Mastering Form 990 Schedule A: Protecting Public Charity Status, IRC 509 Public Support Test Calculations and Reporting

TUESDAY, OCTOBER 17, 2017, 1:00-2:50 pm Eastern

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Mastering Form 990 Schedule A

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  Audit, Tax, Advisory Firm
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  14 offices in 6 states and Grand Cayman
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  17 attorneys
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• Firm Partner with over 20 years experience in sector
Agenda

• Case Studies
• Introduction to public charities and private foundations
• Implications of private foundation status
• Publicly supported organizations – two tests and practical considerations
• Planning - avoiding (or not) private foundation status
• Transition to private foundation status
• Questions?
Case Study I

Lutefisk For All

Lutefisk For All, a nationally known trade association promoting the health benefits of lutefisk* and tax-exempt under IRC Section 501(c) (6), is loosely affiliated with a charitable organization, tax-exempt under IRC Section 501(c)(3), which was formed to assist individuals, including those involved in the lutefisk economy, impacted by terrorist attacks on lutefisk processing plants or harmed by presidentially declared disasters arising from events such as flooding or wind damage in the areas surrounding lutefisk plants. The charity received an initial large contribution from the trade association’s general funds at inception and up until the past three years, in spite of the large contribution, met the 33 1/3% public support test under IRC Sections 509(a)(1) and 170(b)(1)(A)(vi). Unfortunately for public support purposes, there have not been any attacks or natural disasters that have resulted in outside fundraising sufficient to maintain public support higher than 10%, as computed annually on Schedule A, Part II of Form 990. Shortly after the charity’s accountant informed the organization that they have a “public support” issue, disaster hits. A combination of tornadoes and floods wipe out the lutefisk plant, destroying everything within a 50-mile radius. The lingering stench of the lye makes matters worse and makes it difficult for first responders or anybody, for that matter, to breathe. Potable water, food and paper towels must be distributed, power restored and the area rebuilt in order to help get peoples’ lives in order and the area’s economy going. Millions of dollars must be raised quickly. What factors should be considered with respect to maintaining the charity’s public support in light of the pressing human need?

*In case you didn’t grow up in Minnesota or Scandinavia, lutefisk is dried whitefish (normally cod) treated with lye. The first step is soaking the fish in cold water for five to six days (with the water changed daily). The saturated fish is then soaked in an unchanged solution of cold water and lye for an additional two days. It is rinsed with cold water to remove the lye, then boiled or baked, and then served with butter, salt, and pepper.
Case Study II

• Uh Oh!

A charity, in existence for 15 years, has up until the last 2 years met the public support test under IRC Section 509(a)(2) on Form 990, Schedule A, Part III. The organization would have met the IRC Sections 509 (a)(1) and 170(b)(1)(A)(vi) tests for that time period, however, because the accountant had not taken this course, he didn’t know that the second test would be more beneficial to his client, which experienced both decreased contributed support and increased investment revenues. The accountant was, also, unaware that public support classifications can be changed and that there is a 10% facts and circumstances test. How should we advise the accountant?
Implications of Private Foundation Status

If charity transitions to private foundation status:

• Subject to excise taxes of 1-2% on net investment income
• Subject to the strict Chapter 42 rules:
  • Prohibition on self-dealing with disqualified persons
  • Intermediate sanctions under IRC Section 4958, applying to public charities, does not prohibit transactions with disqualified persons. They result from the existence of “excess benefit”.
• 5% minimum distribution requirement
• Limit on excess business holdings
• Additional requirements on grant making to non-public charities and to individuals
Implications of Private Foundation Status, continued

- Less favorable treatment of charitable contributions
  - Contributions limited to 30%/20% of an individual donor’s Adjusted Gross Income, rather than 50%/30% of AGI as a public charity
  - Certain types of donations only receive a basis deduction instead of fair market value deduction
- Many private foundations will not make grants to private foundations despite ability to rely on expenditure responsibility
- Foundation required to file Form 990-PF, in lieu of Form 990
Implications of Private Foundation Status

There are some arguable benefits to private foundation status:

• No need to worry about fundraising for purposes of meeting public support test
• More control by single entity or family is permitted
• More and more operating charitable organizations are choosing to be Private Operating Foundations for this reason
Public Support Tests

• Two different mathematical tests:
  1. Section 509(a)(1) and Section 170(b)(1)(A)(vi) – Part II of Schedule A
  2. Section 509(a)(2) – Part III of Schedule A

• Which test to use?

• Certain organizations are not required to complete either of the mechanical tests
Public Support Tests

• Not required to complete either public support test:
  • A church, convention of churches, or association of churches described in Section 170(b)(1)(A)(i)
    (Form 990 not required)
  • A school described in Section 170(b)(1)(A)(ii). (Schedule E of Form 990 or 990-EZ)
  • A hospital or a cooperative hospital service organization described in Section 170(b)(1)(A)(iii)
  • A medical research organization operated in conjunction with a hospital described in Section 170(b)(1)(A)(iii)
  • A federal, state, or local government or governmental unit described in Section 170(b)(1)(A)(v)
Public Support under 509(a)(1)

Public Support

Total Support = ____ %

* Measured over current and four preceding tax years
The Section 509(a)(1) Denominator: Total Support

• Gifts, grants, donations
• Membership fees
• Gross Investment Income
• Income from unrelated businesses
• All other revenues, except capital gains, gross receipts from EFI, and unusual grants
Unusual Grants

- Criteria for determining whether a grant is unusual [Regs. Sections 1.170A-9(f)(6)(ii) and 1.509(a)-3(c)(3)]—

1. Is a substantial contribution or bequest from a disinterested party;
2. Was attracted by reason of the publicly supported nature of the organization;
3. Is unusual with respect to amount; and
4. Would, by reason its amount, result in the organization not meeting the applicable public support test.

- Listing as part of e-filed return
- Consider filing Form 8940 for advance approval
The Section 509(a)(1) Numerator: Public Support

• Government grants included in full
  ➢ Grants versus program service revenue
• Grants from other Section 509(a)(1) public charities included in full
• Gifts, grants, contributions from all others included, but only up to 2% of total support
  ➢ All donor contribution information required for 2% calculation
• Does not include: investment income, unrelated business income
What the Percentage Means

• < 10%: **Cannot** qualify as a public charity
• 10-33%: **May** qualify, must show “facts and circumstances”
• >33%: **Qualifies** as public charity
10% Facts and Circumstances

• Percentage of support
• Organization’s actual sources of support
• Representative governing body
• Organized and operated to attract further support on a continuous basis
• Services provided or functions performed benefit the public on a continuing basis
• For how long?
Public Support under 509(a)(2)

Public Support

Total Support

• **Must** be at least 33% (no 10% rule)
• <33% from investment income
Section 509(a)(2) Measuring Period

Same as Section 509(a)(1):

• Four preceding tax years plus current tax year
The Section 509(a)(2) Denominator: Total Support

- Gifts, grants, donations
- Membership fees
- Gross investment income
- Unrelated business income
- Unlike in the (a)(1) test, EFI is included
- Capital gains and unusual grants are not included
The Section 509(a)(2) Numerator: Public Support (1 of 2)

GRANTS:

• Government grants included in full
• Gifts from Section 509(a)(1) public charity in full
• Non-disqualified persons: in full
• Disqualified persons: none
The Section 509(a)(2) Numerator: Public Support (2 of 2)

GROSS RECEIPTS FROM EFI:
• Disqualified persons: None
• All others (including governmental units, all types of public charities): greater of $5k or 1%
Disqualified Persons

IRC Section 4946 defines a disqualified person as follows:

1. A substantial contributor, a person who gave an aggregate amount of more than $5,000 if that amount is more than 2% of the total contributions the organization received from its inception through the end of the year in which that person’s contributions were received. A substantial contributor generally remains a substantial contributor.

2. A foundation manager

3. An owner of more than 20% of the voting power of a corporation, profits interest of a partnership, or beneficial interest of a trust or an unincorporated enterprise that is a substantial contributor (defined in item 1) to the organization.
Disqualified Persons

• IRC Section 4946 defines a disqualified person as follows:

4. A family member of an individual described in items 1-3. A family member, for this purpose, is the donor's spouse, ancestors, children, grandchildren, great-grandchildren, and the spouses of children, grandchildren, and great-grandchildren. A spouse includes a legally married same-sex spouse.

5. A corporation, partnership, trust, or estate in which persons described in items 1-4 own more than 35% of the voting power, profits interest, or beneficial interest.
Public Support Tests: Pointers

Pointers to Consider When Preparing Schedule A:

• Schedule A is a required schedule for all charity Forms 990 and 990-EZ
• It’s really important – this calculation protects the organization’s public charity status
• Accounting method must be the same as indicated on Form 990, Part XII, line 1, or Form 990-EZ, line G
• Five-year look-back period for support calculations
Public Support Tests: Pointers

Pointers to Consider When Preparing Schedule A, continued:

• Restate errors or changes from prior years, i.e. not reporting on proper accounting period, uncollected pledge, etc.

• In-kind contributions of things can be included (not in-kind services)

• Monitoring public support during first five years of existence
Public Support Tests: Information Needed

- Detailed revenue information for the five-year period
  - Accrual basis donor schedules (name, address, and amount contributed)
  - Accrual basis trial balance and a description of the nature of each revenue source
Public Support Tests: Information Needed

• Detailed revenue information for the five-year period
  ➢ Detailed information on significant (or unusual) contributions such as a large bequest
Planning — Avoiding (or Not) Private Foundation Status

To preserve public charity status:

• Maintain accurate public support records
• Know your public support percentage
• Consult your legal/tax advisor regarding significant or unusual contributions
• Consider timing of significant contributions from donors
• Consider use of other charitable vehicles
Planning — Avoiding (or Not) Private Foundation Status

Planning to become a private foundation:

• Consider tax implications of 1-2% excise tax on net investment income (direct and indirect investment expenses can offset)
• Consider mandatory 5% charitable distributions – liquidity of assets
• Anticipating other private foundation requirements
  • Are there any potential self-dealing transactions that might occur or any potential excess business holdings issues?
Proactive Support Test Change

• Realizing that an organization will not continue to meet the support test it has been relying on but meets the other test (typically a change from the Section 509(a)(2) test to Section 509(a)(1) and Section 170(b)(1)(A)(vi) test)
  • Make the change on Form 990 (doesn’t change database)
  • Form 8940 (results in database change, also, can be used for advance approval of unusual grant)
  • Also consider Section 509(a)(3) status
Transition to Private Foundation Status

• If the organization fails either public support test for two consecutive years, two-step transition to private foundation status (in second year, Sections 507, 4940 and 6033 rules apply, in following year all private foundation rules apply)
• Considerations for managing transition and avoiding private foundation excise taxes
• Possible request for abatement of private foundation excise taxes due to transition
• Effect on donors/grantors
Questions?

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