May/June 2015

More Than Money

Public charity: *Why you might prefer it to a private foundation*

Internal Revenue Code Section 501(c) lists 29 different types of nonprofit organizations. But the vast majority of tax-exempt organizations are those described in Section 501(c)(3) and have a charitable, religious, educational or scientific purpose.

Every 501(c)(3) tax-exempt organization must be further classified as either a public charity or a private foundation. Some types of charities, such as schools, churches, hospitals and medical research organizations, are statutorily classified as public charities.

If a 501(c)(3) organization is not automatically classified as a public charity, it is a private foundation unless it demonstrates otherwise to the IRS. The proof is most often done as part of the Form 1023 application, the process used to get tax-exempt status.

If the IRS accepts the organization's public charity position, the organization is deemed to be a public charity for the first five years of its existence. During this time, the organization does not disclose its public support percentage on Schedule A. In the sixth and subsequent years, the organization must disclose its public support percentage on Schedule A to demonstrate that it continues to pass the public support test.

What are the consequences of being a private foundation?

From a compliance perspective, a private foundation, or PF, must file a more complex return, Form 990-PF rather than the Form 990 series filed by public charities. This form requires a significant amount of calculations.

Further, unlike a Form 990 filing, the Schedule B attached to a 990-PF, which lists contributors of $5,000 or more, cannot redact the names and addresses of contributors on the publicly available version of the form. As a result, the names of donors to a private foundation are available to the public.

See **Public charity** *on page 3*

Goal of board: Fiscal responsibility

Although each board's involvement in its not-for-profit agency's operations varies from situation to situation, all boards share a mandate to exercise fiscal responsibility.

Certainly, complying with self-dealing rules and following the letter of the bylaws are requirements of fiscal responsibility. But they may be just the minimum requirements.

Here are three ways for boards to further exercise their fiscal responsibility.

1. Assure the agency stays within its budget

Prepare a realistic budget. It is always appropriate to budget based upon educated estimates of the actual costs and revenues of intended services. But these estimates should not ignore the history of the budget item. Neither history nor the estimate should stand as the lone criterion of a budget item.

Justify the budget variances. At each board meeting, receive a report from staff on actual expenditures compared to budget. Significant variances – say, 10 percent or greater – should be explained. A plan should be presented to bring the budgeted item back into line to accomplish the agency's budget goals for the year. While it is important to correct unfavorable variances – spending too much – do not overlook under-spending. Money not spent as planned, such as advertising or program development costs, may result in revenues missing budget later in the period.

Adjust the budget when needed. Occasionally, the budgeted items may prove invalid. A program may not begin because of

See **Fiscal responsibility** *on back*

Financial news & notes for nonprofit organizations from:

Kushner LaGraize, L.L.C.
CERTIFIED PUBLIC ACCOUNTANTS
3330 W. Esplanade Avenue • Suite 100 • Metairie, Louisiana 70002
(504) 838-9991 • Fax: (504) 833-7971 • www.kl-cpa.com

Largest charities average 88 percent for programs

What are the largest charities in the United States? In one of its famous lists, *Forbes* magazine has listed the 50 largest U.S. charities based on private donations for 2013, the last year that complete figures are available. Donations can be cash, securities or goods.

Not surprisingly, once again United Way led the list with $3.87 billion in donations, though the huge charity saw a slight drop (1.5 percent) from the previous year's $3.93 billion. Next were the Salvation Army, which had a 10 percent increase, and Feeding America, which saw a 23 percent increase from the year before, moving it up from No. 4 to No. 3 on the list.

Overall, the 50 charities saw a 3 percent increase in donations, which totaled $31 billion overall. Not included in the ranking are government grants, investment returns and fees for services.

The magazine also measured the effectiveness rate or "charitable commitment," the percentage of donations that were used for the charitable purpose of the organization, as opposed to management, certain overhead expenses and fundraising. The average for all of the top 50 charities was 88 percent. Charities that receive in-kind gifts – goods and services – tend to have higher percentages.

Forbes also looked at fundraising efficiency and found that it averaged 92 percent. So, basically, it cost the top 50 charities an average of 8 cents to earn $1 in donations. The percent can vary widely depending on the type of charity and the fundraising methods necessary.

The following is *Forbes'* list of the top 50 charities, based on donations, as well as the percent of donations that were used directly for the nonprofit's charitable purpose. For more information, go to www.forbes.com/top-charities.

Forbes List of Top Charities	Donations	Percent to Programs
1. United Way	$3.87 billion	86%
2. Salvation Army	$2.08 billion	82%
3. Feeding America	$1.86 billion	98%
4. Task Force for Global Health	$1.58 billion	100%
5. American National Red Cross	$1.08 billion	90%
6. Food for the Poor	$1.02 billion	96%
7. Goodwill Industries International	$975 million	88%
8. YMCA of the USA	$939 million	85%
9. American Cancer Society	$871 million	73%
10. St. Jude Children's Research Hospital	$869 million	74%
11. World Vision	$795 million	83%
12. Boys & Girls Clubs of America	$766 million	80%
13. Catholic Charities USA	$715 million	85%
14. Compassion International	$657 million	84%
15. AmeriCares Foundation	$620 million	98%
16. Habitat for Humanity International	$606 million	84%
17. U.S. Fund for UNICEF	$587 million	91%
18. Catholic Medical Mission Board	$513 million	98%
19. Campus Crusade for Christ	$504 million	84%
20. American Heart Association	$502 million	78%
21. Nature Conservancy	$500 million	72%
22. Save the Children Federation	$455 million	91%
23. Direct Relief	$450 million	99%
24. Feed the Children	$442 million	89%
25. Samaritan's Purse	$426 million	87%
26. Memorial Sloan-Kettering Cancer Center	$389 million	96%
27. Lutheran Services in America	$373 million	85%
28. Boy Scouts of America	$362 million	87%
29. MAP International	$346 million	99%
30. Step Up for Students	$332 million	99%
31. CARE USA	$320 million	89%
32. American Jewish Joint Distribution Committee	$312 million	88%
33. Good 360	$310 million	99%
34. Mayo Clinic	$310 million	82%
35. Leukemia & Lymphoma Society	$279 million	76%

See **Forbes list of top charities** on page 3

Public charity *continued from front*

More importantly, private foundations are subject to much more restrictive operational provisions than public charities, including a number of provisions to help ensure that the private foundation is operated in a manner consistent with its mission and it functions as a charitable organization. These restrictions arose out of a concern for abuse that could arise with private foundations, which are often controlled by a small group of related individuals.

Code Sections 4940-4945 outline the additional restrictions imposed on private foundations. Below is a brief description of each including the initial taxes that may be imposed. "Second-tier" taxes, which are substantial and can be imposed for failure to correct a violation, are not included.

- **Section 4940** imposes a 2 percent excise tax on the net investment income of a private foundation. This tax can be lowered to 1 percent if certain charitable payout requirements are met. Net investment income includes interest, dividends, rents, royalties and securities loan payments.
- **Section 4941** imposes a tax of the amount involved in any act of "self-dealing," which is a prohibited transaction between a private foundation and a "disqualified person" (DP). Disqualified persons include substantial contributors, foundation managers and certain related organizations and individuals. Foundation managers include officers, directors and trustees. The tax imposed on the DP is 10 percent, with 5 percent imposed on a foundation manager who knowingly participates in such acts. Self-dealing includes many transaction types between a private foundation and a disqualified person, the most common of which are the sale or leasing of property, lending or borrowing of money, and payment for services. (There is an exception for reasonable compensation for certain services.)
- **Section 4942** imposes a 30 percent tax on a private foundation for failure to make minimum distributions each year. While the calculation is complex, the rules essentially require a private foundation to make qualified annual distributions of not less than 5 percent of the fair market value of the foundation's noncharitable assets. Qualified distributions are those made to further a charitable purpose and include grants to public charities and administrative expenses incurred by the private foundation necessary to carry out its exempt purpose. However, distributions to controlled entities or to other private foundations generally do not count as qualifying distributions.
- **Section 4943** imposes a 10 percent tax on a private foundation owning more than 20 percent of the voting stock of an incorporated business enterprise. This tax is imposed on the excess holdings. The allowable ownership limit is further reduced by the percentage of voting stock owned by all disqualified persons. However, if a non-DP third party effectively controls management and policies of the enterprise, the private foundation and DPs may collectively own up to 35 percent.
- **Section 4944** imposes a 10 percent tax of the amount invested in a manner that may jeopardize the private foundation's ability to carry out its exempt purposes. This tax is levied on the private foundation and a foundation manager who knowingly participates in making the investment.
- **Section 4945** imposes taxes on "taxable expenditures." The tax is imposed on the private foundation (20 percent rate) and may be imposed on private foundation managers (5 percent rate) who knowingly participated in the prohibited expenditure. The most frequent types of taxable expenditures are expenses incurred for political intervention, lobbying or certain grants. These grants include those made to non-501(c)(3) organizations in which the private foundation does not exercise "expenditure responsibility," an often cumbersome evaluation and recordkeeping process.

These private foundation code section descriptions are brief overviews. The Internal Revenue Code and related regulations are complex and should be referred to for more detailed information.

– John Stancil, CPA, Steve Kelin, CPA, and Richard Locastro, CPA

Forbes list of top charities *continued from page 2*

36. Project HOPE	$273 million	96%
37. Dana-Farber Cancer Institute	$261 million	82%
38. Planned Parenthood Federation of America	$315 million	82%
39. Metropolitan Museum of Art	$259 million	87%
40. Cross International	$257 million	96%
41. Operation Blessing International Relief	$255 million	99%
42. Make-A-Wish Foundation of America	$253 million	75%
43. Population Services International	$251 million	94%
44. Alzheimer's Association	$243 million	77%
45. Catholic Relief Services	$244 million	93%
46. National Multiple Sclerosis Society	$243 million	77%
47. Brother's Brother Foundation	$243 million	100%
48. Chronic Disease Fund	$238 million	92%
49. San Francisco Museum of Modern Art	$236 million	81%
50. Marine Toys for Tots Foundation	$235 million	97%

Kushner LaGraize, L.L.C.

CERTIFIED PUBLIC ACCOUNTANTS

3330 W. Esplanade Avenue
Suite 100
Metairie, Louisiana 70002

Fiscal responsibility *continued from front*

permitting or personnel issues. A major event may disrupt revenues or require overtime. When this happens, create a new budget for the remainder of the period with these events taken into consideration. The budget for unaffected line items remains unchanged. Then, once again, the agency is working with an achievable budget.

2. Secure the future with good practices

Ensure the lines of responsibility are clearly drawn. An agency's bylaws often define how much an executive director can spend without board approval. Are these amounts as practical now as when the bylaw was originally written? If the executive director is permitted to operate outside the budget, there should be a mechanism to control this spending.

If the agency is a membership organization, review the membership recruitment policies to assure the organization is self-perpetuating. Assess the board's makeup to assure its members include those who routinely look into the future such as financial planners, public relations professionals and young people.

On both the board and the staff, identify key positions, and then identify one or more other people who might be able to assume each of those roles should the key positions become vacant for any reason. When appropriate, include these people in the planning processes. Good staffers in key positions tend to be promoted, and board members' terms expire. Planning for successors now will prevent lost ground later.

3. Balance risk with reward

With a qualified financial planner, review the agency's capital structure. Make sure balances in real estate, endowment and cash are appropriate. Inspect the agency's capital assets such as buildings and equipment to assure functionality, serviceability and longevity.

Comparatively evaluate the agency's funding sources. Are program fees in appropriate ratio to program costs when compared to others in your industry? Is there an unfavorable dependence on earnings from unrelated business activities?

Verify the long-term potential of the agency's programs by picturing the client base and the funding sources in five years or so. Are they secure? Will either grow or shrink dramatically? Plan for the changes.

Insurance coverage is important to examine. Look at recent claims for other nonprofits in your industry. Make sure your coverage would allow the agency to withstand a claim while continuing its mission. Conversely, make sure the agency isn't excessively covered.

Looking beyond operational issues is sometimes challenging for board members who often are more concerned with monthly meetings and fundraising. ∎

The technical information in this newsletter is necessarily brief. No final conclusion on these topics should be drawn without further review and consultation.

© 2015 CPAmerica International