Indiana Grantmakers ALLIANCE

Technical Bulletin 9802
Paradise Retained (A Sequel to Bulletin 9704)

You have received exempt status as a 501(c)(3) organization under the Internal Revenue Code. All you have to do from now on is to make sure that your disbursements are primarily for furtherance of the purpose for which 501(c)(3) status was granted. Right? WRONG!

An organization which received 501(c)(3) status is either a private foundation or a public charity, depending on the organization's activities or sources of support. Generally speaking, it is advantageous to be classified as a public charity because private foundations are subject to various restrictions, requirements, and excise taxes. IDA Technical Bulletin 9704: The Public Support Test by Paul Lowell Haines an attorney with Baker & Daniels lists many of these requirements.

But how does an organization maintain its public charity status and avoid private foundation status? If the organization is a church, a school, a certain type of hospital, or a governmental unit or is controlled by one of these organizations, public charity status exists because of the organization's classification and the charitable nature of its activities. Maintaining public charity status for these organizations requires maintaining ongoing operations that are consistent with the organization's exempt purpose. Another public charity, the supporting organization, maintains its public charity status by operating exclusively for the benefit of another public charity. Two other types of public charities, both publicly-supported organizations, maintain their public charity status by maintaining and demonstrating a broad base of public support.

The first type of publicly supported organization is known as a 170(b)(1)(A)(vi) organization. The organization must receive a substantial part of its **support** from the United States or any state or political subdivision, **or** from direct or indirect contributions from the general public or from a combination of these sources. **It will be treated as publicly supported if the support it normally receives from the above described governmental units and the general public equals at least one-third of its total support.** Alternatively, it will also be treated as publicly supported if it can satisfy the facts and circumstances test that confirms that at least 10% of total support is from these sources **and** the organization is set up to attract new and additional public or governmental support on a continuous basis.

The total amount received from any one individual which exceeds 2% of the organization's total support for the prior 4 years is **not** considered as received from the general public, and gross receipts from the exercise of an organization's exempt purpose are not taken into consideration for purposes of the **support** test.

For example, X organization had the following support for the 4-year period 1993 through 1996:

Gifts, Grants & Contributions	$300,000	
Dividends & Interest	$300.000	
Total Support (for purposes of this **support** test)		$600,000
Gross Receipts from admissions, etc., from related activities	$100.000	
Support from all sources		$700.000

Furthermore, of the $300,000 received from gifts, grants, and contributions, $50,000 came in the form of small contributions. from many donors, $40,000 came from United Way, $40,000 as a grant from the City. However, $170,000 came in larger donations from six donors. This latter fact is important, for such larger individual gifts can be subject to the 2% limitation as regards the public support test.

Direct Contributions:		
From persons who each gave <2% of total support	$50,000	
From 6 donors, each of whom gave >2% of total support	$170,000	
Indirect Contributions from the General Public:		
United Way	$40,000	
Grant from City	$40,000	
Total Direct & Indirect Contributions		$300.000

We now can perform our public support test calculations. To do that, we look at our total of public support (here, $300,000) and subtract from that total the excess amount received from those who each individually gave more than 2% of the total support. That is, we determine what the 2% threshold is ($600,000 in total support x 2% = $12,000). Thus, in this case, $12,000 of each larger gift can be counted as pubic support, while the excess above 2% of $12,000 is excluded.

Contributions from donors giving <2% of total support	$50,000	
Eligible amount from donors who each gave >2% of total support (2% x $600,000 x 6 such donors)	$72,000	
Indirect contributions (United Way & City)	$80,000	
Total Public Support		$202,000
Public Support Percentage ($202,000/$600,000)		33.67%

X organization received more than 33 1/3% of its total support for the period from public sources. Thus it qualifies (just barely) as a 170(b)(l)(A)(vi) organization.

An organization that does not meet the one-third support test may be publicly supported on the basis of the facts and circumstances in the case, if it receives at least 10% of its support from public sources.

The second type of publicly supported organization is known as a 509(a)(2) organization, which generally relies on gross receipts from the exercise of its exempt function (for example, the sale of tickets to see the performance of a symphony orchestra). It must satisfy both a **support test** and a **gross investment income test**.

To satisfy the **support test**, the organization must normally receive more than one-third of its support from: (a) gifts, grants, contributions or membership fees, and (b) gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities in an activity that is not unrelated to its exempt function. This one-third of support must be from other publicly supported organizations, governmental sources, or persons other than disqualified persons (i.e., other than officers, directors, etc.). In computing gross receipts, the gross receipts from anyone person or bureau or similar governmental unit are includible only to the extent they do not exceed the greater of $5,000 or 1% of the organization's total support.

To satisfy the **gross investment income test**, the organization must receive *no more* than one-third of its support from dividends, interest, rents, and royalties. Realized and unrealized gains and losses are not gross investment income for this test.

For example, T organization had the following support for the 4-year period 1993 through 1996:

Gifts, Grants & Contributions	$45,000
Membership fees	$50,000
Gross Receipts from admissions, etc., from related activities	$25,000
Dividends & Interest	$80,000
Total Support	$200.000

Let us suppose that $25,000 of the gifts came from disqualified persons. T organization determined whether or not it met its one-third tests of 509(a)(2) in the following manner:

Support from gifts, etc., membership fees & gross receipts		$120,000
Less gifts from disqualified persons	25,000	
Less gross receipts in excess of $5,000/1% limitation	20,000	(45.000)
Total Public Support		$75,000
Public Support Percentage ($75,000/$200,000)		37.5%
Gross Investment Income Percentage ($80,000/$200,000)	40.00%	

T organization met the one-third **support test**, but did not meet the one-third **gross investment income** test. By having investment income equal to 40% of total support, it exceeded the one-third cap.

However, all is not lost. T organization may still be able to pass the facts and circumstances test. Its gifts, grants, and contributions totaled $45,000, and its support from all sources came to $175,000 ($200,000 in Total Support less $25,000 of gross receipts). Thus 25.7% ($45,000/$175,000) would be from the general public. Provided that $45,000 in gifts did not come from any donor who gave >2% of total support, and depending on the facts and circumstances, T organization may meet the 170(b)(I)(A)(vi) test for this year.

*If the organization **fails both** the 170(b)(1)(A)(vi) support test and the 509(a)(2) support and gross investment income tests for 2 consecutive years, the IRS will classify the 501(c)(3) organization as **a private foundation.***

How does the IRS monitor this status? The Form 990 that you file with the IRS each year contains a schedule that must be completed to demonstrate the organization's status.

In summary, all 501(c)(3) organizations are presumed to be private foundations, **unless** the organization shows the IRS that it is a public charity. All 501(c)(3) organizations must use their assets to accomplish the purpose for which they received their tax exempt status. But beyond that, a public charity must continually demonstrate that it is not a private foundation by satisfying certain criteria. Some 501(c)(3) organizations (churches, schools, and supporting organizations), accomplish that task inherently, through their very nature, purposes, and organizational structure. Other 501(c)(3) organizations accomplish that task by demonstrating broad public support.

An organization can show that it is publicly supported in one of two ways:

- A 170(b)(I)(A)(vi) organization gets more than one-third of its **support** from the general public. Failing that, it may succeed in passing the facts and circumstances test.
- A 509(a)(2) organization gets more that one-third of its **support** from any combination of the general public and gross receipts from the conduct of its exempt purpose, and no more than one-third of its support from **gross investment income**.

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