

# Public Charities and Private Foundations

AAA-CPA

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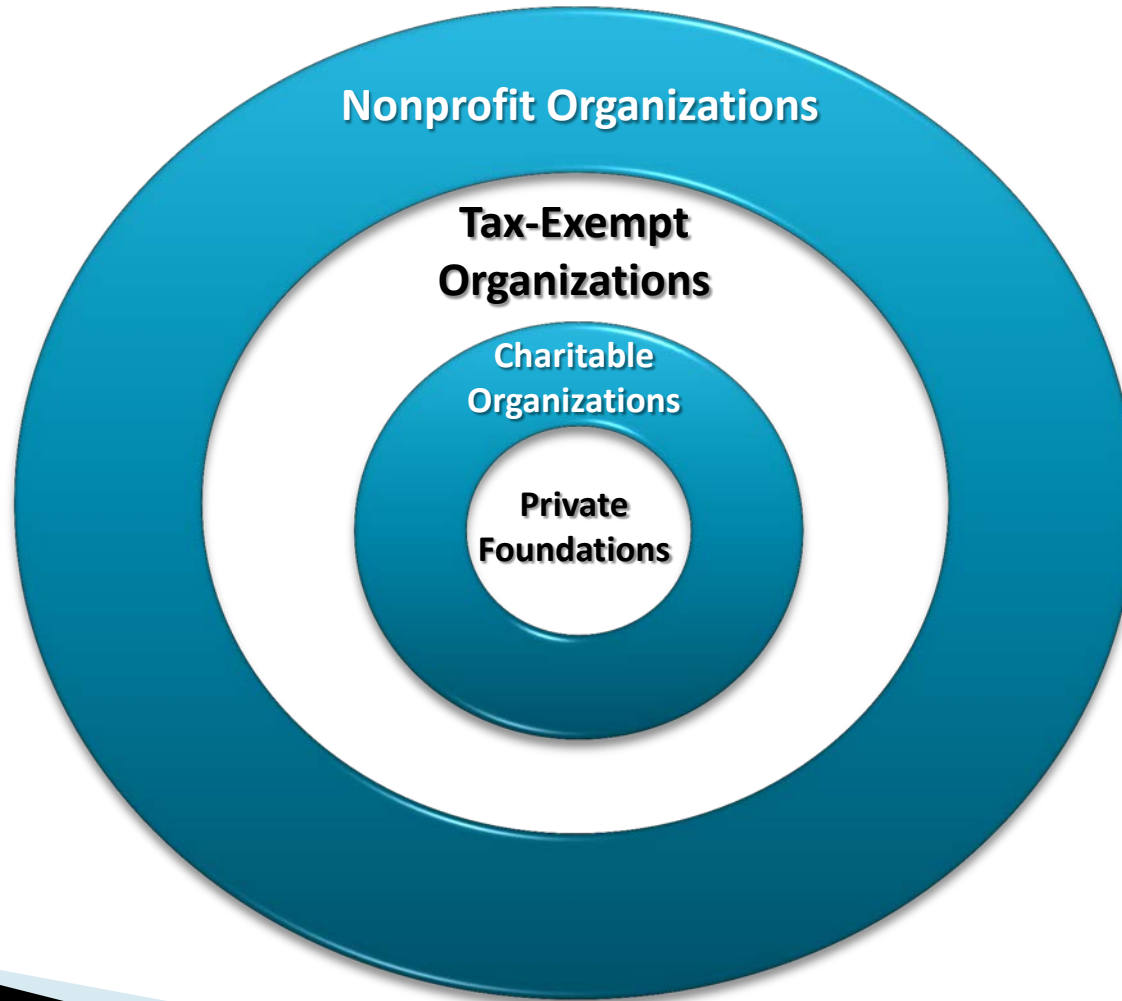
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# Classification of Charitable Organizations

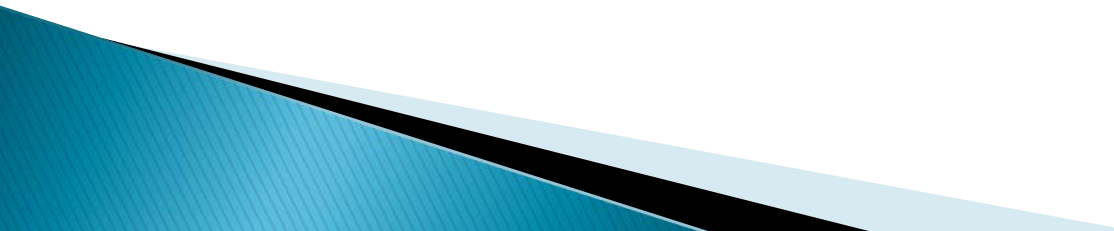


# Private Foundation

- ▶ Per § 509(a): Organization described in § 501(c)(3) other than the following:
  - Traditional public charities
  - Publicly supported charities
  - Supporting organizations
  - Public safety testing organizations

(i.e. § 501(c)(3) is a private foundation if it fails to qualify as a public charity)

# Private Nonoperating Foundation

- Most common
  - Generally receives its funding from one primary source, such as an individual, a family or a corporation
  - Does not generally actively raise funds or seek grants
  - Required to distribute approximately 5% of its assets annually to public charities
  - Donors' charitable income tax deductions are more limited than when made to a public charity.
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# Tax Treatment for Donors

- ▶ Gifts of Cash and Nonappreciated Property
  - Limited to 30% of AGI
    - 50% if to public charity or private operating foundation
- ▶ Gifts of Appreciated Property
  - Limited to 20% of AGI
    - If gift of qualified stock, donor can write off fair market value
    - If not qualified stock, donor must write off basis
  - 30% if to public charity or private operating foundation

# Tax on Net Investment Income – IRC §4940

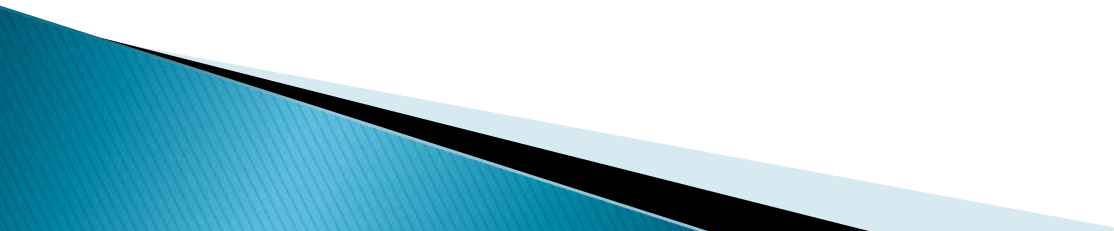
- ▶ “Audit Tax” – originally intended to fund exams of PF’s (within 4940s but not as “prohibited transaction” tax that can be avoided
- ▶ Tax-exempt foundations
  - Tax is 2% of *Net Investment Income*
  - Rate *reduced to 1%* in certain circumstances

# Self-Dealing

Self dealing – certain actions between a private foundation and a disqualified person – can be *direct* or *indirect*, and includes:

- Sale or exchange or leasing of property
- Lending of money or extension of credit
- Furnishing of goods/services/facilities (limited exception)
- Payment of compensation (limited exception)
- See 4941 for comprehensive list

# Self-Dealing (Disqualified Persons)

1. **Foundation Managers** (officers, directors, trustees)
  2. **Substantial contributors** (greater than 2% of total contributions since inception and more than \$5000)
  3. **20% Owners** (owner of 20%+ control of organization that is a substantial contributor)
  4. **Family Member** of (1), (2) or (3) (spouses, ancestors, children, grandchildren, great grandchildren)
  5. **35% owned entities** (organizations more than 35% controlled by any of the above)
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# Minimum Distribution Requirements

- ▶ Private Foundation must generally distribute at least 5% of its Asset Base on an annual basis in qualifying distributions
  - Asset Base includes those assets not used in furtherance of the foundation's exempt purposes, such as the foundation's office building
  - Generally includes cash, stocks, bonds and other investment assets
- ▶ Qualifying Distributions
  - Grants to qualified charitable organizations (other 501(c)(3) organizations)
  - Grants to non-charities for charitable purposes (requires expenditure responsibility)
    - Special rules for grants to individuals for travel, study, or similar
  - Costs of direct charitable activities

# Excess Business Holdings

- ▶ Foundations are limited in business ownership, and may only own
  - 20% of voting stock in a corporation, reduced by the percentage owned by all Disqualified Persons
  - 35% of voting interest (reduced by what Disqualified Person owns) if control is not in Disqualified Person
  - De minimis 2% voting stock or value
  - 5 years to dispose of Excess Business Holdings
  - May not dispose of interest to a Disqualified Person

# Jeopardizing Investments

- ▶ Private Foundation cannot make investments which would jeopardize the exempt purpose
  - No per se violations in code
  - “Prudent Investor” standard of care
  - Examples:
    - Margins, selling short
    - Speculative investments
  - Does not apply to gifts received by the Private Foundation

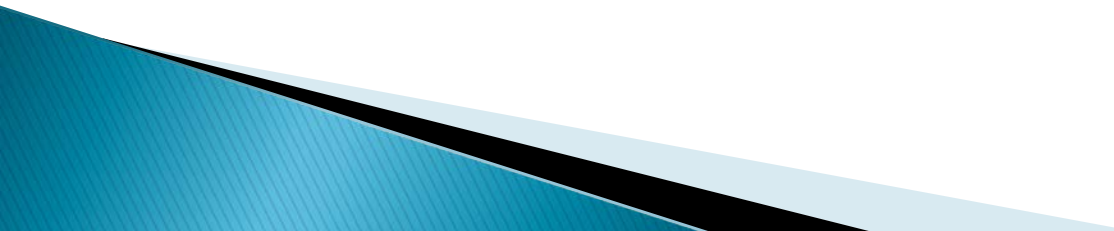
# Taxable Expenditures

- ▶ Expenditures not in furtherance of exempt purpose; Examples:
  - Carrying on propaganda or political activities
  - Distributions to non-charities, including grants to individuals
    - Unless distribution is in fact charitable, IRS approval in advance and Expenditure Responsibility is exercised

# Private Operating Foundations

- ▶ Directly carry on charitable activities, instead of making grants to other organizations
- ▶ Donors receive more liberal public charity deductibility limits
- ▶ Must meet the “income test” **AND** one of three **OTHER** tests
  - “assets test”
  - “endowment test”
  - “support test”
    - Computation Period: Based upon year in question and the three preceding years

# “Income Test”

- ▶ Must distribute Substantially All of the lesser of its Adjusted Net Income or its Minimum Investment Return directly for the active conduct of its exempt purpose
    - Does not include grants to other organizations
  - ▶ Substantially All – means 85% or more
  - ▶ Adjusted Net Income – gross income less deductions allowable to a corporation
    - Does not include gifts, grants or contributions
  - ▶ Minimum Investment Return – 5% of the assets not used directly in carrying out exempt purposes (same test as Minimum Distribution for a Private Foundation)
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# Assets/Endowment/ Support Tests

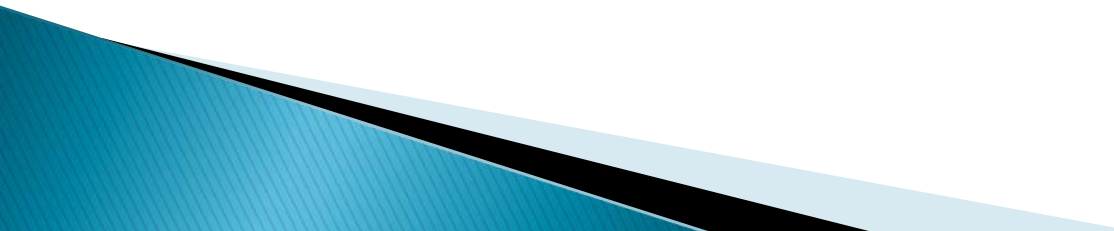
## ▶ Assets Test

- Substantially more than  $\frac{1}{2}$  of assets must be held for use for exempt function activities
  - Defined to be 65% or more

## ▶ Endowment Test

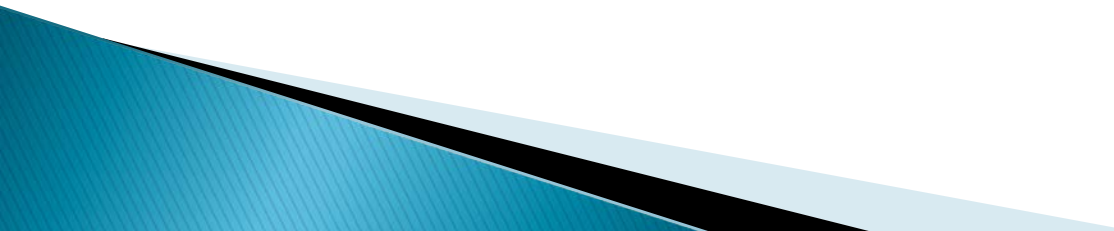
- Direct distributions of at least  $\frac{2}{3}$  of the Foundation's Minimum Investment Return, or  $3\frac{1}{3}\%$  of its endowment

# Support Test

- ▶ At least 85% of the organization's Support (excluding Gross Investment Income) must be from a combination of the general public and 5 or more exempt organizations and
  - ▶ Not more than 25% of Support (excluding Gross Investment Income) must be from any one exempt organization and
  - ▶ Not more than 50% of Support be from Gross Investment Income
  - ▶ Based upon year in question and three prior years (met on aggregate basis)
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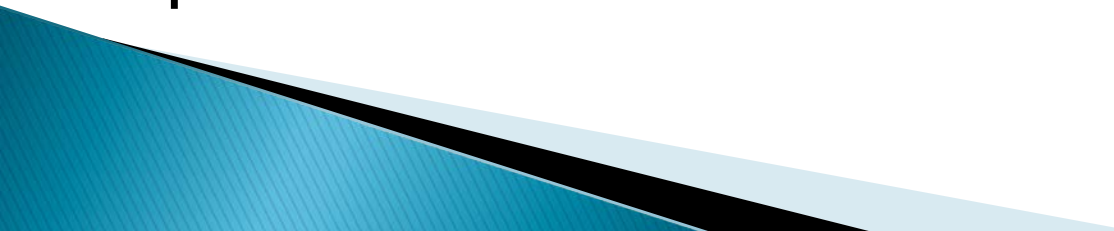
# Prohibited Transactions/Excise Taxes

- ▶ Not subject to the tax on undistributed income
  - ▶ Subject to prohibition/excise tax relating to:
    - Self-Dealing
    - Excess Business Holdings
    - Jeopardizing Investments
    - Taxable Expenditures
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# Types of Public Charities

- ▶ Institutional public charities – Section 509(a)(1); 170(b)(1)(A)(i)–(v)
  - By definition or activity (churches, schools, hospitals)
- ▶ Publicly supported charities
  - 509(a)(1); 170(b)(1)(A)(vi) “donative” public charities (e.g. United Way)
  - 509(a)(2) “gross receipts” or “service provider” public charities (e.g. museum, zoo, opera)
- ▶ Supporting Organizations – 509(a)(3)
- ▶ Public Safety Organizations

# “Traditional” Public Charities

- IRC 170(b)(1)(A) includes
    - Churches and conventions of churches
    - Educational organizations
    - Hospitals/medical research facilities
    - Endowment funds for state and municipal universities
    - Governmental Units
  - Specific and detailed regulations govern each type of IRC 509(a)(1) institutional public charity
  - No additional requirements to be classified as public charities
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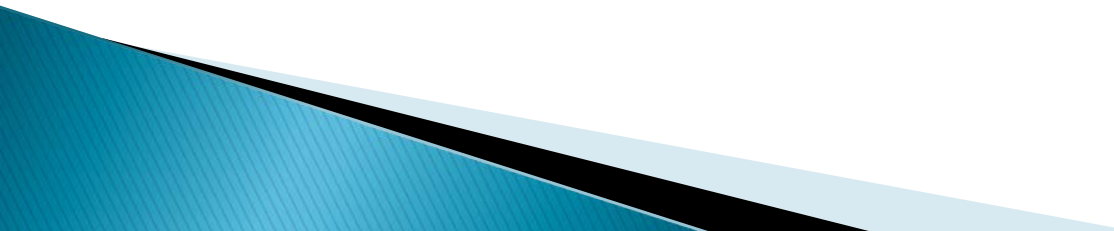
# “Donative” Public Charity

- ▶ Referenced in 509(a)(1) and 170(b)(1)(A)(vi)
- ▶ Does not provide services
- ▶ Must receive a substantial part of its support from the public or governmental units; two “either/or” tests
  - Mechanical Test: Must normally receive at least 1 / 3 of total support from governmental units or the general public
  - Facts and Circumstances Test
- ▶ Example: Humane Society, Union Gospel Mission, United Way

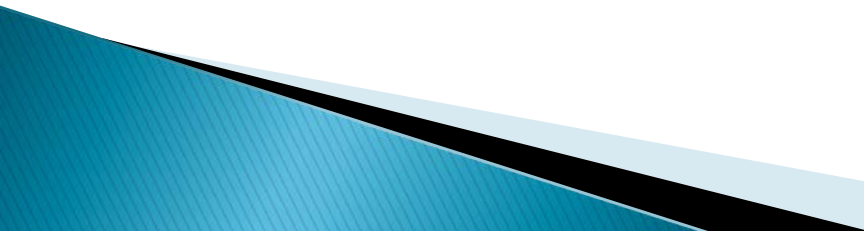
# Donative Publicly-Supported Charities

- ▶ Computation:  $\text{Public Support} / \text{Total Support}$
- ▶ Total Support:
  - Gifts, grants, and contributions
  - Certain membership fees
  - Net unrelated business income
  - Gross investment income (*excluding capital gains*)
  - *Excludes exempt function revenue*
- ▶ Public support is total support minus:
  - Net unrelated business income
  - Gross investment income (excluding capital gains)
  - *Contributions in excess of 2% of total support from one source*
- ▶ *Excludes unusual grants from both public support and total support*

# “Service Provider” Public Charity

- ▶ Described in 509(a)(2)
  - ▶ Generally has members
  - ▶ Provides services or has “gross receipts”
  - ▶ Must meet 2 public support tests (different tests from donative public charities)
  - ▶ Example: Museum of Science & History, Fort Worth Zoo
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# Support Test – 509(a)(2)

- ▶ “Gross receipts” or “service provider” public charity must meet the:
    - **“Not more than 1 / 3” support test** – not more than 1 / 3 of its total support from gross investment income and net unrelated business
    - **“More than 1 / 3” support test** – more than 1 / 3 of its total support from governmental units or general public
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# “More than 1 / 3” Support Test

- ▶ Must normally receive more than 1 / 3 of its support from the public
  - Numerator (Public Support)
    - Amounts from governmental units
    - ***Amounts from other than disqualified persons***
    - Amounts received from other public charities
    - Gross receipts:
      - Counted as Public Support only to the extent the amount received from each individual does not exceed \$5,000 or 1% of the Total Support for the ***year***
      - Gross receipts is exempt function revenue -- public support does not include UBTI



# “More than 1 / 3” Support Test

- ▶ Denominator (Total Support)
  - Includes everything BUT:
    - Unusual grants
    - Voluntary services
    - Capital gains
    - In other words, these items are excluded from the support fraction entirely
- ▶ Receipts from Disqualified Persons
  - *Not counted at all as Public Support, but included in Total Support*
  - DPs include Substantial Contributors
    - Any person who has contributed more than \$5,000 if this amount is more than 2% of all gifts received by the organization **since its creation** (and family members, etc. of the substantial contributor)

# Supporting Organizations

- ▶ Described in 509(a)(3)
  - Organized and operated at all times for the benefit of, and to perform the functions of, a specified IRC 509(a)(1) or (a)(2) charity;
  - Operated, supervised, or controlled by, or in connection with one or more IRC 509(a)(1) or (a)(2) charity; and
  - Cannot be controlled directly or indirectly by one or more disqualified persons other than foundation managers and other than one or more public charities).

# Organizational Test

- ▶ Organizational Documents Must
  - State that purposes of the organization are limited to the purposes or one or more benefited public charities
  - Not expressly empower the SO to engage in activities that do not further the charitable purposes of the benefited charity
  - Designate by class or purpose or by name the public charities to be benefited
    - On 990 SO must list all supported organizations, an indication of the Type of SO it is, and a statement that the SO is not controlled by donors or parties related to donors
  - Not authorize the SO to benefit any other public or private charity or charities

# Operational Test

- ▶ Must be “operated exclusively” for the support of the supported organizations
  - “Permissible beneficiary” requirement
    - Providing for the charitable class benefited by the specified public charity
  - “Permissible activity” requirement
    - Pay to the supported organization or use funds to carry on an independent activity that supports or benefits the supported organization

# Type I Supporting Organization

- ▶ Operated, supervised or controlled by one or more publicly supported organizations
- ▶ Parent/Subsidiary relationship
  - Control by publicly supported organization
  - Majority of officers, directors, trustees appointed by supported organization
  - Purposes similar to and no broader than that of supported organization
  - Specified organization requirement
    - Designate by name in governing documents
    - Designate by class in governing documents, or
    - Have historic and continuing relationship with supported organization and by virtue of this relationship have developed a substantial identity of interest between the organizations

# Type II Supporting Organization

- ▶ Supervised or controlled in connection with publicly supported charity
- ▶ Brother/Sister Relationship
  - Common supervision or control
    - Such that SO will be responsive to needs and requirements of supported organization
  - Mere making of payments not enough of a connection

# Type III Supporting Organization

- ▶ “Operated in Connection With” one or more publicly supported charities
  - Must specify supported public charity by name
  - Not permitted to substitute supported organizations, unless predicated on something out of organization’s control
  - May not support foreign organizations
  - Notification Test
  - Responsiveness Test
  - Integral Part Test
    - Functionally-related Type III supporting organization
    - Non functionally-related Type III supporting organization

# Responsiveness Test

## ▶ Must have:

1. “Appointee requirement”
  - One or more officers, directors or trustees appointed by supported organization
2. OR “common director requirement”
  - One or more common director/trustee/officer
3. OR “close and continuous requirement”
  - Close working relationship
4. AND “significant voice requirement”
  - By reason of 1, 2, or 3, the publicly supported organization has a significant voice in the investment policies of the SO, the timing of grants, etc., and directing the use of income or assets of the SO



# Integral Part Test

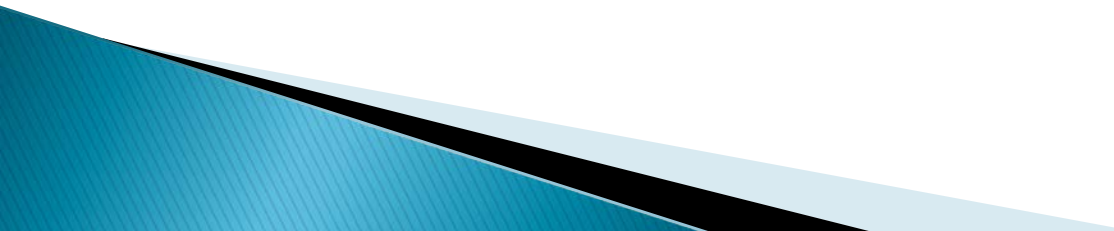
## Functionally Integrated

### ▶ “But For” Test

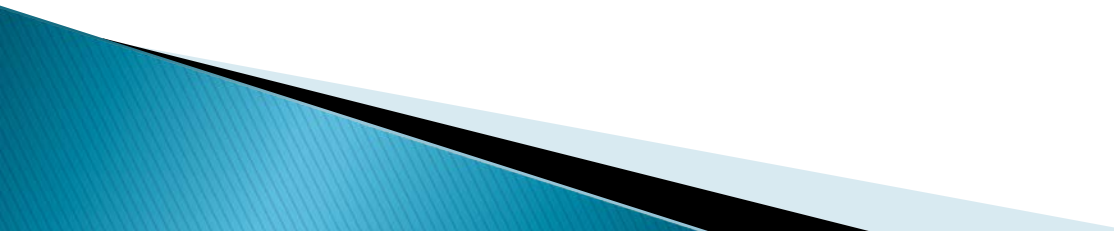
- Engage in activities that directly further the exempt purposes of the supported organization; “but for” the activities of the SO, the supported organization would carry on the activity itself
- Fundraising/investing, etc. insufficient
- Supporting organization is the parent of supported organization

# Integral Part Test

## Non-Functionally Integrated

- ▶ **Distribution Requirement**
  - ▶ **Attentiveness Requirement:** Distribute at least 1 / 3 to one or more supported organizations that are attentive to the supporting organization and to which the supporting organization is responsive
    - Attentive = receive sufficient part of total support from the supporting organization
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# Intermediate Sanctions

- ▶ Public charities are not subject to the private foundation excise taxes under IRC 4940–4945
  - ▶ Instead, subject to “intermediate sanctions,” the rules regarding excess benefit transactions set forth in IRC 4958 and Treas Regs 53.4958–1 through 53–4958–8
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# Excess Benefit Transactions

- ▶ Transactions between public charity and Disqualified Person must be at fair market value
  - Difference from DP for private foundation purposes
  - Defined as any person who is in a position to exercise substantial influence over the affairs of the charity at any time during a 5 year period ending on date of transaction
    - Similar family/business attribution rules to PF
- ▶ Any excess benefit is subject to an excise tax
- ▶ Presumptive safe harbor available

# Donor Advised Fund

Owned and controlled by a sponsoring organization

Tracked with reference to donor(s) or related persons

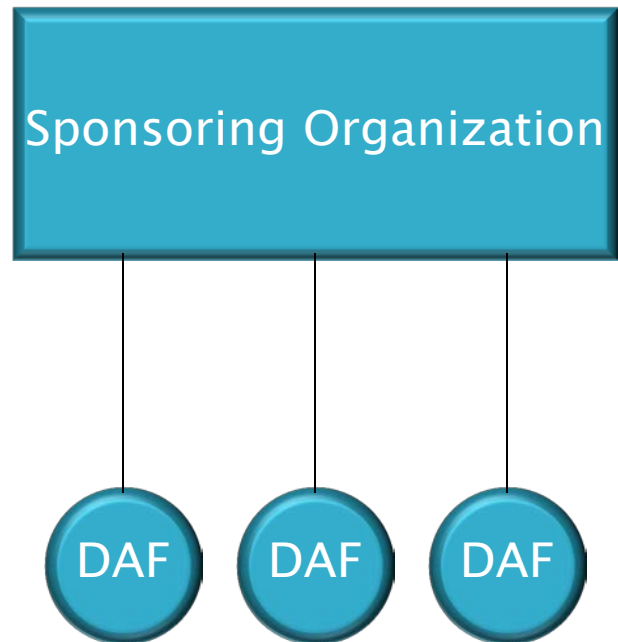
Donor, donor appointee or related party has advisory privileges concerning distributions or investments

Certain exceptions apply (distributions to single org/governmental entity; advised by majority disinterested committee chosen by sponsoring organization)

# Donor Advised Fund

## Special Rules:

- Donors, donor advisors and investment advisors of DAF are automatically DPs of sponsoring organization
- Section 4966 excise tax on distributions to individuals
- Prohibition on DAF making grants, loans, compensation or *similar payments* to donors, donor advisors or related persons
  - Entire prohibited payment is excess benefit transaction
- Section 4967 excise tax on more than incidental benefit to donor, donor advisor or related person



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