

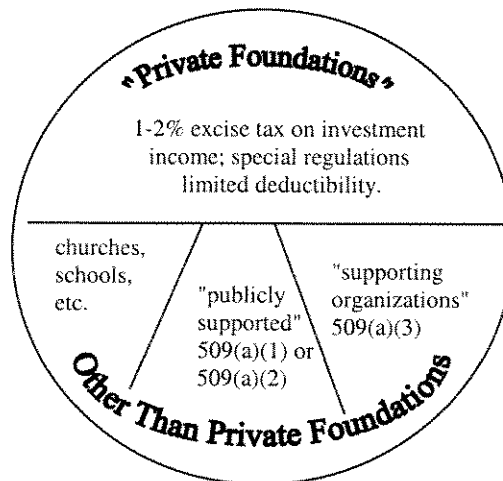
THE PUBLIC SUPPORT TEST: Remember your Fractions

501(c)(3) Status. Organizations are recognized as exempt under Section "501(c)(3)" of the Internal Revenue Code because they are "organized" and "operated" for "exempt purposes" and are "not-for-profit." The 501(c)(3) exemption means that they pay no tax on revenues, and (in most cases) that donors get a deduction when making gifts to them.

501(c)(3) Universe: "Private Foundations" + "Public Charities." In the world of 501(c)(3) there are two categories: "private foundations" and "other than private foundations," often called "public charities." "Private foundations" are generally treated less favorably than "public charities." Why? The key to being a "public charity" is support from the general public. Congress thought that the need to keep raising money from the general public would keep "public charities" honest. By contrast, Congress thought that "private foundations," living off the income from a large fund, controlled by a select few, with no need to demonstrate their good works to the public, would not "keep honest" without regulation.

Disadvantages of being a "Private Foundation"? "Private foundations" pay 1%-2% tax on net investment income and are subject to various prohibitions on transactions between themselves and those who control them, including directors. They are prohibited from lobbying and pay tax on any lobbying expenses, which, along with other prohibited expenditures, are known as "taxable expenditures." Foundations are also subject to other regulations not applicable to public charities. The deductibility of gifts to private foundations is somewhat more limited than to "other than private foundations." Their donors' identities are subject to public disclosure and, in general, foundations have more extensive reporting obligations. ("Operating foundations" that carry on charitable activity other than grantmaking are slightly less heavily regulated.)

How Do You Get to be "Other Than" a "Private Foundation"? The "other than private foundations" ("public charities") subcategory within the 501(3) category includes things like schools and churches, also "publicly supported" organizations (all of these are 509(a)(1) or (2)), and finally, under 509(a)(3), "supporting organizations," of which there are essentially three types. A supporting organization must "support" one or more 509(a)(1) or (2) organizations. The following figure illustrates the world of private foundations and "other than private foundations" ("public charities").



501(c)(3)
organizations

To qualify as "other than a private foundation" under section 509(a)(1) as a "publicly supported" organization, an organization must be able to show (provisionally, in its exemption application; for a final determination, at the end of its advance ruling period upon review of five tax years of support data) that "normally" it EITHER receives at least one-third of its "financial support" from a combination of the "general public" and public charities and government, OR that it receives at least 10% from these sources and meets various other tests (e.g., has a broadly representative board of directors, and actively looks for money). The rules are spelled out in detail in Treasury Regulation sec. 1.170a-9(e). Remember that the 501(c)(3) status of the organization is *not affected* by the determination as to whether it is "publicly supported" or is a "private foundation."

How can the organization meet these 1/3 or 10% tests? There are two tricky aspects to this, one "bad" and three "good." "Unhelpful" and "helpful" might be another way to explain it.

The "bad" part is that when computing these fractions, the amount by which an individual donation (by which we mean, from any individual person or corporation, or from a non-publicly supported charity (e.g., a private foundation) exceeds 2% of the total DOES NOT GO INTO THE NUMERATOR, but it DOES GO INTO THE DENOMINATOR. This means that significant financial support given by an individual, a corporation, or even another non-publicly supported organization, could jeopardize the organization's status as other than a private foundation.

Example: Each of 11 directors gives Small Charity, Inc. \$100.
Major Donor buys Small Charity, Inc. office furniture of \$10,000.
Total support: \$11,100.
2% of \$11,100 = \$220.
Major Donor's contribution counts for only \$220 of the numerator.
Equation:
$$\frac{\$1,100 \text{ (directors)} + \$220 \text{ (Major Donor)}}{\$11,100} = 11.89\% \text{ "public support"}$$

Result: Small Charity, Inc. would fail the "1/3" test and have to argue it met the "10% + facts and circumstances" test in order to remain under 509(a)(1).

The first "good" thing is that gifts of services, or use of space, do not count in either numerator or denominator. The second "good" thing is that "unusual grants" (explained at length y regulation) also do not count. The third "good" thing can really "save the day" for any organization that has a small budget: contributions from government or other *publicly supported* organizations count in BOTH numerator and denominator. (Contributions from an organization's own supporting organization wouldn't qualify because it is not, itself, publicly supported.)

Example: Each of the 11 directors gives Small Charity, Inc. \$100 for a total of \$1,100.
The Community Foundation for Greater New Haven (a publicly supported organization) gives Small Charity, Inc. \$2,000.

Total support: \$3,100.
2% of \$3,100 = \$62
The equation is
$$\frac{\$62 \times 11 \text{ directors} + \$2,000}{\$3,100} = 86.5\%$$

Result: Small Charity, Inc. passes the 1/3 support test with flying colors.

To qualify as "other than a private foundation" under section **509(a)(2)** as a "publicly supported" organization, an organization must pass the "1/3" and "not more than 1/3" tests. It doesn't get a 10% exception. These tests are explained in Treasury Regulation sec. 1.509(a)-3.

A 509(a)(2) organization has a 1/3 public support test similar to the one discussed above, but with some major differences. It DOES include in its numerator not only gifts and grants, but receipts from exempt activities (e.g. theater tickets for a theater) -- let's call those "fees." This is why we sometimes think of this section as appropriate for "service-providing" organizations, those that "earn" their income. But it can NOT include "fees" received from any individual, corporation or government agency that exceed the greater of 1% of the total or \$5,000. In other words, when it comes to "fees," the numerator has instead of a "2%" test, a "greater of 1% or \$5,000" test. It also can NOT include in its numerator ANY receipts from "disqualified persons." These include board members and "major donors" and those with certain family or business relationships. "Major donor" has a very technical definition, but if anyone gives over \$5,000, look this up in Regulations section 1.507-6(b)(1). The organization must also pass another test: it is prohibited from having more than 1/3 of its income come from a combination of investment income and net unrelated business income. (Investment income from its supporting organization would pass through and be treated as its own.)

Example: Science Think Tank Inc. is paid by two government bureaus to do scientific studies, has investment income, sells educational materials, and also has gifts and grants:

Fees paid by Bureau M	\$25,000	- include only \$ 5,000
Fees paid by Bureau N	\$25,000	- include only \$ 5,000
Sales of educational materials to public:	\$24,000	- include all \$24,000
Endowment income: (NOTICE: less than 1/3)	\$11,000	- include 0
Unusual grant (gift of a \$500,000 building)	0	- include 0
Contributions from a major contributor:	<u>\$15,000</u>	- include <u>0</u>
Denominator:	\$100,000	Numerator: \$34,000

If this were 509(a)(1), it would fail, having only \$2,000 public support (the amount allowable for the major contributor's gift).

Although 509(a)(2) is designed for what one could think of as "service-providing organizations," it can also help out a very small organization that has a few donors who give more than the 2% that would be a problem under 509(a)(1).

Example: Tiny Project accepts donations and uses them to provided help to the mentally retarded in its town. It has no income from fees. It also does not have a lot of donors.

Mrs. M, N, O and P each give \$4,000. 4 x \$4,000=	\$16,000	- include \$16,000
Two Major Donors (whose gifts are not "unusual")	\$66,000	- include 0
General Public	<u>\$18,000</u>	- include <u>\$18,000</u>
Denominator:	\$100,000	Numerator: \$34,000

Observe that if this were a 509(a)(1) organization, the contributions of M, N, O and P would count as \$2,000 each (2% x \$100,000), but on the other hand, the contribution of each Major Donor would count for \$2,000 rather than zero; accordingly, there would be \$30,000 in the numerator.