

QUALIFYING FOR PUBLIC CHARITY STATUS: The Section 170(b)(1)(A)(vi) and 509(a)(1) Test and the Section 509(a)(2) Test

Tax-exempt status under Section 501(c)(3) of the Internal Revenue Code permits a charitable organization to pay no tax on any operating surplus it may have at the end of a year, and it permits donors to claim a charitable deduction for their contributions.

There is a further division in the world of Section 501(c)(3) organizations, classifying them into private foundations and public charities. A special regulatory scheme applies to private foundations in addition to the basic rules governing all charities. The private foundation laws impose a 2 percent tax on investment income, limit self-dealing and business holdings, require annual distributions, prohibit lobbying entirely, and restrict the organization's operations in other ways. Also, large donors to a private foundation have a lower ceiling on the amount of deductible gifts they can claim each year. In most circumstances, public charity status is preferable to private foundation status.

A Section 501(c)(3) organization can avoid private foundation status, and thus be classified as a public charity, in any of three ways: (1) by being a certain kind of institution, such as a church, school, or hospital; (2) by meeting one of two mathematical public support tests; or (3) by qualifying as a supporting organization to another public charity. In this memo, we discuss the two mathematical public support tests.

The Public/Governmental Support Test of Sections 170(b)(1)(A)(vi) and 509(a)(1)

This public support test was designed for charities which derive a significant proportion of their revenues from donations from the public, including foundation grants, and from governmental grants. The test has two variations. If an organization can satisfy either of the two variations of this support test, it will qualify as a public charity under Sections 170(b)(1)(A)(vi) and 509(a)(1).

The first variation is known as the *one-third test*. A charity can satisfy this test if public support is one-third or more of the total support figure. Nothing more is needed if this mathematical fraction is attained.

The second variation, known as the *10 percent facts and circumstances test*, has two requirements. First, the charity's public support must be at least 10 percent of its total support. Second, the charity must demonstrate, with reference to facts and circumstances specified by the IRS, that it is operated more like a public charity than like a private foundation.

In order to determine which test applies to your organization, you must begin with the mathematical public support computation.

The first step in that computation is to determine two figures: *total support* and *public support*.¹ These figures are, respectively, the denominator and the numerator of the public support fraction. They are computed with reference to the charity's revenues over a specific measuring period, which is usually four years in length; in the case of newly formed organizations, the measuring period is five years.² In both instances, however, the figures are based on the revenues for the entire period. It is not a year-by-year calculation.

1. Total support (support base, denominator). To determine the charity's support base, which is the denominator of the fraction, we add the following revenue items for the measuring period:

- Gifts, grants,³ contributions, and membership fees received.
- Gross investment income (*e.g.*, interest, dividends, rents, royalties, but not gains from sale of capital assets).
- Taxable income from unrelated business activities,⁴ less the amount of any tax imposed on such income.

¹ As we will explain in the second part of this memo, the definitions of *total support* and *public support* are different under Section 509(a)(2).

² When an advance ruling period is involved, the public support tests are reviewed over a five-year period. After the advance ruling period, the support tests are measured on an ongoing basis over a rolling four-year period. If the tests are satisfied over a particular four-year period, then the organization qualifies as a public charity for the next two years. For example, if a charity satisfies the support tests for the four years from 1988 through 1991, it will be treated as a public charity for 1992 and 1993. The tests are then applied again to the four years from 1989 through 1992 to determine how the charity should be classified for 1994.

³ In some limited circumstances, an unexpectedly large grant may be excluded from both public support tests as an "unusual grant" described in Regulation § 1.170A-9(e)(6). These technical rules are beyond the scope of this memorandum.

⁴ Exempt organizations are generally subject to tax, at corporate rates, on their income from a trade or business which is regularly carried on, the conduct of which is not directly and causally related to the accomplishment of the organization's exempt purposes. There are a number of exceptions to this rule, notably for passive investment income. *See* Internal Revenue Code Sections 511-514 and the accompanying Regulations.

- Benefits from tax revenues received by the charity, and any services or facilities furnished by the government to the charity without charge, other than those generally provided to the public without charge.
- All other revenues, *except for*:
 - Gains from the sale of capital assets.
 - Gross receipts from admissions, merchandise sold or services performed, furnishing of facilities, or other business activities related to the charity's exempt purposes.
 - Unusual grants, as defined by the IRS.

2. Public support (numerator). The numerator of the fraction consists of that portion of total support which falls within the following defined classes of revenue:

- Government grants (not fee-for-service contracts) are included in full.
- Gifts, grants, contributions, and membership fees from other public charities qualified under § 170(b)(1)(A)(vi) are included in full.
- Gifts, grants, contributions, and membership fees from all other sources are counted in full, so long as the amount from each source does not exceed 2 percent of total support -- that is, 2 percent of the denominator.
- Larger gifts, grants, contributions, and membership fees may be counted up to 2 percent of the total support figure, but no more. Any amounts above that figure are not counted as public support. Note: When applying the 2 percent limit, amounts from certain related family members, and from businesses and their major owners, are combined and treated as coming from one source.
- Benefits from tax revenues received by the charity, and any services or facilities furnished by the government to the charity without charge, other than those generally provided to the public without charge.

3. The one-third test. If the public support figure is one-third or more of the total support figure, when the two are combined in a fraction, the organization will qualify automatically as a public charity.

4. The 10 percent facts and circumstances test. If the public support fraction is less than one-third but more than one-tenth, the organization turns to the alternate public support test for donor-supported charities. The organization must provide evidence to the IRS that it meets the following two requirements:

A. Attraction of Public Support. The organization must be so organized and operated as to attract new and additional public or governmental support on a continuous basis. This can be done in one or both of two ways:

1. By maintaining a continuous and bona fide program for solicitation of funds from the general public, community, or membership group involved.
2. By carrying on activities designed to attract support from governmental units or other public charities.

The IRS considers whether the scope of fundraising is reasonable in light of the organization's charitable activities, and recognizes that fundraising may be limited to those persons most likely to provide seed money in its early years.

B. Multi-Factor Analysis. The organization must show that it is in the nature of a publicly supported organization, taking into account *five* factors. It is not generally required that all five factors be satisfied. The factors relevant to each case and the weight accorded to any one of them may differ, depending upon the nature and purpose of the organization and the length of time it has been in existence. The factors are:

1. *Percentage of financial support.* This provides that the higher the percentage of public support above 10 percent, the lesser will be the burden of satisfying the other factors. If the percentage is low due to sizable investment income on an endowment, the IRS will consider whether the endowment came from public or government sources, or from a limited group of donors.
2. *Sources of support.* This factor focuses on whether the public support comes from government, or a "representative number of persons," rather than receiving almost all of its support from members of a single family. Consideration is given to the type and age of the organization, and to whether it appeals to a limited constituency geographically or otherwise.
3. *Representative governing body.* This factor looks at whether the organization's governing body represents the broad interests of the public, or the personal or private interests of a limited number of donors. Boards meeting this factor include those comprised of:
 - a. Public officials acting in their official capacities.
 - b. Persons having special knowledge or expertise in the particular field or discipline in which the organization is operating.
 - c. Community leaders, such as elected or appointed officials, clergymen, educators, civic leaders, or other such persons

representing a broad cross-section of community views and interests.

- d. For membership organizations, individuals elected by a broadly based membership.
4. *Availability of public facilities or services; public participation in programs or policies.* This factor considers evidence that the organization:
- a. Provides facilities or services directly for the benefit of the general public on a continuing basis; *e.g.*, museum, orchestra, nursing home.
 - b. Publishes scholarly studies that are widely used by colleges, universities, or members of the public.
 - c. Conducts programs participated in or sponsored by people having special knowledge or expertise, public officials, or civic or community leaders.
 - d. Maintains a definitive community program, such as slum clearance or employment development.
 - e. Receives significant funds from government or a public charity to which it is contractually accountable.
5. *Additional factors for membership organizations.* These are:
- a. Whether dues-paying members are solicited from a substantial number of persons in a community, area, profession, or field of special interest.
 - b. Whether dues for individual members are designed to make membership available to a broad cross-section of the interested public.
 - c. Whether the activities of the organization would appeal to persons having a broad common interest or purpose; *e.g.*, alumni associations, musical societies, PTA's.

The Exempt Function Income Test of Section 509(a)(2)

The mathematical public support test described in Section 509(a)(2) was designed for charities which sell services or materials to the public. Most of their income comes from these activities, rather than from donations or investment income.

To qualify a public charity under Section 509(a)(2), a charity must first compute its total support during the measurement period. It must then compute two fractions: its percentage of investment income, which *may not* exceed 33 1/3 percent of the total, and its percentage of public support, which *must* exceed 33 1/3 percent of the total. Each of these computations must be determined on the cash method, rather than the accrual method, of accounting.

1. Total Support. The charity first determines its total revenues during the period in question. As you will see from the charts on page 9, in order to compute the charity's public support level, this figure must be computed both *annually* and *in the aggregate*, for the entire applicable period. The figure is the sum of the support received by the charity in the form of:

- Gifts, grants,⁵ contributions, and membership fees received.
- Gross receipts from admissions, merchandise sold or services performed, furnishing of facilities, or other business activities related to the charity's exempt purposes.
- Gross investment income (*e.g.*, interest, dividends, rents, royalties, but not gains from sale of capital assets).
- Taxable income from unrelated business activities,⁶ less the amount of any tax imposed on such income.
- Benefits from tax revenues received by the charity, and any services or facilities furnished by the government to the charity without charge, other than those generally provided to the public without charge.

The sum of all of these items, for the period in question, is the denominator of the fraction for each of the two Section 509(a)(2) tests.

⁵ In some limited circumstances, an unexpectedly large grant may be excluded from both public support tests as an "unusual grant" described in Regulation § 1.170A-9(e)(6). These technical rules are beyond the scope of this memorandum.

⁶ Exempt organizations are generally subject to tax, at corporate rates, on their income from a trade or business which is regularly carried on, the conduct of which is not directly and causally related to the accomplishment of the organization's exempt purposes. There are a number of exceptions to this rule, notably for passive investment income. *See* Internal Revenue Code Sections 511-514 and the accompanying Regulations.

2. The Investment Income Limitation. In order to satisfy the Section 509(a)(2) investment income test, a charity must normally⁷ receive not more than one-third of its total support, as defined above, from the third and fourth sources listed above -- that is, from gross investment income⁸ (other than capital gains) and unrelated business taxable income (less tax on that income). In other words, at the end of each measuring period, the charity must compute a fraction whose denominator is total support, and whose numerator consists of non-capital gain gross investment income and unrelated business taxable income net of tax. If this fraction is more than one-third, the charity cannot qualify under Section 509(a)(2), even if it satisfies the public support requirements to which we now turn.

3. The Public Support Threshold. The second of the two Section 509(a)(2) support tests requires the charity to derive at least one-third of its total support from donations, membership fees, and exempt function gross receipts. This fraction should be computed each year for a four-year period consisting of the prior year and the three immediately preceding years. As noted above, the entire amount of donations, membership fees, and exempt function gross receipts for the period in question must be included in the denominator of the fraction. Depending on the source and amount of the funds, however, the amount which may be included in the numerator of the fraction may vary from 0 to 100 percent. Tables I and II set forth what portions of these income categories may be allocated included to the numerator of the fraction.

⁷ “Normally,” in this context, is defined in the Treasury Regulations to mean “the aggregate amount of the support received from [investment income and unrelated business taxable income] is not more than one-third of the total support of the organization for such four year period.” Thus, it is possible to exceed the one-third ceiling in one year during the period and still pass the test if the fraction, computed over the aggregate measuring period, is still less than one-third. Reg. § 1.509(a)-3(c)(1)(i).

⁸ Because investment income is subject to a strict ceiling and gross receipts must reach a specified floor, it is important to categorize these receipts accurately. The Regulations give the example of a loan program serving a charitable class of persons or organizations by making credit available at below-market interest rates. Under these circumstances, the charity should classify the interest received as gross receipts from a related activity, rather than as investment income.

Table I
Gifts, Grants, Bequests, Memberships and Government Support:
How Much Is Included in the Numerator of
the Public Support Fraction?

SOURCE	INCLUDIBLE AMOUNT
CATEGORY	100%
SUB CAT	WEBSITE
DOC TYPE	MISCELLANEOUS
AUTHOR	*KAY BUSH
Benefits from tax revenues, and government services or facilities furnished at no charge	100%

Table II
Gross Receipts from the Performance of Exempt Functions:
How Much Is Included in the Numerator of
the Public Support Fraction?

	INCLUDIBLE AMOUNT
A governmental bureau or unit	Amounts received in a taxable year up to the greater of \$5,000 or 1% of the total support received by the charity in that taxable year.
A Section 509(a)(1) public charity	Amounts received in a taxable year up to the greater of \$5,000 or 1% of the total support received by the charity in that taxable year.
A disqualified person	None
Individuals and entities that have not become disqualified persons as of the end of the taxable year	Amounts received in a taxable year up to the greater of \$5,000 or 1% of the total support received by the charity in that taxable year.

The tables contain several technical terms whose meaning is important to understand: governmental bureau or unit, Section 509(a)(1) public charity, and disqualified person.

1. A *government bureau or unit* includes any agency or department of the federal government or any state or local government. For purposes of the 1 percent or \$5,000 limitation, each government bureau or unit is treated as a separate payor.

2. In order to qualify for public charity status under *Section 509(a)(1)*, a charity must either perform what Congress considers to be an inherently public function – schools, churches, hospitals, and other functions described in Section 170(b)(1)(A)(I)-(v) – or derive its support from a sufficiently diverse donor pool to satisfy the mathematical support test described in Section 170(b)(1)(A)(vi).

3. A *disqualified person*⁹ may be an individual or a legal entity, such as a corporation or trust, which is described in any of the following categories, and which is neither a governmental bureau or unit nor a public charity described in Section 509(a)(1):

- *Substantial contributor*: one whose gifts or bequests to the charity exceed the greater of \$5,000 or 2 percent of the total amount of donations and bequests received by the charity from its formation through the end of the taxable year in which the gift is made.
- *Owner of a substantial contributor*: any person who owns more than 20 percent of a corporation, partnership, or trust that is itself a substantial contributor.
- *Foundation manager*: an officer, director, trustee, or employee with equivalent responsibilities.
- *Family member*: disqualified person status is attributed to ancestors and descendants of substantial contributors, foundation managers, and their spouses. Brothers and sisters of disqualified persons are not treated as disqualified persons by virtue of that relationship.
- *Related legal entities*: if any person or entity described above owns more than 35 percent of the total voting power of a corporation, more than 35 percent of the profits interest in a partnership, or more than 35 percent of the beneficial interest in a trust, the corporation, partnership, or trust is itself a disqualified person.

This regulatory framework has very practical consequences for organizations which seek to qualify as public charities under Section 509(a)(2). Chief among them is the need to establish tracking and monitoring systems so that your organization and its advisors can assess your organization's compliance with the public charity tests. We will be glad to work with you to develop systems to make this task less daunting.

⁹ The technical definition of a disqualified person may be found in Internal Revenue Code Section 4946. The concept of disqualified persons is primarily used in private foundation law, but it is used by the IRS in connection with the Section 509(a)(2) public support test as well.

Charities which receive grants from governmental agencies or from Section 509(a)(1) public charities, as well as fees for exempt-function services or products, should bear in mind that *grants* from such organizations are counted in full in the numerator of the public support fraction, while *fees* for services or products are subject to the \$5,000 or 1 percent annual ceiling. The line between grants and gross receipts is not always clear, especially where the charity is producing a service or product at the request of the payor. The fundamental question is what the charity is providing in return for the payment, and who is receiving the product. Where the charity provides the payor organization with a service or work product which primarily benefits the public, rather than primarily benefiting the payor, the IRS will treat the payment as a grant. If there is any question how a payment should be classified, a charity should consult its legal counsel or its accountant.