The Real Impact

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The Spectrum of 501(c)(3)s: There's Not Just One Kind

Year-end is a popular time to have charitable giving goals on the mind. There are a variety of different ways to implement these goals, including contributing to an already existing charity, establishing a donor advised fund, or setting up a new, independent section 501(c)(3) charitable organization. Each of these charitable giving tools has its own pros and cons, and while some individuals focus solely on one of these methods, others use a multipronged approach to optimize their philanthropic impact.

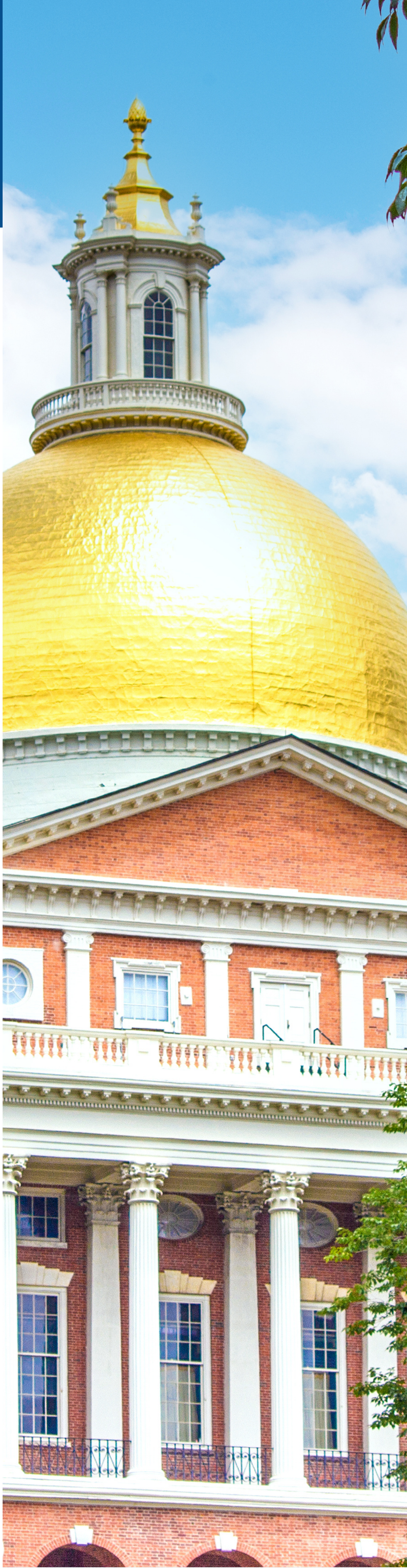
This article focuses on the establishment of a new charity. There are many different decision points to consider in doing so. What will be the organization's charitable mission? Will the organization fundraise and, if so, how? Who should be on the organization's governing body? And, of course, what will the organization be named? One of the most important—and complex—considerations, however, is the organization's specific federal tax status. Being described under section 501(c)(3) of the Internal Revenue Code is how charitable organizations are designated as tax-exempt, but not all section 501(c)(3) organizations are treated equally. There are many different types of 501(c)(3) organizations. Under the Code, a 501(c)(3) charitable organization is, by default, treated as a so-called "private nonoperating foundation" (*i.e.*, a grantmaking foundation), unless it can prove to the Internal Revenue Service that it satisfies the requirements of a more favorable classification, such as a supporting organization or some type of public charity. Because there are qualification requirements for the more advantageous tax classifications, not all charities will be eligible, but there is advanced planning that can be done to ensure nothing is being left on the table.

Below is a summary chart of the most common types of section 501(c)(3) organizations, including a brief description, key qualification requirements, annual payout requirements (if any), and other important attributes to consider. It is organized from least advantageous from a tax perspective on the left, to most advantageous on the right.

Types of 501(c)(3)s	Private Nonoperating Foundation	Private Operating Foundation	Supporting Organization	Publicly Supported Organization
← Least Advantageous to Most Advantageous Tax Treatment →				
Description	Grantmaking foundation	Foundation that directly conducts its own charitable activities	Organized and operates exclusively to support another charity	Fundraising organization
Key Qualification Requirements	Default classification if organization does not meet the requirements of a: 1. Private operating foundation; 2. Supporting organization; or 3. Another type of public charity (e.g., a fundraising organization)	• Expenditures for own charitable activities equal to 85% of the lesser of the organization's: 1. Adjusted net income and 2. 5% of its net investment assets • > 50% of assets must be devoted to own charitable activities (does not include investment assets)[1]	• Must engage solely in activities that support/benefit the supported organization's mission • One qualifying structure is for the supported organization to appoint a majority of supporting organization's directors	Must normally receive at least 1/3 of its support from: 1. Contributions from general public or governmental units; or 2. Contributions, membership fees, and gross receipts from tax-exempt activities and receive no more than 1/3 of its support from gross investment income
Annual Payout Requirement	Grants to qualifying charities equal to 5% of organization's net investment assets	None	None[2]	None
Tax on Net Investment Income	1.39%	1.39%	None	None
Deductibility of Contributions	Less favorable charitable contribution deduction rules	Most favorable charitable contribution deduction rules	Most favorable charitable contribution deduction rules	Most favorable charitable contribution deduction rules
Transactions with Insiders	Strictly prohibited	Strictly prohibited	Must be on same terms as to third parties	Must be on same terms as to third parties

[1]There are other ways to qualify as a private operating foundation, but this test is the most common.
[2]"Type III" supporting organizations must make grants to their supported organization equal to the greater of (1) 85% of their adjusted net income and (2) 3.5% of their investment assets.

Mass Leads Act: Relief Granted in Massachusetts for Nonprofits and their Directors



Recently, the Massachusetts state legislature passed and Governor Healey signed into law the "Mass Leads Act" (officially H5100), which Healey described as "essential to keeping the Massachusetts economy strong and adaptable in a rapidly changing world." Wedged within provisions designed to infuse nearly $4 billion across different sectors in the Commonwealth's economy – notably offering hundreds of millions of dollars of long-term state support to the life sciences and climate industries – the bill includes two provisions of note relevant for nonprofits operating in Massachusetts.

First, the Mass Leads Act extends the statutory protections for volunteer nonprofit directors also to those directors who receive limited stipends. Previously, someone serving as a director on the board of a nonprofit could not receive any compensation for their time and efforts without forfeiting personal civil liability protections under Massachusetts law (M.G.L. ch. 231, sec. 85W). The Mass Leads Act amended this law to allow for a stipend of up to $500, which puts Massachusetts state law on par with the Federal Volunteer Protection Act.

The Mass Leads Act also raises the threshold for financial reporting requirements for nonprofits. Nonprofits now only need to submit financial statements that have been reviewed or audited by an independent certified public accountant if they have gross support and revenue of more than $500,000 in a fiscal year and whether the statements must be audited or reviewed depends on whether the gross support and revenue exceeds $1 million. These thresholds used to be $200,000 and $500,000, respectively. These increases mean that fewer nonprofit organizations will require an audit and smaller nonprofits with revenues under $500,000 will not have to undergo costly reviews and audits to be in compliance.

These changes are effective immediately and promise to have a small, but meaningful, impact on nonprofit operations. For more information, see the explanation on the Massachusetts Attorney General's website.

Private Foundation Grantmaking: 10 Best Practices

December is a popular time for philanthropists and donors to create or add significant assets to grantmaking foundations. As a firm that regularly represents both grantmakers and charities seeking grants, we often notice systematic inefficiencies in the grantmaking process that could be improved to facilitate a more efficient deployment of philanthropic funds that, in turn, could enable both foundations and charities to accomplish their charitable missions more effectively. Often, we find that foundations have significant assets in need of a worthwhile project and charities have excellent plans to advance their missions but struggle to identify like-minded funders. Foundations can do their part by adopting well defined, effective grantmaking practices, as we describe below.

1. **Develop a vision** for the foundation to guide its long-term direction. A vision statement helps foundation trustees, potential grantees, and the public understand the fundamental objectives and long-term goals of the organization.
2. **Develop a mission statement** for the foundation to drive its immediate decisions. Mission statements reduce a foundation's vision into more concrete, specific, and temporal terms. Neither a vision statement nor mission statement prevent a foundation from making a grant to any member of the charitable class described in its formation documents.
3. **Determine**, and articulate to potential grantees, the **types of grants** the foundation will make. A foundation may consider funding a particular project, providing general operating support, contributing to a capital campaign, helping to build an endowment, funding scholarships, supporting pilot projects, sponsoring research or public policy work, or assisting in the expansion of existing programs.
4. **Establish processes** for reviewing requests and selecting grantees. A foundation may accept grant proposals or may, instead, decide to independently select grantees. If a foundation decides to accept proposals, having processes in place to review grant proposals creates consistency and efficiency.
5. **Engage in** pre-grant **diligence**. Before deciding to give a grant, investigate the prospective grantee's ability to support the foundation's goals. Using outside reviewers, site visits, and other sources of information may be an appropriate part of pre-grant due diligence.
6. **Consider** how the **timing** of grant payments may further the foundation's goals. Making future grant payments conditional on the achievement of certain benchmarks or on obtaining matching grant commitments may be appropriate.
7. **Communicate** the foundation's **expectations** in a grant agreement. Beyond notifying the grantee of the amount of the grant, a grant notification/agreement allows the foundation to explain what it will expect of the grantee.
8. **Maintain contact** with grantees to ensure progress on the foundation's mission. While the Internal Revenue Service only requires a foundation to monitor grants to non-charities (called "expenditure responsibility"), foundations generally benefit from receiving information back from all grantees during the period of the grant.
9. **Formally "close"** each grant. After all payments have been made under a grant and the term of the grant is coming or has come to an end, a grantee should be asked to provide the foundation with a final report. Once a final report is submitted and reviewed, a closed grant file should be created to preserve key records for future reference.
10. **Use the systems that work** for the foundation. A foundation's size, the number of people involved, and its long-term goals should all inform the extent of its grantmaking processes.

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About Nutter's Nonprofit Practice Group

Nutter's Nonprofit Practice Group provides a wide range of services to nonprofit organizations, individuals, and businesses utilizing an interdisciplinary team approach that focuses on each client's specific needs. We counsel healthcare, educational, human services, religious, and cultural institutions, as well as donor advised funds, corporate and family foundations, and generations of philanthropic families. Our reach expands beyond charitable organizations to include trade associations, chambers of commerce, social welfare organizations, social clubs, and for-profit enterprises intent on developing or enhancing their philanthropic strategies.