

Public Support Tests: Context & Calculation

Terry Miller¹
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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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- 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

¹ Mr. Miller is neither an attorney nor a CPA. This document should not be used as legal advice.
Terry Miller, 70611.165@compuserve.com, 415-664-1576, 250 Parnassus #204, SF, CA, 94117-3838.

**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

IRC Section	Type of Public Charity	Notes
509(a)(1)		
170(b)(1)(A)(i)	school	Multi factor test for presence of factors such as curricula; place of study; pedagogical method; nondiscrimination in practice, governing documents, recruitment materials and annual notice. Need legal advice. Status granted with determination letter.
170(b)(1)(A)(ii)	church or convention / association of churches	Multi factor test for presence of factors such as doctrine; holy figure / guru; scripture; place of worship; means of worship; congregation. Need legal advice. Status granted with determination letter.
170(b)(1)(A)(iii)	hospital or medical research org	not sure; no longer requires free universal care
170(b)(1)(A)(iv)	support organization to public college/university	not sure
170(b)(1)(A)(v)	governmental unit	not sure
170(b)(1)(A)(vi)	publicly supported organization [donation based]	Formula: today's discussion subject. 990 reports on prior year and three earlier - theory that the support during that period determines the foundation status for the reporting period. Status: advance ruling. At time of tax exemption application, charity asserts fundraising; initial advance ruling determination letter says, in common language: 'OK you are a 501(c)(3) and we believe that it is likely you will qualify as a publicly supported charity under Sections 509(a)(1) and 170(b)(1)(A)(vi). Therefore we are giving you an advance ruling, that for the first five fiscal years, donors may rely on your classification as a publicly supported charity. Provided you file Form 8734 within 90 days of the end of the advance ruling period, donors may rely on your continued classification as a publicly supported charity even beyond the end of the advance ruling period until and unless we publish notice in the Internal Revenue Bulletin that you no longer qualify.' Status: final determination. After filing form 8734, IRS writes a "final determination" letter. Once final determination received, charity may even "flunk" the test for one four-year period.
509(a)(2)	publicly supported organization [fee based]	Formula: today's discussion subject. 990 reports on prior year and three earlier - theory that the support during that period determines the foundation status for the reporting period. Status: advance ruling. At time of tax exemption application, charity asserts fundraising; initial advance ruling determination letter says, in common language: 'OK you are a 501(c)(3) and we believe that it is likely you will qualify as a publicly supported charity under Section 509(a)(2). Therefore we are giving you an advance ruling, that for the first five fiscal years, donors may rely on your classification as a publicly supported charity. Provided you file Form 8734 within 90 days of the end of the advance ruling period, donors may rely on your continued classification as a publicly supported charity even beyond the end of the advance ruling period until and unless we publish notice in the Internal Revenue Bulletin that you no longer qualify.' Status: final determination. After filing form 8734, IRS writes a "final determination" letter. Once final determination received, charity may even "flunk" the test for one four-year period.
509(a)(3)	supporting organization [to a publicly supported organization]	Broad theory is that (a)(3) exists for the benefit of and is controlled by one or more publicly supported charities. Simplest structure is where (a)(3) Bylaws say supported PC appoints board of (a)(3), and (a)(3) makes grant every year to supported PC (counts as disqualified person money to the supported PC). Many variants e.g.: board control may be by a "class" of charities who can come and go; some cases where 'operated in conjunction with' will suffice rather than control (controversial "type 3"); limitations on what the (a)(3) can do besides grant to supported organization, but some freedom allowed; supported PC can actually be a 501(c)(4), (5) or (6) if the supported organization passes the 509(a)(2) test. Must get legal advice for anything fancy with this type.
509(a)(4)	product safety testing	Facts & circumstances. Uncommon classification. Status granted on determination letter.

Public Support Test formula: 509(a)(1) & 170(b)(1)(A)(vi)

Reg 1.170A-9(e)

Advance ruling period: 5 fiscal year-ends from formation; date shown on determination letter;
therefore can range between 49 and 60 months - tax planning opportunity

Reporting period: 4 years, reported on 990 for four prior years
(basis on which current year status is predicated)

Formula Summary:

If Public Support is greater than 1/3, then definitive public charity;
If less than 1/3 but greater than 1/10, then look to facts & circumstances;
If less than 1/10, then FAIL.

Formula Detail (calculated on four year basis):

only:

all gifts, grants & contributions from other organizations described in IRC 170(b)(1)(A)(vi)
all gifts, grants & contributions from governmental units
gifts, grants & contributions up to 2% of the denominator from each private source (aggregated on family and business lines)
tax revenues and government facilities furnished without charge

if > 1/3, then definitive public charity
if < 1/3 but > 1/10, then submit facts & circumstances
if < 1/10, then FAIL

ALL income, minus:

exempt function income (program related earned income)
unusual grants
capital gains on sale of capital assets
tax paid on unrelated business income

Facts & Circumstances

Form 8734 plus 3-5 page detailed response to facts & circumstances test
Form 990 - assertive statement, make notes to defend on audit

broad community based board of directors (civic leaders, not narrow or insider board)
set of fundraising plans which are real, and in action, intended to broaden out number of supporters
substantial support from governmental units
facilities or services made available to the general public

if close to 1/10, higher pressure on facts & circumstances

Public Support Test formula: 509(a)(2)

Reg 1.509(a)(3)

Advance ruling period: 5 fiscal year-ends from formation; date shown on determination letter;
therefore can range between 49 and 60 months - tax planning opportunity

Reporting period: 4 years, reported on 990 for four prior years
(basis on which current year status is predicated)

Formula Summary:

If Public Support is $> 1/3$ and (investment income + after-tax unrelated business income) is $< 1/3$,
then definitive public charity

If Public Support is $< 1/3$ or (investment income + after-tax unrelated business income) is $> 1/3$,
then FAIL

Formula Detail (calculated on overall four year basis, some one-year calculations included):

only:

fees: exempt function income from entities that are not disqualified persons , up to the GREATER of \$5,000 or 1% of the total support in a given SINGLE year
all gifts, grants & contributions from Section 509(a)(1) public charities
all gifts, grants & contributions from governmental units
all gifts from other sources provided they have not become disqualified persons by end of four year period
tax revenues and government facilities furnished without charge

if $> 1/3$, then definitive public charity,
provided investment + after tax UBI $< 1/3$

if $< 1/3$, then FAIL

ALL income less:

unusual grants
capital gains on sale of capital assets
tax paid on unrelated business income

if investment income + after tax UBI $> 1/3$,
then FAIL

Disqualified Persons

Substantial contributors - gifts from entity exceed greater of \$5,000 or 2% of total donations & bequests over entire organizational history

Owner of more than 20% of a substantial contributor

Foundation manager - officer, director, key employee

Family members of other disqualified persons

Certain related legal entities

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