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October 31, 2007

Ms. Linda E. Stiff
Acting Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20044

Re: Payout Requirements for Type III Supporting Organizations That Are Not Functionally Integrated; REG-155929-06; 72 Federal Register 42335 (August 2, 2007).

Dear Ms. Stiff:

The American Bankers Association (ABA) appreciates the opportunity to comment on the Internal Revenue Service's (IRS) proposed payout requirements for Type III supporting organizations that are not functionally integrated. The ABA, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

Many ABA members provide fiduciary and related services to individual and institutional clients. As of year-end 2006, approximately 1800 banks held more than $19 trillion in fiduciary assets for both retail and institutional customers in 19 million accounts.[1] In their fiduciary capacity, these banks provide a number of services to customers such as Type III supporting organizations (Type III SO), including trust administration, investment management, custody of assets, tax preparation and accounting. While acting as a fiduciary or trustee, banks must follow strict duties of loyalty, prudence, and care to the trust and its beneficiaries and are subject to liability for failure to comply with their fiduciary responsibilities.

Background On Type III Supporting Organizations

As defined under the Internal Revenue Code (IRC), a supporting organization is a public charity organized and operated for the benefit of one or more publicly supported organizations. The IRC divides these supporting organizations into three types: Type I, Type II, and Type III. Type III SOs are "operated in connection with" and not supervised or controlled by the charities they support. Type III SOs:

[1] FDIC Call Report Data, December 2006. As used in this letter, the term "bank" includes banks, savings associations, trust companies, and savings banks that act in fiduciary and related capacities.

- must be organized and operated exclusively for the benefit of or perform duties for one or more publicly supported organizations;
- must be operated, supervised, or controlled "in connection with" one or more publicly supported organizations;
- may not be controlled by a disqualified person, such as a substantial donor and his or her family members; and
- must meet the "integral part" test by being involved in the charities' operations to the extent that the charities are dependent on the supporting organization.

The Pension Protection Act of 2006 (Act or PPA) imposed a number of new conditions on Type III SOs: excise taxes on certain payments; limitations on transactions between a supported organization and certain donors; a grant of regulatory authority to adopt a new payout requirement; limits on the permitted business holdings of certain supporting organizations; and new organizational, reporting and operational requirements, including a revised "responsiveness" test to show the supporting organization is operating "in connection with" the supported organizations.

Even before the Act, Type III SOs and their trustees were subject to many levels of reporting and oversight. An extensive and longstanding body of trust law imposes strict fiduciary responsibility on trustees with respect to management, investments and distributions of these and other trusts. Furthermore, when banks serve as trustee,[2] state and federal regulatory agencies – the Federal Reserve Board, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, as well as the state banking commissioners– regularly examine the banks to ensure compliance with fiduciary standards and banking regulations. These examinations occur every 12-18 months or more often if deemed necessary. When examining a bank, the examiners look for compliance with banking laws and manuals, fiduciary standards and principles, and any other guidance, including compliance with tax laws.

RESPONSIVENESS TEST IGNORES FIDUCIARY DUTIES OF INSTITUTIONAL TRUSTEES

Before the PPA was enacted, a Type III SO could satisfy the "responsiveness" test in one of two ways. Under the first test, the supporting organization had to meet extensive governance requirements of IRS Regulation 1.509(a)-4(i)(2)(ii).[3] Under the second test in 1.509(a)-4(i)(2)(iii), Type III SOs

[2] To serve as trustee, banks must be chartered under state trust law or authorized to exercise trust powers under section 92(a) of the National Banking Act.

[3] 26 CFR 1.509(a)-4(i)(2)(ii) requires that: (1) (a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers, directors, or trustees of the publicly supported organizations; and (2) by reason of such a relationship, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.

could meet the "responsiveness" test if: (1) it is organized as a charitable trust under state law; (2) each specified supported organization is a named beneficiary under the trust's governing instrument; and (3) the beneficiary organization has the power to enforce the trust and compel an accounting under state law.

Section 1241(c) of the PPA essentially eliminated the second test for Type III SOs that are organized as charitable trusts. Thus, under requirements of the first test, 1.509(a)-4(i)(2)(ii), Type III SOs organized as charitable trusts must now show that their beneficiaries have a "significant voice" in the operation of the trust. Unfortunately, this requirement is incompatible with fiduciary principles inherent in the trustee-beneficiary structure established by the grantor and ignores the fiduciary liability imposed on trustees. The trustee is responsible for investing the trust's assets, which carries with it all of the liability for those investments. The beneficiaries of the trust, which, under the new requirements, may affect the investment decisions, are *not* subject to such liability.

In a report to Congress, the Panel on the Nonprofit Sector acknowledged this special concern for charitable trust Type III SOs.[4] In footnote 4 on page 46, the report specifically recommends that if the above-mentioned regulation were applied to Type III SO trusts, the standard "may need to be modified to accommodate Type III supporting organizations formed as trusts, *particularly for organizations that have institutional trustees*."[5] [Emphasis added].

The new requirements for Type III SOs were prompted by abuses often involving individual donors. In some cases, donors had created Type III SOs, but either failed to notify the supported organizations that they were beneficiaries or used the entity's assets for the benefit of the donor and the donor's family. With a bank serving as corporate trustee to a Type III SO, these risks of abuse are significantly minimized. As already mentioned, banks are subject to extensive fiduciary and regulatory requirements and are thoroughly examined by federal and state regulators every 12 to 18 months. While examining the bank's trust department, the examiners look closely for compliance with fiduciary standards and principles, as well as compliance with applicable tax laws. Either examiners or regularly conducted internal audits of the trust department would very likely catch any such abuse. Therefore, to the extent possible, ABA strongly urges the IRS to exempt existing Type III SO with institutional trustees from the new responsiveness test.

If the IRS does not grandfather these existing Type III SOs with institutional trustees, many of them will be forced to convert the trust to a private foundation status to preserve their grantors' intent and to maintain the fiduciary framework established by the grantors. Most Type III SOs would prefer to remain in their current status and would only change if absolutely necessary. It seems only equitable to extend some relief to existing Type III SOs, because had the grantors wished to

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[4] Panel on the Nonprofit Sector, Strengthening Transparency Governance Accountability of Charitable Organizations: A Final Report to Congress and the Nonprofit Sector 45-46 (June 2005), http://www.nonprofitpanel.org/final/Panel_Final_Report.pdf.

[5] *Id.*

provide the named beneficiaries with investment and other responsibilities related to the trust assets, the grantors could have done so with a specific bequest.

PAYOUT RULES MAY POSE INVESTMENT AND FIDUCIARY CONCERNS

Under the proposed regulation, Type III SOs that are not functionally integrated must meet a new payout requirement and must limit the number of organizations they support.[6] In particular, these Type III supporting organizations must distribute annually at least five percent of the aggregate fair market value of their assets to or for the use of their supported entities. In addition, any newly created non-functionally integrated Type III SO must limit its support to no more than five publicly supported organizations. A Type III SO in existence before the final regulation may support more than five entities as long as it distributes 85 percent of its payout to entities to which the Type III SO is "responsive."

The new payout requirement may pose significant problems for Type III SOs that do not meet the functionally-integrated test. Not only is the five percent distribution requirement too high, but also it is insensitive to the vastly different needs of the many affected Type III SOs and their supported organizations. To avoid depleting its assets over the years, the Type III SO must earn an investment return significantly greater than five percent to compensate for administration of the entity, trustee fees, and the toll of inflation. Such a high distribution requirement leaves little room for financial and economic fluctuations or for more conservative investment policies of certain Type III SOs. In fact, a 2000 study found that a five percent payout is "perhaps slightly too high to maintain purchasing power in perpetuity. Payout rates in excess of five percent almost guarantee the depletion of the real value of a foundation over the long term, resulting in it being unable to maintain its spending, in constant dollar terms, without liquidating."[7]

A more suitable payout requirement would allow for the distribution of either 85 percent of the net income of the Type III SO <u>or</u> some amount less than five percent of its total assets. These alternatives give the Type III SO appropriate flexibility to make varying distributions depending on the yearly needs of the supported entities. Thus, for example, a Type III supporting organization could distribute less for several years when the needs are not as great, and make a larger distribution later when it is needed.

Lastly, a mandatory payout of any amount may violate the constraints or requirements of the governing trust instruments of Type III SOs that are organized as charitable trusts. A bank acting as trustee to numerous Type III charitable trusts would need significant time to seek court modification of these trust instruments if

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[6] Under the proposal, a functionally integrated Type III SO must meet three tests: (1) the "but for" test in 26 CFR 1.509(a)-4(i)(3)(ii); (2) an expenditure test consistent with 26 USC §4942(j)(3)(A); <u>and</u> (3) an assets test consistent with 26 USC §4942(j)(3)(B)(i). Most Type III SOs set up as charitable trusts will not be able to meet this proposed test and thus will be considered non-functionally integrated.

[7] Council of Michigan Foundations, Sustainable Payout for Foundations 2 (April 2000), http://www.cmif.org/documents/payout.pdf.

they are unable to modify the trust themselves under state law. Without this modification, the trustee would be subject to fiduciary liability for not fulfilling the terms of the instrument. Given this significant concern, we strongly recommend that the final rule give at least a two year transition period for trustees to make the appropriate changes and come into compliance.

NEED FOR TRANSITIONAL RULES

We support the release's statement that the proposed rules would not become effective until taxable years beginning *after* the final rules are published in the Federal Register. Nonetheless, we urge the IRS to create transitional rules to address the effective date laid out in Section 1241(c) in the Pension Protection Act. In that section, it is unclear whether the requirements for charitable trusts apply to taxable years "starting" after August 17, 2007, or "ending" after that date. Many people interpret the provision to mean tax returns for years "ending" after the date. However, under that interpretation, a Type III SO that had to convert to a private foundation due to the Act may need to file two different tax returns in the same fiscal year unless the IRS provides transitional rules. For instance, in 2007, a calendar-year foundation may need to file a Form 990 up to August 17, 2007, (when it was a Type III SO) and Form 990-PF for the period between Aug 18, 2007, and December 31, 2007 (when it was a private foundation). Trustees for these entities would appreciate the IRS proposing transition rules, such as allowing the entity to file as a private foundation for the entire year, when making any clarification.

Similarly, we would appreciate transitional rules or guidance on how to treat charitable foundations, created before 1969, that were exempt from filing Form 1023. Currently, trustees look at this form to determine how the Type III SO satisfied the "in connection with" test. Given this exemption from Form 1023, our members need to know whether these pre-1969 charitable foundations are grandfathered from the provisions of the PPA. If they are not grandfathered, we would appreciate further guidance or transitional rules from the IRS on how to treat these entities.

In conclusion, ABA appreciates the opportunity to offer our comments on the Type III SOs proposal. Should you have any questions or comments with respect to the issues raised in this letter, please do not hesitate to call the undersigned at (202) 663-5053.

Sincerely,

Phoebe A. Papageorgiou