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Public Charity vs. Private Foundation – Transcript

Jess Birken 00:00:02 Welcome to Charity therapy, the podcast where we explore the ups and downs of the nonprofit sector and answer your burning questions. I'm your host, Jess Birken, owner of Birken Law Office, and I'm excited you're here. Imagine hanging out with me and my super smart, funny, nonprofit expert pals. You get to ask them anything about your nitty gritty nonprofit life and get their wisdom for free. Whether you're a seasoned pro or just strapping on your nonprofit boots, we're here to share stories and remind you you're not alone on this journey. So get ready to join the conversation and bring me the tough questions I ain't scared. Ready to rock? Let's dive in. Hi there. It's Megan, your charity therapy co-host. Quick question for you. Is your non-profit a public charity or is it a private foundation? And are you certain what your status really is? We're revisiting an older episode today where Jess and I break down these two versions of the 501 C-3 status, and why the difference really matters for your nonprofit.

Jess Birken 00:01:02 Let's do it.

Meghan Heitkamp 00:01:03 Hello and welcome to this episode of Charity therapy. Meghan and I are back and ready to answer some nonprofit questions. Meghan, how are you today? I am so good. Jess, how are you? I'm good. It's still winter. It's still cold, I know. Right? Yep. Don't think too much about it. Absolutely. All right, Jess.

Jess Birken 00:01:27 Today we have some questions lined up about what a nonprofit's 501 C3 status really is. and because the IRS speaks like a whole other language that us common folk don't actually understand.

Meghan Heitkamp 00:01:43 True.

Jess Birken 00:01:43 First, before we dive in, can you give us, like, a little rundown about what C3 status really means?

Meghan Heitkamp 00:01:50 Absolutely. So the thing to know is that being a 501 C3, that is a tax status from the IRS, which says that the organization doesn't have to pay income tax. That it's going to have to pay other kinds of taxes, potentially employment tax. Property tax, but it won't pay income tax. Now, the 501 C3 is just one kind of 501 C tax exemption.

Meghan Heitkamp 00:02:18 There are others. Right. C5 C6 nonprofits have to apply to the IRS to get their income tax exemption. And you do that by proving that you meet their requirements and showing that you fit into their rubric of like what a charity is. When you apply and you're successful, then the IRS gives you that 501 C3 status, and that means that you're exempt from paying income tax. But in exchange, you have to follow this huge laundry list of rules and regulations to keep that status active and alive, because it can be taken away. Okay. And then the IRS breaks down that 501 C3 category into even smaller subdivisions like private foundations and public charities. And I think that we just bored everybody to death. So I will stop now.

Jess Birken 00:03:10 Right? That's as much IRS speak as we can handle in one sitting. So our first listener writes in and says, I give a lot of money to my nonprofit that I started because it makes sense for me financially to do so. But now the nonprofit CPA is telling me that I could cause the nonprofit to become a private foundation instead of a public charity.

Jess Birken 00:03:31 What does that mean for the nonprofit?

Meghan Heitkamp 00:03:34 Okay, well, first of all, good job using an accountant to help you do the books. That's super professional, I guess is the word I'm looking for. the problem that the CPA is pointing out to you is that the nonprofit is not going to meet what's called the public support test. So in order to be a public charity, and that means you serve the public and you're not serving just like a little group of people. You have to demonstrate to the IRS that you get at least a third of your money from what the IRS considers public sources. So that could be people giving you \$20 or \$200 that could be getting grant money from the government or from a foundation. If you can't prove that at least a third of your money comes from like a variety of sources, they will say, oh, just kidding, you're actually a private foundation because you just have like 1 or 2 donors and you must be a private foundation. So they they that changes the way that your tax forms work.

Meghan Heitkamp 00:04:50 That changes a lot of things about how you operate. So you don't want to have that happen if that's not something you are planning on basically.

Jess Birken 00:04:58 Right. So there are some nonprofits where it makes total sense to be a private foundation, but if you are trying to operate like a public charity, you don't want it to accidentally be switched for you.

Meghan Heitkamp 00:05:10 Yeah, like the Bill and Melinda Gates Foundation before their epic divorce, right? Like that's a private foundation. They have a big bucket of money. They're not out there pounding the pavement and being like, hey, give us \$20 so we can go create vaccinations in Africa or something. They just have a bunch of money. They donate it to this nonprofit and then they distribute it. One thing that's kind of embedded in the question is I give a lot of money to my nonprofit that I started. That's not a great way to start a nonprofit. What I'm reading between the lines here is this person is probably just trying to get a Tax deduction possibly, and just wants to direct funds to good deeds.

Meghan Heitkamp 00:06:03 We have literally no information about what their mission is or what they do, so I have no idea. It just says I give a lot of money to my nonprofit. I started because it makes sense for me financially to do so. So honestly, maybe they don't

need to be a public charity. Maybe there are more like the Bill and Melinda Gates Foundation, that they have a bunch of money and they want to put it into a nonprofit, take a tax deduction because it makes sense for them to do that financially, and then they want to give out the money to causes that they believe in. That's fine. But they're going to be a private foundation. In that case, it's not the end of the world. They just need to start working with somebody who can give them advice about what they need to do, because if it's important to them to maintain the public charity aspect, then they need to figure out a different fundraising solution. They can't be the only donor if they want to act more like the Gates Foundation.

Meghan Heitkamp 00:07:05 There's no problem with that. They just need to work with their tax person to understand what the consequences of being a private foundation are. You have to make a certain amount of disbursements for the year. You have like excise tax. It's just a different 501 C3 vehicle to drive down the highway. But if it meets their family's needs and it's the kind of philanthropic activity they want to engage in, that's okay. There's not much to this question for me to like, say, one way or the other, but it just means there that there's going to be a change if they get converted.

Jess Birken 00:07:42 Right. It's not public charity good, private foundation bad. It's a matter of what fits best for what kind of work the nonprofit is trying to do, and what you can sustain long term.

Meghan Heitkamp 00:07:54 My guess is this person probably did a lot of self-help, or maybe they had a well-meaning accountant to do their 1023, and they just didn't really get a lot of advice about what vehicle they should be driving down the nonprofit highway.

Meghan Heitkamp 00:08:10 And so somebody just assumed that public charity was the right designation, and it might not have been. And so it might be that they're about to be converted into the correct thing. But if they didn't have the right guidance on the front side, then it feels maybe scary or like a bad change. It's easy for an accountant to look up the form to file, but they're not necessarily asking the right questions on like, should this exist, why should it exist? What form should it take? Let's do it right from the beginning.

They're just, you know, underwater with all of their trying to serve all their clients and they're just trying to make people happy.

Jess Birken 00:08:48 Yep. Try to do you a favor, even if it's not in their wheelhouse. Absolutely.

Meghan Heitkamp 00:08:52 So basically, I would say they they should talk to somebody like me. Get some advice about is this okay? Is this not okay? And if it's not okay, what are we going to do about it? Come up with a strategy because I there's just not enough to go on here.

Meghan Heitkamp 00:09:07 And they really just need to get some clarity around what they're doing. What is their mission, how are they doing it. And does that make more sense as a private foundation or does it make more sense as a public charity?

Jess Birken 00:09:21 There we go. All right. I got another question for you. Listener writes in and says, I started a small after school program two years ago. It was just an idea I had, and I did all the paperwork and I did all the grinding myself to make it a real thing. Red flag. Exactly. and now it's starting to get some media attention in my area, and I decided to apply for a grant. The funder rejected my application because we're not a public charity. I don't get it, though. I know I got a letter saying we're a 501 C3, so what gives?

Meghan Heitkamp 00:09:54 Oh, boy. Okay. So again this I'm going to be like a broken record. I started a small program. I did it all myself. Right. Like, I went into this without any good information other than what the internet could provide.

Meghan Heitkamp 00:10:12 That's always a problematic place to start. And I've definitely had many clients come in where even when they did work with an attorney, I

mean, just what we were just talking about, right? They just have a friend who's an attorney or somebody who cares about their mission, who happens to be a lawyer, and they're like, we need to get five one C three status. And the lawyer is like, I can figure this out. And they'd like click, click, click. Push the buttons, make something happen without really understanding what they're doing or the consequences of the choices that they're making. And you end up with a private foundation. Again, this this question's a little light on facts, but they say they know they got a letter saying where 501 C3. I'm going to go with that. They're correct. But I bet if you read the second paragraph of that letter, it says, we further determined that you are a private foundation. And the the place you're applying to the grant for probably only makes grants to public charities, which is a different type of 501 C3.

Meghan Heitkamp 00:11:21 So remember, the private foundation is a bucket of money that gets distributed. It's the Bill and Melinda Gates Foundation, and I just pick on them because it's like the most like brand recognition nationally. So like everybody knows what that is. Yep. That is a big pot of money. And then they decide they want to support this cause and they want to support that cause and they give money out. A public charity is like a dog rescue a church Homeless shelter where you are serving the public, and you are alleviating a need through direct services to a community. It's not just handing out money. The letter that they have probably says, and I don't know this, I don't have a copy of the letter. Obviously I'm just speculating, but the letter that they have probably says you're a big bucket of money. And what I know from working with lots of clients who've made this mistake is that, first of all, they probably did the 1023 easy. So it was like, click, click, you're done.

Meghan Heitkamp 00:12:28 Second of all, when they were asked the question about whether you have donors, they probably said, we have one donor and it's the person who started the organization because, Megan, how many times have we worked with somebody where they are literally the only person who's giving any money to the nonprofit because that they're in the middle of bringing it to life.

Jess Birken 00:12:54 Absolutely. It's hard to rustle out some donors when you don't even have a thing for them to donate to yet. And it's very, very common that when they're going through that ten, 23 years and you see that question, it's like, oh, yeah, I

am the only donor. That's the right answer. But they just don't know what that means when they check that box.

Meghan Heitkamp 00:13:14 And I have seen it where like legal assistance was provided. And the lawyer just says, how many donors do you have? And they say one. And they don't understand the consequence of answering that question that way. What you mean is, I'm the only one right now, but I fully intend to be asking everybody I know and everybody everywhere to give money to this cause, and we will meet the public support test.

Meghan Heitkamp 00:13:42 I just don't meet it right now. But if you don't know the consequence of how you answer that question because the IRS isn't helping you out. They don't have like a little cute explanatory text and a video and a little lesson to teach you about the significance of this question. They're just like, answer the question. So if you answer it very literally, you will end up creating a private foundation accidentally, and then you won't figure it out until you go to apply for a grant or your C3. Public charity status is somehow important to someone. And now here you are three years later with with a private foundation. By the way, you can't file a regular 990 for a private foundation either. So that becomes an issue too, where we have people come in and they're like, I tried to file my 990 and it wouldn't let me. It's like, yeah, because you started a private foundation. Yep. You have to file a 990 90PF. Sorry.

Jess Birken 00:14:40 Exactly. It affects many different things. It's just not immediately obvious, especially to a new organization, when they're like, great, I did the thing.

Jess Birken 00:14:49 I got my status. I can focus on literally anything else now, and it can come back to haunt you and be an expensive and time consuming thing to redo.

Meghan Heitkamp 00:14:59 So if you're listening to this and you're like, oh my God, I what if my teeny weeny dog rescue that we just started has this problem? How do I know if we have this problem? If you have your determination letter, read the whole

thing right. Read all the words that they bury in the body of the letter. You can also check on an organization that you know and love, but you don't have their determination letter. Go to the IRS exempt organization search. If you just put like IRS EO search into Google, it'll bring up the page. You can search for the organization by their tax ID number or by their name. And next to their listing, it will have a little PC for public charity or PDF for private Foundation, and there's a bunch of other ones too. Like so and blah blah blah. But that's a quick way to just check if you're listening to this and you're like, oh my God, I need to make sure this isn't us because we're about to apply for our first grant.

Meghan Heitkamp 00:16:00 Just go look yourselves up.

Jess Birken 00:16:01 Yeah. Yep. It's always good to have the information at hand.

Meghan Heitkamp 00:16:05 And if you can't find yourself on that website, then that means the IRS doesn't know you exist. And in that case, you may have never actually applied. Because that's another thing I see is that people think because they put 501 C3 in their articles of incorporation, that that just makes them an exempt charity. And that's not how it works. So.

Jess Birken 00:16:29 Right. It doesn't seem intuitive that you can have a nonprofit that doesn't have tax exemption. It just feels like it goes hand in hand. But it is a process you have to go through to prove that you are, you know, charitable and deserve not to pay income tax.

Meghan Heitkamp 00:16:44 Yeah. And if you you have to keep telling them through that form 990 that you still meet the requirements. And so the other thing that happens is people lose their status by not filing a 990 for three years in a row. So it's just a really good idea to check that exempt organization's website once in a while, especially if you're on the board of a really small nonprofit.

Meghan Heitkamp 00:17:08 It's just kind of a good thing to, like, do a little due diligence. Set a reminder in your calendar, just like, pull up the listing. Make sure that your last 990 is like appearing that your you know, your charitable registration in your state is active. Like those are just good things to like, look at periodically because it's it can get messed up without you realizing it.

Jess Birken 00:17:32 Yeah. And I think this question is the perfect example of you grind and grind and grind and you know what your mission is and you know what your activities should be. But that doesn't mean that you know all of the paperwork side of things. And you might think you can kind of figure it out on your own, but it can come back to haunt you and it can take you away from the work that you really want to be doing. So when we say red flag, when you're talking about grinding and doing it all on your own, it's not like you're a bad person. It's just that you might be making your own life more complicated and really hampering your own non-profit idea by doing this yourself.

Jess Birken 00:18:08 It doesn't pay to get into IRS troubles to save a few bucks right at the beginning.

Meghan Heitkamp 00:18:15 Totally agree. So what you got for some takeaways, Megan?

Jess Birken 00:18:18 All right, so first a really big one. There are multiple kinds of tax exemption that nonprofits might have. And the kind of exemption you have really matters. It will determine what kind of taxes you file, what kind of taxes you pay, what kinds of grants and different opportunities you are eligible for all kinds of stuff. So if you are applying for tax exemption or you are trying to maintain your tax exemption, it's very important to know what it actually is. Secondly, if you are a 501 C3 public charity, there is a public support test that you should be at least vaguely aware of. And it means that, you know, you should be getting support for the organisation, financial support from the public. It's not all from one person. It is from donations. It's from government grants. And

you know, other organizations. You cannot just be getting all of your money from one pot and be a public charity.

Jess Birken 00:19:19 Yep. And then the last one that I have for you is that if you are starting a nonprofit and you are funding the startup process yourself, that does not mean that you have to be a private foundation. That does not mean that you should check the box on your 1023 that there is one donor. Everyone starts off with one pot of money, but if you are intending to be a public charity and intending to solicit funds from the public, make sure you're starting it up that way and not hampering yourself down the run down the line with a private foundation status that you're going to have to change.

Meghan Heitkamp 00:19:52 And once you have the status, you have to maintain it. So for those of you who are on a board or running a small, small nonprofit, keep tabs on that status. It can go away and you just need to keep tabs on it. Megan, thank you so much for joining me today, folks.

Jess Birken 00:20:13 If you enjoyed this episode, please do me a huge favor. Share it with a friend.

Jess Birken 00:20:18 Rate review. Subscribe in your podcast app. It really does help people find the show. If you have a question or a story to share, we'd love to hear from you. Send me a note online at Charity therapy. And as always, thanks for listening.

About the Author



Hi, I'm Jess Birken

I'm the owner of Birken Law Office, I help nonprofits solve problems so they can quit worrying and get back to what matters most – The Mission. I'm not like most attorneys, I actually have an outgoing personality, and – like you – I like to think outside the box. Most of my clients are passionate and have an entrepreneurial spirit. I'm like that too. My goal is to help you crush it. Getting bogged down in the minutia sucks the joy out of the important stuff. My clients want to do the work – not the paperwork.

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