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When a Small Foundation Becomes a “Private Foundation”

-by Neil E. Harl*

With the increase in wealth in rural areas in recent years has come the growth in non-profit organizations, often organized as family entities to assist in perpetuating some feature of rural life. The focus may be on the local schools; colleges or universities, often in the form of scholarships; the local church; soil conservation; the local community itself or any one of a number of other family concerns. Most are organized as corporations under state law and have sought (and usually obtained) federal status to operate “...for religious, charitable, scientific, testing for public safety, literary or educational purposes. ...” along with some additional charitable functions.¹ This is the highest status recognized in the United States for deductibility for federal income, gift and estate tax purposes and is known as “Section 501(c)(3)” status.²

Public support test

However, non-profit organizations with that status may be deemed a “private foundation” if the organization is not a publicly supported organization receiving more than one-third of its annual support from members and the general public and not more than one-third of its support from investment income and unrelated business income.³ That targets, particularly, foundations heavily funded by an individual, family or corporation where the donor is a “disqualified person.”⁴

The one-third support test is met if the organization normally receives from permitted sources more than one-third of its support in each taxable year from gifts, grants, contributions or membership fees⁵ and gross receipts from activities which are not unrelated trades or businesses⁶ and not more than one-third from gross investment income and the excess from unrelated business income.⁷

An organization will “normally” meet the one-third support test and the not-more-than-one-third-support-test during its first five taxable years as a Section 501(c)(3) organization if the organization “…can reasonably be expected to meet the requirements ...” of the tests.⁸ Thus, the test is basically a test that involves assessing the likelihood that the organization can meet the challenges it faces.

An organization that fails a public support test for two consecutive years is generally treated as a private foundation as of the beginning of the second year of failure; the organization is treated as a private foundation for all purposes beginning the first day of the third consecutive year.⁹

The start-up period

In the start-up phase, and later, IRS monitors the non-profit organization by requiring a balance sheet with the required income tax form, Form 990 EZ. The balance sheet is to

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include all cash, savings and investments as of the beginning and ending of each year and the book value (cost or other basis less accumulated depreciation) of all land and buildings owned by the organization and not held for investment.\textsuperscript{9} If the end-of-year total assets are $500,000 or more, the organization is required to file a Form 990 (which is longer and is more detailed as to reporting).\textsuperscript{10} If an organization has gross receipts of less than $200,000 and total assets at the end of the year of less than $500,000, the organization can file a Form 990-EZ.\textsuperscript{11}

\textbf{Taxation of investment income}

One of the major disadvantages of becoming a “private foundation” is that a two percent excise tax is imposed on the “net investment income” of private foundations for each tax year.\textsuperscript{12} Net investment income is defined to include the foundation’s gross investment income from interest, dividends, rents, payments with respect to securities loans and royalties but not including income to the extent included in figuring the tax on unrelated business income\textsuperscript{13} and net capital gain, less the ordinary and necessary business expenses incurred for the production or collection of gross investment income.\textsuperscript{14} Foundations subject to the net investment income tax can deduct the ordinary and necessary expenses paid or incurred for the production or collection of gross investment income or for the “... management, conservation, or maintenance...” of property held for the production of those items of income.\textsuperscript{15}

\textit{Important for endowments.} This is, of course, of great interest to foundations that maintain endowments. For foundations that do not maintain significant amounts of invested assets, it is of less concern, obviously.

\textit{Exemption for “operating foundations”} The tax on net investment income does not apply to an exempt “operating foundation” that has been publicly supported for at least 10-years, at all times during the tax year the foundation is governed by representatives from the “general public” and at no time during the taxable year does the foundation have an officer who is a “disqualified person.”\textsuperscript{16} A “disqualified person” includes substantial contributors to the foundation, an owner of more than 20 percent of a trust or business which is a substantial contributor or a member of the family of any such individuals.\textsuperscript{17}

A “substantial contributor” is generally a person who contributed (or bequeathed) an aggregate of more than $5,000 to the foundation if that amount is more than two percent of the total contributions and bequests received by the foundation before the close of the taxable year of the foundation in which the contribution or bequest is received by the foundation from the person.\textsuperscript{18}

\textit{The governing instrument.} A private foundation, to be assured of its tax exemption on an on-going basis, needs to be able to show that its governing documents prohibit activities that are in question with private foundations. That includes retaining excess business holdings,\textsuperscript{19} accumulating income,\textsuperscript{20} engaging in prohibited acts including self-dealing,\textsuperscript{21} making specified taxable expenditures\textsuperscript{22} or making investments which jeopardize its charitable purpose.\textsuperscript{23}

\textbf{In conclusion}

It is abundantly clear that if a foundation becomes a “private foundation,” it faces much more in the way of regulatory strictures. If that cannot be avoided, careful attention should be given to literally every facet of the foundation’s operations.

\textbf{ENDNOTES}

1. I.R.C. § 501(c)(3).
2. \textit{Id}.
11. \textit{Id}.
12. \textit{Id.}, p. 2.
15. I.R.C. § 4940(c)(2).
20. I.R.C. § 4943(a) (tax on excess business holdings).
21. I.R.C. § 4942(a) (tax on undistributed income).
22. I.R.C. § 4941(a) (tax imposed on acts of self-dealing between a disqualified person and a private foundation).
23. I.R.C. § 508(e).

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