

FEDERAL TAX DESIGNATION FOR FOUNDATIONS CREATED FROM CONVERSIONS

The establishment of a new foundation from the charitable assets preserved from a conversion presents the opportunity to create a new, permanent institution that may significantly affect the quality of community health for years to come.

The best way to ensure that these resources are used for truly charitable purposes is to establish an independent private foundation, governed by a board of impartial, knowledgeable and diverse individuals, and subject to state oversight of charitable corporations.

The success of the foundation can be greatly influenced by the way it is organized. New foundations have the option of becoming either a 501(c)(3) or a 501(c)(4) Internal Revenue Code tax-exempt organization.

501(c)(3) Foundations

Private foundations and public charities are both classified as 501(c)(3) organizations although they differ in their sources of their funding. If the funding comes from a corporation, an individual or family, the organization is generally a private foundation. Most well known philanthropic foundations, like the Ford Foundation, operate under this tax status. On the other hand, if an organization derives substantial support from the general public, it is usually categorized as a public charity and, as such, is viewed as being more responsive to the public.

To ensure that private foundations are responsive to public needs, they are subject to some additional stringent federal tax rules that do not apply to public charities:

- To maintain its independence and ensure that its decisions are not influenced by its financial holdings, a private foundation is prohibited from holding more than 20 percent of the voting stock of any corporation or 20 percent of the profit interest in any partnership. (The I.R.S., however, does allow a private foundation to take several years to carefully diversify a portfolio that was initially more concentrated.)
- The payout requirement ensures that a foundation makes a minimum level of charitable expenditures each year, defined as at least five percent of the value of its endowment. That amount must be in the form of qualifying distributions, which essentially are grants, outlays for administration, and payments made to acquire charitable assets. This requirement ensures that the foundation conducts substantial charitable activity annually. Without such a requirement, an entity could refrain from making any grants at all.

Other private foundation rules include:

- Prohibition against private inurement;
- Filing of a detailed tax return;
- Prohibition from engaging in any self-dealing transactions;

- Tax on investments that jeopardize the foundation's charitable purposes;
- Prohibition on grants for lobbying;
- Limitations on the ability to make grants to individuals;
- Limitation on the ability of the foundation to make grants to for-profit organizations; and
- Prohibitions on certain types of loans.

Donations to private foundations are tax deductible, but private foundations are required to pay a one or two percent excise tax annually on their investment income, determined by an I.R.S. formula.

A public charity, on the other hand, is subject to fewer federal tax rules, but must meet other restrictions and requirements like a public support test. To satisfy such a test, an organization must receive more than one-third of its funding from any combination of 1) qualifying gifts; grants, contributions from diverse sources, or membership fees, and 2) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in activities related to its exempt functions. Like private foundations, insiders are also prohibited from private inurement (personal gain) and public charities cannot provide an excess benefit (unreasonable price or return) to a private business. A public charity, is not, however, limited in the amount of stock it can hold in one corporation. It may engage in a certain amount of lobbying and thus is not as strictly limited to charitable activities as a private foundation.

One sub-division of public charities is 509(a)(3) supporting organizations. A supporting organization is a separate legal entity with a close relationship to at least one established public charity. Particularly in the case of a moderately sized pool of charitable assets resulting from a conversion, a supporting organization may offer cost or management efficiencies while still providing a relatively high degree of community accountability. Supporting organizations are thoroughly explored in a sister Community Health Assets Project paper, "Creating Supporting Organizations: An Option for Conversion Foundations."

501(c)(4) Organizations

A social welfare organization, established under section 501(c)(4) of the tax code, is less accountable to the public than 501(c)(3) organizations. These (c)(4) organizations include political or lobbying groups like Common Cause or the National Rifle Association. They are not obliged to spend any portion of their assets on charitable activities and are not required to report the same detailed information as private foundations.

Until recently, federal tax law did not prohibit private inurement by a (c)(4). As a result, it was not uncommon to hear of conversion deals that benefited the officers, directors or high-level executives of a health maintenance organization that converted to for-profit status. The Taxpayers Bill of Rights 2, signed by President Clinton on July 30, 1996, amended Section 501(c)(4) to provide that no part of the net earnings of a social welfare organization may inure to the benefit of any private interest.

Current findings

According to a Grantmakers in Health 1998 survey of health care conversion foundations, only three of the 97 responding foundations were classified as 501(c)(4) social welfare corporations. The other 94 were all classified as 501(c)(3) foundations. Forty-two of the 501(c)(3) corporations were private foundations and 52 were public charities as of the survey date. Many foundations, however, initially qualify as public charities in the period immediately following the conversion. The size of their endowments makes it difficult to raise enough funds to meet the public support test and it is likely that the majority will ultimately become private foundations.

Conclusion

For entities that are not themselves Section 501(c)(3) private foundations, local groups should consider drafting the articles of incorporation to include the specific private foundation prohibitions, so that these prohibitions apply to the new entity as a matter of corporate law. (For specific wording see, “ Proposed Articles and By-laws for 501(c)(3) corporations.”)