

The Public Support Test

What a Grant Seeker Should Know

I. Overview: Why Public Support is Important

Organizations that seek grants from foundations are usually principally interested in obtaining the maximum amount of funding to achieve their charitable purposes. Too frequently, they do not realize that a large grant from a foundation may adversely affect their tax status. Most grant recipients need to meet a "public support test" under the tax law, and a large foundation grant may cause a recipient to fail the test. This effect is sometimes known as "tipping." This memorandum is intended to alert grant applicants to the "tipping" issue.

Most grant applicants are exempt from federal tax under Section 501(c)(3) of the Internal Revenue Code. An organization must generally apply for this status, and organizations formed after 1969 should have a "determination letter" from the IRS as evidence of their exemption. (A limited exception applies for churches and certain related organizations.) The tax law divides all Section 501(c)(3) organizations into two categories: public charities, and private foundations. Every Section 501(c)(3) organization is classified as a private foundation unless it has demonstrated to the Internal Revenue Service ("IRS") that it qualifies as a public charity. The public support test, which requires that an organization receive a particular percentage of its revenues from the general public (as defined in the tax law), is the most common means of qualifying as a public charity.

What difference does it make whether a Section 501(c)(3) organization is a public charity or a private foundation? For most organizations, public charity status is preferable. Private foundations are subject to a complex and restrictive body of law that does not apply to public charities. For example, private foundations must make annual distributions of specific amounts, pay tax on investment income, and are prohibited from engaging in certain types of transactions. Individuals and corporations who donate to a private foundation may receive less favorable tax treatment than for contributions to a public charity. Finally, private foundations do not usually make grants to other private foundations, because such grants generally will not satisfy the grantmaker's annual distribution requirements under the tax law.

Every grant applicant should know whether it needs to meet the public support test, and, if so, what effect any particular grant will have on its ability to do so. This memorandum gives grant applicants the basic information needed to make those determinations. This area of the law is highly complex, however, and ideally every organization should seek advice from an accountant and/or attorney who regularly advises tax-exempt organizations. Where this is not feasible, an organization should identify an individual to take responsibility for learning and applying the public support test.

II. Qualifying for Public Charity Status

A. Identifying Current Status. There are three ways in which a Section 501(c)(3) organization may qualify as a public charity.

1. **Nature of Activities.** Certain organizations are automatically classified as public charities because of the nature of their operations. Qualification on this basis is generally limited to churches, hospitals, medical research organizations and schools. These organizations do not need to meet the public support test.
2. **Public Support Test.** Most public charities qualify under one of three public support tests, often referred to as the "one third" test, the "one third/one third" test, and the "facts and circumstances" test. These tests are described in detail below.
3. **Supporting Organization.** Some Section 501(c)(3) organizations are classified as public charities by virtue of being a "supporting organization" of another public charity or charities.

This requires a close relationship with another organization, most commonly through overlapping boards. Supporting organizations do not need to meet the public support test. Private foundations must follow special procedures in making grants to supporting organizations, but those procedures are unrelated to the public support test.

The IRS determination letter for every Section 501(c)(3) organization indicates its classification as a public charity or private foundation. A public charity's determination letter will generally state in the first or second paragraph: "We have determined that you are not a private foundation within the meaning of Section 509(a) of the Code, because you are an organization described in [one of various sections]." If an organization's letter refers to Sections 509(a)(1) and 170(b)(1)(A)(vi), or to Section 509(a)(2), then the organization is a public charity on the basis of a public support test, and must take care that it continues to meet the test. If the letter instead refers to Section 509(a)(3), Section 170(b)(1)(A)(ii) or 170(b)(1)(A)(iii), the organization has another basis for public charity classification and need not worry about the public support test.

B. New Organizations; Public Charity Status During First Five Years.

A new organization will be classified as a public charity during its first five tax years if it can show, on the basis of revenue projections in the organization's exemption application, that it can reasonably be expected to satisfy a public support test during that period. Beginning with the sixth tax year, the organization must demonstrate to the IRS on Schedule A of its IRS Form 990 tax return that it met a public support test. A new organization may demonstrate that it met a public support test for its sixth tax year (based on the support received in its second through sixth tax years), or, in the alternative, for its fifth year (based on the support it received in its first through fifth tax years). A new organization that fails to meet a public support test at the end of its first five tax years based on the support it received during both of these two alternative testing periods may become a private foundation, but will not automatically lose its Section 501(c)(3) status. (See Section V below).

III. Public Support Tests

The three public support tests are described in detail below. An organization that meets any one of the tests will qualify as a public charity, even if it fails the others. Organizations that receive substantial revenues from contributions and membership fees will generally seek to qualify under the "one third" test. Organizations that sell goods and/or services in furtherance of their charitable purposes, on the other hand, will generally seek to qualify under the "one third/one third" test.

A. The "One Third" Test.

Each of the three public support tests requires calculating a fraction. The numerator of the fraction is the organization's "public support," and the denominator is its "total support." Stated simply, the "one third" test requires that an organization derive at least one third of its total support from public support, so the fraction of public support over total support must equal at least 1/3.

1. Total Support.

The first step in applying the test is identifying "total support," which does not in fact include all income from all sources. Total support under the "one third" test includes:

- a. Gifts and Grants.** Gifts, grants, and contributions from individual donors, private foundations, corporations, bequests, other public charities, or from noncharitable nonprofit organizations.

- b. **Government Grants or Contracts.** Government grants or contracts, so long as the purpose of the payment is primarily to enable the organization to provide a service for the direct benefit of the public (as opposed to fees for services rendered to the government).
- c. **Membership Fees.** Membership fees, if the purpose for paying such fees is to provide general support for the organization.
- d. **Unrelated Business Income.** All net income from unrelated business activities (i.e., activities that do not further charitable purposes).
- e. **Gross Investment Income.** Gross income from interest, dividends, rents and royalties.
- f. **Tax Revenues.** Tax revenues levied by a governmental unit for the benefit of the organization.
- g. **Governmental Services.** The value of any services or facilities provided by a governmental organization without charge.

Total support does not include:

- h. **Revenues From Charitable Activities.** Gross receipts from admissions, sales, services, or furnishing of facilities in any activity furthering charitable purposes.
 - i. **Capital Gains.** Capital gains from the sale of property.
2. **Public Support.** Once an organization has calculated the total support denominator, it must calculate the public support numerator. Public support under the "one third" test includes:
- a. **Gifts and Grants From Public Charities.** Gifts, grants, and contributions from governmental entities and from publicly supported charities that meet the "one third" test.
 - b. **Gifts and Grants From Other Sources.** Gifts, grants, and contributions from individual donors, private foundations, public charities other than those that meet the "one third" test, corporations, bequests, or from noncharitable nonprofit organizations (e.g., Section 501(c)(4) advocacy organizations).

Two Percent Limitation: A gift, grant, or contribution from any source other than a governmental unit or a public charity that meets the "one third" test) counts as public support only to the extent of 2% of total support received over the five-year testing period. For example, if total support over the five-year period is \$100,000, a grant of \$40,000 from a private foundation will count as total support, but *only* \$2,000 (2% of \$100,000) will count as public support.

This can cause a "tipping" problem: a private foundation grant is subject to the 2% limit, and may therefore increase the total support denominator without similarly increasing the public support numerator, potentially causing the organization to fail the "one third" test.

- c. **Government Grants or Contracts.** Government grants or contracts, so long as the purpose of the payment is primarily to enable the organization to provide a service for the direct benefit of the public (as opposed to fees for services rendered to the government).
- d. **Membership Fees.** Membership fees, if the purpose for paying such fees is to provide general support for the organization. Such fees are subject to the two percent limitation, described above.

- e. **Tax Revenues.** Tax revenues levied by a governmental unit for the benefit of the organization.
- f. **Governmental Services.** The value of any services or facilities provided by a governmental organization without charge.

If public support equals at least one third of total support, an organization meets the "one third" public support test.

B. The "One Third/One Third" Test. Under this test, the organization must receive:

- More than one third of its total support from public support; and
- Not more than one third of its support from gross investment income, such as interest and dividends, and from net income earned in the conduct of a trade or business that is not substantially related to the organization's exempt purposes.

To add to the complexity of the support tests, the definitions of both "public support" and "total support" are different under the "one third/one third" test than under the "one third" test.

1. Total Support. Total support under the "one third/one third" test includes all of the sources of support listed above for total support under the "one third" test, and in addition includes:

- **Revenues From Charitable Activities.** Gross receipts from admissions, sales of merchandise, performance of services or furnishing of facilities in the conduct of an activity that furthers exempt purposes.

For example, an organization that sells its publications would not include gross receipts from such sales in total support under the "one third" test, but would include such receipts under the "one third/one third" test.

2. Public Support. Public support under the "one third/one third" test includes:

- a. **Gifts and Grants.** Gifts, grants, contributions, and membership fees from individual donors, private foundations, corporations, bequests, other public charities, governmental units or from noncharitable nonprofit organizations.

"Disqualified Person" Limitation: Public support does not include any contributions from "disqualified persons," including but not limited to: (1) officers and directors; (2) "substantial contributors," i.e., any individual or organization (including a governmental unit or a public charity) who has given more than \$5,000 to the organization, if such gift constituted more than 2% of total contributions and bequests that the organization has received over the entire period of its existence; (3) any family member of an officer, director, or substantial contributor; and (4) any corporation, partnership, or other organization owned more than 35% by an officer, director, substantial contributor or family member.

This rule may cause a tipping problem. If a private foundation is a disqualified person, because it has made grants to the organization in the past and is a substantial contributor, its grant will be included in the total support denominator, but not in the public support numerator.

- b. **Revenues From Charitable Activities.** Gross receipts from admissions, sales of merchandise, performance of services, or furnishing facilities in an activity that furthers exempt purposes.

One Percent Limitation: Public support does not include any receipts from such activities that exceed the greater of \$5,000 or 1% of the organization's total support received in the taxable year. (Note that this limit is calculated on an annual basis, rather than over the five-year period.)

If an organization's public support exceeds one third of total support, the organization meets the first prong of the "one third/one third" test. It must also meet the investment income/unrelated business income prong.

- 3. Investment Income/Unrelated Business Income.** An organization's investment income is gross investment income, including income from interest, dividends, rents and royalties.

Unrelated business income is net income, after tax, derived from the regular conduct of a trade or business that does not further charitable purposes. (An organization that has \$1,000 or more of gross unrelated business income for any taxable year must report it on IRS Form 990T.)

If the organization's investment income plus unrelated business income does not exceed one third of total support, it meets the second prong of the "one third/one third" test.

C. The "Facts and Circumstances" Test.

The "facts and circumstances" test uses the same definitions of total support and public support as the "one third" test, but looks to other facts and circumstances beyond sources of support. An organization must have an absolute minimum of 10% public support under this test, but the closer the level of public support is to one third of total support, the more likely the organization will be to meet the "facts and circumstances" test. Other factors that help an organization to meet the test include support that comes from a broad number of persons, rather than a single family or corporation; a governing body that represents broad public interests; the conduct of services or activities that directly benefit the public; and a fundraising program reasonably calculated to generate public support.

While an organization that fails the "one third" and the "one third/one third" tests may be able to retain public charity status under the "facts and circumstances" test, this should be regarded as a fallback position, and an organization should not generally plan to rely on this test. An organization that is unable to meet the "one third" and "one third/one third" tests should consult legal counsel regarding the likelihood of meeting the "facts and circumstances" test.

IV. RULES APPLYING TO ALL PUBLIC SUPPORT TESTS

A. Testing Period for Public Support.

As described above, a new organization will be classified as a public charity for its first five tax years, regardless of the level of public support it in fact received during this period. Beginning with the sixth tax year, a publicly supported charity must demonstrate to the IRS each year on Schedule A of its IRS Form 990 tax return that it continues to meet a public support test. (Organizations that normally have less than \$50,000 annually in gross receipts are not required to file Form 990. However, such organizations must file the "e-postcard," Form 990-N).

The public support test is applied on an average basis over a five-year testing period (including the current year and the four preceding tax years). For example, in 2011, an organization's satisfaction of the public support test is based on the average of tax years 2007 through 2011. If an organization meets the test in a given year, it will be treated as meeting the test in the following year as well (subject to limited exceptions). Therefore, an organization that meets a public support test for tax year 2011, based on the five-year testing period from 2007 through

2011, is a public charity for tax years 2011 and 2012. However, if a public charity fails to meet a public support test for two consecutive years beginning in its sixth year of existence or later, it may lose its public charity status. (See Section V below). Because the tests work on an average basis, one year of poor public support will not necessarily disqualify an organization from public charity status.

B. Unusual Grants.

A gift or grant that is unusual or unexpected in amount, and that is large enough to cause a "tipping" problem, may sometimes be excluded from both the numerator and the denominator of the testing fraction (i.e., from both public and total support) as an "unusual grant." A number of facts and circumstances apply to determine whether a grant is an unusual grant, and an organization generally should consult with legal counsel or an accountant to determine whether a grant may be considered unusual. In general, however, a grant is likely to be an unusual grant if:

1. The donor has not previously made a grant to the organization;
2. There is not a close relationship between the donor and the recipient (e.g., if the donor is an individual, the donor is not a founder, board member or employee of the recipient, or if the donor is an organization, there is no overlap of board membership or officers with the recipient);
3. The grant is made in cash, readily marketable securities, or assets that the recipient will use to further its exempt purposes (e.g., a conservation organization receives land for preservation); and
4. If the grant is to underwrite operating expenses, as opposed to financing capital items, the grant is limited to no more than one year's operating expenses.

It is sometimes possible to avoid "tipping" problems from large grants from private foundations by treating them as unusual grants. This may not be possible, however, where a foundation has previously made significant grants to the recipient.

V. ORGANIZATIONS THAT FAIL TO MEET A PUBLIC SUPPORT TEST

What if an organization completes the calculations under the "one third" and "one third/one third" tests and does not meet either test? There are essentially three possibilities. First, if the organization has at least 10% public support, it may be able to meet the "facts and circumstances" test for public charity status, described above at page 5. The organization should consult legal counsel on this point.

Second, if the organization has less than 10% public support, or fails to meet the "facts and circumstances" test, it may be able to retain public charity status by becoming a "supporting organization" of one or more public charities or governmental entities. The most straightforward way to accomplish this is for the other public charity or governmental entity to have the power to appoint or elect a majority of the organization's board. This will generally require amending the organization's articles and/or bylaws. An organization wishing to restructure as a supporting organization should take all steps to do so before failing the public support test.

Finally, an organization may simply become a private foundation. If an organization fails to meet a public support test or to assert an alternative basis for public charity status, such as a supporting organization relationship, this will be reflected on its annual IRS Form 990. The IRS will eventually notify the organization that it will be treated as a private foundation. This does not mean that the organization will lose its tax-exempt status under Section 501(c)(3), just that, within Section 501(c)(3), it will be classified as a private foundation and not a public charity. It may continue to operate on a

tax-exempt basis, but it will be subject to the complex and restrictive private foundation rules, its donors may receive less in the way of charitable contribution deductions, it will be more difficult to attract funding from other private foundations and a 1% or 2% excise tax will apply to investment income.

This memorandum was prepared by:

LaVerne Woods, Esq.
Davis Wright Tremaine LLP
Suite 2200
1201 Third Avenue
Seattle, Washington 98101-3045
(206) 622-3150

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