THE NEW YORK COMMUNITY TRUST NYCT

# Professional TAX & ESTATE PLANNING Notes

FALL 2015

## 3 Changing a Private Foundation's Status

### Transitioning to a Private Operating Foundation, Public Charity, or Supporting Organization

**In our Spring and Summer 2015 issues, we looked at the early termination of charitable remainder and charitable lead trusts to address changing circumstances. In this issue, we discuss ways a private foundation can change its tax status when the original assumptions no longer apply.**

What happens when a private foundation, or a particular type of private foundation, is no longer the right vehicle for a person's philanthropy? Why might this happen, and what are the steps in making a change? Let's consider three scenarios:

Individual "A" started a private foundation to make grants to cultural organizations. But she wonders if her goals might be better achieved if the foundation becomes a cultural organization, presenting its own exhibitions and performances rather than funding cultural programs put on by others. Also, she would like to donate land for a cultural center and her art collection in order that it may be exhibited to the public. Although both assets have appreciated greatly since she bought them, her income-tax charitable deduction for a gift of these assets to her existing organization will be limited to her basis because the organization is a private, non-operating foundation.

Individual "B" created a private foundation to develop and conduct after-school educational programs for children in his community. He structured the entity as a private operating foundation. Eventually, he discovered that his own resources weren't enough to realize the potential of his ideas. He needs a structure that can attract gifts and grants, and he believes funders are unlikely to contribute to a private foundation, even a private operating foundation, due to a perception that private foundations are endowed and do not need funds. Furthermore, he already has been told by at least one private foundation in his community that it has a policy against making grants to other private foundations due to the requirement to exercise expenditure responsibility.

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This material was developed for The New York Community Trust.

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Individual "C" started a private foundation to formalize her family's charitable giving; over time the family's philanthropic interests have converged on medical research and, in particular, research using stem cells conducted at a major university. Many of the university's alumni and corporate funders are critical of this research. Individual "C" would like to align with the university—a public charity—to attract other funders. At the same time, she worries that controversy within the university about stem cells could create a backlash and jeopardize her vision for this research.

In all three cases, the original choice of a tax structure needs to be re-examined. Happily, generous individuals such as the three mentioned above have a variety of options. This article will consider three of them:

- Converting from a private, non-operating foundation (that is, a grant-making foundation) to a private foundation. *This could be a good alternative for the foundation that wants to become a cultural center, provided there is an appetite for becoming an operating charity, with employees, facilities and other responsibilities.*
- Converting from a private foundation to a publicly supported charity. *This option could be desirable for the foundation that conducts after-school educational programs. It also might be a good idea for the cultural center, if there is a public base of support from volunteers who would join its board and contribute money or other resources.*
- Converting from a private foundation to a supporting organization of a publicly supported charity. *This is a choice worth considering for the foundation desiring to support a university's stem-cell research.*

The options, of course, are not limited to conversion from one tax status to another. There are other possibilities, too:

- The cultural organization in the first scenario might have greater staying power if it were embedded within an existing cultural institution in the community. The donor might be able to make a restricted gift of real property and art directly to that institution and continue to provide cash support through her private non-operating foundation *or* by establishing a designated fund at a community foundation (which is a public charity and enjoys the deductibility benefits associated with that status). Perhaps through this structure, the donor's goals could be achieved more effectively than through a change in tax status of the donor's foundation. Similar considerations also might apply to the after-school education program.
- In the third scenario, the risks of controversy might mean that a supporting organization devoted to one university's research program is risky. Scientists leave; institutional priorities change. Perhaps the donor in that scenario and other funders committed to stem-cell research would elect to pool their resources in one or more field-of-interest funds at a community foundation—where they could define their charitable goals without being committed in perpetuity to any particular institution, enjoy the deductibility benefits of public charity status, and know there would be flexibility to shift funding to other institutions (or allocate it among multiple institutions) if circumstances change.

## Private Foundations vs. Public Charities

Every tax-exempt charitable organization (i.e., every organization described in Section 501(c)(3) of the Internal Revenue Code, or the "Code") is either a private foundation or a public charity. The classification is generally based on the nature and diversity of the organization's sources of financial support; private foundations receive support from relatively few sources (often an individual, a family, or a company).

Because of Congressional concern that private foundations are controlled by just a handful of individuals, often related, and as such may be more susceptible to abuse, they are highly regulated by the Code and subject to a host of technical rules and restrictions that do not apply to public charities. But public charities are hardly unregulated and, from a legal standpoint, are by no means less burdensome than private foundations.

As for public charities, they typically receive support from many sources—including government, other charities, and a broad cross section of the public. In addition, most private foundations limit activities to making grants to other charitable organizations, while public charities operate programs directly.

### Key (But Differing) Legal Considerations for Private Foundations and Public Charities

All private foundations (other than a handful of grandfathered "exempt operating foundations") are subject to excise taxes on their net investment income. This tax must be reported on IRS Form 990-PF and paid annually or in quarterly installments if the total tax for the year is $500 or more.

In addition, excise taxes are imposed in connection with certain financial transactions or arrangements involving a private foundation. These are (1) taxes on certain broadly defined "acts of self-dealing" between a private foundation and its disqualified persons; (2) taxes for failure to make a minimum annual payout for charitable purposes; (3) taxes on excess business holdings; (4) taxes on jeopardizing investments; and (5) taxes on certain types of prohibited grants and payments known as taxable expenditures, including payments for legislative lobbying or to influence the outcome of a public election, and certain types of grants to individuals.

Public charities are not subject to those excise tax rules, but are subject to other rules and excise taxes, including an excise tax on excess benefit transactions between a disqualified person and the public charity. Additionally, some categories of public charity—Type III non-functionally integrated supporting organizations and medical research organizations—are subject to their own minimum distribution requirements. Certain organizations—Type III non-functionally integrated supporting organizations and some Type II supporting organizations—also are subject to the excise tax on excess business holdings.

Finally, the annual information return required for most public charities (IRS Form 990) demands disclosure of much more information about the organization than the private foundation return (IRS Form 990-PF). There is one notable exception: Private foundations are obliged to make public disclosure of their schedule of contributors (Schedule B), but public charities are entitled to hold their schedules of contributors in confidence, other than disclosure of Schedule B to regulators. (One reason many charitable donors prefer to make gifts to community foundations and other public charities is the ability to avoid public disclosure of both their names and the amounts they gave.)

Furthermore, public charities are likely to be fundraisers. Private foundations are not. Therefore, in addition to the tax rules, public charities are likely subject to yet another complex legal regime: the laws governing charitable solicitations. Those laws can require state registration and reporting as well as mandatory disclosure statements in donor solicitation materials.

## Transition to Private Operating Foundation Status

### General Observations about Private Operating Foundations

The most common type of private foundation is a private *non-operating* foundation. There is one major variant, known as the private *operating* foundation. A private operating foundation falls within the broad definition of a private foundation because of its limited sources of support (perhaps only a single donor). However, because it devotes a certain portion of its financial resources *directly* to the *active conduct* of a charitable purpose, it differs programmatically from the classic grantmaking foundation and more nearly resembles, in its operations, a typical public charity. There are many varieties of private operating foundations, including museums, libraries, research laboratories, parks, and "think tanks" (i.e., organizations that study and publish reports on matters of public interest, such as the economy, health care, or the environment).

Private operating foundations are generally subject to the tax on net investment income and the other requirements and restrictions that apply to private *non-*operating foundations. They also are subject to the same IRS Form 990-PF reporting requirements (including public disclosure of donors) that apply to non-operating foundations. The real benefit of private operating foundation status (relative to private non-operating foundation status) is the income tax charitable deduction. A donor to a private non-operating foundation ordinarily may not deduct the appreciated fair market value of any asset other than publicly traded stock; the deduction is limited to basis.

A donor to an *operating* foundation, on the other hand, qualifies for a fair market value deduction for all gifts of appreciated property (e.g., real estate and privately held securities), with the caveat that the same "related use" rule applicable to gifts of artwork and other tangible personal property to public charities is also applicable to gifts of tangibles to private operating foundations. In addition, the annual deduction limitations, expressed as a percentage of the donor's adjusted gross income, or AGI, are the same for private operating foundations as they are for public charities—presenting yet another reason donors may prefer making gifts to private *operating* foundations.

The hypothetical Individual "A" in the first situation, wanting to donate land and art to a private foundation, is far better off if her non-operating foundation can

### Private Operating Foundation Tests

To satisfy the "income test," a private operating foundation must spend directly on the active conduct of its exempt purpose at least 85 percent of the lesser of its adjusted net income and its minimum investment return. Generally speaking, minimum investment return is 5 percent of the aggregate net fair market value of all foundation assets other than those used to carry out the exempt purpose. The rules are complex, but this simplified example illustrates the point: If adjusted net income (interest and dividends) of a private operating foundation is $40,000 and aggregate asset value is $1,000,000, the income test requires paying out (in the form of qualifying distributions that meet the "active conduct" standard) the lesser of $34,000 (85 percent of $40,000) and $42,500 (85 percent of 5 percent of $1,000,000). This is in contrast to the $50,000 in grants or other qualifying distributions that a private non-operating foundation with $1,000,000 would be required to make.

In addition, a private operating foundation also must meet an endowment, asset, or support test. For an operating foundation that lacks a valuable facility in which it fulfills its purposes, the endowment test is usually the proper test—that is, in addition to meeting the income test, it must make active conduct distributions at least equal to two-thirds (66.66 percent) of its minimum investment return. So, in the example above, where two-thirds of $50,000 is $33,333, a foundation that has met the income test also will have automatically met the endowment test.

But if non-exempt-purpose assets were assumed to be worth twice as much (i.e., $2,000,000), the distribution bogey would be doubled as well, to $66,666—nearly doubling what the income test on its own would require, but still less than the $100,000 bogey for a non-operating foundation with $2,000,000. The asset test ordinarily would be applied where an organization has a valuable facility or other valuable property (e.g., an art collection) that is used to fulfill the mission and that accounts for 65 percent or more of the foundation's total assets. The rarely used third alternative test—the support test—resembles the public support test used for public charities. For more information, see www.irs.gov/Charities-&-Non-Profits/Private-Foundations/Definition-of-Private-Operating-Foundation.

transition to operating foundation status (or if an existing public charity commits to establishing the cultural center she has in mind) before a gift of that nature is made.

#### Requirements to Be a Private Operating Foundation

If a private non-operating foundation originally focused on grant-making engages or wishes to engage in direct charitable activity and wants to manage its own charitable programs, it can ask the IRS for reclassification as a private operating foundation. It must demonstrate it meets two tests designed to ensure that charitable activities are conducted actively (as opposed to passively through grantmaking to other organizations): (1) an income test requiring that a specific amount of income be spent directly on the active conduct of the charitable mission and (2) one of three alternative tests regarding the foundation's assets and revenues, called the asset, endowment, and support tests.

Salaries, consulting fees, rent, utilities, licensing fees, liability insurance, capital investments in facilities, and facilities maintenance will ordinarily count as active conduct expenditures, assuming they are incurred to *do* the activity that fulfills the organization's mission. Grants themselves and expenses related to grantmaking and investing, on the other hand, will ordinarily fall outside this category.

Although the transition from one status to another is a federal tax matter, it is important to review an organization's governing documents and determine if they need to be changed to be consistent with the desired tax status. For example, the certificate of incorporation might limit an organization to grantmaking, and prohibit direct charitable activities, or it might refer to Code sections that obliquely limit the organization to grantmaking. Changing the certificate of incorporation or a foundation's trust instrument may require judicial and/or Attorney General approval—and ordinarily will have to *precede* the operational changes that determine tax status.

### Timeframe for Compliance with Private Operating Foundation Tests

A foundation may qualify as a private operating foundation if it met the income test and either the asset, endowment, or support test for any three years during a four-year period, or based on a combination of all relevant amounts of income or assets held, received, or distributed during the four-year period. The four-year period consists of the tax year in question and the three immediately preceding years. The private operating foundation must use the same computation method to satisfy the income test and one of the other three tests. Form 990-PF contains a section (Part XIV) that shows how the operating foundation tests and the timeline apply in actual practice.

#### Mechanics for Transitioning to Private Operating Foundation Status

If a private non-operating foundation fits the profile of a private operating foundation and believes it has met the private operating foundation tests and can continue to meet them, it should request IRS reclassification using Form 8940, *Request for Miscellaneous Determination*. In addition to the necessary numerical data, the form seeks a list and description of the foundation's anticipated direct charitable activities and distributions that demonstrate funds will be used directly for the active conduct of the foundation's programs.

If an organization becomes an operating foundation, it can choose in subsequent years to shift back to private non-operating foundation status. There is no penalty for switching back and forth, although it is necessary to comply with the rules that apply to whatever status an organization has at a given time. Donors will be especially sensitive to these changes if they are relying on the operating status as the basis for claiming a larger (i.e., fair market value) deduction or are concerned about the annual AGI limits on their charitable deductions.

## Transition to Publicly Supported Charity Status

#### Definition of Publicly Supported Charity

Every organization recognized as tax-exempt under Section 501(c)(3) of the Code is a private foundation unless it fits within one of several Code-defined categories. If an organization falls into one of those categories, it is commonly referred to as a public charity, although "public charity" is not a term actually used in the Code. Generally, an organization can be classified as a public charity if:

- It receives a specified level of broad-based support that meets one of two public support tests (sometimes called the "one-third public support test" and the "10 percent plus facts and circumstances test"), or
- It receives a specified level of earned income from fees charged for activities that further the organization's exempt purposes (e.g., fees for services or admission) that meets a mathematical test (sometimes called the "gross receipts test"), or
- It is a church (a category that extends to mosques, synagogues, and other organizations devoted to religious worship), a school (a category that extends to colleges and universities), or a hospital, or
- It qualifies as a "supporting organization" for an institution that fits into one of the classifications described above or satisfies the tests for being a "medical research organization."

The first two bullet points describe a subset of public charities commonly referred to as "publicly supported charities." Because transition from private foundation status to status as a school, church, or hospital is rare, we do not specifically address that possibility. Later on, however, we do address transition to supporting organization status.

For a private foundation that conducts an activity that enjoys a public profile and could attract public support—such as the after-school educational program described earlier—the usual trajectory is for it to seek public charity status under the 10 percent plus facts and circumstances test mentioned above. The one-third public support test represents a higher fundraising hurdle, and is therefore harder for an organization to meet than the lower fundraising threshold applicable to the 10 percent plus facts and circumstances test. The benefit of the one-third standard is that the organization doesn't have to show facts and circumstances consistent with its claimed public status.

#### Requirements to Meet the Public Support Tests

The one-third public support test is purely mathematical. Based on a very specific definition, it requires that one-third of an organization's total support over a specified period of time be in the nature of public support. Broadly speaking, support from a single donor or group of related private donors cannot be treated as public support to the extent in excess of 2 percent of total support. Even support from other charities is subject to the 2 percent limit, unless the other charities also pass the one-third public support test. Support from the government also is deemed to be public, without regard to the 2 percent cap. A person interested in understanding the mathematics in detail might look at Schedule A of IRS Form 990 and the instructions. Those materials show how the one-third public support test is applied in practice.

To meet the 10 percent plus facts and circumstances test, an organization must receive at least 10 percent of its total financial support in the form of "public support" (using the same thresholds as above) **and** it must establish facts and circumstances consistent with its claim of public charity status. The relevant facts and circumstances include whether the organization is engaged in an active fundraising effort (i.e., whether it

is actively soliciting funds on a wide basis), whether its support comes from a representative number of sources, whether the board of directors is broadly representative of the community, whether the organization's activities confer a broad public benefit, and how close the organization's public support fraction is to the "one-third" safe harbor.

The closer an organization's public support is to the one-third figure, the less onerous the burden for establishing these facts and circumstances to the satisfaction of the IRS or a court. Similarly, an organization in the lower end of the range has a higher burden in terms of showing the proper facts and circumstances. The applicable test for public support (whether 10 percent or one-third) is applied on an aggregate basis over a 60-month (five-year) transition period.

#### Mechanics for Transitioning to Status as a Publicly Supported Charity

Once an organization determines that transition is feasible and that it wishes to terminate its private foundation status and obtain advance determination of its new public charity status, the first step is to notify the IRS before the commencement of the 60-month period, during which the organization expects to be able to demonstrate its qualification as a publicly supported charity. The organization should use IRS Form 8940 for this purpose and comply, in particular, with the requirements of Line 8h, which allow an organization to request a 60-month termination of its private foundation status and an advance ruling on its new public charity status.

The instructions to Form 8940 direct the organization to submit supporting materials, including descriptions of the organization's past, current, and proposed activities and how it intends to attract public support, proposed budgets during the 60-month period, the public support schedule from Form 1023, *Application for Recognition of Exemption* (if applicable), and a signed form of agreement extending the period of limitations for assessment of the Section 4940 excise tax (the tax on net investment income) in the event the applicable standards for transition are not met during the 60-month period and excise tax then becomes payable.

With an advance ruling, the organization generally will be treated as a public charity during the 60-month termination period; grantors and contributors can rely on that classification for charitable deduction purposes except in certain circumstances. The organization, however, will remain liable for the private foundation excise taxes under Chapter 42 of the Code (other than the tax on net investment income) until it receives a final determination from the IRS that its conversion is successful. If the conversion is *un*successful, the organization will not incur penalties for its nonpayment of the Section 4940 excise tax during the 60-month period, but will be required to pay interest on any late payments it must make when the transition period ends.

If the organization pays private foundation excise taxes (e.g., the tax on excess business holdings or taxable expenditures) during the 60-month period but is successful in the conversion, it should be entitled to a refund of the taxes paid. The organization will continue to file IRS Form 990-PF for each year in the 60-month period, if that period has not expired before the due date of the return.

Within 90 days of completion of the 60-month period, the organization must again file Form 8940, this time to inform the IRS that it has complied with the public support test requirements for classification as a public charity. Information to be provided at the conclusion of the 60-month period includes a complete description of the organization's current operations pertinent to publicly supported charity status, copies of the organization's governing instruments, and Schedule A, Part II of Form 990, *Public Charity Status and Public Support*. Once information is furnished establishing a successful termination, then, for the final year of the termination period, and annually thereafter, the organization should file IRS Form 990.

### Transition to Supporting Organization

#### Definition of Supporting Organization

A "supporting organization" must be organized and operated to support or benefit one or more organizations that are classified as public charities because of what they do (i.e, being a church, a school, or a hospital) or because they're publicly supported charities (i.e., meeting either the one-third public support test, the 10 percent plus facts and circumstances test, or the gross receipts test). In addition, substantial contributors and their family members (and certain related parties) must *not* control a supporting organization (e.g., by controlling 50 percent or more of board seats or by having veto rights).

NOTES

For a private foundation that supports only one organization (or one group of related organizations), a supporting organization provides a useful middle ground. It preserves an institutional identity and a "place at the board table" for family members or other funders, at the same time as providing the tax benefits of public charity status. For the hypothetical foundation described earlier that is interested in supporting controversial stem-cell research at a university and attracting third-party funding, it provides a structure that is outside the university, with its own corporate purposes and distinct philanthropic identity, while being a more appealing charitable recipient for donors uninterested in supporting someone else's private foundation or concerned about the deductibility limits that apply to gifts to private non-operating foundations.

Every supporting organization is categorized as Type I, Type II, or Type III, depending on the nature of its relationship with the supported organization. Each type of supporting organization has its own set of requirements and characteristics. Type II supporting organizations are comparatively rare in philanthropic contexts, where legal and tax practitioners typically focus on Types I and III. Intensified regulation of Type III supporting organizations, however, has made them less appealing in many circumstances. Accordingly, we focus on the requirements for Type I status.

#### Requirements to Be a Type I Supporting Organization

A Type I supporting organization must be "operated, supervised, or controlled by" its publicly supported organization. Due to the words "controlled by," the relationship between the supported organization and the supporting organization is sometimes analogized to a "parent-subsidiary" relationship between corporations. Notably, however, control does not mean complete domination. The rules allow the supporting organization to have a board on which the so-called parent controls only a bare majority of the seats. Hence, a Type I supporting organization might be more appropriately thought of as a "controlled affiliate" of the supported organization and not as its subsidiary. The founder, family members, and family friends or advisors could fill the remaining seats on the board. In theory, a Type I organization can support multiple public charities, as long as it is controlled by one of them. This may provide useful flexibility, particularly if there is a related group of charities and funding may need to be shifted among them over a period of time.

#### Mechanics of Transitioning to Supporting Organization Status

An organization wishing to make the transition from private foundation status to supporting organization status ordinarily will follow the Form 8940 process outlined earlier for terminating its private foundation status and obtaining an advance ruling on its new status.

In many ways, governance issues rather than tax issues may be the deciding factors here. Will control be turned over completely to the supported organization? Or will there be some sort of middle ground, where the supported organization holds a bare majority on the board, but the other seats are filled by family representatives or representatives of other constituencies (e.g., environmental or scientific organizations or other philanthropic funders committed to similar issues)? And if the purposes are highly specific, as with the hypothetical organization devoted to stem-cell research, perhaps the organization should be formed in a state such as New York, where the regulatory and statutory regime around changing the purposes of a nonprofit corporation is highly sensitive to the protection of donor intent.

## Conclusion

Choices and flexibility: The world of philanthropy provides plenty of both, along with a degree of complexity that can be downright bewildering. Making the wrong choice can be frustrating and expensive. Even the "right" choice at one point in time can turn out to be unworkable as circumstances change. Legal and tax practitioners in this area need to be well versed in guiding clients toward better choices in the first instance—and toward solutions if that first choice becomes problematic. Professionals who work with foundations will want to keep in mind the tax-exempt transitions described in this article. It's also worth remembering that a stand-alone organization may be no solution at all—and that an existing public charity receiving support through a fund at a community foundation such as The New York Community Trust can accomplish much, and perhaps all, that a donor really wants to achieve.

**For further reference regarding private foundation transitions and other topics discussed in this issue, see:**

Code §§ 170(b)(1)(B), 170(b)(1)(D): adjusted gross income deduction limitations for gifts to private non-operating foundations

Code § 170(e)(1)(B)(ii): limitation on charitable income tax deduction for gifts of property to private non-operating foundations

Code § 4942(j)(3): private operating foundations

Treas. Reg. § 53.4942(b)-1(b)(2)(ii): private operating foundations; significant involvement in grantmaking

Treas. Reg. § 1.507-2(b): termination of private foundation status and operation as a public charity

Treas. Reg. § 1.507-2(c): 60-month terminations

Treas. Reg. § 1.170A-9(f)(2): the one-third test for public support

Treas. Reg. § 1.170A-9(f)(3): the 10% plus facts and circumstances test for public support

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