or any party related to a donor or donor advisor;
- c. prior to August 17, 2006: (1) (a) the name of the educational grant recipient, the nature of the educational grant, the amount of the educational grant, the date on which it was awarded, and the educational grant period, were entered on the records of the sponsoring organization

- or were otherwise adequately evidenced, or (b) notice of the payments to be received was communicated to the payee in writing, and (2) the sponsoring organization keeps a record of such information or notice for a period that ends no earlier than three years after the close of the taxable year in which the last payment is made under the grant; and,
- d. there is no material change in the amount or in the conditions of the educational grant, such as a required reapplication for the grant.

Notwithstanding the above, section 4967 may apply to any grant that otherwise fits within the criteria specified. Thus, 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 donor, donor advisor or related person will be subject to excise tax.

Section 6. REQUEST FOR COMMENTS

The IRS and the Department of Treasury request comments regarding this notice and suggestions for future guidance with respect to changes in requirements for donor advised funds and supporting organizations under the PPA

Comments should refer to Notice 2006-____ and be submitted by February 1, 2007, to: CC:PA:LPD:PR (Notice 2006-____), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4:30 p.m. to: _____.

Alternatively, taxpayers may submit comments electronically to _____. Please include "Notice 2006-____" in the subject line of any electronic communications. All comments will be available for public inspection and copying.

Section 7. PAPERWORK REDUCTION ACT

The collection of information contained in this notice has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-____. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The requirements to collect information are in Sections 3 and 5 of this notice. Collecting the required information provides private foundations and sponsoring organizations of donor advised funds with relief from excise taxes imposed by sections 4942, 4945 and 4966 of the Code

The estimated total annual reporting and/or recordkeeping burden is 612,294 hours.

The estimated annual burden per respondent/recordkeeper varies from 7 hours, 53 minutes to 9 hours, 48 minutes, depending on individual circumstances, with an estimated average of 8½ hours. The estimated total number of respondents and/or recordkeepers is 65,000.

The estimated frequency of collection of such information is occasional.

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 tax return information are confidential, as required by 26 U.S.C. § 6103.

Section 8. DRAFTING INFORMATION

The principal authors of this notice are Mary Jo Salins and Robert Fontenrose of the Exempt Organizations, Tax Exempt and Government Entities Division. For further information regarding this notice, contact Ms. Salins at (202) 283-9453, or Mr. Fontenrose at (202) 283-9484 (not a toll-free call).