

Public Support Tests: Context & Calculation

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Outline

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- Regulation of Private Foundations: Key Differences from Public Charities
- Types of Public Charities - outline and table
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- Reporting: Common technical errors
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- Reporting & Planning: Common substantive errors / tax planning issues
- Other tax planning tips & special topics

Definition: A US charity is either a Private Foundation or a Public Charity.

Charity ("c3") All organizations described in IRC Section 501(c)(3)	
Private Foundation ("PF") status: default, no action needed some variants exist	Public Charity ("PC") technically: "non-private foundation" status: must pass a test

Background: public policy reasoning.

PFs - typically narrowly funded, narrowly controlled:
therefore more highly regulated

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**Regulation Of Private Foundations:
Key Differences from Public Charities**
PF's are very highly regulated. PC status is often vital to objectives.

PRIVATE FOUNDATIONS	PUBLIC CHARITIES
Lower deductibility: value of contribution (basis, FMV, etc) by type	higher
Lower deductibility: % AGI note that Private Operating Foundation ("POF") status confers higher deductibility	higher
Required minimum Qualifying Distributions	no minimum
Only easy grantmaking is to public charities Grants to other entities may require PF to exercise "expenditure responsibility" to avoid serious penalties called "taxable expenditures" and/or such grants may or may not be counted as Qualifying Distribution	can grant to any entity (restricted for charitable purposes)
Prohibition on lobbying	limited
Prohibition on self-dealing other than reasonable compensation for services ; no safe harbor on definition of "reasonable"	not prohibited safe harbor available on "reasonable"
Tax on investment income	no tax
Prohibition on certain types of investments	prudence only
Prohibition on owning greater than certain % of business entities	no limit prudence only
Prohibition on private inurement	Same
Prohibition on electioneering (candidates)	Same
Forms 1023 & 990 must be provided for public inspection on demand	Same

Types of Public Charities

There are **nine primary types** of public charity:

- 509(a)(1)...six tests: "see IRC 170(b)(1)(A)(i) - (vi)"
- 1 170(b)(1)(A)(i) - church
- 2 170(b)(1)(A)(ii) - school
- 3 170(b)(1)(A)(iii) - hospital or medical research organization
- 4 170(b)(1)(A)(iv) - support organization to public higher ed
- 5 170(b)(1)(A)(v) - governmental unit
- 6 170(b)(1)(A)(vi) - publicly supported [**donative**]
- 7 509(a)(2) - publicly supported [**earned**]
- 8 509(a)(3) - supporting organization to another publicly supported charity
- 9 509(a)(4) - product safety research

Our focus:

#6 Publicly Supported Charity under IRC Section 509(a)(1) & 170(b)(1)(A)(vi)

publicly supported with emphasis on small gifts
very common type; what most people mean by "nonprofit"
most likely to come up in your practice

#7 Publicly Supported Charity under IRC Section 509(a)(2)

highly inflexible test: no halo assumption
math is complex and time consuming

Table: Types of Public Charities

Reporting: Form 990, Schedule A, Support Schedule & Form 8734

Reporting: Common Technical Errors

- ✓ Wrong periods reported (Form 8734: advance ruling period, exactly; Form 990, Schedule A: last year and three prior years)
- ✓ Accrual method used (cash method required)
- ✓ Confusion about which entities subject to 2% limitation
 - lack of aggregation
 - treatment of public entities as subject to 2%
 - treatment of private foundations as not subject to 2%
 - guessing
- ✓ No list of substantial contributors / excess contributions attached
- ✓ Form 990 Schedule A, Page 2, Part IV only: Box (12) for 509(a)(2) checked in error rather than Box (11a) for 509(a)(1) / 170(b)(1)(A)(vi)
- ✓ Form 990, Schedule A only: list of substantial contributors not marked "Not Open for Public Inspection" and also submitted to A.G. with RRF-1 in error (should only go to IRS unless client and donors want disclosure)
- ✓ Form 8734 only: EINs not provided for excess contributors

Reporting: Form 8734 "Dos & Don'ts"

- ✓ Don't complete it for both 509(a)(2) and 170(b)(1)(A)(vi)
- ✓ Do run full calculation of formula and show the percentage (Exhibit A)
- ✓ Don't wait for IRS to ask
- ✓ Do show exact periods being reported - and do calculate exactly on advance ruling period

Reporting & Planning: Common Substantive Errors

- ✓ Confusion between fees & donations
 - government grants v. government contracts
 - special event income - donative vs. earned portion
- ✓ Income booked as "other income" that could be netted against expenses for tax purposes (but possibly not GAAP)
- ✓ Fear of 170(b)(1)(A)(vi) "10% plus facts and circumstances" test - advising clients in error that they have reverted to PF status and should file 990-PF
- ✓ Confusion about nature of initial funding from a fiscal sponsor or parent organization (nearly always not subject to 2% limitation)
- ✓ Confusion between membership fees that are donative in nature vs. earned in nature (default position for a charity - public benefit organization - is that membership fees are donative)
- ✓ Confusion about definition of "unusual grant"

Other Tax Planning Tips & Special Topics

When forming a new charity, if public support may be an issue, **choose a formation date and fiscal year to give the longest possible advance ruling period.**

For publicly supported (a)(1)'s, **do a mid-period check** during the advance ruling period. If there is any doubt, this leaves time to broaden the board, diversify and intensify fundraising

Words: "a 509(a)(1) and 170(b)(1)(A)(vi) charity" is a mouthful, but it is technically accurate to say "a **publicly supported 509(a)(1) charity.**"

Words: "total support" is often used for the denominator, when it really means "most income." This area does not adhere to the accounting profession's careful use of "support" and "revenue" meaning donative and earned income.

Scope is everything - if projected public support is 60%, little problems in the classification of income (earned v. donated) will not do any harm; if it's closer to 34%, frequent monitoring may be necessary.

Consider **two other types of entity** in re: client objectives:

- ✓ Supporting Organization - 509(a)(3)
 - offers tax planning / strategic advantages in some cases
 - loss of control
 - legal advice needed
- ✓ Private Operating Foundation ("POF") (special type of Private Foundation)
 - narrowly supported, broadly operated
 - offers some of favorable deductibility of PC's with narrow financial support
 - complicated three part test

How much fee income is too much for an organization to qualify under (a)(1)?

Interestingly, Regulation says only that it does not work if an organization has \$500,000 in government fee income and \$5,000 in donated income. (100-to-1). *Reg. 1.170A-9(e)(7)(ii)*

509(a)(1) is much better than 509(a)(2)

- ✓ (a)(1) offers alternative 10% plus facts & circumstances test
- ✓ no gifts from any disqualified person go in (a)(2) numerator
- ✓ substantial donors to (a)(2) become virtually permanently disqualified
- ✓ the annual part of the (a)(2) formula requires at least 34 separate fee payers per year - not all business models work even when it is 100% exempt function income but fewer payers
- ✓ gifts from an (a)(2) to another (a)(1) are treated more favorably

Failing the public support test for the advance ruling period will not ordinarily jeopardize donors' deductions. It will subject the charity to the investment income tax retroactive to inception, but will only subject it to other private foundation constraints on a going-forward basis.

Capital Gains on investments do not appear on the support schedule, so it is possible in a tight situation to manage investments to generate gains rather than interest and dividends.

Switching between 509(a)(2) and 509(a)(1)/170(b)(1)(A)(vi) does not require approval; for that matter, for example, a 509(a)(1) Church may also qualify as a 170(b)(1)(A)(vi) and be so classified by a donee PC calculating its own 170(b)(1)(A)(vi) numerator.

Funds from Subsidiary For-profits and from 509(a)(3) Supporting Organizations are treated unfavorably, as disqualified person money, subject to the 2% limitation in 170(b)(1)(A)(vi) and not included in the numerator at all for 509(a)(2).

Private Foundations may convert to public charities by going through “private foundation termination” [IRC §507(b)(1)(B)]. by filing for an advance ruling period of 60 months, or, in some instances, proving that they were publicly supported for the preceding four years and get final determination.

A publicly supported charity failing its advance ruling period **may convert to 509(a)(3) status** going forward (will require changes to governing documents). It will still owe investment income tax for the period from inception until it qualifies as a Supporting Organization.

Exhibits

- A. Sample Form 8734 with supplemental schedule
- B. Form 8734 Instructions
- C. 990 Schedule A - pages 2 & 3 and Instructions