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## PRIVATE FOUNDATION VERSUS PUBLIC CHARITY

*(Non Profit Advisory No. 5)*

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Most nonprofit entities -- and especially their primary donors -- want to insure that they have “public charity” status for the 50% deduction of contributions, rather than being a “private foundation” with a restricted 30% deduction for contributions.

This Advisory sets forth the tax formulas used by the Internal Revenue Service (IRS) (and state taxing authorities) to maintain “public charity” status. Yearly testing of the contributions and revenues of your nonprofit organization, along with necessary corrections to achieve IRS defined “public support” allows you to maintain the 50% deductibility of donations to your public charity.

This Advisory is neither exhaustive nor tailored to your specific situation. You should discuss your circumstances with us or with your own attorney. Our representation is only undertaken through a written engagement letter and not by distribution of this Advisory.

**Private Foundation or Public Charity?** A 501(c)(3) tax exempt organization is classified as either a “private foundation” or a “public charity”. A 501(c)(3) organization is automatically presumed to be a private foundation unless it can show that it is a public charity.

There are nine types of organizations which are specifically excluded from the definition of a private foundation and are automatically classified as public charities. This advisory will focus on two public support exemptions -- those found under sections 509(a)(1) and 509(a)(2) -- as these are the situations we most routinely encounter.

Section 509(a)(1) sets out the first level of exclusions:

- (1) Churches, conventions or associations of churches;
- (2) Educational organizations such as schools or colleges;
- (3) Hospitals and medical research organizations which are operated in conjunction with hospitals;
- (4) Endowment funds for the benefit of certain state and municipal colleges and universities;
- (5) Governmental units;
- (6) *Publicly supported organizations (discussed below)*

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There are additional exclusions set out in other code sections:

- (7) Organizations that qualify under Section 509(a)(2) (discussed below)
- (8) Supporting organizations (section 509(a)(3)); and
- (9) Public safety testing organizations

**Public Charity Classification – Public Support Exemptions.** To be classified as a public charity, an organization must be able to show the IRS that it receives a substantial part of its support from governmental units or the general public (“public support test”). There are two main tests the IRS uses to decide whether an organization fits into this category – the public support tests under section 509(a)(1) (which includes the “facts and circumstances test”) and as an alternative, the section 509(a)(2) test.

(1) *Public Support Under Section 509(a)(1)*

- (a)  $\frac{1}{3}$  Public Support Test. To be considered a public charity, an organization must receive  $\frac{1}{3}$  of its total support from governmental units, contributions from the general public or a combination of the two. In addition, the financial support must come from a sufficiently broad base of public donors – i.e. if one donor provides a donation equal to  $\frac{1}{3}$  of the total support, even though it is classified as a public donation, the entire contribution is not able to be used in this calculation, and the organization will not meet the  $\frac{1}{3}$  public support test. Each support source may only be counted for up to 2% of the total support.

The equation is as follows:

$$\frac{\text{Public Support}}{\text{Total Support}} = \frac{\text{(1) government grants; (2) gifts, grants, contributions and membership fees from other public charities; (3) gifts, grants, contributions and membership fees from all other sources (but each source may only be included for up to 2% of total support)}}{\text{(1) gifts, grants, donations, membership fees, (2) gross investment income (excluding capital gains); (3) taxable income from UBI less UBIT; (4) benefits from tax revenues received by the organization; (5) value of services/facilities furnished to organization by the government without charge; (6) all other revenues except capital gain and gross receipts from exempt}}$$

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function activities

If public support (numerator) is  $\frac{1}{3}$  more of the total support, the organization will qualify as a public charity. If the organization fails the  $\frac{1}{3}$  public support test, it may still qualify under the facts and circumstances test (below).

To decide whether an organization meets the  $\frac{1}{3}$  test, the IRS will look at the four tax years preceding the current tax year. If the  $\frac{1}{3}$  test is met, in aggregate, over the previous four years, the organization will be classified as a public charity.

- (b) Facts and Circumstances Test. If the organization fails the  $\frac{1}{3}$  public support test, they may be able to rely on the “facts and circumstances test”. This requires that the organization:
  - (i) normally receives 10% or more in public support (“normally” means that for the preceding four years before the current tax year it can show the 10% support factor on an aggregate basis); and
  - (ii) must be organized and operated “in a manner to attract new and additional public or governmental support on a continuous basis” e.g. through a continuous fund-raising program; and
  - (iii) satisfies a sufficient combination of other factors described in Treasury Regulations §1.170A-9(e)(3). These factors include the extent to which the public support exceeds the 10% requirement, the breadth of sources of support, the extent to which the organization represents the broad interests of the public, whether the organization generally provides facilities/services to the general public, and whether the activities of the organization will appeal to persons having a broad common interest or purpose.
  
- (2) *Public Support Under 509(a)(2)*. An alternative test is the public support test under section 509(a)(2), which allows income from charitable activities to be included in the calculation of public support. This is satisfied if the organization receives:
  - (a) at least  $\frac{1}{3}$  of its total support from the public; and
  - (b) no more than  $\frac{1}{3}$  of its total support from investment income.

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Here, the definitions of “public support” and “total support” differ from that set forth above – as mentioned above, under this section the organization is able to use income from their exempt activities in their calculation of public support.

$$\frac{\text{Public Support}}{\text{Total Support}} = \frac{\begin{array}{l} \text{(1) donations, membership fees (does not include any funds} \\ \text{received from disqualified persons), (2) gross receipts, (3)} \\ \text{income from performance of exempt functions (limited to the} \\ \text{greater of \$5,000 or 1\% of total support)} \end{array}}{\begin{array}{l} \text{(1) donated income; (2) investment income (excludes capital} \\ \text{gains, but includes UBIT less taxes on that income); (3) UBI; (4)} \\ \text{value of governmental services and facilities above those} \\ \text{normally provided to public; (5) gross receipts from income} \\ \text{generating activities relating to organization's exempt purpose} \end{array}}$$

For purposes of this qualifying test, a disqualified person includes:

- (a) a substantial contributor (someone who donated more than \$5,000, if those contributions are more than 2% of all contributions received by the organization from date of creation until end of year in which substantial contributor's contributions were received);
- (b) an organization's manager;
- (c) an owner of more than 20% of the total combined voting power of a corporation that is a substantial contributor;
- (d) a family member of anyone described above;
- (e) a corporation, partnership or trust where a person previously described holds more than 35% of the combined voting power, profits interest or beneficial interest; and
- (f) any private foundation that is effectively controlled by the same person who controls the organization or whose contributions were made by substantially the same contributors.

In addition to meeting the  $\frac{1}{3}$  public support test, the organization must receive no more than  $\frac{1}{3}$  of its support from investment income.

**Differences Between Private Foundation and Public Charity.** There are distinct differences between a private foundation and a public charity. Listed below are several of the more significant attributes that may favor one type of tax-exempt entity over another.

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<i>Attribute</i>	<b>Private Foundation</b>	<b>Public Charity</b>
<i>Charitable contributions deduction</i>	Maximum deduction up to 30% of contribution base; if capital gain property contributed, subject to 20% limitation	Dependent upon type of property, maximum deduction up to 50% of contribution base
<i>Maintenance of tax-exempt status</i>	Must distribute annually at least 5% of its net investment assets for charity purposes (assets held by a foundation for charitable purposes is not counted in this computation).	
<i>Excise and Other Taxes</i>	2% annual excise tax is imposed on net investment income Termination tax imposed on voluntary termination of Private Foundation status	Not applicable
<i>Tax and Information Returns</i>	Annual information returns required regardless of amount and source of income/receipts	Not required until and unless annual gross receipts exceed \$25,000, but 990-N “e-postcard” filing required.
<i>Other Limitations</i>	(1) Restrictions on self-dealing between Private Foundations and substantial contributors and other Disqualified persons. (2) Limits on holdings in private businesses. (3) For a Private Foundation to be tax-exempt, its governing instrument must contain certain special provisions.	

We hope that your nonprofit flourishes – as a “public charity” – and that you maintain donations and other receipts within the levels described herein to achieve that result. It is important to have your tax returns reviewed annually by an attorney and accountant knowledgeable in this tax area, to insure that your support levels are within “public charity” levels. Blindly filing tax returns that do not meet the “public support” tests may lead to a loss of your 50% tax benefit for your donors.

As always, you should be sure that additional legislation has not been enacted or court decisions rendered, that would change the above advisements. This Advisory is neither

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S. Timothy Buynak, Partner  
Business and Tax Attorney

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*This Advisory is one of a series of business and tax advisories prepared by the attorneys at the Buynak, Fauver, Archbald & Spray, LLP. Should you have further questions regarding the information provided in this Advisory, please contact the author at the number listed below.*

*Buynak, Fauver, Archbald & Spray, LLP provides business legal services to individuals, business entities and nonprofit organizations from entity formation and start-up, through day-to-day operations and exit strategies.*

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