

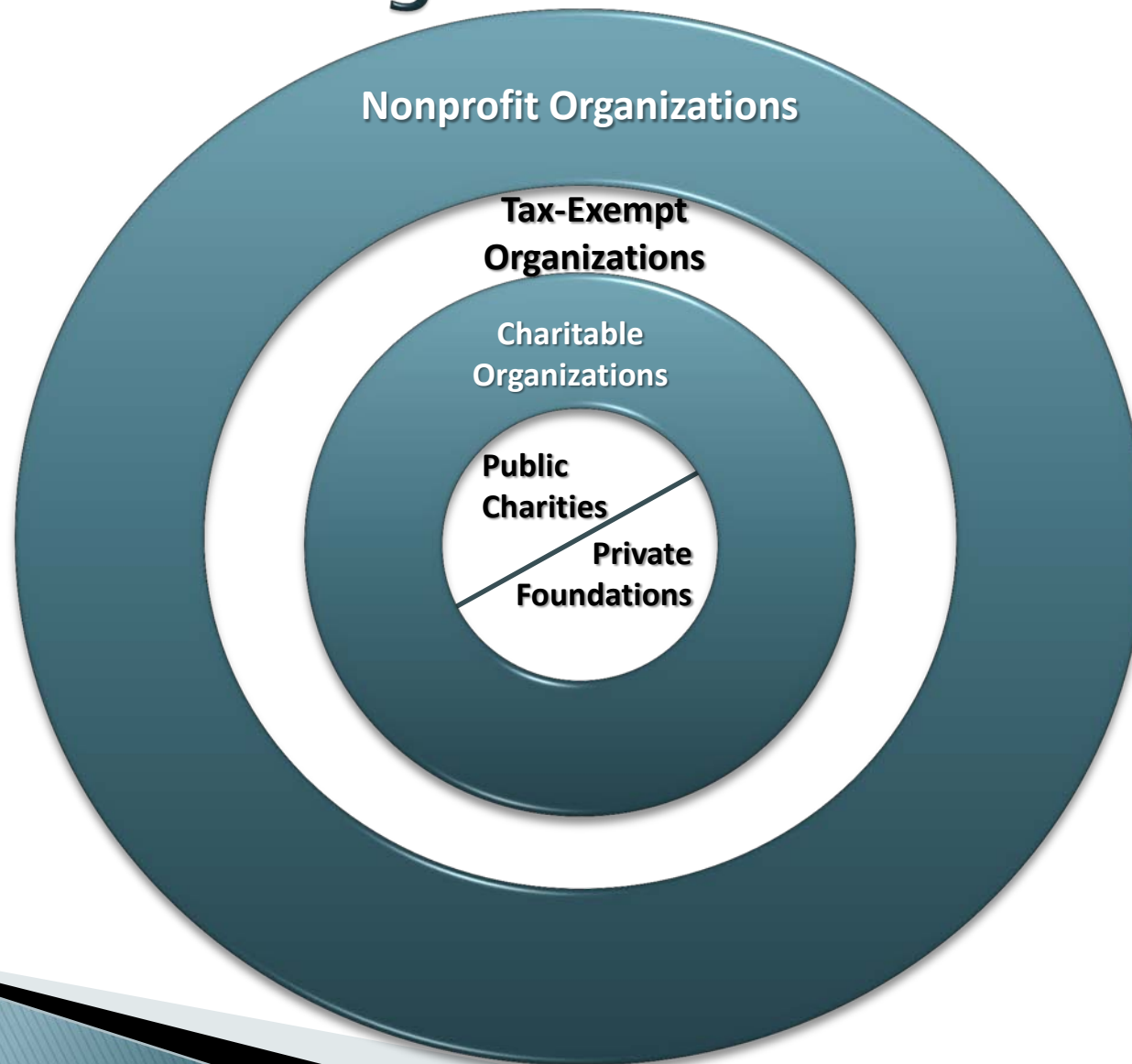
Care and Feeding of Private Foundations and Public Charities

2016 Estate Planning and
Community Property Law Journal CLE & Expo
March 4, 2016
Lubbock, Texas

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Classification of Charitable Organizations

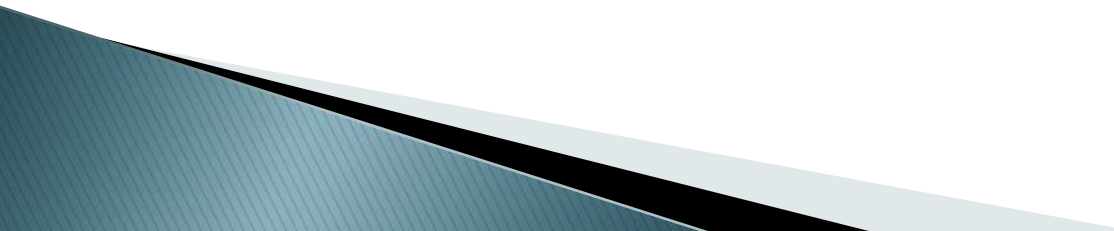


Private Foundation

- ▶ 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

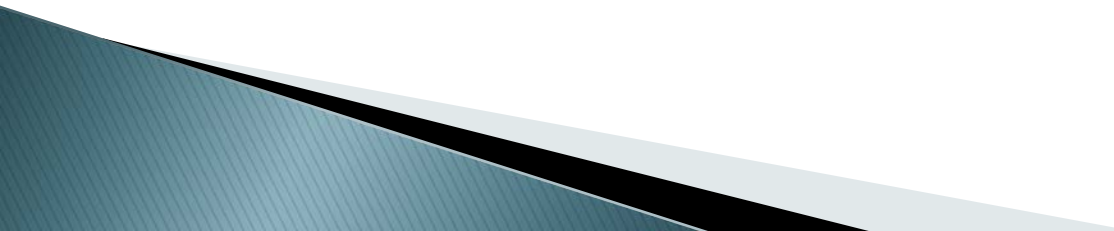
- ▶ Gifts of Cash and Nonappreciated Property
 - Limited to 30% of AGI
 - 50% if to public charity or private operating foundation

- ▶ 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
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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)

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
 - Carrying on propaganda or political activities
 - Distributions to non–public charities
 - Unless distribution is in fact charitable and expenditure responsibility is exercised
 - Grants to individuals
 - Unless IRS approval in advance or disaster relief, etc.

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)

Assets / Endowment / Support Tests

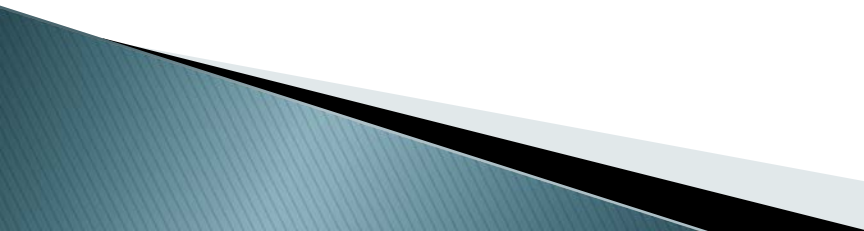
▶ Assets Test

- 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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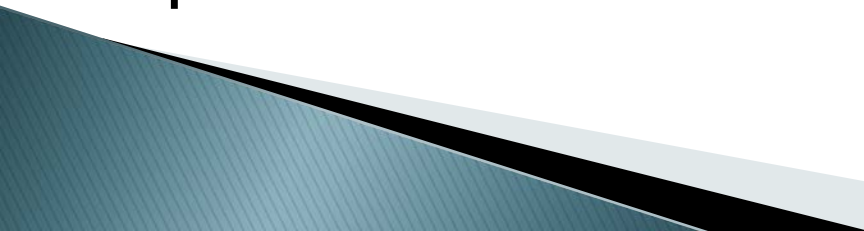
Prohibited Transactions/Excise Taxes

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

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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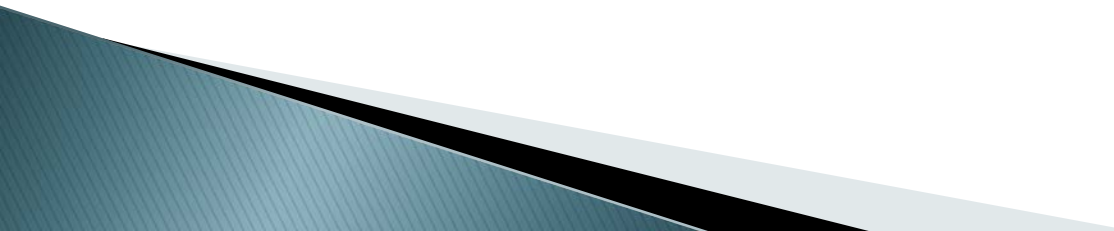
“Donative” Public Charity

- ▶ 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 income
 - **“More than 1 / 3” support test** – more than 1 / 3 of its total support from governmental units or general public support

“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
 - Historic and Continuing Relationship

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”
2. OR “common director requirement”
3. OR “close and continuous requirement”
4. AND “significant voice requirement”

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**
 - Greater of 85% of adjusted net income or 3.5% of FMV non-exempt use assets
- ▶ **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

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

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

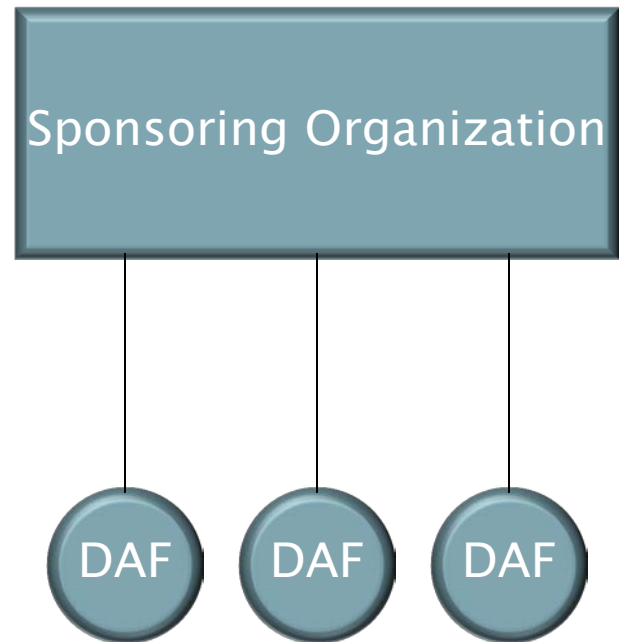
Donor, donor appointee or related party has advisory privileges concerning distributions or investments

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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