



# Public Charity Status Simplified (a little)

By Gabrielle Lessard

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Managers of publicly-supported nonprofits often seem confused by questions about their organizations' public charity status. It can be a complicated issue, but it's important to understand. The loss of public charity status is extremely detrimental, and can be avoided through ongoing monitoring of your organization's financial support.

The IRS has raised the profile of public charity status through its redesign of Form 990, the annual return for tax-exempt organizations. The redesigned 990 replaces the 'support schedule' with a new Schedule A. The Schedule refers specifically to public charity status and asks filers to identify their organization's public charity classification. Certain regulatory changes were needed to implement the revised 990, which the IRS recently published as final and temporary regulations.<sup>1</sup> The changes implemented by the temporary regulations include simplification of the process for determining a publicly-supported organization's public charity status.

Public charity status is applicable only to organizations exempt from tax under Section 501(c)(3) of the Internal Revenue Code ("IRC"). The IRS classifies all 501(c)(3) organizations as either public charities or private foundations. Public charity status is more beneficial. Private foundations are subject to extensive reporting requirements, must pay tax on their net investment income and risk various excise (penalty)<sup>2</sup> taxes.<sup>2</sup> Public charities also have fundraising advantages. Donors to public charities are subject to more favorable rules regarding the deductibility of their contributions. In addition, many private foundations will make grants only to public charities because there is a risk of excise tax liability associated with grants to non-charities.<sup>3</sup>

Unfortunately, private foundation status is the default classification. The IRS will treat a 501(c)(3) organization as a private foundation unless it meets one of the tests set out in IRC Sections 509(a)(1) - (4). For most organizations engaged in charitable or educational activity, the relevant tests are set out in

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<sup>1</sup> Implementation of the Form 990, Final Rule, 73 Fed. Reg. 52,528 – 52,555 (Sept. 9, 2008). The temporary regulations were effective on the publication date, and apply to tax years beginning on or after January 1, 2008. The IRS publishes temporary regulations when it determines that the public needs immediate guidance. Temporary regulations can be relied on until they expire, are withdrawn, or are replaced with final regulations.

<sup>2</sup> Excise taxes can be imposed if the foundation fails to:

- Refrain from acts of self-dealing (IRC §4941),
- Meet minimum distribution requirements (IRC §4942),
- Abstain from "excess business holdings" (IRC §4943) and "jeopardizing investments" (IRC §4944), and
- Refrain from making certain taxable expenditures (IRC §4945).

<sup>3</sup> Under IRC §4945, grants to non-charities are treated as taxable expenditures if the foundation fails to exercise 'expenditure responsibility'.

IRC Sections 509(a)(1) and 509(a)(2).<sup>4</sup> These “public support tests” base the determination of public charity status on an organization’s financial support. An organization that receives funding from diverse and public sources is considered to be responsive to the general public, rather than the private interests of a limited number of donors.

In general, 509(a)(1) organizations receive a substantial amount of their income in the form of grants and donations from government and general public sources, and 509(a)(2) organizations receive a substantial amount of income from membership dues or activities related to their tax-exempt purpose.

The public support analysis applies to the support an organization has received over a period of time. Under the previous regulations, a new organization without a financial support history would request an “advance ruling” of public charity status on its Form 1023 Application for Recognition of Tax-Exempt Status. At the end of the five year advance ruling period, the organization was required to report the support it had received during the period on Form 8734. If the organization failed the public support test, or did not file Form 8734, it was reclassified as a private foundation and could be taxed retroactively on its net investment income.

The temporary regulations eliminate the advance ruling process and extend the period for the public support computation from four years to five. A new organization is classified as publicly supported during its first five years of existence if its Form 1023 shows it can reasonably be expected to meet one of the public support tests during that period. After its first five years of existence, the information the organization has provided on its Form 990 will be used to determine if it meets the public support tests. Any organization with an advance ruling of public charity status which expires after June 9, 2008, will also be treated as publicly supported for the advance ruling period, regardless of its actual support.

For both newly-formed and existing organizations, an organization that meets the public support test will be classified as a public charity for the filing tax year and for the following year. Accordingly, an organization must fail the public support test in two successive years to lose its public charity status and be reclassified as a private foundation.

The temporary regulations also simplify calculation of the public support test for organizations that use the accrual method of accounting – after an initial transition year. Under the previous regulations, an organization was required to use the cash method of accounting to report its public support, even if it used the accrual method of accounting to keep its books and to complete the other sections of the 990. The temporary regulations require organizations to use their normal accounting method to report their public support on Schedule A. Since the computation period for public support is five years, Schedule A requires filing organizations to report their support for the current year and the preceding four years. Organizations that use the cash method of accounting can copy their prior years’ support calculations from previous 990s. Organizations that use the accrual method of accounting will need to recalculate their support, using the accrual method, for those preceding four years.

## The Public Support Tests

The calculation of an organization’s public support is essentially a fraction – the sum of the organization’s public support during the five year measurement period over the sum of the organization’s total support during the five-year period. Normally an organization must have at least 33Y3% public support to qualify as publicly supported, however, 509(a)(1) organizations may qualify with as little as 10% public support if they provide a narrative explanation.

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<sup>4</sup> The 509(a)(3) and 509(a)(4) tests apply to organizations that have the purpose of providing support to one or more other public charities and organizations that do testing for public safety, respectively.

Organizations are assumed to be serving general public interests when they are supported by a broad cross section of the public, rather than a few wealthy benefactors. Accordingly, if an organization receives a significant contribution from a private source such as an individual, business or private foundation, some or all of the contribution may be excluded from public support. This is true under both 509(a)(1) and 509(a)(2), although the two tests accomplish this in different ways. The tests also differ significantly in the sources of income they classify as public and total support. For example, 509(a)(2) organizations can include in public support income they generate by carrying out their tax-exempt purpose (“exempt function income”), while 509(a)(1) organizations must exclude exempt function income from both public and total support.

While conceptually similar, the two public support tests differ in their application. To qualify as publicly supported under 509(a)(1), an organization must normally (over the five year period) receive at least 33Y3% of its total support from governmental sources or directly or indirectly from the general public. A 509(a)(1) organization can qualify as publicly supported with as little as 10% public support by submitting a narrative “facts and circumstances” description of how it is organized and operated to attract public support. An organization that is publicly supported under 509(a)(2) does not get this second chance. The organization will lose its public charity status if it fails the 33Y3 support test for two consecutive tax years.

## Applying the Public Support Test

The first step in applying the public support test is to determine whether the organization is a 509(a)(1) or 509(a)(2). With that information, the next step is to calculate the organization’s total support.

### Calculating Public Support under §509(a)(1)

#### Step 1 – the organization is a 509(a)(1)

#### Step 2 – calculate the organization’s total support

#### Total Support under 509(a)(1):

Includes	Does not include
Monetary gifts, grants and contributions	Contributions of services, except for contributions of services and facilities by a unit of government, where the services or facilities are not provided to the general public free of charge the general public free of charge
Net income from activities unrelated to the organization’s exempt purpose	Income from activities related to the organization’s exempt purpose.
Gross investment income	Capital gains
Taxes levied for the organization’s benefit or paid to or expended on behalf of the organization	The value of exemption from any tax
	Unusual grants

Unusual grants are substantial contributions or bequests from disinterested parties that are unexpected, and would adversely affect the organization’s status as publicly supported. They are considered to be attracted by the organization’s publicly-supported nature.

**Step 3 - calculate the organization's public support**

**Public support under 509(a)(1):**

Includes	Does not include
Gifts, grants and contributions from governmental and public sources (including other publicly-supported organizations)	Amounts passed through a public charity or governmental unit by a donor who has expressly 'earmarked' them for the benefit of the recipient organization
Gifts, grants and contributions from private sources, such as individuals, businesses and private foundations, subject to the 2% limitation (see below)	
Government contracts to provide a service or maintain a facility for the direct benefit of the general public	Income from activities related to the organization's exempt purpose
Qualified sponsorship payments (subject to the 2% limitation)	
Membership fees paid for the organization's general support	Membership fees paid in exchange for a benefit, such as the use of facilities

The "two-percent limitation" limits to no more than 2% of the organization's total support for the measurement period the amount of countable public support an organization receives from any private source.

**Example:**

Able Workforce Development Program has received the following support during the computation period:

	2004	2005	2006	2007	2008	Total
Private Foundation A			\$25,000	\$50,000	\$50,000	\$125,000
Private Foundation B	\$5,000					\$5,000
Community Foundations	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$50,000
Government Grants	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$50,000
Revenue from Job-Training Programs	\$20,000	\$20,000	\$20,000	\$20,000	\$20,000	\$100,000

Able's **total support** for the computation period is \$230,000

Private Foundation grants:	\$130,000
Community Foundation grants:	\$50,000
Government Grants:	\$50,000

The revenue from job training programs, activities related to the organization's tax-exempt purpose, is excluded from total support under 509(a)(1).

In calculating its **public support** percentage, the organization must apply the 2% limitation to the private foundation grants.

Grants from Private Foundation A:	\$6,600 (2% of \$330,000)
Grants from Private Foundation B:	\$5,000

Grants from community foundations (public charities):	\$50,000
Government grants:	\$50,000

Able's public support percentage is 111,600/230,000 or 45%. Therefore it is a public charity for the current tax year and the next tax year.

## Calculating Public Support under §509(a)(2)

### Step 1 – the organization is a 509(a)(2)

### Step 2 – determine total support

#### Total support under 509(a)(2):

Includes	Does not include
Gifts, grants, contributions and membership fees	Earmarked and unusual grants
Gross receipts from activities related to the organization's exempt purpose.	
Net income from business activities unrelated to the organization's exempt purpose	
Gross investment income	Capital gains
Taxes levied for the organization's benefit or paid to or expended on behalf of the organization	The value of exemption from any tax
Contributions of services and facilities by a unit of government, where the services or facilities are not provided to the general public free of charge	

**Note:** Organizations that are publicly supported under §509(a)(2) must also meet a negative 331/3 support test. An organization will not qualify as publicly supported if it normally receives at least 331/3 of its total support from the sum of:

- gross investment income and
- income from unrelated taxable business activities, minus the tax imposed on that income.

### Step 3- calculate public support

#### Public Support under 509(a)(2):

Includes	Does not include
Gifts, grants, and contributions subject to exclusion of amounts received from disqualified persons (see below)	Contributions of services and facilities by a unit of government, where the services or facilities are not provided without charge to the general public
Membership fees	Investment income
Gross receipts from performance of exempt activities, subject to a 1% / \$5000 limitation (see below)	Receipts from unrelated business activities
	Taxes levied for the organization's benefit or paid to or expended on behalf of the organization
	Earmarked and unusual grants

Under §509(a)(2), contributions from “disqualified persons” are excluded from public support. Disqualified persons include substantial contributors, managers and certain persons and entities related to them.

**Substantial contributors** are persons or entities whose total contributions to the organization, over time, exceed \$5,000, where the sum of the contributions is greater than 2% of the support received by the organization since it was formed. Units of government and 509(a)(1) public charities are never disqualified persons, regardless of the amount of support they provide.

The §509(a)(2) test also limits the amount of exempt function income from any single person, entity or government agency that can be included in public support. For any tax year, the exempt function income the organization receives from a single source is excluded from public support to the extent it exceeds the greater of \$5000 or 1% of the organization’s total support.

**Example:**

Government Agency contracts with Tax-Exempt Child Care Center (TECCC) to provide day care for foster children living in group homes. TECCC relies on Government Agency for 25% of its business. Government Agency has also given TECCC a grant to improve its facility.

TECCC was founded in 2004. It has received the following support:

	2004	2005	2006	2007	2008	Total
Private Foundation A	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$50,000
Private Foundation B				\$50,000	\$50,000	\$100,000
Community Foundations	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$50,000
Government Grants	\$10,000	\$10,000	\$10,000	\$10,000	\$10,000	\$50,000
Revenue from Child Care	\$10,000	\$10,000	\$20,000	\$30,000	\$30,000	\$100,000

Grants from private foundations:	\$150,000
Grants from community foundations (509(a)(1) public charities):	\$50,000
Government Agency grants:	\$50,000
Gross revenue from child care:	\$100,000

All of these sources are included in total support. TECCC’s total support for the computation period was \$350,000.

In calculating TECCC’s public support, we need to consider that each year it received 25% of its exempt function income from Government Agency. For each tax year we need to exclude any amount that exceeds the greater of \$5,000 or 1% of TECCC’s total support. (We are assuming that no other source of exempt function income reached this threshold).

	2004	2005	2006	2007	2008	Total
Total Support	\$40,000	\$40,000	\$50,000	\$110,000	\$110,000	\$350,000
1% of total support	\$400	\$400	\$500	\$1,100	\$1,100	
Exempt function income from government agency	\$2,500	\$2,500	\$5,000	\$7,500	\$7,500	
Included in Public Support	\$2,500	\$2,500	\$5,000	\$5,000	\$5,000	\$20,000

In evaluating the grants, we need to consider whether either Private Foundation is a substantial contributor. The grants from Government agency and the community foundations do not raise substantial contributor issues because units of government and §509(a)(1) public charities are never disqualified persons.

Private Foundation A's total contributions to TECCC are \$50,000. Private Foundation B's total contributions are \$100,000. Since these amounts exceed both \$5,000 and 2% of TECCC's cumulative total support, both Private Foundations are disqualified persons and no portion of their contributions will be included in public support.

Therefore, TECCC has \$195,000 of public support:

Gross revenue from child care:	\$95,000
Community foundation grants:	\$50,000
Government Agency grant:	\$50,000

TECCC's public support percentage is  $195,000/350,000$  or 56%, therefore it is a public charity for the current and the next tax year.

## Conclusion

The public support tests are complicated, but easier to understand when viewed through the lens of a single organization. It is important to understand how the tests apply to your organization. Managers who monitor their organization's public charity status can work with funders to control the amount and timing of their contributions to safeguard the organization against the consequences of loss of public charity status. If a loss of public charity status seems likely, organization managers should contact their tax advisor to explore alternatives, such as establishing a §509(a)(3) supporting organization.