

The following is for use by assistive readers and users who prefer a text version of this course.

## **The Wonderful World of Foundation Classification: 509(a)(1) and 509(a)(2)**

### **Page 1 – Welcome**

The following is a fictitious discussion between Coach, the knowledgeable, straight-talking IRS Revenue Agent from the website, StayExempt.org and some EO representatives at a nonprofit tax law clinic.

This program is brought to you by IRS Exempt Organizations.

### **Page 2 – Introduction**

Bert: Hey, Coach, it's been a while since you came to speak to our Nonprofit Tax Law Clinic.

Coach: I'm glad to be back.

Bert: Hello everyone! Welcome! You remember Coach, from the IRS's StayExempt program? StayExempt gave us a great "foundation" for understanding basic tax compliance for 501(c)(3) organizations. Today we'd like to learn more about foundation status and some of the recent rule changes that affect it.

### **Page 3 – Foundation Status Classification**

Bert: Coach, to start with, why does our foundation classification matter? Aren't all 501(c)(3) organizations pretty much the same?

Coach: I'll get to why it matters in a minute, but to answer your second question first, no, not all 501(c)(3) organizations are the same.

I'm sure you already know that an organization has to fill out an application and be approved by the IRS as a 501(c)(3) tax-exempt organization. But here's what you may not be as familiar with – every new 501(c)(3) organization also receives a *foundation classification* from the IRS. That classification is right at the top of the letter – we call it your *determination letter* – that the IRS sends congratulating an organization on its 501(c)(3) exemption. But I think that some folks are so happy to get their tax-exempt status, they really don't pay attention to the foundation status part or understand what it means.

Actually, all 501(c)(3) organizations would be classified as *private foundations* – you know, like the big grant-making outfits – if not for a section in the Internal Revenue Code that provides for *exceptions* to that status. You may not remember doing it, but I'll bet that most of the 501(c)(3)s represented at the clinic today asked to be covered by one of those exceptions in its application for tax exempt status.

We call an organization that qualifies for an exception to private foundation status a *public charity*, but that's just IRS shorthand. You won't find this term in the Internal Revenue Code

anywhere. There are several ways that an organization can qualify, and I'll cover the major ones in just a few minutes.

## **Page 4 – Why is Foundation Status Important?**

Now, as to your first question, foundation classification is important because private foundations and public charities have to follow different rules. Private foundations are more strictly regulated, and are subject to a number of anti-abuse rules and excise taxes that don't apply to public charities. For example, private foundations are subject to tax on their net investment income and other excise taxes. The Code imposes other requirements on foundations as well, including strict restrictions on self-dealing, annual income distribution requirements, limits on holdings in business and restrictions on certain investments. Violations can result in taxes not only on the foundation itself but also on foundation directors and certain related parties. You can learn more about the rules for private foundations by reading Publication 4221-PF, our *Compliance Guide for Private Foundations* or checking out the *Lifecycle of a Private Foundation* on the EO website at [irs.gov/eo](http://irs.gov/eo).

## **Page 5 – Donations to Public Charities and Private Foundations**

Dakota: Does it make any difference to our potential contributors if we are a private foundation or public charity?

Coach: It sure does. There is a cap on the amount of a contribution that a donor can take as a charitable deduction. For donations to a public charity, that limit is 50% of the giver's adjusted gross income. For contributions to a private foundation, the limit is 30%. These limits won't impact donations of most people, but for those that they do apply to, it's an important difference. In addition, contributors can deduct a higher percentage for contributions of capital gain property to public charities.

## **Page 6 – Types of Public Charities**

Dakota: It sounds like public charity classification is the way to go. How do we make sure we qualify?

Coach: There are several categories of organizations that are classified as public charities. The Internal Revenue Code grants public charity status to some specific types of groups – the main ones are schools, hospitals, certain medical research organizations and churches. But just churches qualify, not all religious organizations.

## **Page 7 – Types of Public Charities (cont.)**

Another big category includes all organizations that normally receive at least one-third of their contributions from many sources, including the general public, government agencies, corporations, private foundations or other public charities. We call these organizations *publicly supported*, but only certain types of contributions qualify as "good" public support. We'll talk more about that a little later.

## **Page 8 – Types of Public Charities (cont.)**

And then, there are organizations that normally receive at least one third of their gross receipts from a combination of public support and what we call *exempt function income* – admissions or

fees for services that further an exempt purpose – are also classified as public charities. However, organizations in this category can't receive more than one third of their support from investment income or unrelated business income.

Grace: Can you give me some examples of this kind of organization?

Coach: A membership-fee organization, such as a parent-teacher organization, is one; or an arts group with box office revenue is another. Both of these have significant exempt function income – the membership fees and the box office income – in addition to contributions from the general public.

## **Page 9 – Types of Public Charities (cont.)**

Grace: What about an entity like a hospital auxiliary that provides services exclusively for the hospital or an organization that raises funds for a university's sports program? Would they be public charities?

Yes, and thanks for providing some good examples of our last major type of public charity: organizations that qualify because they maintain an active, specific relationship with one of the other types of public charities. The Code refers to them as supporting organizations. We've got another session coming up later to go over all of the particulars of supporting organizations and some recent legislative changes that affected them. So stayed tuned for that.

## **Page 10 – Public Charities in a Nutshell**

Bert: So, let me see if I've got it. To be classified as a public charity – not a private foundation – an organization has to be one of the specific types of organizations named in the Code, like a hospital or church; OR show that it has broad public support; OR show a combination of broad public support and income from its exempt activities; OR have a special relationship with another public charity. Right?

Coach: That's it in a nutshell. Of course this is the federal tax code we're talking about, so there are some details we need to look at.

## **Page 11 – What's Included in Public Support?**

Let's go back and discuss some of the issues that come up with *publicly supported organizations* – organizations that normally receive one-third or more of their support from the general public or from governmental sources.

First, what income counts as public support, and how do we calculate that "one-third" amount? Public support includes contributions and gifts an organization gets from the general public and grants from governmental units. But there are some limits on how much support from any one donor counts as public.

As you probably know, private foundations – those big grant-givers I mentioned a while ago – generally get their funding from a single major source—a single family or corporation. But as I've said, a publicly supported public charity, on the other hand, has to show that it gets its support from lots of places.

So, even though public charities can and do have major donors, there is a limit on how much of each of those big givers' support can count when the organization is calculating its public support. That amount is limited to two percent of a public charity's *total support*.

The two percent limitation also applies to contributions from any person or persons related to the donor. For example, contributions from a husband and wife would be treated as one person for purposes of the two percent limitation. The two percent limitation does not generally apply to support from governmental sources or from other publicly supported organizations.

## Page 12 – What's Included in Total Support?

Dakota: Hold up a minute there, Coach. Now you've gone and confused us. You've been talking about "public support," but you just threw in another term – "total support." What is that?

Coach: By "total support," I mean all of an organization's revenue, from any source – except for any money it gets from sales or services related to carrying out its charitable purpose. That's that *exempt function income* that I mentioned earlier.

Total support includes a wide range of income. Besides all of the gifts and grants an organization receives, it includes any membership fees, investment income, grants or other income from government sources, and income from any unrelated business activities. But not exempt function income.

## Page 13 – One-Third Support Test

So, now that we know what counts as public support, what the limit is for big givers, and how to define total support, let's talk about how we do the "one-third" calculation: the numerator is all of the public support an organization gets, after taking into account the limit on support from big donors. The denominator is the organization's total support – as I just defined it.

Divide the numerator by the denominator. If the result is 33 1/3% or higher, you're golden; a bona fide publicly supported organization. If it's lower, an organization might still qualify, depending on some special considerations.

## Page 14 – Unusual Grants

Grace: Oh, lovely. Please tell us all about those special considerations.

Coach: No, really, this is good news! For example, if your organization receives a big, one-time contribution or grant that would throw your calculation out of whack, you might be able to exclude it from both the numerator and the denominator as an "unusual grant." Cool, huh? Of course, the IRS has criteria for determining what's an unusual grant and what's not. The IRS considers whether:

- the donor was attracted by the organization's publicly supported nature
- the size of the contribution was unusual or unexpected and
- the contribution would adversely affect the organization's public charity status

## Page 15 – Unusual Grants (cont.)

Grace: What factors would tend to make the Service more likely to view that large contribution as an "unusual grant"?

Coach: A grant will more likely be viewed as an unusual grant if the grant comes from a disinterested person—someone other than the creator or a person who was a substantial contributor in the past or someone who is in a position of authority within the organizations. The IRS is also more likely to view a contribution as an unusual grant if:

- the grant is unrestricted
- the grant is made in cash, liquid assets or as bequest
- the organization has a representative board or
- the organization has previously met the 1/3 support test, actively solicited contributions from the public and can be expected to attract public support in the future

## Page 16 – Facts and Circumstances Test

Bert: What if an organization can't quite show 1/3 public support for some reason but it comes really close?

Coach: If your public support calculation results in a percentage of more than 10% but is not quite all the way up to 33 1/3%, you still might not be dead in the water. In this situation, the IRS will consider some other criteria showing that an organization is truly publicly supported. These include whether the organization:

- maintains a bona fide fund-raising program that is reasonable in light of the scope of its charitable activities
- has support from more than members of one family
- has a governing body representative of the general public
- makes its facilities available to the public on a regular basis
- receives a significant part of its support from a governmental unit or public charity to which it is in some way accountable and
- conducts programs designed to address real community needs – like a slum clearance program or an employment development program

If you meet most of these criteria, you may still be a public charity, even though the organization's percentage is under 33 1/3%. Of course, the higher the percentage of public support is to start with, the better.

## Page 17 – Public Support and the Internal Revenue Code

Bert: Coach, you mentioned another category of organization earlier – groups that earn a lot of their income through exempt function activities. Mine does, and we have some contributors too. Are there specific rules for us to qualify as a public charity?

Coach: Right. There are. I hate to go all bureaucratic on you, but I need to mention a couple of Internal Revenue Code sections to help us keep things straight: for the last few minutes, we've been talking about organizations that qualify for public charity status as publicly supported under Internal Revenue Code sections 509(a)(1) and 170(b)(1)(A)(vi). Code section 509(a)(2) describes our type of organization and it's another way to qualify for public charity, or non-private foundation, classification.

## Page 18 – Public Support and the Internal Revenue Code (cont.)

For 509(a)(2), the definition of “public support” includes all contributions, grants, membership fees and exempt function income with a couple of limitations. First, it includes only up to the greater of \$5000 or 1% of gross receipts from one individual or government source. Also, money from “disqualified persons” – substantial contributors, foundation managers, and persons and entities related to them – are totally excluded from an organization’s public support. But, 509(a)(1) public charities and governmental units are never considered to be “disqualified persons.”

So, to qualify under 509(a)(2), an organization needs to show public support – taking into account those limitations – that is at least 1/3 of its gross receipts. By the way, “gross receipts” means just what it sounds like, believe it or not. All of an organization’s income, from whatever source, is included in gross receipts for the 509(a)(2) calculation. Also, it can’t receive more than 1/3 of its gross receipts from gross investment income and net unrelated business income combined.

Some organizations might qualify either way. If that’s the case, the organization will be given 509(a)(1) status.

## **Page 19 – “Advance Ruling” on an Organization’s Public Charity Status**

Grace: My organization’s determination letter says that we have an “advance ruling” that ends on December 31, 2010. Something tells me that is all about our foundation status. Am I right? What do I have to do to keep our public charity status intact after that date?

Coach: You are right. Yours is a pretty new organization, and when you applied for your 501(c)(3) exempt status, the IRS, as part of its review, made an educated guess that your organization would qualify for public charity status once you got up and running. But we wanted to hedge our bet a little, so we issued an *advance ruling* which said that we’d treat you as a public charity for 5 tax years. The plan was that we’d take another look then.

For organizations like yours, we used to send out a form for you to complete and send back to us at the end of your advance ruling period. But, we’ve done away with that process and the form. More good news!

Under new regulations, the IRS will treat organizations that had received advance ruling letters but have not yet received a final ruling as if they had received one. You can ignore the part of your determination letter that says we’ll be sending you a form near the end of your advance ruling period, because we won’t.

Dakota: What if my organization’s public support goes up and down from year to year? I remember that you said something about “normally publicly supported.” How do we know if we’re normal?

Coach: To determine if the organization is “normally publicly supported” we look at the organization’s support over several fiscal years.

Under new regulations, which we expect to be published in 2008, the measurement period will be five years – an organization’s current fiscal year and the previous four years. If an organization meets a public support test, it will be treated as a publicly supported organization

for the current year and the next year. You'll notice that Part II and III of the newly revised Schedule A for 2008 require financial information for a five-year computation period.

## Page 20 – Changes Under 2008 Regulations

Coach: Under the new regulations, any new organization that wants to be a public charity will get that status for its first five years if it shows that it can reasonably expect public support, regardless of the support it actually receives during that time. The organization won't have to show that it actually met a public support test for its first 5 years.

But beginning with its sixth year, it will be required to show in its annual Form 990 filing that it is a publicly supported organization using a rolling five year computation period – or show that it is not a private foundation for one of the other reasons we've discussed.

Bert: What happens if after the end of the five year period we don't qualify as a public charity? Will we have to pay foundation excise taxes? What about our donors? Will they be able to rely on us telling them that we're a public charity?

Coach: If a new charity obtains a ruling that it is publicly supported, the organization and donors can rely on the public charity status of the organization until the IRS publishes a notice that the organization's foundation status has changed. In addition, under the new rules, a new 501(c)(3) organization that has received a ruling that it is publicly supported will not owe section 4940 tax or other foundation excise taxes for its first five years, regardless of the public support it may receive, subject to an anti-abuse exception.

## Page 21 – For More Information

Bert: Hey Coach, our time's up but we really want to thank you for giving us so much useful information. If we want to know more about this topic, what can we do?

Coach: The IRS has a wealth of information on its website, [irs.gov/eo](http://irs.gov/eo), and in its printed publications.

## Page 22 – Publications

Publication 557, *Tax Exempt Status for Your Organization*, has an exhaustive (some would say *exhausting*) discussion of foundation classifications.

## Page 23 – [www.irs.gov/eo](http://www.irs.gov/eo)

And if you haven't done so yet, sign up for our electronic newsletter, *EO Update*. About once a month, we'll send you all of the IRS info on exempt organizations that's fit to email!

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  - Lifecycle of a Private Foundation
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Thanks for inviting me, and good luck to you all!

