



Public Support Test

If you received a letter from the IRS stating you have been recognized as tax-exempt under Section 501(c)(3) of the Internal Revenue Code, you have already been designated either as a private foundation or a public charity. This publication is designed to remind organizations designated as a 501(c)(3) public charity that they must meet certain tests regarding their revenue sources in order to retain such status.

Public Charity Status

Generally, public charity status is more favorable than private foundation status. While both public charities and private foundations are classified as exempt from taxation under IRS Code section “501(c)(3),” private foundations are subject to much more complex and restrictive laws. Among other things, private foundations must pay a 1% or 2% excise tax on investment income, and must meet certain annual distribution requirements. Self-dealing transactions (i.e., transactions between the foundation and disqualified persons) are generally taxed, even in the absence of private inurement. Additionally, donors to private foundations may generally take a deduction for gifts of assets on a cost-basis – whereas public charity donors may generally take deductions up to the fair market value of the donated asset.

If an organization has been designated a public charity and fails to meet the applicable support test for the applicable computation period (see below), this will be evidenced when it files its Form 990 or Form 990-EZ at the end of each year with the IRS. The IRS may eventually notify the organization that its status has reverted to that of private foundation. At such time, the organization will still be classified as tax-exempt under Section 501(c)(3), but, within Section 501(c)(3), it will have private foundation status. The organization would then no longer be able to report to its donors that it is a “public charity.”

Which Test Applies?

Organizations designated as 501(c)(3) public charities will usually be described under either Internal Revenue Code Section 509(a)(1) or 509(a)(2).¹ Your IRS determination letter (recognizing your tax-exempt status) will indicate the code section your organization falls under. This is important because it will tell you which of the applicable tests your organization is subject to.

1) One Third Support and Facts and Circumstances Tests (509(a)(1) and 170(b)(1)(A)(vi) Organizations)

If an organization is classified by the IRS under Section 509(a)(1), it must meet the test designated for such organizations. The organization must show that it normally either:

- a) receives at least **one third** of its total support from “public support,” which includes government grants, membership fees, and/or contributions made directly or indirectly by the general public (including from other publicly supported organizations); **OR**

¹ There are some categories of public charities to which the public support test does not apply. Among these are “supporting organizations,” churches, schools and colleges, hospitals, and governmental units.

- b) receives at least **one tenth** of its total support from the above sources, and it expects to attract more public support through, among other things, a program geared towards continuous solicitation of funds (“facts and circumstances test”).²

Generally, under this test, the organization will have to show that it receives **one third** of its total support from public sources. If an organization cannot show one third support, it may resort to the “Facts and Circumstances Test” discussed below.

What is total support? Total support (i.e., the “denominator”) generally includes all of an organization’s revenue excluding gross receipts from admissions, sales of merchandise, or other business activities related to a charity’s exempt purpose. For example, total support includes gifts, grants,³ contributions, membership fees, gross investment income, and income from unrelated business activities.⁴

What is public support? Public support (i.e., the “numerator”) includes grants from government agencies, grants from public charities, and gifts from the general public (e.g., donations from an individual, private foundation, or a corporation) to the extent that the gift does not exceed two percent of the organization’s total support. For example, if an organization’s total support in the relevant time period was \$100,000, only the first \$2,000 of a donor’s gift would count toward “public support.” The two percent limitation requires organizations to have support from a broad array of sources. Note that the two percent limitation does not generally apply to governmental grants or grants from publicly supported charities.⁵

What are relevant “facts and circumstances”? The IRS will permit an organization to receive less than one third (as low as one tenth) public support on a showing that the organization is continuously attracting public support. The organization would have to show this by maintaining a continuous program for solicitation of funds. Additionally, the organization would want to show that it has a wide array of supporters; a governing body made up of individuals representing broad public interests (e.g., public officials and community leaders); its facilities are continuously available to the public; and it solicits dues-paying members in a way that is designed to enroll a large group of people in the community.⁶

What is “normally”? Both the “One Third Support” and “Facts and Circumstances” tests require that a proportion of an organization’s total support “normally” consists of public support. An organization “normally” receives the required amount of public support if, for the fiscal year being tested and the four immediately preceding fiscal years, the organization meets the applicable support test on an aggregate basis. If so, then the organization would be considered publicly supported for the fiscal year being tested and the immediately succeeding fiscal year.⁷ That means, that if for one year, public support fell below the threshold needed to pass the public support test, an organization’s public charity status would not be threatened so long as the aggregate public support for the current year and previous four years was above the threshold. The current year and four previous years is also the applicable time frame for calculating whether an individual’s contributions are above the two percent threshold.⁸

² 26 U.S.C. § 170(b)(1)(vi); 26 C.F.R. 1.170A-9(f)(1)-(3).

³ In some circumstances, an unexpectedly large grant may be excluded from the calculation of both total support and public support as an “unusual grant.” A discussion of “unusual grant” is beyond the scope of this publication. See 26 C.F.R. 1.170A-9(f)(6).

⁴ 26 U.S.C. 509(d); 26 C.F.R. 1.170A-9(f)(7).

⁵ 26 C.F.R. 1.170A-9(f)(6). The two percent limitation does not apply to governmental units or public charities to the extent these contributions do not represent amounts that have been earmarked by a donor for the recipient organization.

⁶ 26 C.F.R. 1.170A-9(f)(3).

⁷ 26 C.F.R. 1.170A-9(f)(4).

⁸ 26 C.F.R. 1.170A-9(f)(6)(i).

2) One Third/One Third Test (509(a)(2) Organizations)

If an organization is classified by the IRS under Section 509(a)(2), it must meet the test designated for such organizations. The organization must show that it normally:

- a) receives at least **one third** of its total support from certain permitted sources, including:
 - government grants, membership fees and/or contributions made directly or indirectly by the general public (including from other publicly supported organizations), and
 - gross receipts from admissions, sales of merchandise, and performance of services in any activity which furthers the organization's charitable purpose; **AND**
- b) receives **not more than one third** of its support each year from the sum of its (a) gross investment income; and (b) the excess of any unrelated business income over the amount of tax imposed on such income.

What is total support? For purposes of 509(a)(2) organizations, total support (i.e., “the denominator”) includes most of an organization's revenue, such as gifts, grants,⁹ investment income, membership fees, etc. Crucially, unlike with 509(a)(1) organizations, gross receipts from admissions, sales of merchandise, or other business activities related to a charity's exempt purpose are included in the calculation of total support.

What are permitted sources? Permitted sources (i.e., “the numerator”) include gifts, grants, contributions, membership fees, and, notably, unlike the 509(a)(1) tests, gross receipts from admissions, sales of merchandise, and performance of services related to an organization's charitable purpose. This test makes it appropriate for many 501(c)(3) groups to include receipts from performing exempt purposes (e.g., sale of goods or services) as part of the public sources numerator, and is suitable for organizations that are self-sustaining rather than those that are primarily reliant upon grants and contributions.

Gifts, grants, bequests, and gross receipts from the performance of exempt functions should be excluded from the calculation of permitted sources if from a “disqualified person.” Disqualified persons include officers, directors, trustees, or employees with equivalent responsibilities; substantial contributors to the organization; family members of substantial contributors; individuals who own more than twenty percent of a corporation or partnership which is a substantial contributor to an organization; and corporations and partnerships of which a substantial contributor owns thirty-five percent or more.¹⁰ A substantial contributor is an individual or entity (other than a governmental unit or a public charity) who has contributed an aggregate amount of at least \$5,000 to an organization and that aggregate amount is more than two percent of the cumulative contributions the organization has received by the end of the tax year in which the amount was received.¹¹

Gross receipts from the performance of exempt functions received from any person, public charity, or governmental unit count toward the permitted sources numerator only up to the greater of \$5,000 or one percent of the total support received by the organization that year.¹² However, grants or gifts can be fully

⁹ Like with the One Third Support and Facts and Circumstances Tests, “unusual grants” are excluded from both the denominator and the numerator. 26 C.F.R. 1.509(a)-3(c)(3).

¹⁰ 26 U.S.C. § 4946.

¹¹ 26 U.S.C. § 507(d)(2)(A). To illustrate, Maya makes a \$3500 contribution to Nonprofit on September 30, 2013 and makes another \$3500 contribution to Nonprofit on March 31, 2015. As of December 31, 2015, Nonprofit has received a total of \$250,000 in contributions from all sources. As of March 31, 2015, Maya's contributions total is greater than \$5,000 in the aggregate and are now over two percent of the total contributions received by Nonprofit by the end of the tax year (December 31, 2015). Therefore, Maya is a substantial contributor and a disqualified person and her contributions don't count toward the public support calculation in the numerator. Once a person or entity becomes a substantial contributor, he/she/it is considered a substantial contributor for every year thereafter, even if their contributions fall below the two percent threshold in subsequent years. For more information on substantial contributors, see IRS, Internal Revenue Memorandum, Public Charities, Part 4.76.3.6.1(3), available at https://www.irs.gov/irm/part4/irm_04-076-003.html#d0e1122.

¹² 26 U.S.C. § 509(a)(2)(A)(ii); 26 C.F.R. § 1.509(a)-3(b)(1).

counted toward the public sources numerator (as long as they are not from a disqualified person, in which case they are completely excluded).

What is gross investment income? Gross investment income is defined as the gross amount of income from interest, dividends, payments with respect to securities loans, rents, and royalties.¹³ In order to qualify as a public charity under 509(a)(2), an organization must normally not receive more than one third of its support from “gross investment income” and the excess (if any) of the amount of unrelated business taxable income over the amount of the tax imposed on such income.

What is “normally”? Both prongs of the 509(a)(2) test (i.e., that at least one third of support comes from public sources and no more than one third is derived from gross investment income and the excess of unrelated business income) are computed on the basis of the organization’s “normal” sources of support. An organization will be considered as “normally” receiving one third of its support from public sources and not more than one third of its support from gross investment income and the excess of unrelated business income if, for the fiscal year being tested and the four immediately preceding fiscal years, the organization meets the applicable support tests on an aggregate basis. If so, then the organization would be considered publicly supported for the fiscal year being tested and the immediately succeeding fiscal year.¹⁴

3) What an Organization Must Submit to the IRS to Prove it is a Public Charity

An organization which receives an IRS letter designating it as a public charity will automatically qualify as publicly supported for its first five years. Beginning with the organization’s sixth tax year, and each year thereafter, the organization will need to show that it qualifies as a public charity by meeting one of the tests for that year and the preceding four years. If the organization is required to file Form 990 or Form 990-EZ, it must show that it meets the applicable test for each year on Schedule A of Form 990 or Form 990-EZ. An organization that is eligible to file the 990-N E-Postcard should monitor its support consistent with the tests described above. In the event that such an organization no longer qualifies as a public charity, it is required to self-declare to the IRS that it is a private foundation and file the 990-PF (the annual filing for private foundations).

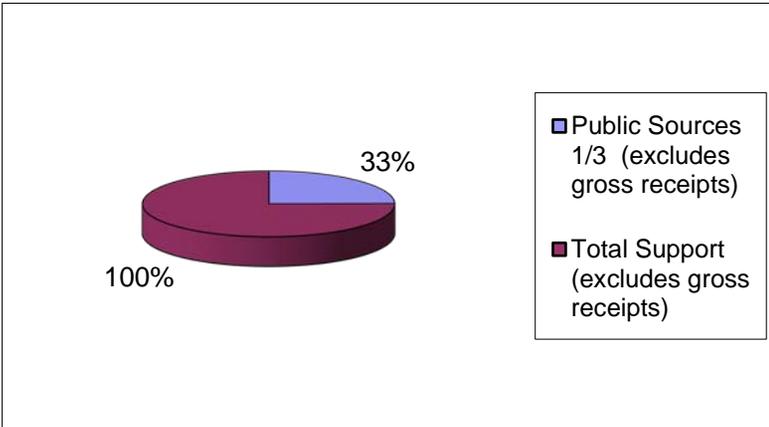
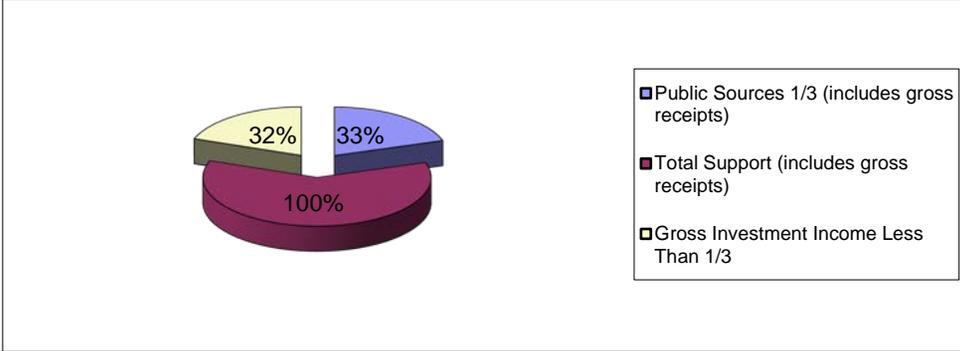
If an organization currently relies on a small handful of donors, it is crucial that it begins to devise a plan to diversify its funding sources so that it can retain its public charity status. Although it is common for new organizations to be primarily supported by founders and initial directors, by its sixth tax year, an organization will need to prove to the IRS that it has funds from a variety of donors (or a fundraising program aimed at attracting new donors and grants) or that it derives a substantial portion of its revenues from program income.

The above descriptions are summaries of each test and do not purport to be a complete description. In fact, there are many variables to each test which may not be covered in this publication. If an organization has questions about whether it currently qualifies as a public charity on the basis of its support, it should contact an attorney or an accountant who has experience with tax-exempt organizations. Please refer to the chart below for a summary of the factors applied in calculating each test.

¹³ 26 U.S.C. § 509(e).

¹⁴ 26 C.F.R. § 1.509(a)-3(c).

Comparison of Public Support Tests

<u>IRC Section 509(a)(1) and 170(b)(1)(A)(vi)</u>	<u>IRC Section 509(a)(2)</u>
<p>Organization must generally receive at least 1/3 of its support from public sources (excluding gross receipts from charitable activities).</p> <div style="text-align: center;">  </div> <p><u>Public Sources</u> include, generally: gifts and grants from public charities, gifts and grants from private sources (e.g., individuals, private foundations, corporations, etc.), government grants, membership fees, tax revenues, and the value of governmental services rendered without charge. <u>Total Support</u> includes, generally: gifts and grants from public and private sources, government grants, membership fees, income from unrelated business activities, gross investment income, tax revenues, and the value of governmental services rendered without charge.</p>	<p>Organization must receive at least 1/3 of its support from public sources (including gross receipts from charitable activities); AND must not receive more than a third of its support each year from</p> <p>(a) gross investment income; and (b) the excess of any unrelated business income over the amount of tax imposed on such income.</p> <div style="text-align: center;">  </div> <p><u>Public Sources</u> include, generally: gifts and grants from private and public sources (including government and membership fees) and gross receipts from exempt purpose (charitable) activities (e.g., sales of goods/services). <u>Total Support</u> includes, generally: all public sources from the 509(a)(1) test AND receipts from exempt purpose activities.</p>
May use the 1/10 th support test (facts and circumstances) if unable to show 1/3 rd public support.	No fallback test is available.
<u>What, specifically, constitutes a “public source”, and what is included in the definition of “total support”?</u>	
<ul style="list-style-type: none"> Contributions from private sources (including from board members, individuals, corporations, and private foundations) and membership fees are public support to the extent they do not exceed 2% of the total support. 	<ul style="list-style-type: none"> Contributions from individuals, corporations, and government units are public support.
<ul style="list-style-type: none"> Grants and contributions from public charities and governmental sources are generally not subject to the 2% limitation outlined above 	<ul style="list-style-type: none"> Contributions from board members, substantial contributors, founders, and certain related persons do not count as public support but are included as total support.
<ul style="list-style-type: none"> Gross receipts from activities furthering the charitable purpose are not included either as public support or as total support. 	<ul style="list-style-type: none"> Gross receipts from exempt (charitable) purpose activities are public support to the extent they do not exceed the greater of \$5,000 or 1% of total support from one source in a single year's time.
<ul style="list-style-type: none"> Generally, investment income is not included as public support but is included as total support. 	<ul style="list-style-type: none"> Investment income is not included as public support, but as total support, and (together with any unrelated business income less the tax imposed) is limited to 1/3rd of the total support.