



# **Maintaining Your Tax-Exempt Status When You have Close Ties with a Separate For-Profit**

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**December 11, 2018**

## **Mission of Pro Bono Partnership of Atlanta:**

To provide free legal assistance to community-based nonprofits that serve low-income or disadvantaged individuals. We match eligible organizations with volunteer lawyers from the leading corporations and law firms in Atlanta who can assist nonprofits with their business law matters.

## **Pro Bono Partnership of Atlanta Eligibility & Other Information**

- In order to be a client of Pro Bono Partnership of Atlanta, an organization must:
  - ✓ Be a 501(c)(3) nonprofit.
  - ✓ Be located in or serve the greater Atlanta area.
  - ✓ Serve low-income or disadvantaged individuals.
  - ✓ Be unable to afford legal services.
- *Visit us on the web at [www.pbpatl.org](http://www.pbpatl.org)*
- We host free monthly webinars on legal topics for nonprofits
  - ✓ To view upcoming webinars or workshops, visit the [Workshops Page](#) on our website
  - ✓ Join our mailing list by emailing [rla@pbpatl.org](mailto:rla@pbpatl.org)

## Legal Information:

- ✓ This workshop presents general guidelines for Georgia nonprofit organizations and should not be construed as legal advice. Always consult an attorney to address your particular situation.
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## Scenario 1

- Charity A provides free counselling services to low income individuals. Five years ago, Charity A was founded by Jesse Smith who is the owner of for-profit Counseling Services. Jesse found that lots of low income people need counselling services that he could not afford to provide through Counseling Services, so he founded Charity A to assist them.
  - Counseling Services provides Charity A with space
  - Counseling Services provides Charity A with an employee
  - Counseling Services donates money to Charity A
  - Counseling Services and Charity A send clients to one another

## Three Tax Concepts

- Private Inurement
- Public Charity Status
- Private Benefit

## No Private Inurement

- Violations = Loss of Exemption **or** “Intermediate Sanctions”
- Arrangements/agreements with founders, officers, directors, substantial donors or family members thereof
  - ✓ Insiders prohibited from receiving benefits greater than she or he provides in return (*e.g., excessive compensation, loans at below market rates, etc.*)
  - ✓ Insiders = founders, officers, directors, anyone with control/influence over organization during the past 5 years, and certain family members and affiliated companies



## No Private Inurement

- Excess Benefit Transaction involving an insider
- Entering into a contract where pay more than value received in return
- Intermediate Sanctions
  - ✓ Rebuttable presumption of reasonableness under IS
  - ✓ Penalties: Excess amount returned; Excise taxes imposed:
    - Insider: 25% of excess benefit amount if returned within fiscal year provided; 200% tax thereafter
    - Organizational Managers: 10% of excess benefit amount



## Private Inurement & Scenario 1

- **Independence important**
- Payment for Rent to Counseling Services
  - ✓ Comps?
  - ✓ Board analysis?
- Payment for employees to Counseling Services
  - ✓ Why? Rates?
- Referrals to Counseling Services
  - ✓ Refer to other counseling services?

## Public Charity/Private Foundation Status

- § 501(c)(3) organizations are classified as either Public Charities or Private Foundations under § 509(a) of IRC
- Determination Letter states public charity status – top right of letter

## Public Charity/Private Foundation Status

- **Public Charities:** § 509(a)(1) of IRC says organizations listed in § 170(b)(1)(A) other than ( § 170(b)(1)(A)(vii or viii) are public charities
  1. Statutorily Classified – churches, schools, organizations that provide medical or hospital care ( § § 170(b)(1)(A) (i-v))
  2. Publicly Supported: must receive 1/3 or more of its support from gifts, grants and contributions from governmental agencies, contributions from the general public, and contributions or grants from other public charities **OR** 10% or more of its total support must come from governmental agencies, contributions from the general public, and contributions or grants from other public charities and the facts and circumstances indicate it is a publicly supported organization ( § 170(b)(1)(A)(vi))
    - Example: A human service organization whose revenue is generated through widespread public fundraising campaigns, federated fundraising drives, grants from other public charities or government grants is a publicly supported charity under § 170(b)(1)(A)(vi).

## Public Charity/Private Foundation Status (cont.)

### ➤ **Public Charities (cont.)**

- ✓ § 509(a)(2) of IRC defines another category of public charities:
  - Service Provider Publicly Supported - generally must receive more than 1/3 of its support from gifts, grants, contributions and receipts from admissions, merchandise sold, or services provided AND no more than 1/3 of its support from gross investment income or unrelated business income( § 509(a)(2))
    - Examples: A membership-fee organization, such as parent-teacher organization, or an arts group with box office revenue is a publicly supported charity under § 509(a)(2).
- ✓ § 509(a)(3) of IRC defines another category of public charities: Supporting organizations (not relevant for this discussion)

## Public Charity/Private Foundation Status (cont.)

- **Private Foundations** - any § 501(c)(3) not qualifying as a “public charity” **Generally less desirable!**
  - ✓ Unattractive to Donors
  - ✓ May not line up with mission of organization
  - ✓ Many more complex requirements!
    - 5% Minimum Annual Distribution – distribute 5% of the value of the foundation’s net investment assets during the preceding year.
    - Net Investment Income – 2% annual tax (can be reduced to 1% in certain cases) on net investment income.
    - Self Dealing – Substantial excise tax imposed on any acts of “self-dealing” with a “disqualified person” (substantial contributors, foundation managers, and certain related entities and family members).
    - Excess Business Holdings
    - Jeopardizing Investments
    - Taxable Expenditures

## Calculating Public Support

- Schedule A of Form 990 - calculation
  - ✓ **Need to be wary of tipping – where a majority of income is from one source.**
- Must meet public support test in Year 6 of organization's existence
  - ✓ Should track & try to meet before then;
  - ✓ If 1023 application doesn't show trend toward meeting public support, may be classified as private foundation
  - ✓ Some flexibility; time to ramp up
- If meet the public support test for a tax year, then treated as a publicly supported charity for that year and the succeeding year, regardless of its actual support for the succeeding year.
  - ✓ If meet public support test in Year 7, then treated as public charity for Year 8.
- However, if don't meet public support test in Year 9 or Year 8, then considered a private foundation.



## Public Charity Status: Excess Contributions

- **Excess contributions = contributions that exceed 2% of total support for five-year period**
- Excess contributions are not included in the numerator of public support test
- Donors that are governmental units, 501(c)(3) public charities under 170(b)(1)(a)(iv), churches, hospitals, schools, etc. are exempted from the 2% limit
- Example: Charity C earned \$100,000 a year in each of five years totaling \$500,000.
  - ✓ Jolene Michaels gave Charity C \$10,000 or more during that five-year period, Jolene Michaels' donation is above the 2% limit and must be excluded from the numerator of the public support test



## Public Support Calculations: Unusual Grants (cont.)

- **Unusual grants** = Significantly large and uncommon donations
- Unusual grants are excluded from the public support and total support definitions for both of the support tests (excluded from numerator and denominator)
- **Criteria**
  - ✓ A substantial contribution or bequest from a disinterested party;
  - ✓ Attracted by reason of the publicly supported nature of the organization;
  - ✓ Is unusual or unexpected in amount; and
  - ✓ Would, by reason of its large amount, result in the organization's not meeting the applicable public support test.
- **Example: Donation of \$100,000 from a disinterested person to organization that helps the homeless with annual revenues of \$300,000.**
  - ✓ Analysis: 1. the contribution is substantial & unusual in amount, 2. donation given due to publicly supported nature of organization and 3. organization won't meet public support test because of its amount

## Modified Scenario 1

- Charity A provides free counseling services to low income individuals. Five years ago, Charity A was founded by Jesse Smith who is the owner of for-profit Counseling Services. Jesse found that lots of low income people need counseling services that he could not afford to provide through Counseling Services, so he founded Charity A to assist them.
  - Counseling Services provides Charity A with **free space**
  - Counseling Services provides Charity A with an employee **for free**
  - Counseling Services donates **a significant amount of money** to Charity A
  - Counseling Services and Charity A send clients to one another

## Public Charity Status & Modified Scenario 1

- Charity A is a public charity under the Publicly Supported test: must receive 1/3 or more of its support from gifts, grants and contributions from governmental agencies, contributions from the general public, and contributions or grants from other public charities
- Must analyze income from Counseling Services
  - Been in existence 5 years, so public support test must be calculated in next year
  - Address significant donation
    - One time unusual grant?
    - 2% limitation & the effect of that
  - Whether free space included in calculation
  - Whether provision of the employee is included in the calculation
- Could cause problems for public support test requirements
- **TALK TO YOUR ACCOUNTANT!**

## Private Benefit

- Substantial Private Benefit = Loss of Tax-Exemption
  - ✓ A tax-exempt organization must serve a public not private interest
    - Organization cannot benefit a charitable class that is too small
  - ✓ Can apply to disinterested or interested parties
  - ✓ Incidental private benefit
  - ✓ Examples of Potential Substantial Private Benefit
    - Co-Venturer agreements ( § 43-17-6 Charitable Solicitation Act)
    - Other arrangements with individuals or taxable entities
- Loss of Exemption

## Scenario 2

- Charity B in Anytown, GA, provides job training to low income individuals in need of better paying jobs. Lockhart Construction, a local company located in Anytown, believes Charity B is doing a great job and wants to help.
  - Lockhart provides Charity B with **free space and equipment**
  - Lockhart provides Charity B with an employee **for free**
  - Lockhart donates **a significant amount of money** to Charity B
  - Charity B's training includes construction training, and Charity B is able to send Lockhart training graduates for employment which is beneficial to Lockhart as the turnover rate in the construction business is high and there are not enough trained construction workers

## Scenario 2 Analysis

- Need to analyze Public Support Test Issues
- Private Benefit Issues
  - Lockhart receiving trained new employees for its business
    - High turnover rate
    - Difficult to find trained workers
    - Who is really benefitting?
      - Is Lockhart's benefit incidental to the benefit to Charity B's benefit?
      - Does Charity B send trained workers to other construction companies?
        - Comparison
  - **Lockhart's "significant donations of cash, equipment, space, employees" really a donation?**
    - **Payment for training workers and finding employees for Lockhart?**



## Summary

- Watch for close relationships with For-Profit entities
- Consider how much the For-Profit assists your charity and in what ways
- Consider how close the relationship is – insiders or outsiders?
  - ✓ Insiders – is there a private inurement concern?
  - ✓ Outsiders – is there a private benefit concern?
- Consider whether public charity status will be jeopardized



# Questions

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## **For More Information:**

If you would like more information about the services of Pro Bono Partnership of Atlanta, contact us at:

[www.pbpatl.org](http://www.pbpatl.org)

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