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CPAS & ADVISORS

Public Support for Nonprofits

HOW TO MAINTAIN YOUR PUBLIC CHARITY STATUS AND PASS THE PUBLIC SUPPORT TEST

Contents

INTRODUCTION

Many nonprofits qualify as public charities. The public charity designation, also known as a public 501(c)(3), has many benefits. But did you know just because the IRS determination letter says the organization is a public charity doesn't mean it maintains that status forever? How is that status determined and maintained?

Reasons for Public Charity Status

Every public 501(c)(3) entity must meet one of the criteria in Part I of Schedule A of Form 990 to continue to be a public charity. The criteria utilized does not have to match the one applied for in the IRS determination letter. That gives the nonprofit some leeway as things change.

Certain public charity statuses are based solely on the purpose of the entity. Exempt entities include the following:

- A church, convention of churches, or association of churches
- An entity meeting the definition of a school
- A hospital or cooperative hospital service organization
- A medical research organization operated in conjunction with a hospital
- An organization operated for the benefit of a college or university owned or operated by a governmental unit
- Agricultural research organizations operated with a land-grant college or university or a non-land-grant college of agriculture.
- Organizations operated exclusively to test for public safety

All of the entities named above are exempt based on their purpose or underlying entity type. As long as the organization maintains operations for the same purposes, it will continue to be a public charity.

Another way to meet public charity status is through being a supporting organization. There are four types of supporting organizations, and they range from being a supporting organization due to their underlying structure (control mechanisms) to being a supporting organization based solely on who they provide funding to. The requirements of exemption as a supporting organization are very detailed, and there are no “second chances” if mistakes are made. Therefore, if your organization is a supporting organization, please reach out to your tax advisor and ensure you know all the legal requirements to maintain this public charity status; it is the least favorable in the IRS’s eyes.

That leaves two other ways that an organization can maintain public charity status. These are the two most common ways. They both involve meeting public support tests over a five-year period. However, the two tests are different. Organizations may need to plan to meet these support tests, and the rules vary based on the particular support test.

170(b)(1)(A)(vi) Support Test

CONTRIBUTION DRIVEN (FORM 990 SCHEDULE A PART II)

This support test, 170(b)(1)(A)(vi), is designed for tax-exempt organizations that are primarily contribution driven. It does not forbid program service revenues, investment income, or unrelated business income, but it assumes a large quantity of contribution income. This is the most favorable of the public support tests. If a nonprofit meets this test, all donations from that entity to another nonprofit will continue to be considered public support. This test has flexibility in that the test must be met once every two years, but there is also a facts and circumstances test that can be met to get public support requirements down from 33 1/3% to only 10%.

We will look at the numerator of this public support test first. The numerator includes gifts, grants, contributions, and membership fees that are considered contributions; this means everything listed on the 990 that is considered a contribution.

It also includes tax revenues levied for the organization's benefit, whether or not paid to the organization or expended on its behalf. Generally, those are already in government contributions, but not always. It also includes the value of services or facilities furnished by a governmental unit without charge. This is unique because generally, donated services or use of facilities are not considered contributions in the IRS realm; here, they are for purposes of public support tests only.

Schedule A (Form 990) 2022 Page **2**

Part II **Support Schedule for Organizations Described in Sections 170(b)(1)(A)(iv) and 170(b)(1)(A)(vi)**
(Complete only if you checked the box on line 5, 7, or 8 of Part I or if the organization failed to qualify under Part III. If the organization fails to qualify under the tests listed below, please complete Part III.)

Section A. Public Support

Calendar year (or fiscal year beginning in)	**(a)** 2018	**(b)** 2019	**(c)** 2020	**(d)** 2021	**(e)** 2022	**(f)** Total
1 Gifts, grants, contributions, and membership fees received. (Do not include any "unusual grants.")						
2 Tax revenues levied for the organization's benefit and either paid to or expended on its behalf						
3 The value of services or facilities furnished by a governmental unit to the organization without charge						
4 **Total.** Add lines 1 through 3						

Not everything that meets the definitions in the previous paragraph winds up as public support, though. The first item to be backed out is unusual grants. Unusual grants are removed from both the numerator and denominator. Unusual grants are contributions from disinterested persons (unrelated people or entities) that are attracted because of the organization's publicly supported status, unusual and unexpected because of the amount, and large enough to potentially endanger the entity's public support status. Think of things like a large bequest from an estate.

In addition, certain amounts from large contributors are not considered public support and are removed from the numerator (but not the denominator). "Large contributors" in this case are different from those in 509(a)(2). Large contributors are those who have contributed (as contribution income, not program service income) more than 2% of total support (the denominator, not just contributions, and not all revenues) over the entire five-year period. This means the calculation is done on a rolling five-year period rather than being done on each individual year. In 2020, maybe the contribution was not considered a large contribution, but the exact same contribution that was given in 2020 may be considered a large contribution on the 2021 Schedule A. We recommend tracking contributions above $5,000 on a spreadsheet for the rolling five-year period. These large contributors are only contribution revenues, not program service revenues, and do not include anything deemed an unusual grant. However, not every large contributor is deemed non-public support. Contributions are not subject to the 2% of total support calculation and therefore are 100% public support if they are from other tax-exempt organizations that are exempt under 170(b)(1)(A)(vi) (the same code section this entity is using; you can verify by looking at the donor's Schedule A) or governmental units (contributions on the government line of the 990, tax revenues, or those governmental services/use of facilities). Note that entities exempt based on their purpose, such as a church, may also qualify under 170(b)(1)(A)(vi), but don't always; if they do qualify under 170(b)(1)(A)(vi), they can be excluded from large contributors.

5	The portion of total contributions by each person (other than a governmental unit or publicly supported organization) included on line 1 that exceeds 2% of the amount shown on line 11, column (f)						
6	**Public support.** Subtract line 5 from line 4						

The hardest part of this test seems to be determining those large contributors. A spreadsheet must be maintained and updated each year. Of those large contributors, the amounts greater than 2% per contributor of total support for the five-year period are not considered public support. This means if ABC Private Foundation gives $100,000 over the five-year period, and 2% of total support is $60,000, then $60,000 of ABC Private Foundation's contributions are public support and the remaining $40,000 are not. But if the same $100,000 was given by XYZ Nonprofit that qualifies under 170(b)(1)(A)(vi), the entire $100,000 is public support.

The denominator includes all the contributions, tax revenues, and value of services or facilities, except for unusual grants, plus some. It also includes any gross income from interest, dividends, payments received on security loans, rents, royalties, and similar items. It includes *net income*, not gross income, but net after expenses, for unrelated business activities *whether or not regularly carried on*. That means any income reported on the 990-T is recorded, at net, in the denominator. In addition, if the only reason income was reported in the 990 as excluded from tax (column D), rather than exempt purpose (column B) income, was that it was not regularly carried on, that will also be included in the denominator, at net income. Also, anything listed on the 990 in other income at the bottom of the revenue page that is not exempt purpose income is included in the denominator.

Section B. Total Support

Calendar year (or fiscal year beginning in)		**(a)** 2018	**(b)** 2019	**(c)** 2020	**(d)** 2021	**(e)** 2022	**(f)** Total
7	Amounts from line 4						
8	Gross income from interest, dividends, payments received on securities loans, rents, royalties, and income from similar sources						
9	Net income from unrelated business activities, whether or not the business is regularly carried on						
10	Other income. Do not include gain or loss from the sale of capital assets (Explain in Part VI.)						
11	**Total support.** Add lines 7 through 10						

What is not included in the denominator? As we've discussed, unusual grants are excluded from both the numerator and denominator. However, any exempt function income, so Part VIII column B on the 990, is not included in the denominator. It is instead listed as a total for the five-year period on a single line. The purpose of this is for the IRS to verify that there is not too substantial an amount of income from related activities rather than contributions, but there isn't a clear definition of what is too substantial.

The preferred method of public support test here is to meet 33 1/3% public support.

12	Gross receipts from related activities, etc. (see instructions)	**12**	

Now you have the numerator and denominator and can determine the percentage of public support. If the entity is in its first five years (so not all five columns can be filled out, or this is the first year all five can be filled out), it is deemed publicly supported. Essentially, the IRS knows it takes some time to gain public support. After the first five years, the test must be met. Failure to meet it in the current year (which, remember, is calculated over the last five years) will not cause a loss of public charity status. But if it is not met for the second year in a row, that second year, the entity actually must file Form 990-PF as it has transitioned to a private foundation.

The preferred method of public support test here is to meet 33 1/3% public support. However, this support test does have an option for a 10% facts and circumstances test. In that case, it still must meet the test one of the two years. But the hard and fast percentage becomes 10%. For the facts and circumstances test, the organization must explain in the 990 how it meets the facts and circumstances test. It must explain whether it maintains a continuous bona fide program for solicitation from the general public, community, membership, governmental units, or other public charities. In other words, how is it soliciting contributions from those who would be public support? In addition, include information such as how the governing body represents the broad interest of the public rather than just certain non-public contributors. Also include whether facilities or services are provided directly for the benefit of the general public, rather than just certain related people or entities, on a continuing basis. If the organization is a membership organization (where memberships are contributions), explain how the solicitation for dues-paying members is designed to enroll a substantial number of persons from the community, including how the dues rates are structured to be cost-effective for the members of the community.

This is the preferred test. It provides flexibility in the ability to do facts and circumstances. It provides that certain contributions in and of themselves are considered public support based on who they came from. It assumes the major revenue sources are contributions. The calculation of non-public support contributions is done over the entire rolling five-year period and allows up to 2% of total support to be provided by any one individual and still be considered public. It also assists grantees in maintaining their public support test since all contributions from these entities are public support. Some entities that meet one of the exemption requirements based on purpose still calculate this test on their Schedule A to allow their grantees to count the grants as public support.

Contributions + tax levies + services/facilities use from governments - unusual grants - large contributor amounts over 2% support

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Contributions + tax levies + services/facilities use from governments - unusual grants + investment income + net income from unrelated business activities + net income from activities not regularly carried on + other income

= **33 1/3% (or 10% facts and circumstances) or more**

Section C. Computation of Public Support Percentage

14	Public support percentage for 2022 (line 6, column (f), divided by line 11, column (f))	14		%
15	Public support percentage from 2021 Schedule A, Part II, line 14	15		%
16a	**33 1/3% support test—2022.** If the organization did not check the box on line 13, and line 14 is 33 1/3% or more, check this box and **stop here**. The organization qualifies as a publicly supported organization			☐
b	**33 1/3% support test—2021.** If the organization did not check a box on line 13 or 16a, and line 15 is 33 1/3% or more, check this box and **stop here**. The organization qualifies as a publicly supported organization			☐
17a	**10%-facts-and-circumstances test—2022.** If the organization did not check a box on line 13, 16a, or 16b, and line 14 is 10% or more, and if the organization meets the facts-and-circumstances test, check this box and **stop here**. Explain in Part VI how the organization meets the facts-and-circumstances test. The organization qualifies as a publicly supported organization			☐

509(a)(2) Support Test

PROGRAM SERVICE REVENUE DRIVEN (FORM 990 SCHEDULE A PART III)

This support test, 509(a)(2), is designed for tax-exempt organizations that are primarily program service revenue driven. It does not exclude contributions, nor does it prohibit investment income or unrelated business income, but it works best for program service revenue-driven entities. This does have some flexibility in that the test needs to be met every other year, not every year. However, it is a hard and fast minimum of 33 1/3% public support and a maximum of 33 1/3% investment income; if the minimum or maximum is not met for two consecutive years, no facts and circumstances are allowed. There are many similarities to the previous test, but also many differences.

We will look at the numerator of this public support test first. Like the previous public support test, it includes gifts, grants, and contributions while excluding unusual grants. It also includes tax revenues levied for the organization and the value of services or facilities furnished by a governmental unit without charge. It also includes gross receipts from admissions, merchandise sold, or services performed, or facilities furnished in any activity related to the organization's tax-exempt purpose. This means any gross revenues listed on the 990 as exempt-function income are included in the numerator and the denominator. Also, gross receipts from activities that are not an unrelated trade or business are included.

Schedule A (Form 990) 2022 Page **3**

Part III **Support Schedule for Organizations Described in Section 509(a)(2)**
(Complete only if you checked the box on line 10 of Part I or if the organization failed to qualify under Part II. If the organization fails to qualify under the tests listed below, please complete Part II.)

Section A. Public Support

Calendar year (or fiscal year beginning in)	**(a)** 2018	**(b)** 2019	**(c)** 2020	**(d)** 2021	**(e)** 2022	**(f)** Total
1 Gifts, grants, contributions, and membership fees received. (Do not include any "unusual grants.")						
2 Gross receipts from admissions, merchandise sold or services performed, or facilities furnished in any activity that is related to the organization's tax-exempt purpose . . .						
3 Gross receipts from activities that are not an unrelated trade or business under section 513						
4 Tax revenues levied for the organization's benefit and either paid to or expended on its behalf						
5 The value of services or facilities furnished by a governmental unit to the organization without charge						
6 **Total.** Add lines 1 through 5						

Like the other support test, not everything that meets the definitions in the previous paragraph winds up as public support. The first item to be backed out is still unusual grants. Unusual grants are removed from both the numerator and denominator. Unusual grants are contributions from disinterested persons (unrelated people or entities) that are attracted because of the organization’s publicly supported status, unusual and unexpected because of the amount, and large enough to potentially endanger the entity’s public support status. Think of things like a large bequest from an estate. In addition, all receipts from disqualified persons, whether contributions or gross receipts, are backed out from public support, the numerator, but not the denominator. This means $0 of revenue from disqualified persons is considered public support. Also, gross receipts, but not contributions, that exceed the greater of $5,000 or 1% of the year’s (not the five years’) total support are backed out of the numerator but not the denominator.

7a Amounts included on lines 1, 2, and 3 received from disqualified persons .						

In most nonprofits’ cases, the gross receipts, such as membership revenue, are not greater than $5,000 for an individual, so nothing gets backed out of the gross receipts from other than disqualified persons. However, if dues revenues are > $5,000 per individual/entity, it may be that not all the dues revenues are considered public support. Essentially, if dues are over $5,000 per person/entity, the nonprofit needs a bare minimum of 34 dues-paying members who all pay the same dues to have any chance of meeting the public support test.

If dues are over $5,000 per person/entity, the nonprofit needs a minimum of 34 dues-paying members who all pay the same dues to have any chance of meeting the public support test.

b Amounts included on lines 2 and 3 received from other than disqualified persons that exceed the greater of $5,000 or 1% of the amount on line 13 for the year						

However, the bigger issue in this support test is disqualified persons since no contributions or gross receipts from them count as public support; $0. First, we need to look at the correct definition of a disqualified person since there are multiple different IRS definitions. In this case, organizations described in 509(a)(1) are not considered disqualified persons. What is 509(a)(1)? Essentially, it is a 501(c)(3) organization that is not a private foundation, and the box it marks on its Schedule A is not the 509(a)(2) box, the supporting organization 509(a)(3) box, nor the public safety testing 509(a)(4) test. The donor marks one of the boxes on Schedule A that indicates a section 170(b)(1)(A) reason.

If the donor isn't a 509(a)(1) organization, what makes them a disqualified person? The first way to be disqualified is to be a substantial contributor. Substantial contributors give contributions; we are not looking at gross receipts for goods and services. A substantial contributor gave in aggregate more than $5,000 and more than 2% of the total contributions (not gross receipts). However, that calculation of $5,000 and 2% of contributions is done from the entity's inception through now! Once deemed a substantial contributor, they remain so until they provide no contributions to the organization for ten years. As you can see, this test is not designed for entities that have a lot of contributions.

Substantial contributors aren't the only disqualified persons. Officers, directors, or trustees of the organization are also disqualified. That includes the IRS definition of an officer with top-most management and top-most financial official, regardless of whether they are legally officers. So, no contributions or gross receipts from any board members are public support, and you need to be able to determine those amounts. If an entity is a substantial contributor, any owner of 20% or more of that entity, or the beneficial interest of a trust of 20% or more, is considered disqualified person. A family member of a substantial contributor, officer, director, trustee, or owner of 20% or more is also a disqualified person. A family member is a spouse, ancestor, brother/sister (including whole and half, but not step), children (natural or adopted), grandchildren, great-grandchildren, or spouses of brothers/sisters/children/grandchildren/great-grandchildren. Also, an entity, including a trust or estate, in which any other disqualified person owns more than 35% of the voting, profits, or beneficial interest. Remember, $0 of contributions plus $0 of gross receipts are included in the numerator for these disqualified persons! But 100% of those amounts are included in the denominator. It would be highly unlikely that this amount from disqualified persons is $0.

What else is included in the denominator, then? All of the amounts listed above, except for the unusual grants, are included in the denominator. Also included are interest, dividends, payments received on security loans, rents, royalties, and income from similar sources. If an unrelated business was acquired after June 30, 1975, the taxable income (from the 990-T) is included in the denominator. That would be after the standard deduction and after any NOL carryforwards. Also, net income from unrelated business activities acquired prior to June 30, 1975, so the gross revenues less the expenses, but not necessarily less the standard deduction or NOL carryforward. In addition, if income is excluded from the 990-T solely because it is not regularly carried on, that net income is included in the denominator. Also, any income listed as other income is included in the denominator.

Contributions + gross receipts from exempt purposes + gross receipts that are not unrelated business + tax levies + services/facilities use from governments - unusual grants - amounts above from disqualified persons - gross receipts from exempt purposes/that are not an unrelated business for any other person > $5,000 or 1% of support

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Contributions + tax levies + services/facilities use from governments - unusual grants + gross receipts from exempt purposes + gross receipts that are not unrelated business + investment income + net or taxable income from unrelated business activities + other income

= **33 1/3% or more**

Investment income

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Contributions + tax levies + services/facilities use from governments - unusual grants + gross receipts from exempt purposes + gross receipts that are not unrelated business + investment income + net or taxable income from unrelated business activities + other income

= **33 1/3% or less**

Section B. Total Support

Calendar year (or fiscal year beginning in)	**(a)** 2018	**(b)** 2019	**(c)** 2020	**(d)** 2021	**(e)** 2022	**(f)** Total
9 Amounts from line 6						
10a Gross income from interest, dividends, payments received on securities loans, rents, royalties, and income from similar sources .						
b Unrelated business taxable income (less section 511 taxes) from businesses acquired after June 30, 1975						
c Add lines 10a and 10b						
11 Net income from unrelated business activities not included on line 10b, whether or not the business is regularly carried on						
12 Other income. Do not include gain or loss from the sale of capital assets (Explain in Part VI.)						
13 **Total support.** (Add lines 9, 10c, 11, and 12.)						

Similar to the 170(b)(1)(A)(vi) test, the first five years of an entity's existence can be used to work up to the public support test. Also, similarly, the numerator listed above divided by the denominator listed above must be at least 33 1/3% either for the current year being calculated or the prior year. Unlike the other test, there is no option of facts and circumstances; it is met or not met. In addition, the entity must take the sum of interest, dividends, payments received on security loans, rents, royalties, and income from similar sources and, for an unrelated business acquired after June 30, 1975, the taxable income (from the 990-T), and use that as a second numerator. This second numerator is divided by the original denominator, and the percentage must be less than 33 1/3%.

These two 33 1/3% tests work together. To meet the public support test in a year (this year or last year), both tests must be met in that same year. At least 33 1/3% must be public support and no more than 33 1/3% can be investment income. Note that standard rounding rules to the nearest 100th of a percent should be used, and sometimes can matter.

Section C. Computation of Public Support Percentage

15	Public support percentage for 2022 (line 8, column (f), divided by line 13, column (f))	15		%
16	Public support percentage from 2021 Schedule A, Part III, line 15	16		%

Section D. Computation of Investment Income Percentage

17	Investment income percentage for **2022** (line 10c, column (f), divided by line 13, column (f)) . . .	17		%
18	Investment income percentage from **2021** Schedule A, Part III, line 17	18		%

19a **33 1/3% support tests—2022.** If the organization did not check the box on line 14, and line 15 is more than 33 1/3%, and line 17 is not more than 33 1/3%, check this box and **stop here**. The organization qualifies as a publicly supported organization . . ☐

b **33 1/3% support tests—2021.** If the organization did not check a box on line 14 or line 19a, and line 16 is more than 33 1/3%, and line 18 is not more than 33 1/3%, check this box and **stop here**. The organization qualifies as a publicly supported organization . ☐

What Next?

It's important to maintain an entity's public charity status. This allows the entity to operate with fewer rules and regulations, as compared to a private foundation, and may allow donors to deduct a larger percentage of contributions at times. But what can be done to maintain that status?

First and foremost, an organization needs to know its public support reason and status. Every year you have Form 990 (or a 990-EZ) and it has a Schedule A. Make sure you are looking at it. Make sure you review it and understand where the numbers come from. Make sure you know what percentages you have. You also need to understand the timing of when your organization's tax return is normally done. Nonprofits could wait until the 15th day of the 11th month after year-end to file. But if they do, that means there is one-and-a-half months left in the next fiscal year to deal with any potential support problems. As soon as a public support test is below 33 1/3% on Schedule A (or in the case of investment income for a 509(a)(2), it is above 33 1/3%), the organization needs to start making significant plans and forecasting their public support.

However, if your organization typically extends, waiting until that first Schedule A is below 33 1/3%, it may be too late to do anything. As you approach the threshold of 33 1/3%, you need to pay attention and start implementing significant plans. Look at the percentages over the past few years and see how much it is declining each year. If it is averaging a 5% decline per year, the first year it is at 38% (33 1/3% plus 5%), you want to start taking action.

TAKE ACTION – THE REASON FOR PUBLIC SUPPORT

The easiest way to maintain public support when it is becoming questionable is to see if a different test will work. Suppose the organization uses the 170(b)(1)(A)(vi) test. Would it meet the facts and circumstances test whereby maybe just ensuring you are doing those items required by facts and circumstances would give the organization sufficient action to maintain public support? Otherwise, look at what the calculations would be on a different test. Have your revenue sources changed now so that they are more contribution versus program services, and possibly 170(b)(1)(A)(vi) would assist? Or do you have more program revenues, and potentially 509(a)(2) would assist? Does your purpose match one of the specific purposes? You may also need to look into planning to become a supporting organization.

TAKE ACTION – SUPPORTING ORGANIZATION

A supporting organization is a public charity based not on its purpose or revenues, but on its relationship with another public charity. To become a supporting organization, the entity must have a supported organization. A supporting organization can engage solely in activities that support or benefit the supported organization. Now, that does include benefiting the same beneficiaries that the supported organization does, rather than directly benefiting the supported organization. For example, if the supported organization helps the blind in Michigan, the supporting organization can help the blind in Michigan or give support directly to the supported organization. It could not help the blind in Arkansas since Arkansas does not have beneficiaries of the supported organization.

However, that isn't all that is needed for a supporting organization. The supporting organization must designate the supported organization in its articles of incorporation. This may require a legal update of the articles of incorporation. For type I or II organizations, that supported organization can be named or referenced by class or purpose; for a type III organization, it must be named. The supported organization also must be a 501(c)(3) entity. There are also restrictions on disqualified persons (officers, directors, etc.) in the supported organization having controlling interests in entities the supporting organization has interests in. The disqualified persons of the supported organization cannot benefit personally from the supporting organization's assets.

Supporting organizations have no "grace" allowed to them. If you fail to meet the requirements of being a supporting organization, you are a private foundation in the tax return year you failed to meet them. Generally, a supporting organization is not allowed to file a 990-N either. And the supporting organization will need to file Schedule R, as will the supported organization. Pages' worth of questions will have to be answered on Schedule A to prove the entity meets the definition of a supported organization.

Supporting organizations need to have some type of relationship with their supported organization. This may be another place where lawyers get involved or where an organization needs to look into changes in how the entity is run to meet the supporting organization tests. There are four types of supporting organizations.

1. **Type I** is the most favorable in the IRS's eyes and requires that the supporting organization be operated, supervised, or controlled by one or more of its supported organizations. Generally, that means that the supported organization has the right to determine at least a majority of the board of the supporting organization.
2. **A type II** organization is slightly less favorable, and the supporting organization is supervised or controlled in connection with the supported organization. This is typically where there is overlap of the majority of the board, but one must be careful to ensure the overlap continues as it is not built into the legal documents.
3. **Type III** functionally integrated is not the preferred method of being a supporting organization, but it is satisfactory.
4. **A type III** non-functionally integrated is the IRS's least favorite public charity test and is only slightly above private foundation status.

All type III supporting organizations, both functionally integrated and non-functionally integrated, have certain requirements. A type III entity must provide to the supported organization their tax return, notice describing the type and amount of support, and copies of any governing document changes. Documentation is due the last day of the fifth month of the type III's tax year. In addition, a type III supporting organization must have an adequate relationship with the supported organization, which typically means at least one board member overlaps (once again, this needs to be watched) or the supported organization elects at least one board member, and there needs to be a close and continuous working relationship.

Then there are distinctions between functionally integrated and non-functionally integrated. A functionally integrated supporting organization must meet an integral part test whereby the supporting organization is considered an integral part of the supported organization. This can be determined in three ways. The activities test means substantially

all the supporting organization's activities directly further the exempt purpose of the supported organization and are such that the supported organization would typically do those activities if not for the supporting organization.

If the supporting organization is the parent of the supported organization (so supporting determines the board members of supported), that meets the integral part test. Or if the supporting organization is supporting a governmental entity and the government would have to do those activities if not for the supporting organization, that meets the integral part test. All those functionally integrated tests get back to either the purpose or the legalities of how the two entities are related. The final option is non-functionally integrated, where there are specific distribution requirements that must be met annually (similar to a private foundation), but the overall type III requirements still must be met.

As you can tell, supporting organizations are complex and aren't the first choice of the reason for public support. They require careful planning to ensure that all the requirements are met, as there is no grace if one is missed. Also, keep in mind, any contributions from the supporting organization to the supported organization could be subject to the supported organization's public charity test limitations (2% of total support over the five years or $5,000/1% of support over the year.) In addition to ensuring that the supporting organization maintains its public support test, the supported organization may have public support test issues as well.

TAKE ACTION – OTHER PLANNING

If an entity is concerned about its public support and cannot find another test, then tax planning is the key. However, this planning would not just impact taxes; it would also impact operations. The board really needs to dive into the operational aspects of what would happen if the organization became a private foundation. Yes, there are clearly tax issues in becoming a private foundation. But there are also more restrictions on what can be done legally, which could impact operations. And most importantly, if the organization receives contributions, they need to look at major funders and what would happen to those funding sources if the organization were to become a private foundation. Some entities choose not to provide funds to private foundations based solely on the quantity of paperwork and monitoring they are required to do.

What are the tax consequences of private foundation status? Net investment income is taxable; as long as you know the organization is a private foundation, this is easy enough to plan for. Excise tax is generally due on acts of self-dealing which include sale, exchange, or leasing, borrowing money from or lending money to, furnishing goods/services/facilities, paying compensation or reimbursing expenses, or transferring income or assets to a disqualified person. There are some exceptions, but those items are generally prohibited or the exempt organization must get a good deal. Self-dealing also generally must be corrected, or additional tax is due. There are taxes on failure to distribute sufficient income; minimum amounts of charitable expenses must be spent each year based on assets. The organization, combined with its disqualified persons, cannot hold more than 20% of the interests in an entity without incurring tax. Investments made by the organization must be subject to ordinary business care to provide for the foundation's long- and short-term financial needs, or taxes will be imposed. Certain expenditures are taxable, and this can include things such as providing grants to individuals for travel, study, grants to organizations that are not charitable, etc.

If becoming a private foundation is a problem, then solutions need to be determined to prevent that. Contribution-based entities need to make a concerted fundraising campaign for new donors. This means that development needs to go to those who have only contributed small amounts or those who have not contributed anything before, as those amounts would be public support. Contributions should be requested of other organizations that are 170(b)(1)(A)(vi) organizations, and therefore public support. Governmental entity contributions, where the government itself does not benefit from the transaction, even though it may be considered a grant, should be obtained. In addition, the organization needs a gift acceptance policy and needs to evaluate gifts from large donors. The organization may need to turn down gifts from certain donors because the gifts would not be considered public support and are not unusual grants.

Those organizations that are program service-based may be able to do some fundraising but need to be careful that the fundraising results in non-disqualified persons donating, and not donating over $5,000 per person. In addition, consider a membership drive or a drive to obtain more new customers providing program revenues to spread out the base. Similar to contribution-driven organizations, there may need to be times when donations or program service revenues are declined from certain disqualified persons.

These are potentially painful decisions. They may involve turning away funding, meaning fewer expenses can be paid and fewer results can be met. That is why it is so critical to determine the operational consequences of private foundation status. If 50% of the revenue will dry up if the organization becomes a private foundation, but you can turn down 5% of the revenue to prevent it from becoming a private foundation, the choice is clear. A 5% reduction is much better than a 50% reduction. But if you would have to turn down 50% of the revenue to maintain public support status and only 5% would go away with private foundation status, the choice is clearly to become a private foundation. Decisions related to whether to ensure an entity maintains its public charity status are really operationally driven decisions.

Conclusion

Public support tests are hard. They are confusing. They don't always make sense and sometimes don't seem reasonable. But to maintain public charity status, an organization needs to understand how they are a public charity and what its options are. There are options to manage public support tests or change public support tests. Most of these options cannot be done in a month-and-a-half, and the organization will not have the option of operational changes if they are not watching the support tests far enough in advance.

Know your public support status. Discuss it with your tax preparer. Realize 100% public support is not likely. Contribution-oriented organizations may have all contributions as public support, but it is unlikely if there are major donors that are individuals, businesses, or private foundations. Program service-oriented organizations will almost always have something in revenue from disqualified persons; having a zero indicates the organization didn't even try to follow the rules. The organization needs to have the supporting documentation for these tests; it is the organization's responsibility. When signing the tax return, your officer is attesting under penalty of perjury that the return is true to the best of their knowledge and belief.

Yeo & Yeo can help. Yeo & Yeo's Nonprofit Services Group serves more than 300 nonprofit organizations throughout Michigan. Our professionals' extensive experience translates into recommendations to improve accounting controls and operating efficiencies that are practical and realistic. We provide the advice and support you need – allowing you to concentrate on your organization's central purpose.

Contact Us

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