Understanding Foundations, DAFs and Other Forms of Philanthropy

27th Annual This Year in Nonprofit Law

November 30, 2017

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READY REFERENCE PAGE

NO. 92
FOR YOUR FILE

What Do We Mean When We Say "Nonprofit"?

Terminology obscures distinctions that are critical to understanding the rules that apply to organizations

We often start our lectures by quizzing the participants on their understanding of "nonprofits."

By show of hands, how many think the following organizations are nonprofits?

The Bill Gates Foundation; your church, synagogue, or mosque; the local United Way; the local community foundation; a major local university such as Harvard; a local social service organization; the Sierra Club; the local private golf club; the National Football league; the New York Stock Exchange.

A whole lot of people do not raise their hands very often. The hands particularly start to drop after the United Way or the community foundation. Yet all of these organizations are nonprofits except the New York Stock Exchange. And even the New York Stock Exchange was a nonprofit until 2006.

We all think we know what we mean when we say "nonprofit." But the key to understanding nonprofits is to understand that there are many different types of nonprofits. Different rules apply, depending upon the type of organization. An understanding of the difference is critical to understanding the world of nonprofit organizations.

Nonprofit

"Nonprofit" is a concept of state law, which means that an organization may not pay dividends or otherwise pass any surplus revenue, or "profits," from the enterprise on to shareholders, members, or other individuals. Although a nonprofit may pay reasonable compensation for services actually rendered to it, in general, any surplus generated by the organization must stay within the organization and be used for its stated purposes.

(New York Attorney General Eliot Spitzer's suit against Richard Grasso, former President of the New York Stock Exchange, was based on the provision of the New York Not-for-Profit Corporation Law which, like most nonprofit corporation laws, permits payment of reasonable compensation only. There is no corresponding limitation in the business corporation law. (See Ready Reference Page: "Spitzer Challenges Grasso Salary as 'Objectively Unreasonable'."))

A nonprofit corporation is not "owned" by anyone. It may be controlled by individuals or other entities, but those who control the nonprofit do not have an ownership interest in the organization. (See Ready Reference Page: "The Key Question: Whose Organization Is It?")

Tax Exempt

When we say "nonprofit" we are usually thinking of an organization that is exempt from taxation. Most, but not all, nonprofit organizations are exempt from paying *federal* income tax on their earnings.

Section 501(c) of the Tax Code now spells out 29 separate categories of exempt organizations. These categories include:

Section 501(c)(2) title holding companies (See Ready Reference Page: "Title Holding Companies Have Limited Uses."); Section 501(c)(4) social welfare and advocacy organizations like the Sierra Club or the new organizations set up to participate in political campaigns; Section 501(c)(5) agricultural or labor organizations; Section 501(c)(6) business leagues, professional and trade associations, like the National Football League; Section 501(c)(7) social clubs; Section 501(c)(8) and (10) fraternal organiza-tions; cemetery organizations ((c)(13)); veterans organizations ((c)(19)) and so on down to (c)(29).

Charities

The largest category, and the one most people usually think of when they think of "nonprofit" or "tax exempt," is Section 501(c)(3) "charitable" organizations. Virtually all charities are nonprofits; but not all nonprofits are charities.

Under the Tax Code definition, a Section 501(c)(3) charitable organization is one which is "organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals."

In addition, no part of the net earnings may inure to the benefit of any private shareholder or individual, no substantial part of the activities may consist of carrying on propaganda, or otherwise attempting, to influence legislation, ("lobbying"), and the organization may not participate in any political campaign for or against any candidate for public office ("electioneering"). (See Ready Reference Pages on Requirements for Federal Tax Exemption, and on Lobbying and Electioneering.)

When the U.S. Supreme Court decided in the *Citizens United* case in 2010 that corporations could spend unlimited amounts on "uncoordinated" political campaign advertising, many existing and newly created 501(c)(4) advocacy groups and 501(c)(6) trade associations significantly increased their electioneering activity, as they are permitted to do under the law. Unfortunately, in much of the media discussion of the expenditures, the media referred to spending by "nonprofits," without distinguishing between those allowed to participate in elections and charities that are not so permitted. While the media was not wrong in calling these organizations nonprofits, the use of the term was hugely confusing because many people equate "nonprofit" with "charitable" and charities cannot participate in election campaigns.

The other critical distinguishing feature of charities, as opposed to almost all other types of federally exempt organizations, is that individuals and corporations may make charitable contributions to charitable organizations and claim a charitable contribution deduction on their own federal income tax returns.

Public charities and private foundations

Section 501(c)(3) charities are further subdivided under Section 509(a) of the Tax code between "public charities" which receive broad public support and "private foundations" which receive the great

bulk of their income from a very limited number of contributors and investment income. All charities are deemed to be private foundations unless they show the Internal Revenue Service that they qualify as public charities. (See Ready Reference Page: "Calculating Public Support.")

Section 509(a)(1) describes publicly supported organizations such as churches, hospitals, and schools, which are considered publicly supported by virtue of what they do, and also organizations that receive a specified percentage of their revenue from a broad range of contributions such as the United Way, or a community foundation.

Section 509(a)(2) describes those that are deemed publicly supported because they receive a broad range of public support from contributions and fees for service, such as many social service organizations or a nursing home.

Section 509(a)(3) describes those organizations that are deemed publicly supported because they are "operated, supervised, or controlled by or in connection with" a publicly supported charity or governmental unit. (See Ready Reference Page: "Supporting Organizations Are Public Charities.")

Charities that don't meet the criteria of Section 509(a) are considered private foundations. Like the Gates Foundation, essentially all of their income has come from a single or limited number of individuals, families, or corporations and income on their investments. Private foundations are subject to more stringent regulation. (See Ready Reference Pages on Private Foundations.)

Nonexempt nonprofits

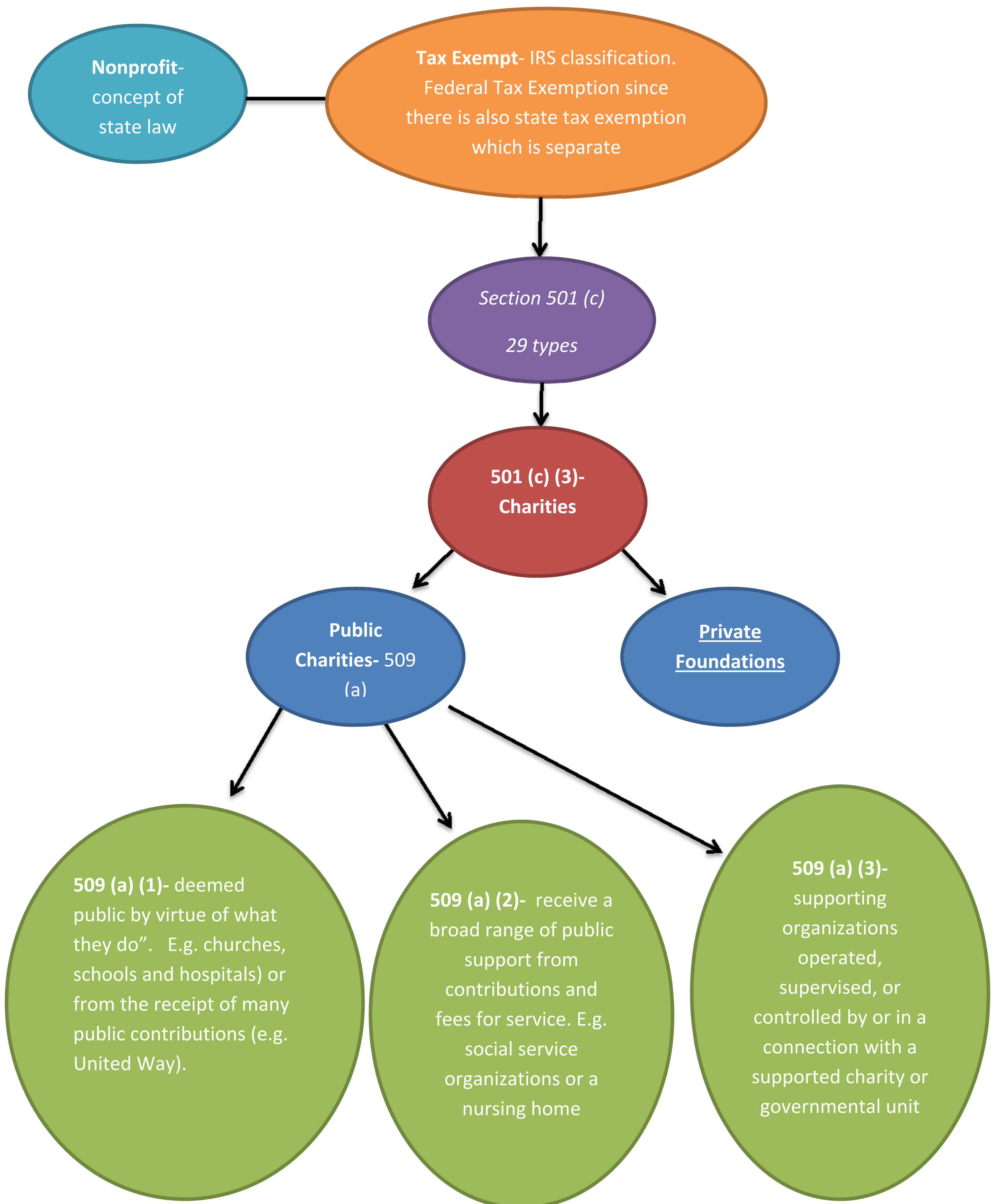
Although rare, there are nonprofit organizations that are not tax-exempt, like the New York Stock Exchange immediately before it converted to a for-profit so that it could sell stock to provide an ownership interest to investors. A "nonprofit" organization partakes of some of the "halo effect" of the term, even though most people do not understand that the term is not completely descriptive.

Some state nonprofit corporation laws make distinctions between charitable, mutual benefit, religious and other types of nonprofit corporations, and apply different rules for each, but many nonprofit corporation laws have only a single classification that includes all nonprofits.

State tax exemption

State tax exemption in most states is an entirely separate matter. Although most nonprofits are likely to be exempt from state corporate income taxes, if any, many states have separate criteria, often more stringent than the federal 501(c)(3) criteria, for real estate or state sales tax exemption.

If you can't identify the category in which a nonprofit fits, you can't know the rules by which it is regulated.



Nonprofit- concept of state law
Tax Exempt- IRS classification. Federal Tax Exemption since there is also state tax exemption which is separate
Section 501 (c)
29 types
501 (c) (3)- Charities
Public Charities- 509 (a)
Private Foundations
509 (a) (1)- deemed public by virtue of what they do". E.g. churches, schools and hospitals) or from the receipt of many public contributions (e.g. United Way).
509 (a) (2)- receive a broad range of public support from contributions and fees for service. E.g. social service organizations or a nursing home
509 (a) (3)- supporting organizations operated, supervised, or controlled by or in a connection with a supported charity or governmental unit

READY REFERENCE PAGE

NO. 136
FOR YOUR FILE

Commentary:

Keep Charities Out of Politics

Don't put more "dark money" into elections —and make it tax-deductible

President Donald J. Trump has promised to "destroy" the so-called "Johnson Amendment" that prohibits 501(c)(3) charities from participating in election campaigns. Several Republicans in Congress have introduced bills to do just that.

And yet, the National Council of Nonprofits, the Independent Sector, the Council on Foundations and many operating charities have taken strong positions against a change. Is this an issue that makes much of a difference? Is it really something to get worked up about?

We think it is. It would undermine the trust in the charitable sector and make them less effective in pursuing their missions. But equally important, it would put more unaccountable "dark money" into our political system —and make it *tax-deductible!*

The impetus to eliminate the prohibition has come primarily from religious organizations that argue that their freedom to promote their religious views is impaired by not being able to support candidates who will promote their views in legislation and oppose those who won't. But the principal legislative proposals presently pending in Congress do not limit the change to churches and other religious organizations. They cover all organizations exempt under Section 501(c)(3).

There are many reasons important to the charitable sector for keeping the current limitation in place. It has been effect for more than 60 years, and, as described by the National Council of Nonprofits, "has a proven track record of working well to protect against politicization."

Ironically, a provision that was allegedly passed to protect politicians like Lyndon Johnson from attack by charities is now being defended as a provision to protect charities from an onslaught by politicians.

Charities like the rule because it protects them from demands by candidates for campaign contributions that would divert limited funds from mission-related work. Many charity leaders want to avoid appearing partisan because they know that their issues are likely to outlast any incumbents in office and they want to be able to deal with all elected officials on the basis of the public interest, not narrow political interest. They recognize how hard it might be to get a sympathetic audience with someone they had unsuccessfully opposed in the last election.

They view their nonpartisan role as a "safe haven" in a sea of partisan rancor, where parties of all beliefs can work together to resolve community problems. Some point out that public trust in charities is usually higher than the public trust in politicians.

They recognize that the Tax Code allows them to advocate on issues, and also allows individual officers or directors of charities to endorse or oppose candidates on their own time and in their private capacity. But the organizations try to avoid the partisan taint that would come with putting the organization behind or against specific candidates.

There would be even broader implications for our society if the rule were to be repealed, however. It would allow more unaccountable "dark money" in politics and would make it tax-deductible, unlike any other political contributions.

One of the pending bills (H.R. 172) would eliminate the restriction entirely. Two other bills (S. 264 and H.R. 281) would provide that an organization would not be deemed in violation of the prohibition if a statement is made "in the ordinary course" of "regular and continuing activities" and requires "not more than *de minimis* incremental expense."

If the provision were eliminated entirely, it would have a significant impact on politics in the country. We have already seen the rush of political money into 501(c)(4) social welfare organizations since the Supreme Court's decision in the *Citizens United* case allowed corporations to spend unlimited amounts of money in political campaigns so long as it is not coordinated with a candidate. This rush of money is not because (c)(4) organizations don't have to pay tax on their income. Political parties and political action committees are likewise exempt. The rush is because (c)(4) organizations do not have to reveal the names of their donors.

As a result, this kind of "dark money" is totally unaccountable and not subject to the disclosure requirements for candidates, political parties and political action committees. The IRS has not even ruled on the question of how much political activity is permitted within the social welfare exemption (See Ready Reference Page: "IRS Proposes New Regulations for 501(c)(4) Social Welfare Organizations") and was prohibited by Congress from making such a ruling before the last election. (See *Nonprofit Issues*®, 1/1/16)

If charities are released from their prohibition on participation in political campaigns, they are likely to see a flood of new unaccountable money, not only because the donors don't have to be disclosed to the public, but also because the "charitable" contributions to 501(c)(3)s would be tax-deductible, unlike contributions to (c)(4)s and political organizations. It would be a seismic change in our tax policy of keeping tax-deductible charitable money entirely separate from non-deductible political money. The opportunities for abuse, through the creation of new "charities" or the capture of existing ones, would be huge.

The potential for abuse with churches is even greater. "Churches" don't have to obtain recognition of exemption from the IRS. Anyone can create a church and claim exempt status without the IRS even knowing that it exists. In addition, churches don't have to file tax returns of any type. At least with (c)(4)s, we have some idea of the total amount spent on political activities to the extent that they accurately report on their Form 990 tax returns. We are unlikely to ever know anything about the extent of political activity of a church. They have no reporting requirements at all.

The bills permitting statements in the ordinary course of regular activities are not a whole lot more protective. They would be almost impossible to administer. Every activity would become an opportunity for supporting or opposing candidates, undermining all of the reasons charities like to be non-partisan. "Regular" activities could be amped up during election season. The increased activity could be funded with tax-deductible charitable contributions and would presumably be okay so long as making a political statement didn't cost significantly more than making a non-political statement. The IRS certainly doesn't have the personnel to police this effectively. With churches, it would be almost impossible to tell whether a political statement cost any more because they don't have to disclose their costs.

The proposals to eliminate the prohibition on charitable participation in election campaigns may sound benign. But they would seriously undermine the long-term trust, and therefore effectiveness, of charities, and would significantly and adversely affect our political system.

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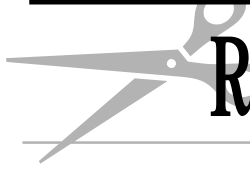

READY REFERENCE PAGE

NO. 26
FOR YOUR FILE

Calculating Public Support Percentage - Part I

Section 501(c)(3) charities are divided between private foundations and public charities; Section 509(a) sets the rules for qualification as publicly supported

THE PUBLIC SUPPORT FRACTION

	509(a)(1) and 170(b)(1)(A)(vi)	509(a)(2)
1. Gifts, grants, contributions memberships:		
a. Direct and indirect from public.	Included to 2% of support	Included in full, except from disqualified persons
b. From disqualified persons.	Same as above	Excluded
c. From government or 170(b)(1)(A)(vi) groups.	Included in full	Included in full
2. Gross receipts from activities which are not unrelated business.	Excluded	Included, except from disqualified persons. Limited to greater of $5,000 or 1% of support, annually, from any single payor.
3. Net unrelated business income, whether or not taxable.	Excluded	Excluded
4. Gross investment income.	Excluded	Excluded
5. Tax revenues, services and facilities given by government without charge.	Included	Included
1. Gifts, grants, contributions, memberships.	Included	Included
2. Gross receipts from activities which are not unrelated business	Excluded	Included
3. Net unrelated business income, whether or not taxable.	Included	Included
4. Gross investment income.	Included	Included
5. Tax revenue, services and facilities given by government without charge	Included	Included

Charities, especially newly created ones, are frequently confused about their classification under Sections 501(c)(3) and 509 of the Tax Code. It's not surprising. The rules are some of the most technical and confusing of all the tax rules affecting charities.

Many organizations qualify as "tax-exempt" under Section 501(c) of the Tax Code. There are now 27 separate subclassifications, including civic leagues ((c)(4)), trade and professional associations ((c)(6)) and social clubs ((c)(7)). Those organized and operated exclusively for religious, charitable, scientific, educational or other philanthropic purposes are exempt as "charities" under Section 501(c)(3).

Charities are further divided between private foundations and non-private foundations, generally called public charities. This classification is based on Section 509(a) of the Code. The Code basically provides that every charity will be deemed a private foundation unless it qualifies as a public charity under Section 509(a)(1),(2) or (3) of the Code.

Section 509(a)(1) specifically includes three types of organizations which are deemed publicly supported without regard to the source or type of income. They are (1) churches, (2) educational institutions, such as schools and colleges which normally maintain a regular faculty and curriculum and have a regularly enrolled student body in attendance at a specific place of instruction, and (3) hospitals and medical education or research organizations.

Section 509(a)(1) also includes organizations, such as the United Way, which must normally receive a substantial portion of their support in the form of gifts, grants and contributions from the general public as described in Section 170(b)(1)(a)(vi) of the Code.

Section 509(a)(2) includes charities which also must receive a substantial portion of their support from a combination of gifts, grants, and contributions, plus fees for the services for which they have obtained their exemption. A nursing home which is supported primarily by resident fees is a typical example.

Section 509(a)(3) gives public charity status to an organization organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more groups defined as public charities under Section 509(a)(1) or (2), or a governmental agency. Such a "supporting organization" must be "operated, supervised or controlled by or in connection with" the supported group or groups. It need not meet a public support percentage test most groups must meet under either (a)(1) or (a)(2).

Calculation of the public support percentage is different under 509(a)(1) and (a)(2), and the fraction is represented visually by the chart above. A charity claiming public support under either test must include the information for the calculation on Schedule A of its Form 990 tax return. The test is based on a 4-year period.

The Code defines "support" for the purposes of making the calculation. Support includes:

(1) Gifts, grants, contributions and membership fees (to the extent that the membership fees are general operating

continued on other side

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The Public Support Test

contributions and not payments for goods or services).

(2) Gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in an activity which is not an unrelated trade or business. This is basically a charity's exempt function income, such as the nursing home charges, or admissions to the theater. Note that in the 509(a)(1) calculation, these gross receipts are not included in either numerator or denominator of the fraction.

(3) Net income from unrelated business activities.

(4) Gross investment income from interest, dividends, rent and royalties to the extent they are not taxed as unrelated business income. Capital gains are not deemed gross investment income and are not included in the calculation.

(5) Tax revenues and the value of services or facilities furnished by a government agency without charge, to the extent not generally available free to the public. Free office space in City Hall would be an example.

Under Section 509(a)(1), an organization is publicly supported if it normally receives one third of its support (which, remember, does not include fees for related service income) from the public. There is a limit on how much support from any one donor qualifies as "public" support. Gifts from individuals, corporations or private foundations count as "public support" only up to 2% of the total support during the period. If an individual gives a total of $10,000 during the period and the total support is $100,000, only $2,000 of the gift counts as "public support."

This 2% limitation does not apply to grants from government or other publicly supported charities, such as the United Way or a community foundation.

If the organization does not meet the one-third test, it may still qualify under a "facts and circumstances" test with as little as 10% public support if it is seeking to attract additional public support, its governing body is broadly representative of the public, and its services are available to the general public.

Under Section 509(a)(2), an organization must meet a two-part test. More than one-third of its support must be public support, and it may not receive more than one-third of its support from gross investment income.

Under the 501(a)(2) test, contributions are counted differently. There is no 2% limitation on gifts, but gifts from "disqualified persons" are not counted as public support at all. Disqualified persons include foundation managers, such as officers or directors, and "substantial contributors." Substantial contributors are persons, other than government or public charities, who have given more than $5,000 or 2%, whichever is greater, of the total gifts, grants and contributions received by the organization from its inception. (Certain persons related to substantial contributors are also disqualified.)

Not all fees for services are counted as public support. Fees for services from any one payor which count as public support are limited each year to the greater of $5,000 or 1% of the total support during the year.

The Regulations provide a procedure under both Sections 509(a)(1) and (a)(2) to disregard an "unusual grant," which, because of its size, might adversely affect the public support status of the organization.

With these definitions perfectly clear, we'll apply the rules to an example next month.

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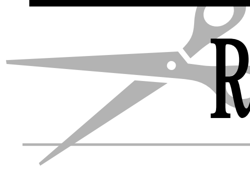

READY REFERENCE PAGE

NO. 27
FOR YOUR FILE

Calculating Public Support Percentage - Part II

Section 509(a)(1) limits portion of gifts counting as public support; Section 509(a)(2) excludes gifts from disqualified persons

THE PUBLIC SUPPORT CALCULATION

	Total Support	Public Support 509(a)(1)	Public Support 509(a)(2)
Gifts, grants contributions, memberships			
Public contributions			
(none over $500)	$5,000	$5,000	$5,000
President	$2,000	$1,800	—
Board of Directors	$1,000	$1,000	—
Mr. A.	$3,000	$1,800	$3,000
Ms. B. (2 annual gifts of $4000)	$8,000	$1,800	$4,000
State Arts Council	$6,000	$6,000	$6,000
Foundation X	$2,000	$1,800	$2,000
Federated Arts Appeal	$18,000	$10,000	$10,000
(Including $8000 designated this year by Company C.)		$1,800	—
Gross Receipts (not unrelated business)			
Sale of Art Books	$1,000	—	$1,000
City D contract to restore paintings	$7,000	—	$5,000
Annual Volunteer Bake Sale	$2,000	—	$2,000
Net Receipts (unrelated business)			
Sale of Logo T-shirts	$5,000	—	—
Gross Investment Income	$35,000	—	—
Fair rental value of space in City D property	$5,000	$5,000	$5,000
Total	$100,000	$36,000	$43,000

Last month, we set out the visual representation of the public support fraction for charities which determine their public support under Sections 509(a)(1) and 509(a)(2). This month, we'll run through a sample calculation, showing how some of the rules are applied.

Remember that public support is based on a four-year test. If you qualify for a four-year period, you will usually be considered a public charity — and not a private foundation — for the following two years. Consider how the rules apply to the City D Art Gallery, a new organization which has the four year income and support set out in the chart on this page.

The first thing to do is determine the full amount of income and support for the organization over the four year period. The Gallery claims $100,000 of support, but that includes $5,000 in the fair value of free rental space given to the Gallery in City property. This value will not show up on the financial statements or go through the bank account of the organization. You have to know it exists and add it to your response to the support schedule on Schedule A of your Form 990 tax return.

Now let's calculate under Sections 509(a)(1) and 170(b)(1)(A)(vi). Here, the first key is to eliminate gross receipts from activities that are not an unrelated trade or business from the entire calculation. The Gallery lists four items of earned income. The sale of art books about the collection is related. The restoration of paintings is also related.

The annual bake sale is not related, but it is not a trade or business in the IRS's view because it is conducted entirely by volunteers. Therefore, the gross income from the sale is included among gross receipts from activities which are not unrelated business.

Net income from the regular sale of souvenir T-shirts is deemed unrelated business taxable income and the net is included in the denominator of the fraction for calculation purposes, though not the numerator. As a result of the elimination of the three activities which are not unrelated business (sale of art books $1,000, restoration contract $7,000, and bake sale $2,000), the total support for the calculation under Section 509(a)(1) is $100,000 less $10,000 or $90,000.

Now we must count the portion of gifts, grants and contributions which qualify as public support. Remember that any donor's contribution over the four years can count as public support only up to 2% of total support, unless the donor is a governmental unit or another publicly supported charity. In this case, only $1,800 of any individual, corporate or foundation gift qualifies as public support (.02 x $90,000).

How is the limit applied?

The small public contributions all qualify as public support. The President's gift is limited to $1,800. The board of directors count in full because they do not exceed the limitation. The portion of the gifts of Mr. A and Ms. B which qualify as public support are each limited to $1,800.

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Public Support Calculation

The State Arts Council is a governmental agency and its gift is entirely public support. The Federated Arts Appeal is a publicly supported charity and ordinarily its gift would count fully as public support. This gift, however, includes a gift designated for the Gallery by Company C. That part of the gift must be counted as if given directly by Company C, and therefor only the $10,000 given by the Federation itself and $1,800 of the gift from Company C can qualify as public support.

The only other item of public support is the $5,000 fair rental value of the space in the City D building.

The total of this public support is $36,200, or 40.22% of the $90,000 in support over the period. The Gallery is safely above the one-third support test.

The calculation under Section 509(a)(2) is slightly different. There is no percentage limitation on gifts, grants or contributions which qualify as public support, but no gifts from disqualified persons are included.

The $5,000 in small contributions counts as public support. The gifts from the President and Board of Directors are all excluded because, as foundation managers, they are disqualified persons. Mr. A's gift counts in full.

Ms. B presents an interesting distinction. Her first gift of $4,000 is less than the $5,000 level which would make her a substantial contributor and therefore counts as public support. When she makes her second gift, she has exceeded the limit and become a disqualified person. The second (and any subsequent gift) is excluded from public support so that only $4,000 from her is public support.

The State Arts Appeal counts fully, as does the small gift from Foundation X. With the Federated Arts Appeal, its own gift is public support. But Company C is a substantial contributor since its gift exceeds $5,000, and its entire gift is not included in public support.

The income from the sale of the art books is public support, as is the income from the bake sale. The income from the painting restoration contract is public support also, but only up to the limit on receipts from one payor, in this case $5,000 a year.

The net unrelated business income is not public support, nor is the gross investment income. The value of the rental space is public support.

Adding up all these figures, we find that the Gallery has $43,000 of public support out of a total of $100,000 support, or 43%. Ordinarily, this would be safely above the minimum.

This Gallery does not qualify under Section 509(a)(2), however, because its total of gross investment income and net unrelated business income (after payment of tax) exceeds one-third of support.

Since the Gallery qualifies under one of the two tests, it is deemed to be publicly supported and not a private foundation.

What happens when I.M. Loaded dies and leaves the Gallery $5 million,which throws off all the public support fractions? The Gallery can exclude it as an "unusual grant" and not count it at all in the calculation. A grant which is not of the type an organization normally receives and which, because of its size, could cause loss of public charity status, may qualify for exclusion as an unusual grant.

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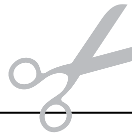


READY REFERENCE PAGE

NO. 109
FOR YOUR FILE

New Schedule A Reflects Change in Public Support Rules

Test is now based on five-year rolling average and reporting is on same basis as other accounting

The new Schedule A required for the Form 990 tax information return reflects the change in method of calculating "public support" for a charitable organization that seeks classification as a public charity rather than a private foundation.

A 501(c)(3) organization that is neither a hospital, a church, or an educational institution (or certain related entities) or a supporting organization to a public charity avoids being a private foundation by satisfying a "public support" test in generating its revenue from a wide variety of sources. It is generally advantageous to avoid private foundation status because a private foundation is subject to the more stringent self-dealing rules, the 2% excise tax on net investment income, the 5% annual payout requirement, severe limits on lobbying activity, and less favorable deductions for its donors.

The two public support tests are intended to ensure that the organization has broad public support. One of the tests—called the 509(a)(1) test—is intended to be used by organizations that receive most of their support from donations. The other—the 509(a)(2) test—is intended to be used by fee for service organizations such a nursing homes. (See Ready Reference Page: "Calculating Public Support.")

Prior to September 9, 2008, when a newly formed organization expected to qualify as a public charity under one of the two public support tests, it would request in its Form 1023 Application for Recognition of Exemption that the IRS issue either a definitive ruling or an advance ruling that the organization was not a private foundation.

If the IRS issued an advance ruling, at the end of the four or five year advance ruling period, the organization had to file a Form 8734 demonstrating that it met a public support test for the period. Thereafter, the organization was required to meet a public support test on a rolling four year test period. If the organization met the test for a four year test period, it qualified as a public charity for the two years following the test period. The test was applied on a cash method of accounting, even if the organization kept its books and filed its Form 990 on the accrual method.

Effective for tax years beginning on or after January 1, 2008, the IRS changed the method of calculating public support. The 2008 rules do away with the advance ruling period. If the information submitted on the organization's Form 1023 demonstrates that it is likely to meet one of the public support tests, the determination letter will classify the organization as a 509(a)(1) or 509(a)(2) public charity. The organization will not be subject to the private foundation rules for its first five years, even if as a matter of fact it fails to meet either public support test for that five year period.

Beginning with its sixth year, however, the organization must meet one of the two tests in order to maintain status as a public charity. It must demonstrate that it meets one of the tests with the information it provides on Schedule A to its Form 990, the annual information return it files with the IRS. The new Schedule A calls for the information for the most recent five year period, including the year of the return.

(Organizations with an advance ruling outstanding for which the five year period had not yet expired do not need to submit the Form 8734 to confirm their public support status, and will be judged by the information on the Schedule A.)

Under the new rules, if the organization has sufficient public support for the five year period ending with the current tax year, it will qualify as a public charity for the current year (the year of the report) and the following year. For example, if a calendar year organization passes one of the tests for the years 2005 through 2009, it qualifies as a public charity for 2009 and also for 2010. It qualifies in 2010 even if it does not pass one of the tests for the five year period 2006 through 2010. If it fails the test for 2010, however, it will then be classified as a private foundation for 2011 unless it passes one of the tests for the five year period 2007 through 2011.

Under the prior rules, if the organization met one of the tests for the four year period preceding the current year (which was all that was reported on the old Schedule A) it qualified as a public charity for the current year and the following year. The IRS recognizes that the change to include the current year in the test period may put an organization that fails to pass for a particular period, say 2005 through 2009, in the position at the end of 2010 of not knowing until after the end of the year whether it will be a private foundation or a public charity beginning in 2011, because it will not have all of its financial results for the year 2010 until after the end of the year.

The IRS helpfully suggests that an organization in this position monitor its public support closely.

In the other major change in calculating public support, an organization is now required to use the method of accounting that it uses in keeping its books and that it otherwise uses in reporting on its Form 990. Under the old rules, the Schedule A was a cash basis calculation, regardless of the general method of accounting.

The change will bring a degree of simplicity for organizations keeping books on the accrual basis, because they will be able to use the accrual method for reporting contributions and other items on the Schedule A as well as elsewhere on the Form 990. On the other hand, multi-year grants to accrual basis organizations will now be included in the support fraction in the year awarded without regard to the year actually paid, and, unless such a grant can be excluded from the calculation as an unusual grant, the acceleration of inclusion could make it more difficult to pass a public support test.

The charts provided on the Schedule A and the explanation of the requirements for filling in the figures generally do a good job in helping the preparer calculate the public support percentage correctly if the preparer follows the instructions carefully.

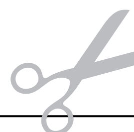
There are two areas, however, in which errors are very common, and can cause an organization to appear to flunk the test when it actually passes.

One is a failure to include the value of services (including the value of the use of property) provided by the government at no charge as qualifying public support. A rent-free office in City Hall, for example, would qualify in this category.

This figure does not usually show up on financial statements, and is frequently overlooked by the preparer of the return. But since the value qualifies as public support (in the numerator of the public support fraction), omitting it from the calculation would reduce the reported percentage of public support and could show it below the amount necessary to qualify as a public charity.

The other common error is the inclusion of capital gains in gross investment income (the denominator of the public support fraction), which reduces the reported percentage of public support by improperly increasing the denominator of the fraction. In some cases, an organization that appears to be a private foundation based large capital gains qualifies as a public charity after capital gains are excluded. Since capital gains or losses are excluded entirely from the definition of "support," they should not be included in the calculation.

--Virginia P. Sikes
Montgomery, McCracken, Walker & Rhoads, LLP



READY REFERENCE PAGE NO. 118 FOR YOUR FILE

Supporting Organizations Qualify As Public Charities

Pension Protection Act of 2006 imposed significant new limitations on activities

As "supporting organizations" played an increasingly important role as a means of avoiding private foundation status over the decade preceding the Pension Protection Act of 2006 (the "Act"), Congress became concerned about apparent abuses. The Act placed additional limits on supporting organizations, and particularly on Type III supporting organizations. Proposed regulations issued in 2009 provide insight into the IRS's intended interpretation of the new limitations.

Under the Internal Revenue Code, all Section 501(c)(3) charities are considered to be private foundations unless they can show the IRS that they qualify as public charities. Section 509(a) sets out three primary classifications of "publicly supported" organizations that are not considered private foundations and therefore avoid the excise tax on investment income and significant limitations, including limitations on self-dealing and lobbying.

Section 509(a)(1) includes churches, schools, hospitals and other organizations, such as a United Way, which are publicly supported through gifts, grants and contributions from many donors. Section 509(a)(2) includes those which are publicly supported primarily through income earned from their charitable functions, such as nursing homes. (See Ready Reference Pages: "Calculating Public Support" and "New Schedule A Reflects Change in Public Support Rules" for rules on calculating public support under these sections.)

Section 509(a)(3) sets forth the rules for a "supporting organization." A supporting organization does not have to generate public support from its sources of income, but must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of, one or more specified organizations recognized as public charities under Section 509(a)(1) or (2), or a governmental entity.

If the organization meets the complicated test, it will also be classified as a public charity even though its sources of income are so narrow that it could not meet either of the percentage tests on its own.

For example, a small business incubator in a disadvantaged neighborhood may obtain rental income only from its tenants, and not have enough tenants to meet the one-third public support test. It could be publicly supported if it attached itself to a publicly supported charity in the neighborhood. A "parent" organization in a health care system, which receives income only from management fees from a few subsidiaries, could be classified as a supporting organization because it performs parts of their operations.

Smaller grant-making organizations, which receive income only from investments or contributions from a single family, have found it appropriate to become supporting organizations to community foundations. An organization formed to rent historic houses owned by a city and restore them for general use became a supporting organization to the city because its initial funding came primarily from a single private foundation and its only long-term income would come from its few tenants and it would not pass the public support test on its own.

Limitation on Control. Section 509(a)(3) not only requires that the organization support another public

charity or government, it also requires that it be "operated, supervised, or controlled by or in connection with" such an organization, and that it not be controlled by a "disqualified person" other than a foundation manager or an organization classified as a public charity under Section 509(a)(1) or (2). If at any time, the supported organization loses its public support status, the supporting organization will also lose its status.

Under the organizational test, the governing instruments must limit the organization's purposes to those permitted by supporting organizations, may not expressly permit any other activity, must specify the supported organizations, and may not expressly empower it to support any other entity.

The governing instruments may specify the supported entities by name, or, in the case of a Type I or Type II supporting organization, by a designated class, such as all publicly supported community development corporations operating in City X, or all publicly supported charities controlled by the Y Health System.

Under the operational test, the requirement to operate "exclusively" for the benefit of the supported organizations is read more narrowly than the general requirement of charities to operate "exclusively" for charitable purposes. In general, a charity must operate "primarily" for charitable purposes, so long as no substantial part of its activities is not charitable. A supporting organization must operate "solely" in support.

The pre-Act IRS regulations set out three separate categories, with three sets of requirements, for the relational test. The Act adopted practitioners' terminology and named these categories Type I , Type II and Type III. It also imposed significant new requirements and limitations.

"Type I -Operated, supervised or controlled by." Type I is essentially a parent-subsidiary relationship. A majority of the officers or governing body of the supporting organization must be elected or appointed by the supported organizations. In limited cases even without such direct control, a supporting organization can meet this test if it can show that it carries out the purposes of the supported organizations

"Type II -Supervised or controlled in connection with." Type II includes brother-sister relationships, in which the supported and supporting are under common supervision or control which assures that the supporting organization is responsive to the needs and requirements of the supported organizations. The same persons must control the supported and supporting organizations.

The relationship is not met merely because the supporting organization makes payments to the supported organizations, even if the obligation is legally enforceable. That arrangement alone does not provide a sufficient con-nection between the groups.

"Type III -Operated in connection with." Type III is the loosest of the three relationships, without the same type of control by the supported organizations. It requires that the supporting organization be responsive to and significantly involved in the operations of the supported organizations. After the Act, a Type III supporting organization must meet a "notification" test a "responsiveness" test, and an "integral part" test. The Treasury has issued proposed regulations outlining the criteria.

To meet the notification test, the Type III must provide to each of its supported organizations by written notice postmarked or electronically transmitted by the last day of the 5th month after the close of the Type III's tax year: (1) a report to a principal officer indicating the type and amount of support provided to the supported organization in the past year; (2) a copy of the Type III's most recently filed Form 990; and (3) a copy of the Type III's governing documents (including its charter, articles of incorporation or trust instrument and bylaws), unless these have previously been provided and have not since been amended.

To meet the responsiveness test, (1) one or more officers or directors of the supporting organization must be selected by the supported organization, (2) one or more members of the boards of the supporteds must be officers, directors or other key individuals of the supporting organization or (3) the officers or

directors of the supporting organization must maintain a continuing close relationship with the supported organizations AND the supported organizations must as a result have a "significant voice" in the investment policies of the supporting organization, the timing of grants, the manner of making them, the selection of recipients and in otherwise directing the use of the income or assets of the supporting organization. (Under the prior rules, a trust was deemed to be responsive if the beneficiary charity could legally enforce the provisions of the trust. The elimination of that safe harbor is causing many such trusts to lose their classification as supporting organizations and to be classified as private foundations.)

Under the proposed regulations, there are two "integral part" tests, one that applies if the Type III is “functionally integrated” and one that applies if it is “non-functionally integrated.” A functionally integrated Type III (“Type III FI”) meets the integral part test if it: (1) engages in activities (a) substantially all of which directly further the exempt purposes of the supported organizations to which it is responsive, by performing the functions of, or carrying out the purposes of such supported organizations, and (b) that, but for the involvement of the Type III FI, would normally be engaged in by the supported organizations, or (2) is the parent of each of its supported organizations (meaning that the Type III FI exercises a substantial degree of direction over the policies, programs, and activities of the supported organization and the governing body or officers of the Type III FI select a majority of the officers, directors, or trustees of the supported organization). The “parent holding company” of a health care or social service system of entities would typically be a Type III FI supporting organization.

Holding title to exempt-use property and managing exempt-use property are activities that directly further the exempt purposes of a supported organization, but fundraising, investing and managing non-exempt-use property and making grants are not. (There is a very narrow exception if there is only one supported organization and it is a governmental entity).

A non-functionally integrated Type III supporting organization (“Type III NFI”) meets the integral part test if it satisfies the “distribution requirement” and the “attentiveness requirement”. (Certain trusts can meet the Type III NFI integral part test by meeting pre-1970 trust requirements.) Under the proposed regulations, the distribution requirement requires the supporting organization to distribute, with respect to each taxable year, to or for the use of one or more supported organizations amounts equaling or exceeding 5% of the net fair market value of its investment assets (called the “Annual Distributable Amount”). This is very similar to the 5% payout requirement that applies to private foundations. Supporting organizations and their advisors have asked the IRS to reduce this percentage in the final regulations, to, for example, 3 1/3%.

Under the attentiveness requirement, a Type III NFI must distribute one-third or more of its Annual Distributable Amount to one or more supported organizations that are “attentive” to the Type III NFI and to which the Type III NFI is responsive within the meaning of the responsiveness test. A supported organization is attentive to a Type III NFI if the amount of support the Type III NFI distributes to the supported organization annually is either: (1) 10% or more of the supported organization’s total support; (2) necessary to avoid the interruption of the carrying on of a particular function or activity (support is necessary if either the supported organization or the Type III NFI earmarks the support for a particular program or activity, even if it is not the supported organization’s primary program or activity, so long as the program or activity is a substantial one); or (3) a sufficient part of the supported organization’s total support, based on the consideration of all pertinent factors, including the number of supported organizations, the length and nature of the relationship between the supported organization and the Type III NFI and the purpose to which the funds are put. The more substantial the amount involved, in terms of a percentage of the supported organization’s total support, the greater the likelihood that the required degree of attentiveness will be present. However, evidence of actual attentiveness (including attentiveness to the nature and yield of the Type III NFI’s investments) is of almost equal importance. If the Type III NFI makes payments to, or for the use of, a particular department or school of a university, hospital or church, the total support of the

department or school is substituted for the total support of the supported organization. Amounts distributed to a donor advised fund held by a supported organization are not taken into account for purposes of the attentiveness requirement.

Prior to the finalization of the proposed regulations, a Type III NFI is not required to meet these proposed rules, but can continue to meet the payout requirement of the existing regulations—distributing annually an amount equal to 85% of its net income to supported organizations with a substantial amount of the support going to supported organizations that receive sufficient support that they are attentive to the Type III NFI.

Finally, a supporting organization may not be controlled by disqualified persons, primarily substantial contributors. Since another publicly supported charity is, by definition, not a disqualified person, most supporting organizations are controlled by their supported entities.

Other restrictions. The Act limits transactions between supporting organizations and insiders to make it more like a private foundation in its limitations. Grants, loans, compensation and expense reimbursement from a supporting organization to a substantial contributor (or any individual or entity related to a substantial contributor) must be repaid, and the recipient is subject to a 25% excise tax. If there is a bargain to an insider who is not a substantial contributor or related to a substantial contributor (or an individual or entity related to such an insider) in a transaction with a supporting organization, the bargain element, must be repaid and the recipient is subject to a 25% excise tax on the bargain element. A person who is an insider with respect to a supported organization is also treated as an insider with respect to the supported organizations. So a transaction that would be subject to excise tax if between the insider and the supporting organization is subject to excise tax if between the insider to the supporting organization and the supported organization.

The so-called "excess business holdings" rule that applies to private foundations now applies to Type III NFIs. Under this rule, the Type III NFI and all insiders and related persons can generally hold no more than 20% of any business enterprise (other than one producing primarily passive investment income). The excess business holdings rule also applies to a Type II, if it accepts a contribution from a person (other than a public charity which is not a supporting organization) who: (1) controls, directly or indirectly, alone or with the persons described in (2) and (3), the board of the supported organization; (2) is a family member of such a person; or (3) is an entity 35% controlled by persons in (1) and/or (2). (Together, the persons in (1), (2) and (3) are "Control Persons.")

If a Type I or Type III accepts a contribution from a Control Person (other than a public charity that is not a supporting organization), it is treated as a private foundation until it establishes that it qualifies as a public charity other than by being a supporting organization.

A Type III may not support an organization that is organized outside of the U.S.

A private foundation may not count as a "qualifying distribution" toward its 5% payout requirement, any amount paid to (1) a Type III NFI, or (2) any other supporting organization if an insider (a "disqualified person") with respect to the private foundation directly or indirectly controls the supporting organization or a supported organization of the supporting organization. Any amount so paid that does not qualify as a qualifying distribution is treated as a taxable expenditure, and therefore subject to excise tax.

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NO. 50
FOR YOUR FILE

Private Operating Foundations Are Hybrids

Organizations which are not publicly supported but use most of their assets and income in the active conduct of their charitable activities avoid some private foundation limitations

Most charities exempt under Section 501(c)(3) of the Tax Code are classified either as publicly supported organizations, including churches, schools, hospitals, social service or healthcare organizations and cultural groups, or as private foundations, which are usually endowments making grants to other charities.

Private foundations must function under significantly more stringent limitations, and organizations would usually rather qualify as publicly supported.

Private operating foundations, however, are a sort of hybrid classification. Organizations that do not meet the public support tests of Sections 509(a)(1) or 509(a)(2) may qualify as private operating foundations if they use most of their assets and income for the active conduct of charitable activities, rather than making grants. (See Ready Reference Pages No. 26 and 27, September and October 1999 for calculating public support.) For the most part, the private foundation limitations apply to private operating foundations. But they receive some of the benefits applicable to public charities.

Groups qualify as private operating foundations if they do not meet the public support tests but use their assets and their income, under fairly specific requirements, for the active provision of charitable services.

A family controlled museum, for example, which owns significant historical artifacts which it puts on public display and holds a substantial endowment which it uses to provide the income as its primary operating money, is the kind of organization that could qualify as a private operating foundation. Others do not have special physical assets, but use their income for direct educational or other charitable services.

Most of the general private foundation limitations apply to private operating foundations. They are required to pay the 2% (or in some cases 1%) excise tax on net investment income (Section 4940 of the Tax Code). They are also subject to the limitations on self-dealing (Section 4941), excess business holdings (Section 4943), "jeopardy investments" (Section 4944) and "taxable expenditures," including the almost absolute limits on lobbying (Section 4945).

They are not required, however, to distribute or use the full 5% of net investment assets (Section 4942 of the Code) in their operations although they are required to use substantially all of their income for charitable purposes.

Major Benefits

The two major benefits of the operating foundation status come from better benefits for donors. The first is that gifts to private operating foundations qualify for deduction to the same extent that they would if made to public charities, that is, up to 50% of adjusted gross income each year and up to 30% for gifts of appreciated property held for a year prior to the gift. In addition, gifts of such appreciated property can be deducted at full fair market value where applicable, rather than only at tax cost as often limited for gifts to private foundations.

The more significant benefit of the private operating foundation status, however, is that other private foundations may make grants to an operating foundation as if it were a public charity and will not be required to exercise "expenditure responsibility" as if it were a grant to another private foundation. Since few foundations make expenditure responsibility grants because of the paperwork and risks to the foundation managers, this is a significant advantage.

(If the organization could attract enough foundation grants from enough different sources, of course, it might be able to qualify as publicly supported.)

In order to qualify as a private operating foundation (under Section 4942(j)(3) of the Code), an organization must meet one test, called the "income test" and any one of three alternative tests, known as the "assets test," the "endowment test," and the "support test."

The Income Test

To meet the income test, the operating foundation must make qualifying distributions "directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated" and exempt equal to *the lesser of* its adjusted net income or its minimum investment return (5% of its net investment assets). The Regulations define substantially all to mean 85%. To qualify as direct, the funds must

continued on other side

YOU NEED TO KNOW

Private operating foundations are rare, but can be the vehicle of choice where an individual or family plans to provide the vast bulk of the assets and endowment to run a particular program. The operating foundation can earn income and receive grants and other contributions, but need not operate so that it generates enough outside income to meet the public support requirements of Sections 509(a)(1) or 509(a)(2) of the Code. The family can keep control of the program in a way it might not otherwise be able to do.

continued from other side

Private Operating Foundations Are Hybrids

be used by the foundation itself, including administrative expenses, and not by a grantee. The IRS has ruled that certain distributions qualify where the foundation has been "significantly involved" with "program partners" in jointly conducting operations.

Therefore, if it earns more than a 5% return, it could allow its endowment to grow or could make grants to others with the excess. If it earns less than the 5% return, it need use only 85% of its actual income.

Adjusted gross income is defined to exclude gifts and contributions received and long term capital gains, among other items, but includes income received from related business activity, such as admissions to a museum or sale of publications.

Alternative Tests

Assets Test. The assets test requires that "substantially more than half," which the Regulations define as 65%, of the assets of the operating foundation must be used directly for its charitable program or functionally related businesses. This is particularly applicable to museum type entities. The Regs also say how to value the assets, with any reasonable method consistently applied on a monthly basis for securities, and physical assets used in the exempt function to be valued at cost unless a different value is shown by a formal appraisal.

Endowment Test. The endowment test requires distribution of at least two-thirds of the foundation's minimum investment return, or 3 1/3% of its endowment. Assets held for use in the exempt activities and reasonable cash balances to cover expenses, not in excess of 1 1/2% of the foundation's total assets, are excluded from the endowment computation.

Support Test. The support test requires that at least 85% of the support, other than gross investment income, come from the general public and five or more exempt organizations, not more than 25% of such support be from any one exempt organization, and not more than 50% of total support be from gross investment income. Support includes essentially all income as if determining the percentage under Section 509(a)(2). This includes fee for service income as well as gifts.

The period for calculating qualification as an operating foundation is different from that used in calculating under 509(a)(1) and 509(a)(2). Unlike the other tests, which are based on the preceding four years, this test is based on the year in question and the three prior years. The test may be met on an aggregate basis for the four years, or for any three separate years out of four so long as both the income test and one of the alternative tests is made in each of the three years. The fact that the foundation uses one method of qualifying in one year does not preclude it from using another method in a subsequent year.

A new organization may obtain an advanced ruling that it will qualify based on a good faith estimate that it will qualify in its first year.

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READY REFERENCE PAGE

NO. 68
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Donor Advised Funds Still Compare Well with Private Foundations

Pension Protection Act imposed new limitations but absolute control of foundations has costs and other limits

Donor advised funds ("DAFs") are often considered the small donor's private foundation. They may be more quickly established, are often less expensively administered, and are more tax advantageous.

But for donors who want absolute control over administration, investment policies, and grantmaking -- and who want to be paid for doing it -- a private foundation may be the only answer. The charitable reform provisions of the Pension Protection Act of 2006 have made it more likely that donors seeking control, and particularly those seeking compensation, will opt for a private foundation. (See Ready Reference Page: "Congress Passes Charitable Reforms.")

For donors who do not want the responsibility or cost of maintaining a perpetual foundation, a DAF sponsored by a community foundation or one of the national donor advised fund charities may be the perfect answer. The fund can be used to make grants to other charities, can be used to introduce family members to philanthropy by involving them in grantmaking decisions, and can take advantage of the more liberal deduction rules for gifts to public charities.

One of the principal advantages of creating a DAF at a public charity is the ability to obtain a full fair market value deduction for a gift of appreciated property other than publicly traded securities. Entrepreneurs who own stock in their closely held corporations have found gifts to donor advised funds sponsored by public charities to be significantly more advantageous than gifts to private foundations because they can deduct the full fair market value of a gift to a public charity, rather than only their cost basis. The Pension Protection Act has imposed the excess business holding rules of private foundations on DAFs, however, so an entrepreneur cannot give long-term control of a company to a DAF.

Donors may recommend grant recipients and, in some cases, investment policies, but the ultimate decisions lie with the public charity sponsoring the fund.

For those contemplating larger gifts, usually assets totaling at least $3 million to cover administrative costs, the private foundation, though subject to foundation taxes and limitations, provides absolute control over the funds, the opportunity to run programs directly, and the opportunity to install family members in permanent positions of charitable administration.

For those seeking to be paid for their work, a private foundation may be the only option. The Pension Protection Act makes it an automatic excess benefit to pay compensation or "similar payments," including reimbursement of expenses, to donors or donor/advisors. Private foundation executives can be paid for certain services and reimbursed for reasonable expenses.

The other major new limitation on DAFs is the prohibition on gifts to individuals, including individuals in personal need. A private foundation may make such gifts, but gifts to individuals for "travel, study or other similar purposes" can be made by a private foundation only pursuant to nondiscriminatory procedures approved in advance by the IRS. Many DAFs have been utilized for scholarship funds, but under the new

rules donors may be involved in selecting scholarship recipients only if they are a minority voice on a scholarship recommendation committee selected and controlled by the sponsoring organization.

A comparison of the major features of a DAF sponsored by a public charity and a private foundation are set out below.

Feature	***Donor Advised Fund***	***Private Foundation***
Set-up time	Usually within a day or two	Time to establish and obtain recognition of exemption
Set-up cost	Usually free or limited charge	Perhaps $5,000 -$15,000
Limits on deductibility	Cash up to 50% of AGI, appreciated property up to 30% of AGI Not deductible if given to veterans organization, fraternal societies, cemetery companies or disqualified Type III supporting organizations No IRA rollover	Cash up to 30% of AGI, appreciated property up to 20% of AGI No IRA rollover
Deductibility of gifts of appreciated property held more than a year	Fair market value (except personal property deductible at cost basis)	Fair market value only for publicly traded stock; cost basis for privately held stock, real estate, etc.
Substantiation Letter Required	Regular, plus acknowledgment that sponsor has exclusive control over assets	Regular
Excise tax on net investment income	None	Generally 2%, may be reduced to 1%
Required payout	None. May accumulate income, though some sponsors may require 5% distribution	Required to spend 5% of net investment assets for charitable purposes
Grants to Individuals	Generally prohibited	Possible, with limitations on travel and study grants
Scholarship Grants	Donor may advise only as minority voice on recommendation committee and nondiscriminatory policies	Permissible with IRS-approved nondiscriminatory policies

Feature	*Donor Advised Fund*	*Private Foundation*
Compensation and similar payments to donors, advisors	Automatic excess benefit	Some compensation, expenses permitted but other self-dealing limitations
Other private foundation restrictions	Expenditure responsibility for gifts to other than public charities Excess Business Holdings rules	Expenditure responsibility for gifts to other than public charities Excess Business Holdings rules Other taxable expenditure rules
Anonymity	May be maintained	Required public disclosure
Administration	Sponsor responsible for investment, grantmaking, other administration	Foundation responsible for administration, investment, grantmaking
Cost of administration	Usually 1% of assets or less	Foundation usually hires staff or consultants to administer at costs unrelated to asset value. With smaller foundations, it could be far more than 1%. With larger, less.
Insurance	Covered by sponsor's policies	Must be purchased separately
Control of administration	None	Full
Control of investments	With some sponsors, may recommend policies or mutual funds	Responsibility of foundation
Assistance with grants	May obtain assistance from sponsor	Foundation solely responsible
Control of grants	May recommend	May determine
Period of donor advice	May be multi-generational, usually not perpetual	Perpetual
Tax Return	Included in sponsor's return	Separate 990-PF required
Conduct of active charitable program	Usually not possible	Possible
Opportunity for family salaried positions	None	Possible

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NO. 63
FOR YOUR FILE
SUPERSEDES NO. 14

Charities Must Avoid Excess Benefit Transactions

Intermediate sanctions statute imposes tax on "disqualified persons" who receive more from a transaction with a nonprofit than they give in return

Organizations that are tax exempt as public charities under Section 501(c)(3) or exempt under 501(c)(4) must be careful to avoid entering into Excess Benefit Transactions. An Excess Benefit Transaction is essentially a business dealing in which:

(1) the organization gives more value than it receives (the difference constituting the "Excess Benefit"), and

(2) someone or something with power to influence the organization's decision (a "Disqualified Person") is or has an interest in the party on the other side of the transaction.

Excess Benefit Transactions may occur in any of several contexts. One is a classic "conflict of interest" business dealing with one of the organization's own Directors, or with an entity in which one of the organization's Directors has an interest. Another is a business arrangement between an organization and another entity to which it is related, such as a contract with a for-profit service corporation within a group of interrelated entities including the charitable provider. This second type of transaction may be easier to overlook, but represents a significant danger for charitable healthcare providers operating within complex corporate systems. A third type of transaction involves dealings with employees who may be Disqualified Persons even if they do not sit on the organization's governing body. This is a common problem for healthcare providers, and sometimes a difficult one to identify.

Under the long-standing law of Private Inurement, organizations can lose their tax-exempt status by engaging in transactions or other business arrangements that are unfairly advantageous to Directors or other organizational insiders. The law of Excess Benefit Transactions has been created over the past few years, in part to give the IRS additional means of penalizing such transactions. These penalties are sometimes called "intermediate sanctions." Penalties for engaging in Excess Benefit Transactions are mostly leveled against the Disqualified Person who benefited from the transaction, but there can also be personal liability for the managers of the charity.

Whether the IRS approaches a transaction as a matter of Private Inurement or of Excess Benefit, penalties for all involved in the transaction can be severe. Final Treasury Regulations provide simple procedures for greatly reducing the risks of incurring such penalties, however, and covered organizations should follow those procedures as closely as possible.

Definition of Excess Benefit Transaction

An "Excess Benefit Transaction" includes "any transaction in which an economic benefit is provided by an applicable tax-exempt organization directly or indirectly to or for the use of any disqualified person if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit." IRC § 4958(c)(1)(A). Economic benefit may be conferred directly or indirectly, and will be measured in the context of the entire economic relationship between the relevant parties. Treas. Reg. § 53.4958-4(a)(1).

Economic benefits are valued using either of two standards. The value of property, including the right to use property, is the fair market value. Treas. Reg. § 53.4958-4(b)(1)(i). The value of services is "the amount that would ordinarily be paid for like services by like enterprises (whether taxable or tax-exempt) under like circumstances." Treas. Reg. § 53.4958-4(b)(1)(ii). This standard for valuing services is generally referred to as the "reasonable compensation" standard.

An "applicable tax-exempt organization" includes any organization described under § 501(c)(3) or § 501(c)(4), at the time of the transaction or at any time during the five years preceding the transaction. Private foundations are excluded, however, since they are subject to a separate penalty regime for self-dealing. IRC § 4958(e). (See Ready Reference Page No. 58, September 2002.)

A "Disqualified Person" includes any person who was, at any time during the five years preceding the transaction, "in a position to exercise substantial influence" over the affairs of the applicable tax-exempt organization. It also includes family members of such individuals, as well as businesses or other entities over which such individuals exert at least 35% control. IRC § 4958(f)(1).

The term "person" may include individuals, but also entities of all types, including corporations, companies, associations, trusts, estates and partner-

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YOU NEED TO KNOW

Excess Benefit Transactions can trigger serious consequences for all involved. Happily, the IRS provides very simple guidelines for investigating and approving business deals. These guidelines also constitute sound business practice, even in the negotiation of an arm's-length deal that cannot be an Excess Benefit Transaction.

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Simple Guidelines Help Charities Avoid Risks

ships. IRC § 7701(a)(1).

Persons "in a position to exercise substantial influence" automatically include any of the following: voting members of the governing body; any person serving as president, chief executive officer, chief operating officer, chief financial officer or treasurer, or holding the types of responsibility typically associated with such positions; and, if the applicable tax-exempt organization is a hospital that participates in a provider-sponsored organization (as defined in § 1855(e) of the Social Security Act), any person with a material financial interest in that provider-sponsored organization. Treas. Reg § 53.4958-3(c).

Other persons may be also deemed to be in a "position to exercise substantial influence" if facts and circumstances so indicate. Treas. Reg § 53.4958-3(e)(1). The IRS will tend to view a person as having such status if that person:

(1) founded the organization;

(2) is a substantial contributor to the organization within the meaning of § 507(d)(2)(A), taking into account only those contributions received by the organization during the current and the four preceding years (in most relevant situations, this means anybody who has contributed more than 2% of the donations received by the organization during that period);

(3) is compensated primarily based on the organization's revenues, or on the revenues of a department or division that the person controls;

(4) has or shares authority over a substantial portion of the organization's capital expenditures, operating budget or compensation of employees;

(5) manages a segment of the organization that represents a substantial portion of the organization's activities, assets, income or expenses;

(6) owns a controlling interest in an entity that is a Disqualified Person; or

(7) is an entity controlled, directly or indirectly, by a Disqualified Person. Treas. Reg. § 53.4958-3(e)(2).

Some of these factors may cause a related entity, such as a for-profit service provider under shared control with the applicable tax-exempt organization, to be deemed a Disqualified Person (along with those managers exercising the joint control). However, § 501(c)(3) and (c)(4) entities are deemed not to hold such influence regardless of titles, facts or circumstances (Treas. Reg. §§ 53.4958-3(d)(1) and (2)), and so cannot be Disqualified Persons.

Sanctions

In theory, any covered § 501(c)(3) or (c)(4) organization that enters into an excess benefit transaction could have its exemption revoked, since each of those Sections includes an absolute prohibition against net earnings inuring to the benefit of any private individual. In practice, the standard for revocation is somewhat more permissive. The IRS considers factors including "whether the organization has been involved in repeated excess benefit transactions; the size and scope of the excess benefit transaction; whether, after concluding that it has been party to an excess benefit transaction, the organization has implemented safeguards to prevent future recurrences; and whether there was compliance with other applicable laws." 63 Fed. Reg. 41486, 41488 (Aug. 4, 1998).

Safe harbor rules create presumption of fairness

Even if the IRS determines that revocation is not warranted, however, parties to an Excess Benefit Transaction are subject to the following consequences.

IRC § 4958(a)(1) imposes on each Excess Benefit Transaction a tax equal to 25% of the amount of the Excess Benefit. The tax is imposed on the Disqualified Person.

The organization managers of an applicable tax-exempt organization are personally liable for an additional tax if they knowingly and willingly participate in an Excess Benefit Transaction. IRC § 4958(a)(2). "Organization Managers" includes any officer, director, or trustee of the organization, or any individual having powers or responsibilities similar to those of officers, directors, or trustees of the organization. IRC § 4958(f)(2). Organizational Managers are jointly and severally liable for any such tax. IRC § 4958(d)(1). The tax is equal to 10% of the Excess Benefit, up to a limit of $10,000. IRC §§ 4958(a)(2), 4958(d)(2).

After paying the 25% Excess Benefit tax, a Disqualified Person may avoid further penalties by correcting the Excess Benefit Transaction. IRC § 4958(b). "Correction" consists of undoing the Excess Benefit to the extent possible, and taking any additional measures necessary to restore the financial position of the applicable tax-exempt organization. IRC § 4958(f)(6).

If the Disqualified Person fails to correct the Excess Benefit Transaction, she, he or it incurs an additional tax of 200% of the Excess Benefit. IRC § 4958(b).

In addition to penalties imposed by the Internal Revenue Service, there may be other detrimental effects. For example, entry into an Excess Benefit Transaction may breach covenants in bond documents. Section 501(c)(3) tax exempt bonds are typically issued in reliance on a covenant by the borrower to do nothing that might jeopardize 501(c)(3) status. Since loss of such status is a potential result of any Excess Benefit Transaction, an entity bound by such a covenant might create an event of default by entering an Excess Benefit Transaction. This may be true even if the IRS takes no action in regard to the transaction. A review of any particular entity's contracts, licenses and other documents may reveal other restrictions or covenants that could be similarly relevant to the contemplated transaction.

Safe Harbor

In any particular case, the deter-

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Charities Must Avoid Excess Benefit Transactions

mination of whether a transaction is an Excess Benefit Transaction will turn on a determination of fair market value or reasonable compensation. There is no single, clear protocol for establishing that an organization will receive or has received fair or reasonable value in any given transaction. Treasury Regulations do, however, provide a "safe harbor" within which organizations may operate with relative security. Treas. Reg. § 53.4958-6.

The safe harbor is defined by a set of procedural guidelines for considering and approving transactions. If an organization follows those guidelines in entering a transaction, the IRS presumes that the transaction was for fair or reasonable value. Treas. Reg. § 53.4958-6(a). That presumption is rebuttable, but the IRS would bear the burden of proof if it wished to characterize a transaction as involving Excess Benefit. Treas. Reg. § 53.4958-6(b). Affected organizations should follow those guidelines as closely as possible, particularly in regard to any transaction with a party that might be a Disqualified Person under IRC § 4958(f)(1).

The "safe harbor" guidelines at Treas. Reg. § 53.4958-6 may be summarized as follows:

(1) The transaction will be approved only if its terms are reasonable, in the case of compensation arrangements, or at fair market value, in the case of transfer or use of property;

(2) The transaction will be approved in advance by a body of Directors or other appropriate decision makers who do not have any conflict of interest in regard to the transaction, i.e. individuals with conflicts of interest will excuse themselves from both the deliberation and the vote on the transaction;

(3) The approving body will obtain and rely upon appropriate data as to comparable transactions involving similarly situated organizations; and

(4) At the time of approving the transaction, the approving body will document its basis for determining that the transaction is fair and reasonable.

Note that revenue sharing arrangements present a special case, and are subject to unique considerations. Revenue sharing arrangements should always be reviewed by counsel.

Directors and other managers who follow the safe harbor guidelines should be aware that there may be separate, state law provisions covering the same types of transactions. For example, most state nonprofit corporation laws contain a distinct set of guidelines under which transactions involving interested members, directors or officers may be deemed void or voidable. Directors should also be aware of state law regarding their fiduciary duties.

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READY REFERENCE PAGE NO. 58 FOR YOUR FILE

Private Foundations Must Avoid Self-Dealing

Disqualified persons and foundation managers can be personally liable for excise taxes for certain transactions even where it is clear that the foundation has suffered no loss

Private foundations are subject to a number of limitations and restrictions on their operations, but none is more sweeping — or potentially more likely to cause personal liability — than the limitations on "self-dealing" transactions.

Individuals and organizations that are considered "disqualified persons" and the foundations for which they are disqualified are essentially prohibited by Tax Code Section 4941 from participating in a whole series of economic transactions with each other. Subject to limited exceptions, these transactions include any direct or indirect selling or leasing property to or from the foundation, making loans or extending credit to or by the foundation, providing goods or services to or by the foundation, paying compensation to a disqualified person (other than for certain personal services necessary for the foundation to carry out its purposes), transferring income or assets of the foundation for the benefit of the disqualified person, and making payments to public officials.

Unlike the excess benefits tax provisions applicable to insiders at public charities, which trigger penalties only if the insider receives more from the charity than he or she provides in return, the private foundation self-dealing rules apply to any regulated transaction, even if the foundation clearly receives the better part of the bargain. A disqualified person may give things to the foundation, but, with limited exceptions such as certain personal services, may not receive anything of value in return.

If the parties engage in an improper self-dealing transaction, both the disqualified person and the foundation managers can be personally liable for significant excise taxes. They can be liable even where it is clear that the foundation has not suffered a loss.

Disqualified Persons

There are several categories of disqualified persons. They include:

• Substantial contributors to the foundation, which includes any person who has contributed more than $5,000 or 2% of the total of gifts, grants, and contributions received by the foundation since its inception, whichever is greater.

• Owners of more than 20% of the total combined voting power of a corporation, or interest in the profits of a partnership, or beneficial interests in a trust which is a substantial contributor.

• Foundation managers such as officers, directors or trustees or other employee having responsibility for any specific self-dealing transaction.

• Members of the family of an individual disqualified under the foregoing criteria, which include only a spouse, ancestor, child, grandchild, great-grandchild and the spouses of such lineal descendants.

• Corporations, partnerships, trusts, or estates in which any of the foregoing, other than family members, owns more than 35% of the total combined voting power, profits interests, or beneficial interests, respectively.

• Governmental officials.

A charitable organization described in Section 501(c)(3) of the Tax Code, including another private foundation (but excluding an organization operated exclusively for testing for public safety) is generally not considered a disqualified person. This exclusion permits transactions within the charitable community among related and affiliated entities.

How do the rules apply?

• **Sale, exchange or lease of property.** Neither a disqualified person nor a foundation may sell, exchange or lease property to the other. A sale of a $1 million painting to the foundation for $100,000 would trigger the tax, as would a donation of a $1 million piece of real estate subject to a mortgage or similar lien which has not existed for more than 10 years. The rule has been interpreted by the IRS to cover even a sale to a disqualified person at a public auction, where anyone had the chance to bid.

Redemption of stock by a disqualified corporation would generally be a self-dealing transaction unless it falls within a limited exception for certain sale or exchange transactions between a foundation and a disqualified corporation if they involve a liquidation, merger, redemption, recapitalization, or other corporate reorganization, if all securities of the class held by the foundation are subject to the same terms and conditions, and if the terms provide for the foundation to receive no less than fair market value.

• **Loans and other extensions of credit.** Loans between the foundation and a disqualified person are considered self-dealing transactions even where they are adequately secured and made at fair interest rates.

The rule is so stringent that the IRS has had to provide special guidance about advancing funds to foundation managers when going on trips or otherwise needing to pay expenses for which they will be reimbursed. Advancing funds is permitted only in limited amounts when reasonable and necessary for foundation to function.

• **Furnishing goods, services or facilities.** This rule covers items such

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Private Foundations Must Avoid Self-Dealing

as office space, automobiles, secretarial help, libraries, publications, laboratories and parking lots. A foundation manager who gave a home to the foundation but continued to live there after the gift was completed was deemed to be involved in an act of self-dealing.

Foundations can provide incidental meals and lodging to a foundation manager that is reasonable and necessary to carry out the purposes of the foundation. A foundation may also provide goods or services to a disqualified person if they are supplied on a basis no more favorable than supplied to the general public.

• **Payment of Compensation and Expenses.** A foundation may pay a disqualified person reasonable compensation for personal services which are necessary to carry out the exempt purposes of the foundation. It may pay a bank trustee for ordinary and necessary banking services, but the IRS ruled in 1973 that it could not pay the bank an overdraft charge of more than it cost the bank to process the transaction. It may pay brokerage fees, but may not buy securities from or sell them to a disqualified person which acts as a dealer for its own account. It may pay investment management fees and legal fees, but one case has ruled that a foundation cannot pay a disqualified person for property maintenance services since the services were not professional or managerial.

• **Use of assets.** A private foundation created by a corporation has been held to commit self-dealing by allowing officers of the corporation to use tickets to a fund raising dinner purchased by the foundation, although use of the tickets by foundation officers was permitted. Providing foundation artwork to a disqualified person's home is an act of self-dealing, unless used only in the foundation office, or otherwise generally available to the public. The IRS does not object to the prestige that disqualified persons obtain from making foundation gifts, calling it only incidental personal benefit.

After considerable controversy, the IRS issued rules in 1995 to provide that a foundation could pay for insurance or directly provide indemnification, including settlement costs and judgments, for foundation managers involved in litigation without committing an act of self-dealing so long as the payments are reasonable, the manager did not act willfully and without reasonable cause, and the foundation does pay a manager's liability for excise taxes due under the foundation rules of the Tax Code.

• **Payments to governmental officials.** A foundation may not make payments to government officials, with limited exceptions such as public awards and scholarships.

A disqualified person is subject to a tax of 5% of the amount involved, whether or not the violation was knowing. A foundation manager is liable for 2 1/2% of the amount involved, but only if the violation was knowing and not due to reasonable cause. If the transaction is not corrected, the disqualified can be subject to an additional tax of 200% of the amount involved and the manager can be subject to a tax of 50%, to a maximum of $10,000.

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Foundations Avoid Excess Business Holdings

Private foundations may be subject to tax if they and their disqualified persons hold too much stock in a business functionally unrelated to the purpose of the foundation

The recent passage of Pennsylvania's law requiring charitable trusts to consider community interests and get Attorney General approval before selling a controlling interest in a business enterprise, passed in reaction to the Hershey Trust situation (See *Nonprofit Issues®* October 2002), calls attention to the directly opposite sentiment expressed by Congress in prohibiting private foundations from controlling business activities.

Congress added Section 4943 to the Tax Code in the 1969 revisions to require private foundations (though not public charities) to divest themselves of "excess business holdings."

In a Congressional Committee report on the change, Congress said that some foundation managers had "become so interested in making a success of the business, or in meeting competition, that most of their attention and interest was devoted to this with the result that what was supposed to be their function, that of carrying on charitable, educational, etc., activities was neglected.

" Even when such a foundation attains a degree of independence from its major donor, there is a temptation for its managers to divert their interest to the maintenance and improvement of the business and away from their charitable duties. Where the charitable ownership predominates, the business may be run in a way which unfairly competes with other businesses whose owners must pay taxes on the income that they derive from the business."

Business entrepreneurs often gave significant interests in their businesses to their private foundations, knowing they could keep control of the business while passing income-tax-free dividends back to the foundation.

To remedy the perceived problems, Congress said that a private foundation (along with its disqualified persons) generally may not hold more than a 20% interest in a business enterprise. If it ever holds more, it must divest itself of the excess, not all its holdings.

The limitation applies to the percentage of interest in the business enterprise, not the percentage of the foundation's holdings which are invested in the business. A foundation could have half of its own portfolio invested in a single company so long as the foundation's percentage of interest in the business is not above the limit.

A "business enterprise" generally includes any trade or business which is not functionally related to the charitable purposes of the foundation. If the activity of the business would not be an unrelated trade or business if carried on directly by the foundation, the foundation may hold an interest in the entity without limitation.

The Code includes another important exception and permits holdings in a business which receives more than 95% of its income from "passive sources."

Such sources of income could include interest and dividends, royalties, rents and other items specifically excluded from the Tax Code definition of unrelated business taxable income. This includes the sale of goods if the seller does not manufacture, produce, physically receive or deliver, negotiate the sale of or maintain inventories of such goods.

The Code specifically provides that passive income in the business does not lose such characterization merely because it is debt-financed.

This exception might allow a private foundation, for example, to own a shopping center and rent out the space to commercial tenants, to hold an interest in an investment partnership, or invest in a brokerage business which operates under fixed contracts.

The Code also includes an exception for program related investments which have a primary purpose of carrying out the foundation's charitable purposes and do not have a significant purpose of producing income. (See Ready Reference Page No. 8, January 1998)

In determining whether the foundation has excess holdings, the Code aggregates all interests held by the foundation and any person categorized as a "disqualified person" under the Code.

Generally this includes all foundation managers, any substantial contributors to the foundation, certain family members and various entities in which such persons have significant

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YOU NEED TO KNOW

Private foundations don't normally have to worry too much about excess business holdings because they diversify their investments in publicly traded companies where the chance of their owning more than 20% of the stock is remote at best.

When they invest in a small business, however, they should be sure to question their disqualified persons on their personal holdings, because the limit is based on the aggregate holdings of the group. Don't forget to send the questionnaire to a disqualified substantial contributor who is no longer on the Board. You could easily to be blind-sided by the aggregate holdings if you are not vigilant in making your inquiries.

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Foundations Avoid Excess Business Holdings

interests as defined in Section 4946.

The foundation is deemed not to have excess holdings if its own holdings in the business enterprise are not more than 2% of the voting stock and all other outstanding shares of all classes of stock of the entity.

In other words, even if the foundation managers owned a majority interest in the business, the foundation would not have excess business holdings if it did not own more than 2% of the interests in the business.

If the foundation and its disqualified persons do not own more than 35% of the interests in the business and they can show to the satisfaction of the IRS that the business is effectively controlled by one or more other persons, the combined holdings of the foundation and its disqualified persons can exceed 20%.

When the law was passed in 1969, there were extensive transition periods during which a foundation could divest its excess holdings held at the time. All of those transition periods have expired.

Under the current rules, a foundation cannot purchase an excess business holding, but has five years to divest such holdings that may be acquired "other than by purchase." If a major donor leaves a foundation a majority interest in a will, the foundation will not be subject to tax unless it fails to divest its excess interest within five years.

If a disqualified person acquires interests in the company, whether by purchase or by gift, which would, when aggregated with the holdings of the foundation, exceed the limit, the Code nevertheless allows the foundation five years to divest itself if its excess holdings.

Under the statute, all of the holdings in the business enterprise are deemed to be held by the disqualified person, who is not bound by the limit, rather than the foundation which is.

The IRS may extend the time for an additional five years if the gift is "unusually large" and the foundation has been unable to divest itself of the interest without the loss of a substantial portion of its value.

If a foundation purchases an interest in a business entity and did not know that its disqualified persons held enough of the interest to create an excess holdings situation, the foundation has a 90 day period within which to divest itself of its excess interest without being subject to the tax.

If a foundation does hold an excess business interest it is subject to an initial tax of 5% of the value of the excess amount. The tax is assessed on the last day of the fiscal year, but is based on the highest value of excess holdings during the year.

The IRS has the authority to abate the tax if the foundation can show that the violation was due to reasonable cause and not willful neglect and the foundation divests itself of the excess interest.

If the foundation fails to divest itself of its excess interest promptly after the tax becomes due, it can be assessed an additional tax of 200% of the excess value.

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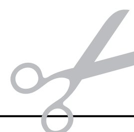

READY REFERENCE PAGE NO. 8 FOR YOUR FILE

Foundations May Be Source of Venture Capital

Their little-used power to make program related investments offers opportunity for creative financing of projects

Nonprofits being squeezed by lack of funds are trying to develop new sources of revenue to expand their programs or just to keep them alive.

Some set up "profitable" nonprofit subsidiaries. Others start for-profit enterprises, with or without partners. But the necessary start-up costs may be both substantial and hard to find.

In searching for funds, nonprofit entrepreneurs usually look to private foundation grants as the most readily available and cheapest source of venture capital. But outright grants are not the only way a foundation can help.

Private foundations have surprising powers to make "program related investments" which may provide the leverage you need to get your new project underway. The foundation may find the investment proposal an attractive opportunity to achieve its own purposes while still retaining or recycling its funds.

Foundation managers are normally held to a standard of prudent business judgment in the investment of foundation funds. But they are permitted to make certain investment that would not be prudent business risks if the investment furthers their charitable purposes. They are permitted to make low- or no-interest loans to both nonprofit and for-profit organizations and are even permitted to buy stock in for-profit corporations.

A few foundations, perhaps most notably the Ford Foundation, have ventured far into the field of supporting projects by loans or purchases of stock. Program related investments allow a foundation to support its own program with the very real likelihood that it will recover some or all of the money, thereby replenishing its endowment. While it's hard to imagine a more productive "win-win" situation, most foundations remain reluctant to go beyond traditional grants to public charities.

In a circuitous fashion not unusual in the Internal Revenue Code, program related investments are not affirmatively spelled out as appropriate activities for foundations. They are referred to as an exception to the general prohibition on "jeopardy investments."

Section 4944 of the Tax Code imposes a tax on foundations and their managers if they invest "any amount in such a manner as to jeopardize the carrying out of its tax exempt purposes."

The regulations define a jeopardy investment as one in which the managers "have failed to exercise ordinary business care and prudence" at the time of the investment to provide for the long-and short-range financial needs for the foundation. In selecting stocks, bonds and other investments, they are supposed to consider the expected return, both income and appreciation, the risks, and the need for diversification. If the investments fail the "prudence" test, both the foundation and the managers are subject to tax.

The Code, however, provides an exception for "program related investments." The regulations describe them as having three characteristics.

First, "the primary purpose" of the investment must be to accomplish one or more charitable purposes. It must significantly further the purpose of the foundation and be an investment which would not have been made but for the attempt to fulfill the foundation's purpose.

Second, "no significant purpose" of the investment can be the production of income or appreciation of property. In determining the investment potential, it is relevant whether investors solely interested in profit would have made the investment on the same terms and conditions. The less business-like the transaction, the more likely the classification as program related. The fact that the investment is ultimately profitable is not conclusive evidence that its original purpose was to make a profit.

Third, the regulations impose a condition not specifically included in the statute, that "no purpose" of the investment may be to conduct lobbying or political activities.

Noticeably absent from the criteria is a prohibition on private inurement. In many, if not most, cases, private investors are also involved in the project and stand to gain as the result of the investment. However, so long as the overall purpose of the foundation is within its charitable purpose, such investments are permitted.

The form or terms of the investment may change over time, such as extending the repayment date of a loan, so long as the changes are primarily to further the charitable purpose of the foundation and not to produce additional income.

The regulations give several examples of program related investments.

- A private foundation makes a loan at below market interest rates to a minority owned business in a deteriorated urban area when conventional sources will not provide such funds on economically feasible terms. The purpose is to encourage economic development of the minority group, a purpose of the foundation. The loan is program related even though the interest rate is comparable to or greater than the return which would be received from more prudent conventional portfolio investments of lower risk.
- A small minority owned business in a blighted area is unable to borrow funds from conventional sources unless it increases its equity capital. The private foundation purchases shares of the company stock to encourage economic development activity. Because the investment significantly furthers the foundation's exempt purposes and would not have been made otherwise, the investment is considered program related, even though the foundation could realize a substantial profit if the business becomes successful.
- A business owned by a nonprofit community development corporation will market agricultural products, thereby providing a market for low-income farmers in a depressed rural area. A private foundation makes a below market interest rate loan to the business pursuant to it program to encourage economic development of depressed areas. No significant purpose is to produce income, the loan further the foundation's purpose and would not have been made but for the program. The loan qualifies as a program related investment.

Although examples in the regulations tend to concentrate on economic development activities, in private letter rulings, the IRS has specifically approved investment in an energy demonstration project, purchase

of preferred stock in a minority bank, investment in a business which operates live theater, a low interest construction loan to another foundation, and a loan to a limited partnership building a hotel in a blighted area.

Proposed regulations issued in 2013 clarify that a wide range of investments qualify as program related investments.

In particular, the proposed regulations illustrate that charitable purposes served by a program related investment are not limited to situations involving economically disadvantaged individuals and deteriorated urban areas. They also demonstrate that program related investments can be made through a variety of investment vehicles, including loans to individuals, tax-exempt organizations and for-profit entities, equity investments in for-profits and credit enhancement arrangements. They show that an activity conducted in a foreign country furthers a charitable purpose if the same activity would further a charitable purpose if conducted in the U.S. Foundations are permitted to rely on the proposed regulations before they are adopted as final regulations.

In one of the new examples, a new business enterprise in a developing country collects recyclable solid waste materials and delivers them to recycling centers that are inaccessible to a majority of the population. If successful, the collection business will prevent pollution caused by the usual disposition of solid waste materials. The business has obtained funding from only a few commercial investors because the expected rate of return is significantly less than potential investors find acceptable. A private foundation enters into an investment agreement to purchase shares of the business's common stock on the same terms as the initial investors. Although there is a high risk associated with the investment, there is also the potential for a high rate of return if the business is successful. The foundation's primary purpose in making the investment is to combat environmental deterioration. No significant purpose of the investment involves the production of income or the appreciation of property. The foundation would not have made the investment if it did not further the accomplishment of the foundation's exempt purposes. The foundation's purchase of the stock is a program related investment.

Another example involves the same facts, except that the business offers the foundation shares of its stock in order to induce the foundation to make a below-market rate loan. The business made the same offer to a number of commercial investors who were unwilling to provide loans because the expected return on the combined stock and debt was below market return for such an investment. The commercial investors were also unwilling to provide loans on terms the business considered feasible. The foundation accepts the stock and makes the loan on the terms that the business offered the commercial investors. The foundation plans to liquidate the stock as soon as the business is profitable or it is established that the business will never become profitable. The loan and acceptance of the stock is a program related investment.

In an example involving loans to individuals, there is a natural disaster in a developing country, causing significant damage to infrastructure. A private foundation makes loans with below market rate interest to two poor individuals to enable them to start small businesses. Conventional sources of funds were unwilling to provide loans on terms the individuals considered economically feasible. The foundation's primary purpose in making the loans is to provide relief to the poor and distressed, and the loans would not have been made if they did not significantly further the foundation's exempt purposes. No significant purpose of the loans involves the production of income or the appreciation of property. The loans are program related investments.

Another example involves a loan to a 501(c)(4) social welfare organization formed to develop and encourage interest in painting, sculpture and other art forms, including by conducting weekly community art exhibits. The 501(c)(4) needs to purchase an exhibition space to accommodate the demand for exhibition space within the community. Conventional sources of funds are unwilling or unable to provide funds on terms the 501(c)(4) considers economically feasible. A private foundation makes a loan to the 501(c)(4) at a below market interest rate for commercial loans of comparable risk. The foundation's primary purpose in making the loan is to promote the arts, and the loan would not have been made if it did not significantly further the accomplishment of the foundation's exempt purposes. No significant purpose of the loan involves the production of income or the appreciation of property. The loan is a program related investment.

A program related investment constitutes a qualifying distribution for the foundation so that it helps meet the foundation's annual distribution requirement of 5% of its gross investment assets.

Foundations which make such investments must be careful not to violate the rules on self-dealing, excess business holdings, and taxable expenditures. If the investment is made in an organization which is not a public charity, the foundation will be required to exercise "expenditure responsibility" in approving the investment and following up on reporting.

Although it is slightly more complicated for a foundation to make a program related investment than to make an outright grant, there is nothing in the requirements which cannot be complied with under normal circumstances.

YOU NEED TO KNOW

Because program related investments are somewhat more complicated and slightly riskier than a straight grant to a public charity, most private foundations have been reluctant to get into the program related investment business. But they have the power to do so, and that provides the creative nonprofit entrepreneur with another opportunity to suggest ways a venturesome foundation can support a charitable program.

Expenditure Responsibility

Expenditure responsibility requires a foundation to:

1. Conduct a pre-grant inquiry to determine whether the proposed grantee is reasonably likely to use the grant for the specified purposes.

2. Will sign a written grant agreement with the grantee with specific terms prohibiting use of the funds for lobbying or campaigning, or for either grants to individuals for scholarship or travel or for grants to organizations without complying with the rules that apply to such grants when made by foundations, or for any non-charitable purpose.

3. Have the grantee commit to maintain the grant funds in a separate account on the grantee's books.

4. Have the grantee submit reports, in writing, during the term of the grant (at least annually, but perhaps every six months), explaining how it used the funds and describing its compliance with the grant terms and its progress toward the grant purposes.

5. Report on Form 990 the grant, including a description, amount, charitable purpose, and current status.

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IRS updates private foundation rules on MRIs and equivalency determinations

The Internal Revenue Service has given new approval to mission related investments by private foundations and spelled out specific requirements for making "good faith determinations" that grants to foreign organizations are qualifying distributions that don't require expenditure responsibility.

The Tax Code, in Section 4944, imposes an excise tax on private foundation investments that "jeopardize the carrying out of any of its exempt purposes," but specifically excepts from the limitation "program related investments" where the primary purpose is to accomplish its charitable purpose and "no significant purpose" is the production of income or the appreciation of property. (See Ready Reference Page: "Foundations May Be Source of Venture Capital") PRIs are not only permitted, but are counted toward the minimum distribution requirement of the foundation.

The exception applies, however, only where there is "no significant purpose" to generate income. Some foundation managers have been concerned that they might be liable if they invested portions of their endowments in "mission related investments" or "socially responsible investments" which are aligned with their charitable goals but still provide — and are expected to provide — a return on investment, although not necessarily the highest return. Investing in alternate energy sources rather than fossil fuels might be an example.

In IRS Notice 2015-62, the Service says an investment will not be considered a jeopardizing investment "if, in making the investment, the foundation managers exercise ordinary business care and prudence (under the circumstances prevailing at the time the investment is made) in providing for the long-term and short-term financial needs of the foundation to carry out its charitable purposes.… foundation managers may consider all relevant facts and circumstances, including the relationship between a particular investment and the foundation's charitable purposes. Foundation managers are not required to select only investments that offer the highest rates of return, the lowest risks, or the greatest liquidity so long as the foundation managers exercise the requisite ordinary business care and prudence … and do not jeopardize the private foundation's charitable purposes."

The IRS says the standard "is consistent with investment standards under state laws," citing the Uniform Prudent Management of Institutional Funds Act. The relatively new UPMIFA allows managers to

consider the asset's special relationship or special value, if any, to the charitable purposes of the organization. (See Ready Reference Page: "New UPMIFA Sets Rules for Management of Charitable Funds")
The IRS has also issued final regulations on standards for a private foundation to make a "good faith determination" that a foreign grantee is a charitable organization that is not equivalent to a private foundation. Grants to such organization may be qualifying distributions and not taxable expenditures. A private foundation is permitted to make a grant to a foreign organization that meets the definition of a U.S. public charity (including a supporting organization other than a non-functionally integrated Type III supporting organization) or a private operating foundation. To make grants for charitable purposes to other organizations, the foundation must exercise expenditure responsibility. The final regulation slightly modifies proposed regulations issued in 2012 and is effective as of September 25, 2015.

The final regs under Section 53.4942(a) attempt to balance two important considerations, the IRS said, —removing barriers to international grantmaking and ensuring that foundations' good faith determinations are informed by a sufficient understanding of applicable law, are based on all relevant facts, and are likely to be correct.

The final regs expand the class of advisors who may provide written advice on which a foundation may rely to include "qualified tax practitioners," including CPAs and enrolled agents. Attorneys may be in-house counsel or outside counsel. All must be licensed in their disciplines and authorized to practice in a state or as an enrolled agent at the IRS. Foundations will not be able to rely on an opinion of grantee's counsel unless that counsel meets the qualifications for a qualified tax practitioner. Opinions by foreign lawyers or CPAs not licensed in the U.S., therefore, will not be sufficient.

Foundations will also be unable to rely solely on an affidavit from the foreign grantee. Although the IRS recognized that some affidavits could be reliable because the person understood the requirements of U.S. law, it said that some of them would be unreliable because the grantee did not understand U.S. law. Therefore, reliance solely on the grantee's affidavit would not be considered a good faith determination. The IRS said, however, that a qualified tax practitioner could rely on foreign counsel for questions of foreign law or other matters within such counsel's experience.

Some private foundations who make grants to the same foreign organizations have wondered whether U.S. grantmakers may share their determinations and still meet the good faith determination standard. The IRS again said that some determinations could be good, while others would be invalid because they are not made by people familiar with U.S. law. The final regulations do not prohibit the sharing of information and determinations, but each foundation must rely on advice given to it by a qualified tax practitioner, not by another foundation.

The IRS said that these new guidelines can be used by sponsors of donor advised funds in making grants abroad "until further guidance is issued."

READY REFERENCE PAGE

NO. 16
FOR YOUR FILE

Lobbying Rules Create Opportunity for Charities

There are many ways to advocate for public policy goals without going beyond the limitations of the Tax Code

Public charities can usually advocate on public policy issues a lot more than they think they can.

For years, they were conditioned to fear losing their exemption if they got involved in advocacy of any type. They knew that one of the conditions of Section 501(c)(3) status is that "no substantial part" of an organization's activities can include attempting to influence legislation or "lobbying."

Since there was no clear line to determine what is "substantial," and since they did not always understand what was meant by "attempting to influence legislation," many tended to shy away from any involvement in public policy debate.

In 1976, Congress attempted to relieve the fears by enacting Code Section 501(h), allowing most public charities to elect to measure their lobbying activity solely by the amount of money spent. The final regulations, which were promulgated 14 years later in 1990, eliminate many of the definitional problems. Public charities, and the private foundations which want to fund their advocacy efforts, should be a lot more confident about their ability to jump into the public policy fray.

Although technically the definitions apply only to those groups which have made the 501(h) election, they seem to embody the IRS thinking that would be applied even for non-electing organizations.

The first important point is that not all advocacy is limited. The limitation applies only to attempting to influence "legislation."

"Legislation" includes action by a legislative body at any level of government, such as Congress, a state legislature or city council. It also includes action by the public on a referendum, ballot initiative, constitutional amendment or similar procedure.

Legislation does not include promulgating administrative regulations or taking executive actions which do not require changes in the law. It does not include action by administrative bodies, such as school boards, zoning boards, housing authorities or other agencies which do not pass laws. And it does not include litigation.

An arts organization seeking an additional appropriation in this year's budget for the National Endowment for the Arts is lobbying. The same organization working with the NEA on its definition of decency for purposes of making grants is not lobbying, since an administrative regulation is not legislation.

Understanding this distinction opens a whole lot of territory for advocacy, without having to worry whether it is a substantial portion of your activity. When dealing with legislation, the regulations define two types of lobbying: direct lobbying and grass roots lobbying.

Direct lobbying is any attempt to influence legislation through communication with 1) a member or employee of a legislative body or 2) any government official or employee who may help formulate legislation, when the communication a) refers to specific legislation and b) reflects a view on that legislation.

Grass roots lobbying is a communication with the general public that a) refers to specific legislation, b) reflects a view on the legislation and c) encourages the recipient to take action.

It will be considered a call to action if it a) encourages the recipient to contact a legislator or employee of a legislative body; b) states the address or phone number of a legislator or employee of a legislative body; c) provides a tear-off postcard to mail to the legislator or employee; or d) specifically identifies that a legislator scheduled to vote on the legislation is opposed or undecided on the views expressed in the communication or is the recipient's representative, or identifies the legislator as a member of the committee that will consider the legislation.

A group may purchase a full page newspaper ad stating that a proposed bill is the most enlightened proposal possible on the subject. It is not grass roots lobbying unless it contains the call to action.

Certain activities are specifically excluded from the definition of lobbying. One of the more important exceptions is "nonpartisan analysis, study or research." Such analysis may even advocate a particular viewpoint "so long as there is a sufficiently full and fair exposition of the pertinent facts to enable the public or an individual to form an independent opinion or conclusion" on the issue.

Even where the research is later used for the purposes of lobbying, the costs of the research will not be considered lobbying expenses where "the primary purpose" of the research was not for use in lobbying. The regulations provide a "safe harbor" which says that the primary purpose will not be for use in lobbying if, prior to or contemporaneously with the use of the materials in lobbying, the organization makes a substantial non-lobbying distribution, i.e. without a call to action.

The regulations exempt provision of technical advice in response to a written request by a governmental body. A charity may testify before a legislative committee without limitation if the testimony is pursuant to a written request. Assistance to an individual legislator or to a single political party does not qualify for this exemption.

The regulations also exempt "self defense" communications where a legislative body is considering action that may affect the continued existence of the charity, its powers or duties, its exempt status or the deductibility of contributions to it. Charitable activity opposing the Istook Amendment several years ago was widely believed to be self defense lobbying because the Amendment would have significantly reduced a charity's right to participate in public policy questions.

The rules for distributions to bona fide members of an organization are slightly more lenient and allow a broader range of activity without having it go against the limits.

Private foundations are also helped significantly by the final regulations. Private foundations, with very few limited exemptions, such as the "self defense" exemption, must pay an excise tax on any lobbying expenditures and traditionally were even more reluctant to engage in or support advocacy efforts.

The new rules, however, establish clear safe harbor provisions by which foundations may support ad-

vocacy projects without serious worry about their own status.

A grant for general support, unless earmarked for lobbying activities, will be deemed not to be a lobbying expense. A grant for a specific project will not be deemed to be a lobbying expense if the total of the foundation's grant to the project for the year does not exceed the amount budgeted for non-lobbying activities.

If a $100,000 project budget contains $20,000 for lobbying, the foundation may fund up to $80,000 without concern. The foundation is able to rely on the grantee's budget unless it has reason to know that the budget is wrong. The grantee charity may also get the other $20,000 from a private foundation without either foundation having a problem. Each of the two grants, although together they will provide funds for lobbying, is deemed to go to the non-lobbying activity.

Armed with a clear understanding of the rules, a charity interested in public policy advocacy should be able to mount significant efforts, and should be able to obtain foundation funding to support its work.

YOU NEED TO KNOW

A charity that does not spend at least a portion of its time in advocacy work is probably not doing its job as well as it should.

Therefore, charities must understand the tax law definitions of "lobbying" and "legislation." There is a vast amount of advocacy that can be carried on without approaching tax limitations. Private foundations can support most of it, and preparing an application with foundation rules in mind can make it easier to get funded.

Tax law is not the only issue, however. Beware of federal and state lobbying registration requirements, with different definitions and different reporting.

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How do we deal with basis of gift of appreciated stock?

When a donor gives appreciated publicly-traded stock owned more than 12 months to a 501(c)(3) foundation, the donor reports the donated value as the fair market value at the time of transfer. What is not clear to me is how the receiving organization records the cost basis of the stock. Does the (c)(3) record the FMV on the date of transfer as its cost basis, or does it record and maintain the donor's original cost basis?

The answer depends, in part, on the tax status of the 501(c)(3) "foundation" that receives the gift. As you know, the term "foundation" is not, by itself, legally significant. The organization could be a public charity, like a community foundation or one of the many "foundations" soliciting gifts to cure a specific disease, or it could be a private foundation, like the Gates Foundation or the Ford Foundation. The rules are slightly different. As we have often said, if you don't know what box you fit in, you don't know what rules apply. (See Ready Reference Page: "What Do We Mean When We Say 'Nonprofit'?")

For financial accounting purposes, it probably does not make a difference. Ordinarily accountants will account on the financial statements and 990-series tax return for the fair market value of the gift when received on the income statement, the same value that the donor will use when claiming a charitable contribution deduction, and the fair market value at the end of the year on the balance sheet. If, as you say, the value has appreciated since the donor acquired the stock, the fair market value upon receipt will be more than the donor's tax basis or cost.

In general, the recipient of a gift takes the cost basis of the donor of the gift, and does not, for tax purposes, get a step-up in basis to the value at the time of the gift. But a public charity doesn't have to pay any income tax when it sells the stock, so it doesn't have to worry about the basis in the hands of the donor. It pays no tax if it sells at a profit and gets no offset if it sells at a loss. It doesn't need to record the basis anywhere.

The rule is different for a private foundation, however. A private foundation is required to pay a 2% excise tax (occasionally 1%) on its net investment income each year. Its net investment income includes net capital gain. Like an individual who receives a gift, the private foundation must measure its gain or loss when it sells on the carry-over basis it received from the donor. Therefore, in order to

pay the proper tax, a private foundation needs to keep a record of the original cost basis of the donor somewhere in order to determine its gain or loss correctly.

To avoid having to pay the excise tax on the gain, the private foundation may want to give the stock to one or more grantees in kind. Just like the tax treatment of the donor who gave the stock to the foundation originally, a gift in kind is not treated as a sale, so the private foundation would not have to pay the 2% tax on the gain but would still get a full fair market value credit towards its 5% minimum distribution requirement.