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## PRIVATE FOUNDATIONS AND PUBLIC CHARITIES

The purpose of this chapter is to explain the distinctions between *private foundations* and *public charities*. There are, however, different types of private foundations and likewise different types of public charities. Specifically, this chapter will:

- Provide a generic and a technical definition of the term *private foundation*.
- Explain the terms *private operating foundations*, *exempt operating foundations*, *conduit private foundations*, and *nonexempt charitable trusts*.
- Explain the concept of a *public charity*.
- Define the public charities that are the *institutions*.
- Define the public charities that are the *donative publicly supported charities*.
- Define the public charities that are the service provider publicly supported charities.
- Provide a comparative analysis of publicly supported charities.
- Define the public charities that are *supporting organizations*.
- Define the public charities that *test for public safety*.
- Summarize the rules as to the excise tax on net investment income.

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- Explain the significance of the private foundation-public charity dichotomy.
- Review some of the most recent IRS statistics on these subjects.

### **PRIVATE FOUNDATION DEFINED**

A *private foundation* is a form of tax-exempt charitable organization. In this context, the term *charitable* includes program undertakings that are classified as *educational*, *scientific*, and *religious*. Generically, however, a private foundation typically has four other characteristics:

1. A private foundation is usually funded from a single source, often an individual, a family, or a corporation.
2. This funding is usually a one-time occasion, by means of a sizeable charitable contribution. While a private foundation may receive an ongoing flow of gifts, that is a rarity.
3. The year-by-year revenue derived by a private foundation is almost always in the form of investment income earned on their assets (also known as *principal* or *corpus*).
4. The typical private foundation makes grants for charitable purposes to other persons (individuals and/or organizations), rather than conduct its own programs.

The *private* aspect of the concept of a private foundation, then, principally reflects the nature of its financial support, particularly its initial funding. The *private* nature of a foundation, however, is often reflected in its governing board structure (see Chapter 12).

Because private foundations are generally exempt from federal income tax, the term *private foundation* appears in the Internal Revenue Code. This technical tax law definition, however, does not match the generic definition. Congress could have crafted a definition of private foundation in accord with the four unique attributes of foundations but it elected another approach. The reason for this distinction is rooted in the history of private foundation law, which came into being in 1969.

When most of the law as to private foundations was created in that year, Congress was in a horrific anti-foundation mood. The antipathy toward foundations at that time was substantial, largely because members of Congress were being regaled with tales of foundation abuse (mostly apocryphal) and many were in a populist mind-set, with foundations seen as playthings (and pocketbooks) of the wealthy. Consequently, when fashioning a definition of the term *private foundation*, Congress was careful to write

it in such a way as to minimize the likelihood that crafty tax lawyers would find ways around the foundation laws.

Thus, the technical definition of *private foundation* has two key characteristics:

1. Despite the fact that the Internal Revenue Code purports to define the term, it does not. Instead, the Code defines what a private foundation isn't. (A private foundation is a tax-exempt charitable organization that is not a public charity.)
2. A unique feature in the law causes every tax-exempt charity in the United States to be *presumed* to be a private foundation. Among other outcomes, this forces nearly all charities that are not private foundations to convince the Internal Revenue Service of that fact and be officially classified as public entities. Put another way, a charitable organization that cannot, or subsequently fails to, qualify as a public charity is, by operation of law, a private foundation.

#### PRIVATE OPERATING FOUNDATIONS

As noted, one of the characteristics of a conventional private foundation is that it is a grant-maker. That is, the typical foundation serves as a funder of the charitable programs of other organizations. There are some private foundations, however, that, instead of grant-making, use their funds principally to administer their own charitable programs. This type of private foundation is known as a *private operating foundation*, with the word *operating* intended to convey this feature of internal program operations (rather than external funding). (These foundations are exempt from the standard income distribution requirement [see Chapter 4].) Some museums, libraries, housing and health care facilities, and scientific research entities, for example, are structured as private operating foundations. To qualify as an operating foundation, a private foundation must meet an income test and one of three other tests: an assets test, an endowment test, or a support test.

A private foundation satisfies the *income test* if it expends at least 85% of the lesser of its (1) *minimum investment return* (which, as explained in Chapter 4, is an amount equal to 5% of the foundation's investment assets) or (2) adjusted net income for the direct, active conduct of charitable activities. *Adjusted net income* is the amount of income from charitable functions, investment activities, set-asides, unrelated business, and short-term capital gains that exceeded the cost incurred in earning the income.

To meet the *assets test*, a private foundation must directly use at least 65% of its assets for the active conduct of charitable activities. Satisfaction of the *endowment test* requires that the foundation regularly make distributions for the active conduct of charitable activities in an amount not less than two-thirds of its minimum investment return. To meet the *support test*, a

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private foundation must regularly receive substantially all of its support (other than from gross investment income) from the public or from five or more qualifying exempt organizations; receive no more than 25% of its support (other than from gross investment income) from any one qualifying exempt organization; and receive no more than 50% of its support in the form of gross investment income.

### **EXEMPT OPERATING FOUNDATIONS**

Certain private operating foundations are exempt from the excise tax on net investment income paid by most private foundations (discussed later in this chapter). This type of operating foundation must maintain public support for a minimum of 10 years; maintain a governing body at all times that is broadly representative of the public, where no more than 25% of that board consists of disqualified individuals; and not have at any time during the year an officer who is a disqualified individual. These foundations are also exempt from the expenditure responsibility requirements (see Chapter 5).

### **CONDUIT FOUNDATIONS**

A *conduit private foundation* is not a separate category of private foundation; it is a standard private foundation that, under certain circumstances, is regarded as a public charity for charitable contribution deduction purposes. A foundation functions as a conduit when it makes qualifying distributions (see Chapter 4) that are treated as distributions from its corpus in an amount equal to 100% of all contributions received in the year involved, whether as money or property. These distributions, to qualify, must be made not later than the 15th day of the third month after the close of the foundation's tax year in which the contributions were received. The foundation must not have any remaining undistributed income for the year.

These distributions are treated as made first out of contributions of property and then out of contributions of money received by the private foundation in the year involved. The distributions cannot be made to an organization controlled, directly or indirectly, by the distributing foundation or by one or more disqualified persons (see Chapter 2) with respect to the foundation or to a private foundation that is not a private operating foundation.

### **NONEXEMPT CHARITABLE TRUSTS**

Nonexempt charitable trusts are trusts that are not tax exempt but are treated as private foundations for federal tax law purposes. These trusts are funded and operated in nearly identical fashion as exempt private

foundations. This type of trust has exclusively charitable interests; donors to them are allowed to claim a tax deduction for charitable contributions. Unlike private foundations, nonexempt charitable trusts are required to pay an annual tax on income that is not distributed for charitable purposes.

### CONCEPT OF PUBLIC CHARITY

The dichotomy thus established in the Internal Revenue Code forces every U.S. charity to be classified as a public charity or a private foundation. This is by no means an equal division, in that, while there are millions of public charities, there are about 80,000 private foundations. (This disparity as to numbers, however, is not reflected in any balancing of the volume of federal tax law concerning charitable organizations; there are many pages of rules in the Internal Revenue Code that are applicable only to private foundations.)

As noted, a private foundation is a tax-exempt charitable organization that is not a public charity. The Code “definition” of *private foundation* focuses on the meaning of the term *public charity*. There are many categories of public charities. From a big-picture standpoint, however, there are four types of public charities: the *institutions*, *publicly supported charities*, *supporting organizations*, and (of minor import) *public safety testing organizations*.

As will be seen, public charities tend to be organizations with inherently *public* activity, entities that are financially supported by the public, or entities that have a close operating relationship with one or more other public charities. The term *public* can, however, be misleading; it is not used in the sense of a governmental entity (department, agency, etc.). The confusion is emblematic in the notion that a private school is a public charity. (Governmental entities are public charities.)

Most private foundations confine their grant-making to public charities. Therefore, it is essential (to avoid tax penalties [see Chapter 4]) that foundations having that approach understand the various ways in which a tax-exempt charitable organization can also be a public charity.

### INSTITUTIONS

A category of public charity is loosely defined as *institutions*. These are entities that have inherently public activity. Embraced by the ambit of the institutions are churches, certain other religious organizations, schools, colleges, universities, hospitals, medical research organizations, and governmental units.

#### Churches

A *church* (including a synagogue and a mosque) is a public charity. The federal tax law is imprecise in defining this term, largely due to constitutional law (First Amendment) constraints. Although the term is not defined in the

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Internal Revenue Code, the IRS formulated criteria that it uses to ascertain whether a religious organization constitutes a *church*. Originally, these criteria (unveiled in 1977) were in a list of 14 elements, not all of which needed to be satisfied. These elements include:

- A distinct legal existence
- A recognized creed and form of worship
- An ecclesiastical government
- A formal code of doctrine and discipline
- A distinct religious history
- A literature of its own
- Established places of worship
- Regular congregations
- Regular religious services
- Schools for the religious instruction of youth and preparation of its ministers

Over the ensuing years, however, the IRS has added criteria and become more rigid (and inconsistent) in its interpretation of the term *church*. It is currently the position of this agency that, to be a church, an organization must—in addition to being *religious*—have a defined congregation of worshippers, an established place of worship, and regular religious services. Some of the criteria in the original 14-element list have been downgraded in importance, as being common to tax-exempt organizations in general.

### **Associations and Conventions of Churches**

Some religious entities are public charities because all of their members are churches. An *association of churches* is a church-membership entity where the membership is confined to churches in a state. A *convention of churches* is a church-membership entity where the membership embraces a multistate region of the United States or perhaps the entire nation.

### **Educational Institutions**

An *educational institution* is a public charity. The concept of what is *educational* is much broader than *educational institution*, so it is insufficient for these purposes that an organization is merely educational in nature. To be an educational institution, an organization must normally maintain a regular faculty and curriculum, and normally have a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. This type of institution is generically a *school*;

consequently, it must have as its primary function the presentation of formal instruction.

Educational institutions that qualify for public charity status include primary, secondary, preparatory, and high schools and colleges and universities. (Public schools are public charities by virtue of being units of government.) An organization cannot achieve public charity status as an operating educational institution where it is engaged in educational (institution-type) and educational (non-institution-type) activities, unless the latter activities are merely incidental to the former. For example, an organization cannot qualify as this type of public charity if its primary function is the operation of a museum, rather than the presentation of formal instruction.

A *university* generally is an institution of higher learning with teaching and research facilities, comprising an undergraduate school that awards bachelor's degrees and a graduate school and professional schools that award master's or doctor's degrees. A *college* is generally referred to as a school of higher learning that grants bachelor's degrees in liberal arts or sciences; the term is also frequently used to describe undergraduate divisions or schools of a university that offer courses and grant degrees in a particular field. The term *school* is defined as a division of a university offering courses of instruction in a particular profession; the term is also applicable to institutions of learning at the primary and secondary levels of education.

An organization may be regarded as presenting formal instruction even though it lacks a formal course program, or formal classroom instruction. For example, an organization that conducted a survival course was classified as a public charity, even though its course periods were only 26 days and it used outdoor facilities more than classrooms; it had a regular curriculum, faculty, and student body. By contrast, an organization, the primary activity of which was providing specialized instruction by correspondence and a five- to ten-day seminar program of personal instruction for students who completed the correspondence course, did not qualify as an operating educational institution.

Even if an organization qualifies as a school or other type of formal educational institution, it will not be able to achieve public charity (or tax-exempt) status if it maintains racially discriminatory admissions policies or if it benefits private interests to more than an insubstantial extent. As an illustration of the latter, an otherwise qualifying school that trained individuals for careers as political campaign professionals was denied exempt status because of the private benefit accruing to a national political party and its candidates, inasmuch as nearly all of the school's graduates became employed by or consultants to the party's candidates.

### **Hospitals**

A tax-exempt organization, the principal purpose or functions of which are the provision of medical or hospital care, medical education, or medical research, if the organization is a hospital, is a public charity. The term *hospital*

includes exempt federal government hospitals; state, county, and municipal hospitals that are instrumentalities of governmental units; rehabilitation institutions; outpatient clinics; extended-care facilities or community mental health or drug treatment centers; and cooperative hospital service organizations. This term does not include convalescent homes, homes for children or the elderly, or institutions whose principal purpose or function is to train disabled individuals to pursue a vocation, nor does it include free clinics for animals. The term *medical care* includes the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, as long as the cost of the treatment is deductible by the individual treated.

### **Medical Research Organizations**

A *medical research organization* directly engaged in the continuous active conduct of medical research in conjunction with a public charity hospital can qualify as a public charity. The term *medical research* means the conduct of investigations, experiments, and studies to discover, develop, or verify knowledge relating to the causes, diagnosis, treatment, prevention, or control of physical or mental diseases and impairments of human beings. To qualify, an organization must have the appropriate equipment and professional personnel necessary to carry out its principal function. *Medical research* encompasses the associated disciplines spanning the biological, social, and behavioral sciences.

An organization, to be a public charity under these rules, must have the conduct of medical research as its principal purpose or function and be primarily engaged in the continuous active conduct of medical research in conjunction with a qualified hospital. The organization need not be formally affiliated with an exempt hospital to be considered primarily engaged in the active conduct of medical research in conjunction with the hospital. There must, however, be a joint effort on the part of the research organization and the hospital to maintain close cooperation in the active conduct of the medical research. An organization is not considered to be primarily engaged directly in the continuous active conduct of medical research unless it, during a computation period, devotes more than one-half of its assets to the continuous active conduct of medical research or it expends funds equaling at least 3.5% of the fair market value of its endowment for the continuous active conduct of medical research.

If an organization's primary purpose is to disburse funds to other organizations for the conduct of research by them or to extend research grants or scholarships to others, it is not considered directly engaged in the active conduct of medical research.

### **Public College Support Foundations**

Public charity status is accorded to certain organizations providing support for public (governmental) colleges and universities. This type of organization

must normally receive a substantial part of its support (exclusive of income received in the performance of its tax-exempt activities) from the United States and/or direct or indirect contributions from the public. It must be organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university that is a public charity and that is an agency or instrumentality of a state or political subdivision of a state, or that is owned or operated by a state or political subdivision or by an agency or instrumentality of one or more states or political subdivisions.

These expenditures include those made for any one or more of the regular functions of these colleges and universities, such as the acquisition and maintenance of real property comprising part of the campus; the construction of college or university buildings; the acquisition and maintenance of equipment and furnishings used for or in conjunction with regular functions of these colleges and universities; or expenditures for scholarships, libraries, and student loans.

#### **Governmental Units**

The United States, possessions of the United States, the District of Columbia, states, and their political subdivisions are classified as *governmental units*, which are public charities. This type of a unit qualifies as a public charity without regard to its sources of support, partly because it is responsive to all citizens. The concept of a governmental unit also embraces government instrumentalities, agencies, and entities referenced by similar terms.

#### **Other Institutions**

One of the many anomalies of the federal tax law is that some of the charitable institutions in U.S. society that are not generically private foundations are not accorded a public charity classification, unlike churches, schools, hospitals, and the like. Organizations in this position include museums, libraries, and organizations that operate orchestras and operas. To be public charities, these entities must be publicly supported or (much less likely) be structured as supporting organizations (as discussed later in this chapter). Some of these types of organizations are private operating foundations or exempt operating foundations (as discussed previously in this chapter).

### **DONATIVE PUBLICLY SUPPORTED ORGANIZATIONS**

A way for a tax-exempt charitable organization to be a public charity is to receive its financial support from a suitable number of sources. A publicly supported charity is the antithesis of a private foundation, in that a foundation customarily derives its funding from one source, whereas a publicly supported charitable organization is (by definition) primarily or wholly

supported by the public. One type of publicly supported charity—the *donative* type—is an organization the revenues of which are in the form of a range of contributions and grants.

### General Rules

An organization is a donative publicly supported entity if it is a tax-exempt charitable organization that normally receives a substantial part (defined later in this section) of its support (other than income from the performance of one or more exempt functions) from a governmental unit or from direct or indirect contributions from the public. It is this focus on support in the form of gifts and grants that causes this type of organization to be considered a *donative* one.

Organizations that qualify as donative publicly supported entities generally are organizations such as museums of history, art, or science; libraries; community centers to promote the arts; organizations providing facilities for the support of an opera, symphony orchestra, ballet, or repertory drama group; organizations providing some other direct service to the public; and organizations such as the American National Red Cross or that conduct federated fundraising campaigns.

The principal way for an organization to be a publicly supported charity under these rules is for it to normally derive at least one-third of its financial support from qualifying contributions and grants. (This one-third threshold is the definition of the phrase *substantial part* in this context.) Thus, an organization classified as this type of publicly supported charity must maintain a *support fraction*, the denominator of which is total gift and grant support received during the computation period (defined later in this chapter) and the numerator of which is the amount of support qualifying in connection with the one-third standard from eligible public and/or governmental sources for the period. The cash basis method of accounting is used in making these calculations.

### 2% Rule

A 2% ceiling is generally imposed on contributions and grants in determining public support. Only this threshold amount of a particular gift or grant is counted as public support, under this rule, irrespective of whether the contributor or grantor is an individual, corporation, trust, private foundation, or other type of entity (taking into account amounts given by related parties). In computing public support in this manner, the IRS has traditionally used a four-year measuring period, consisting of the organization's most recent four years. Beginning with the 2008 tax year, however, the measuring period is the organization's most recent five years.

An illustration will undoubtedly be helpful. Consider a charitable organization that received total gift and grant support in the amount of \$1 million during the measuring period. In that instance, all contributions and grants

up to \$20,000 each are counted as public support (the total of them being the numerator of the support fraction). The amount of all gifts and grants during the period comprise the denominator of that fraction. If a person gave, for example, \$80,000 during the measuring period, only \$20,000 is public support from that source for that period. This organization thus must receive, during the period, at least \$333,334 in contributions or grants of \$20,000 or less each. It could receive \$666,666 from one source and \$10,000 each from 34 sources, or \$20,000 each from 17 sources, for example.

A meaningful exception to this rule is available. Support received by a donative publicly supported charity from governmental units and/or other donative publicly supported charities is considered to be a form of *indirect* contributions from the public (in that these grantors are regarded as conduits of direct public support). This type of support is public support in its entirety. That is, this form of funding is not limited by the 2% rule. The same is true with respect to support from charitable organizations that satisfy the donative publicly supported organization definition, even though they are classified as some other form of public charity (such as a church).

For these purposes, the legal nature of the donors and/or grantors is not relevant. That is, in addition to individuals, charities, and governments, public support can be derived from for-profit entities (such as corporations and partnerships) and nonprofit entities (including various forms of charitable and noncharitable tax-exempt organizations). In another example of the English language failing in this regard, private foundations can be sources of public support. Generally, the fact that contributions or grants are restricted or earmarked does not detract from their qualification as public support.

Nonetheless, the 2% limitation applies with respect to support received from a donative publicly supported charitable organization or governmental unit if the support represents an amount that was expressly or impliedly earmarked by a donor or grantor to the publicly supported organization or unit of government as being for or for the benefit of the organization asserting status as a publicly supported charitable organization.

### **Support Test**

A matter that can be of considerable significance in determining whether a charitable organization can qualify as a donative publicly supported entity is the meaning of the term *support*. For this purpose, *support* means amounts received in the form of, as noted, contributions (including corporate sponsorships) and grants, along with net income from unrelated business activities (see Chapter 8), gross investment income, tax revenues levied for the benefit of the organization and paid to or expended on behalf of the organization, and the value of services or facilities (exclusive of services or facilities generally furnished to the public without charge) furnished by a governmental unit to the organization without charge. All of these

items comprise the denominator of the support fraction. (The larger the denominator, the greater the amount of public support that is allowed by the 2% threshold.) *Support* does not include gain from the disposition of property that is gain from the sale or exchange of a capital asset; the value of exemption from any federal, state, or local tax or any similar benefit; or funding in the form of a loan.

In constructing the support fraction, an organization must exclude from the numerator and the denominator any amounts received from the exercise or performance of its exempt purpose or function and contributions of services for which a charitable contribution deduction is not allowable. An organization will not be treated as meeting this support test, however, if it receives *almost all* of its support in the form of gross receipts from related activities and an insignificant amount of its support from governmental units and/or the public. Moreover, the organization can exclude from the numerator and the denominator of the support fraction an amount equal to one or more unusual grants (discussed later in this chapter).

### **Concept of *Normally***

In computing the support fraction, the organization's support that is *normally* received must be reviewed. This means that the organization must meet the one-third support test for a period encompassing the five tax years immediately preceding the year involved, on an aggregate basis. (Prior to 2008, this measuring period was four years.) When this is accomplished, the organization is considered as meeting the one-third support test for its current tax year and for the tax year immediately succeeding its current tax year. For example, if an organization's current tax year is calendar year 2009, the computation period for measuring public support pursuant to these rules is calendar years 2004–2008; if the support fraction requirement is satisfied on the basis of the support received over this five-year period, the organization satisfies this support test for 2009 and 2010. (A five-year period for meeting this support test is available for organizations during the initial five years of their existence.)

### **Unusual Contributions or Grants**

Under the *unusual grant* rule, a contribution or grant may be excluded from the public support fraction. A gift or grant is *unusual* if it is an unexpected and substantial amount attracted by the public nature of the organization and received from a disinterested party. (Thus, this term is somewhat of a misnomer. The exception is not confined to grants and the operative word should be *unexpected*, not *unusual*.)

A number of factors are taken into account in this regard; no single factor is determinative. The positive factors follow, with their opposites (negative factors) in parentheses:

- The contribution or grant is from a person with no connection to the charitable organization. (The contribution or grant is received from a person who created the organization, is a substantial contributor (see Chapter 2) to it, is a board member, an officer, or is related to one of these persons.)
- The gift or grant is in the form of cash, marketable securities, or property that furthers the organization's exempt purposes. An example of the latter is a gift of a painting to a museum. (The property is illiquid, difficult to dispose of, and/or not suitable in relation to the organization's functions.)
- No material restrictions or conditions are placed on the transfer.
- The organization attracts a significant amount of support to pay its operating expenses on a regular basis, and the gift or grant adds to an endowment or pays for capital items. (The gift or grant is used for operating expenses for several years; nothing is added to an endowment.)
- The gift is a bequest. (The gift is an *inter vivos* [lifetime] transfer.)
- An active fundraising program attracts significant public support. (Gift and grant solicitation programs are limited or unsuccessful.)
- A representative and broad-based governing body controls the organization. (Related parties are in control.)
- Prior to the receipt of the unusual grant, the organization qualified as a publicly supported entity. (The unusual grant exclusion was relied on in the past to satisfy the test.)

#### **Facts-and-Circumstances Test**

One of the defects of the donative organization support rules is that organizations that are not private foundations in a generic sense, because they have many of the attributes of a public organization, may nonetheless be classified as private foundations because they cannot meet the somewhat mechanical one-third support test. Charitable organizations with this dilemma can include entities such as museums and libraries that heavily rely on their endowments for financial support and thus have little or no need for contributions and grants. Although the statutory law is silent on the point, the tax regulations somewhat ameliorate this rigidity of the general rule by means of a *facts-and-circumstances test*.

The history of an organization's programmatic and fundraising efforts, and other factors, can be considered as an alternative to the rather strict mechanical formula for qualifying as a public charity under the general donative publicly support charitable organization rules. These factors must be present for this test to be met:

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- Public support (computed pursuant to the general rule) must be at least 10% of the total support, and the higher the better.
- The organization must have an active “continuous and bona fide” fundraising program designed to attract new and additional public and governmental support. Consideration will be given to the fact that, in its early years of existence, the charitable organization may limit the scope of its gift and grant solicitations to those persons deemed most likely to provide seed money in an amount sufficient to enable it to commence its charitable activities and expand its solicitation program.
- Other favorable factors must be present, such as:
  - The composition of the organization’s governing board is representative of broad public interests.
  - Support is derived from governmental and other sources representative of the public.
  - Facilities and programs are made available to the public.
  - The organization’s programs appeal to a broad range of the public.

As to the governing board factor, the organization’s public charity status will be enhanced where it has a governing body that represents the interests of the public, rather than the personal or private interests of a limited number of donors. This can be accomplished by the election of board members by a broad-based membership or by having the board composed of public officials, individuals having particular expertise in the field or discipline involved, community leaders, and the like.

As noted, one of the important elements of this facts-and-circumstances test is the availability of facilities or services to the public. Example of entities meeting this standard are a museum that holds its building open to the public, a symphony orchestra that gives public performances, a conservation organization that provides services to the public through the distribution of educational materials, and a home for the elderly that provides domiciliary or nursing services for members of the public.

### Issues

Nine issues can arise in computing the public support component (the numerator) of the support fraction for donative publicly supported organizations. They are:

1. Proper calculation of the denominator of the support fraction
2. Whether a payment constitutes a contribution or a grant

3. Whether a membership fee can be treated as a contribution rather than a payment for services
4. Whether a payment pursuant to a contract is a grant rather than revenue from a related activity (exempt function revenue)
5. Whether a grant is from another donative publicly supported charity (or a charity *described in* the rules)
6. Whether a grant from a publicly supported charity or governmental unit is a pass-through transfer from another grantor
7. Whether a grant constitutes an unusual grant
8. Whether an organization is primarily dependent on gross receipts from related activities
9. Whether the organization needs to rely on the facts-and-circumstances test

The fourth item warrants additional mention. When the term *contract* is used in this context, it usually connotes a payment for services rendered or goods provided, which means that the funds involved are exempt function revenue and thus must be excluded from the support fraction. Confusion can arise because a grant is often the subject of a contract, although in that setting the term used usually is *agreement*. While sometimes it is difficult to differentiate between the two, a *grant* is a payment made to a charitable organization to enable it to operate one or more programs, while a payment pursuant to a contract is for the acquisition of a good or service.

The principal point with these issues is that the resolution of them can materially affect the construct of the support fraction and thus the public support percentage. Sometimes, an organization will want to exclude a large amount from the fraction (such as a payment made in accordance with a contract) so as to increase the support percentage. It is not uncommon for a support fraction to be improperly computed, so that the resulting public support percentage is below the one-third threshold. It can be a great joy for a tax lawyer to review a draft of an anemic public support fraction calculation, and discover, for example, that a grant that was limited by the 2% threshold can in fact be counted in full as public support (issue 5) or that a large grant can in fact be excluded from the fraction as an unusual grant (issue 7), thereby enabling the charitable organization to report a public support ratio that is considerably in excess of the one-third minimum.

### **Community Foundations**

In the world of charities, the term *foundation* is often used in conjunction with an organization that is not a *private foundation*. An illustration of this

word interplay is the *community foundation*, which usually is a donative publicly supported charity. These foundations almost always attract, receive, and depend on financial support from members of the public on a regular, recurring basis. Community foundations are designed to attract large contributions of a capital or endowment nature, with the gifts often received and maintained in separate trusts or funds. These entities are generally identified with a particular community and are controlled by a representative group of persons in that area.

For classification as a public charity, however, a community foundation wants to be regarded as a single entity, rather than an aggregation of funds. To be treated as a component part of a community foundation, a trust or fund must be created by gift or similar transfer and may not be subjected by the transferor to any material restriction. A community foundation must, to be considered a single entity, be appropriately named, be so structured as to subject its funds to a common governing instrument, have a common governing body, and prepare periodic financial reports that treat all funds held by the foundation as its assets. The board of a community foundation must have the power to modify any restriction on the distribution of funds where it is inconsistent with the charitable needs of the community, must commit itself to the exercise of its powers in the best interests of the foundation, and must commit itself to seeing that the funds are invested in accordance with standards of fiduciary conduct.

A private foundation may make a grant to a designated fund within a community foundation (often a donor-advised fund [see Chapter 11]). The private foundation can receive a payout credit (see Chapter 4) for this type of grant, even though it acquires the ability to make recommendations as to distributions to other charitable organizations from the fund, as long as there are no prohibited material restrictions. Grants of this nature are regarded as made to the community foundation as an entity and not to a discrete fund.

#### **SERVICE PROVIDER PUBLICLY SUPPORTED ORGANIZATIONS**

The second way that a tax-exempt charitable organization can be a publicly supported entity is to be a *service provider* organization. As is the case with the donative organization rules, qualification for public charity status focuses on sources of revenue, although there are considerable differences between the two ways to compute public support. Public support in this context includes gifts and grants, but also includes forms of exempt function revenue. Thus, this type of publicly supported charity usually has a major portion of its support in the form of fees and like charges derived from the conduct of its programs, such as exempt dues-based entities, theaters, arts organizations, educational publishers, day care centers, and animal shelters.

A two-part support test must be met for an organization to qualify as this type of publicly supported charity:

- Investment income cannot exceed one-third of total support. *Total support* basically is all of the organization's gross revenue normally received (discussed later in this chapter), other than capital gains and the value of exemptions from local, state, and federal taxes.
- More than one-third of total support must be a combination of:
  - Contributions, grants, and membership dues from sources other than disqualified persons (see Chapter 2)
  - Admission fees to exempt function facilities or activities, such as payments for theater tickets, access to a museum or historical site, seminars, lectures, and athletic events
  - Fees for performance of services, such as day care fees, counseling fees, testing fees, laboratory fees, library fines, animal neutering charges, and athletic activity fees
  - Sales of merchandise related to the organization's exempt purpose, including books and other educational literature, pharmaceuticals and medical devices, handicrafts, reproductions and copies of original works of art, byproducts of a blood bank, and goods produced by disabled workers

Exempt function revenue from one source may not be treated as public support to the extent it is in excess of \$5,000 or 1% of the total support of the organization, whichever is higher.

### **Permitted Sources**

Generally, to be public support under these rules, the support must be derived from *permitted sources*. Consequently, a charitable organization seeking to qualify as a publicly supported entity under these rules must construct a support fraction, with the amount of support from permitted sources constituting the numerator of the fraction and the total amount of support being the fraction's denominator.

*Permitted sources* are certain public and publicly supported charitable organizations, governmental units, and persons other than disqualified persons (see Chapter 2) with respect to the organization. Thus, in general, support (other than from disqualified persons) from another service provider publicly supported organization, a supporting organization (see below), any other tax-exempt organization (other than the institutions and donative publicly supported organizations, a for-profit organization, or an individual constitutes public support for this type of organization, albeit

limited in some instances (see next section). The cash basis method of accounting is used in making these determinations.

### Support

The term *support* means (in addition to the categories of public support, which may include corporate sponsorships) (1) net income from any unrelated business (see Chapter 8), (2) gross investment income, (3) tax revenues levied for the benefit of the organization and either paid to or expended on behalf of the organization, and (4) the value of services or facilities (other than services or facilities generally furnished to the public without charge) furnished by a governmental unit. These items of support are combined to constitute the denominator of the support fraction.

The concept of support does not include (1) any gain from the disposition of a capital asset; (2) the value of local, state, and/or federal tax exemptions or similar benefits, and (3) the proceeds of a loan.

### Limitations on Support

The support taken into account in determining the numerator of the support test under these rules must come from permitted sources. Thus, transfers from disqualified persons (see Chapter 2) cannot qualify as public support under the service provider publicly supported organizations rules. The fact that a contribution or grant is restricted or earmarked does not detract from its qualification as public support.

In determining the amount of support in the form of gross receipts that is allowable in calculating the numerator of this support fraction, gross receipts from related activities (other than membership fees) from any person or from any bureau or similar agency of a governmental unit are includible in any tax year only to the extent that these receipts do not exceed the greater of \$5,000 or 1% of the organization's total support for that year.

The phrase *bureau or similar agency* of a government means a specialized operating (rather than a policy-making or administrative) unit of the executive, judicial, or legislative branch of a government, usually a subdivision of a department of a government. Therefore, an organization receiving gross receipts (a grant) from both a policy-making or administrative unit of a government (e.g., the Agency for International Development [AID]) and an operational unit of a government's department (e.g., the Bureau for Latin America, an operating unit within AID) is treated as receiving gross receipts from two sources, with the amount from each agency separately subject to the \$5,000/1% limitation.

A somewhat similar *permitted sources* limitation excludes support from a disqualified person, including a substantial contributor (see Chapter 2). In general, a *substantial contributor* is a person who contributes, grants, or bequeaths an aggregate amount of more than \$5,000 to a charitable

organization, where that amount is more than 2% of the total contributions, grants, and bequests received by the organization before the close of its tax year in which the contribution or the like from the person is received. As noted, however, grants from governmental units and certain public charities are not subject to this limitation.

The federal tax law defines and distinguishes the various forms of support referenced in the service provided publicly supported organizations rules: *contributions* or *gross receipts*, *grant* or *gross receipts*, *membership fees*, *gross receipts* or *gross investment income*, and *grant* or *indirect contribution*. For example, the term *gross receipts* means amounts received from the conduct of an activity related to an exempt function where a specific service, facility, or product is provided to serve the direct and immediate needs of the payor; a *grant* is an amount paid to confer a direct benefit for the public. A payment of money or transfer of property without adequate consideration generally is a *contribution* or a *grant*. The furnishing of facilities for a rental fee or the making of loans in furtherance of an exempt purpose will likely give rise to *gross receipts* rather than *gross investment income*. The fact that a membership organization provides services, facilities, and the like to its members as part of its overall activities will not result in the fees received from members being treated as *gross receipts* rather than *membership fees*.

#### **Investment Income Test**

An organization, to be classified as a service provider publicly supported charity, must normally receive no more than one-third of its support from (1) gross investment income, including interest, dividends, royalties, rent, and payments with respect to securities loans, and (2) any excess of the amount of unrelated business taxable income over the amount of tax on that income. To qualify under this test, an organization must construct a *gross investment income fraction*, with the amount of gross investment income and any unrelated income (net of the tax paid on it) constituting the numerator of the fraction and the total amount of support being the denominator. On occasion, there may be an issue as to whether a revenue item is a *gross receipt* from the performance of an exempt function or is *gross investment income*.

#### **Concept of Normally**

These public support and investment income tests are computed on the basis of the nature of the organization's *normal* sources of support. An organization is considered as *normally* receiving at least one-third of its support from permitted sources and no more than one-third of its support from gross investment income for its current tax year and immediately succeeding tax year if, for the *measuring period*, the aggregate amount of support received over the period from permitted sources is more than one-third of its total support and the aggregate amount of support over the period from gross investment income is not more than one-third of its total support.

In computing support under these rules, the IRS has traditionally used a four-year measuring period, involving the organization's most recent years. Beginning with the 2008 tax year, however, the measuring period is the organization's most recent five years. For example, if an organization's current tax year is calendar year 2009, the computation period for measuring support pursuant to these rules is calendar years 2004–2008; if the support fraction is satisfied on the basis of the support received over this five-year period, the organization satisfies this support test for 2009 and 2010. (A five-year period for meeting these support tests has long been available for organizations during the initial five years of their existence.)

### Issues

The issues that arise in connection with calculation of public support under the service provider publicly supported organization rules are somewhat the same as those that can emerge in the donative publicly supported organization context ("discussed previously"). Of the nine issues in that setting, numbers 1 through 4 and 7 apply equally here. (A facts-and-circumstances test is not available for service provider entities.) There are five other potential issues (and thus a total of ten issues) for service provider publicly supported organizations:

1. Accurate identification of the organization's disqualified persons (see Chapter 2)
2. Correct computation of exempt function revenue
3. Correct application of the 1% rule
4. Whether a grant is from another service provider publicly supported organization (or a charity described in the rules)
5. Correct ascertainment of gross investment income

### COMPARATIVE ANALYSIS OF PUBLICLY SUPPORTED CHARITIES

The two principal types of publicly supported charities can simultaneously meet both public support tests if they have a broad base of financial support in the form of contributions and grants. Indeed, many charities can easily satisfy either test at any time.

A significant deviation arises, however, concerning the matter of *exempt function revenue*. In the case of donative publicly supported charities, exempt function revenue is omitted from the fraction and too much of it can prevent or cause loss of public charity status. By contrast, some or all of exempt function revenue can be public support for service provider publicly supported charities. This distinction is one of the principal determinants for

a charitable organization in deciding which category of publicly supported charity is appropriate. A dues-based charitable organization, for example, would almost always select the service provider publicly supported charity classification.

There are other considerations. The donative publicly supported charity calculates its public support using a rather mechanical formula, while the service provider publicly supported charity must go through the machinations of determining whether any of its financial support has been derived from disqualified persons. The donative publicly supported charity status has a preferred aura, if only because the service provider publicly supported charity (usually being fee-based) can appear too commercial in nature. Most service provider publicly supported charities are not permitted to maintain a pooled income fund (see Chapter 9), although today this is not much of a distinction because these funds are out of favor.

## SUPPORTING ORGANIZATIONS

A category of tax-exempt charitable organization that is a public charity is the *supporting organization*. Charitable supporting organizations usually are entities that do not qualify as *institutions* or *publicly supported charities* but are sufficiently related to one or more charitable organizations that are institutions or are publicly supported organizations so that the requisite degree of public control and involvement is considered present. Certain types of non-charitable tax-exempt organizations also may be supported organizations.

A supporting organization must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more eligible supported organizations. Also, a supporting organization must be operated, supervised, or controlled by one or more qualified supported organizations, supervised or controlled in connection with one or more such organizations, or operated in connection with one or more such organizations. A parsing of this rule has led to a quadruple classification of supporting organizations:

- Parents and subsidiaries (also known as Type I supporting organizations)
- Commonly controlled organizations (Type II)
- Functionally integrated organizations (Type III)
- Nonfunctionally integrated organizations (also Type III)

A third fundamental requirement is that a supporting organization must not be controlled, directly or indirectly, by one or more disqualified persons (other than foundation managers or eligible supported organizations).

A supporting organization may be created by one or more donors or by an organization that becomes the supported organization. To qualify as a supporting organization, a charitable entity must meet an organizational test and an operational test.

### **Organizational Test**

A supporting organization must be organized exclusively to support or benefit one or more specified public institutions, publicly supported charitable organizations, or certain noncharitable organizations. Its articles of organization must limit its purposes to one or more of the purposes that are permissible for a supporting organization, may not expressly empower the organization to engage in activities that are not in furtherance of these purposes, must state the specified entity or entities on behalf of which it is to be operated, and may not expressly empower the organization to operate to support or benefit any other organization.

To qualify as a supporting organization, an organization's stated purposes may be as broad as, or more specific than, the purposes that are permissible for a supporting organization. Thus, an organization that is formed "for the benefit of" one or more eligible supported organizations will meet this organizational test, assuming the other requirements are satisfied. An organization that is *operated, supervised, or controlled by* (a Type I entity) or *supervised or controlled in connection with* (Type II) one or more qualified supported organizations to carry out their purposes will satisfy these requirements if the purposes stated in the articles of organization are similar to, but no broader than, the purposes stated in the articles of the supported organization or organizations.

An organization will not meet this organizational test if its articles of organization expressly permit it to operate to support or benefit any organization other than its specified supported organization or organizations. The fact that the actual operations of the organization have been exclusively for the benefit of one or more specified eligible supported organizations is not sufficient to permit it to satisfy this organizational test.

### **Operational Test**

A supporting organization must be operated exclusively to support or benefit one or more specified qualified supported organizations. Unlike the definition of the term *exclusively*, as applied in the context of charitable organizations generally, which has been held by the courts to mean *primarily* (see Chapter 3), the term *exclusively* in the supporting organization context means *solely*.

A supporting organization must engage solely in activities that support or benefit one or more eligible supported organizations. One way to do this, although it is not mandated but will be in certain instances (see Chapter 11), is for the supporting organization to make grants to the supported organi-

zation; this is often done, for example, where the supporting organization houses an endowment for the benefit of a supported organization. Another form of support or benefit occurs where a supporting organization carries on a discrete program or activity on behalf of a supported organization. In one instance, a tax-exempt hospital wanted a facility near the hospital in which patients about to undergo serious surgery, and their families and friends, could stay in immediate advance of the surgical procedure; the hospital created a supporting organization, which purchased a nearby motel and converted it into the facility the hospital needed. In another case, a supporting organization, supportive of the academic endeavors of the medical school at an exempt university, was used to operate a faculty practice plan in furtherance of the teaching, research, and service programs of the school. A supporting organization may engage in fundraising activities, such as solicitation of contributions and grants, special events, and unrelated business, to raise funds for one or more supported organizations or other permissible beneficiaries.

The allowable activities of a supporting organization may include making payments to or for the use of, or providing services or facilities for, members of the charitable class benefited by the charitable supported organization. A supporting organization may make a payment indirectly through an unrelated organization to a member of a charitable class benefited by a supported charitable organization but only where the payment constitutes a grant to an individual rather than a grant to the organization.

A supporting organization has many characteristics of a private foundation, such as the absence of any requirement that it be publicly supported. Thus, like a private foundation, a supporting organization can be funded entirely by investment income. It can satisfy this organizational test by engaging solely in investment activity, assuming charitable ends are being served.

### **Specification Requirement**

As noted, a supporting organization must be organized and operated to support or benefit one or more *specified* supported organizations. This specification must be in the supporting organization's articles of organization, although the manner of the specification depends on which of the types of relationships with one or more eligible supported organizations is involved.

Generally, it is expected that the articles of organization of the supporting organization will designate (i.e., *specify*) each of the supported organizations by name. If the relationship is one of *operated, supervised, or controlled by* (Type I) or *supervised or controlled in connection with* (Type II), however, designation by name is not required as long as the articles of organization of the supporting organization require that it be operated to support or benefit one or more beneficiary organizations that are designated by class or purpose and that include one or more supported organizations, as to which there is one of these two relationships, or organizations that

are closely related in purpose or function to supported organizations as to which there is one of the two relationships (in either instance, where there is no designation of the organization(s) by name). If the relationship is one of *operated in connection with* (Type III), the supporting organization must designate the supported organization or organizations by name.

A supporting organization is deemed to meet the specification requirement, even though its articles of organization do not designate each supported organization by name—irrespective of the nature of the relationship—if there has been a historical and continuing relationship between the supporting organization and the supported organizations and, by reason of that relationship, there has developed a substantial identity of interests between the organizations.

Nonetheless, in practice, it is common to specify the supported organization or organization in the supporting organization's articles of organization, irrespective of the type of supporting organization.

### **Required Relationships**

As noted, to meet these requirements, an organization must be operated, supervised, or controlled by or in connection with one or more eligible supported organizations. Thus, if an organization does not stand in at least one of the required relationships with respect to one or more eligible supported organizations, it cannot qualify as a supporting organization. Regardless of the applicable relationship (Type I, II, or either of the IIIs), it must be ensured that the supporting organization will be *responsive* to the needs or demands of one or more eligible supported organizations and that the supporting organization will constitute an *integral part* of or maintain a *significant involvement* in the operations of one or more qualified supported organizations. (Additional information about these relationships and other supporting organization rules is in Chapter 11.)

### **Operated, Supervised, or Controlled By**

The distinguishing feature of the relationship between a supporting organization and one or more eligible supported organizations encompassed by the phrase *operated, supervised, or controlled by* is the presence of a substantial degree of direction by one or more supported organizations in regard to the policies, programs, and activities of the supporting organization. This is a relationship comparable to that of a parent and subsidiary (Type I).

### **Supervised or Controlled in Connection With**

The distinguishing feature of the relationship between a supporting organization and one or more eligible supported organizations encompassed by the phrase *supervised or controlled in connection with* is the presence of common supervision or control by the persons supervising or controlling the supporting organizations and the supported organization(s) to ensure that the

supporting organization will be responsive to the needs and requirements of the supported organization(s). Therefore, in order to meet this requirement, the control or management of the supporting organization must be vested in the same individuals who control or manage the supported organization(s) (Type II).

### **Operation in Connection With**

Qualification as a supporting organization by reason of the *operated in connection with* relationship entails the least intimate of the relationships between a supporting organization and one or more supported organizations. This relationship usually is more of a programmatic one than a governance one. This type of relationship (Type III), prevalent for example in the health care field, is often structured so as to avoid legal liability, from the standpoint of a supported organization, for something done by the supporting organization.

The distinguishing feature of the relationship between a supporting organization and one or more supported organizations encompassed by this phrase is that the supporting organization must be responsive to and significantly involved in the operations of the supported organization or organizations. Generally, to satisfy the criteria of this relationship, a supporting organization must meet a *responsiveness test* and an *integral part test*.

### **Noncharitable Supported Organizations**

Certain tax-exempt organizations that are not charitable entities qualify as supported organizations; this means that a charitable organization that is supportive of one or more of these noncharitable entities constitutes a supporting organization. These eligible supported organizations are exempt social welfare organizations [501(c)(4) entities]; labor, agricultural, and horticultural organizations [501(c)(5) entities]; and business leagues, such as trade associations [501(c)(6) entities]. The principal requirement is that these organizations have to satisfy the one-third support test applicable to service provider publicly supported organizations. These organizations frequently meet this support requirement because they have a membership that pays dues.

This rule is principally designed to facilitate public charity status for related foundations and other funds (such as scholarship, award, and research funds) operated by the specified noncharitable organizations. This type of supporting organization can be in an awkward position: It must be charitable in function to be tax exempt, yet be supportive of a noncharitable entity to be a public charity.

### **Substitutions**

The federal tax law is vague as to how a supported organization with respect to a supporting organization can be changed (substituted), without loss of

the supporting organization's public charity status. In what may be the only example of this type of substitution to date, the IRS ruled that a tax-exempt entity could retain its status as a supporting organization, notwithstanding a transaction in which a supported organization was substituted. An exempt university caused a related supporting organization to become affiliated with another entity that also functioned to support and benefit the university. This ruling is of limited utility in understanding the bounds of supported organization substitution, however, because, under the facts of the ruling, the functions of the supporting organization remained essentially the same and it continued to indirectly support the university.

An organization that is *operated in connection with* one or more eligible supported organizations can satisfy the specification requirement (discussed earlier in this chapter) even if its articles of organization permit an eligible supported organization that is designated by class or purpose to be substituted for the supported organizations designated by name in its articles but only if the substitution is conditioned on the occurrence of an event that is beyond the control of the supporting organization. This type of event includes, as to a supported organization, loss of tax exemption, substantial failure or abandonment of operations, or dissolution of the entity.

#### **Limitation on Control**

As noted, one or more disqualified persons with respect to a supporting organization, other than its officers and the like (technically termed *foundation managers*) cannot (without jeopardizing its public charity status), directly or indirectly, control the organization. An individual who is a disqualified person with respect to a supporting organization does not lose that status because a beneficiary supported organization appoints or designates him or her to be a foundation manager of the supporting organization, to serve as a representative of the supported organization.

A supporting organization is considered *controlled* if the disqualified persons, by aggregating their votes or positions of authority, may require the organization to perform an act that significantly affects its operations or may prevent the supporting organization from performing this type of an act. Generally, control exists if the voting power of these persons is 50% or more of the total voting power of the organization's governing body or if one or more disqualified persons have the right to exercise veto power over the actions of the organization. All pertinent facts and circumstances, including the nature, diversity, and income yield of an organization's holdings, the length of time particular securities or other assets are retained, and the manner of exercising its voting rights with respect to securities in which members of its governing body also have an interest, are taken into consideration in determining whether a disqualified person does in fact indirectly control an organization.

Caution needs to be exercised in this context. The IRS can find indirect control of a supporting organization by disqualified persons by going beyond the foregoing rules. One such instance involved a charitable organization that made distributions to a tax-exempt university. The organization's board of directors was composed of a substantial contributor to the organization; two employees of a business corporation, of which more than 35% of the voting power was owned by the disqualified person; and an individual selected by the university. None of the directors had veto power over the organization's actions. Conceding that disqualified persons did not directly control the organization, the IRS said that "one circumstance to be considered in whether a disqualified person is in a position to influence the decisions of members of the organization's governing body who are not themselves disqualified persons." Thus, the IRS concluded that the two directors who were employees of the disqualified person corporation should be considered the equivalent of disqualified persons for purposes of applying the 50% control rule. This position led to the conclusion that the organization was indirectly controlled by disqualified persons and, therefore, could not be a public charity by virtue of being a qualified supporting organization.

#### **PUBLIC SAFETY TESTING ORGANIZATIONS**

Another category of organization that is deemed to be a public charity is an organization that is organized and operated exclusively for testing for public safety. Although these entities are considered public charities, they are not eligible to receive tax-deductible charitable contributions.

#### **IMPORT OF PUBLIC-PRIVATE DICHOTOMY**

As a general proposition—and this is from a law standpoint—public charity status is preferable to private foundation status. That is, again, purely from the perspective of the law, there is no advantage to a charitable organization in being a private foundation. (There is nothing inherently wrong in being a private foundation, of course, and about 80,000 of them function quite nicely in that capacity.)

The biggest disadvantage of classification as a private foundation is that a charitable organization is subject to and expected to comply with the private foundation rules concerning mandatory payouts, self-dealing, excess business holdings, jeopardizing investments, and prohibited expenditures (see Chapters 4 through 8). Public charities are generally not caught up in this barrage of restrictions and requirements.

Having said that, however, some of the private foundation rules are being applied in the public charity setting. The excess business holdings

rules are applicable to certain supporting organizations (see Chapter 11). At this time, Congress and the IRS are working on mandatory payout requirements for some supporting organizations. Although the self-dealing rules (see Chapter 6) do not apply to public charities, rules as to excess benefit transactions apply in connection with public charities; in several instances, the requirements are the same. Certain basic principles of the law, such as the private inurement and private benefit doctrines (see Chapter 3) are applicable to both categories of charitable organizations.

Another disadvantage to private foundation status is that the charitable giving rules (see Chapter 9) considerably favor public charities. This problem (if there is one) usually is presented at the time a private foundation is initially funded, either because percentage limitations restrict the extent of a charitable contribution deduction or because a deduction for a gift of property is confined to the donor's basis in the property.

### **SOME STATISTICS**

The IRS collects data on private foundations and nonexempt charitable trusts, based on information in these organizations' annual information returns (see Chapter 10). The most recent year for which the IRS has developed these statistics is 2004.

For that year, the total number of returns filed by private foundations was 76,897; nonexempt charitable trusts filed 3,511 returns. The fair market value of foundations' assets for that year was \$509.9 billion; the asset value for charitable trusts was about \$5.6 billion. Private foundations disbursed \$32.1 billion, of which \$27.6 billion was in the form of grants; charitable trusts distributed \$332 million. Private foundations had \$58.7 billion in total revenue in 2004; nonexempt charitable trusts had total revenue in the amount of \$502 million. Private foundations had \$34 billion in net investment income; the net investment income of nonexempt charitable trusts was \$304 million.

Large private foundations—those with \$50 million or more in fair market value of total assets at the end of tax year 2004—accounted for the majority of financial activity by the annual return filers. Although they represented less than 2% of the filers (including nonexempt charitable trusts), they held 67% of the aggregate fair market value of total assets. Nearly 60% of all assets were held by the 610 private foundations with assets valued at \$100 million or more. Large foundations received 57% of the revenue and distributed 55% of the grants.

For 2004, ten private foundations held nearly one-fifth of private foundations' assets, totaling \$97.1 billion. The largest of these foundations held \$28.8 billion in assets; the tenth largest of these foundations held \$5 billion in assets. The largest private foundation grant-maker distributed \$1.3 billion in 2004; the tenth largest grant-maker made grants totaling \$210 million.

**SUMMARY**

This chapter provided basic information as to the distinctions between private foundations and public charities. The types of public charities were discussed, as were the different types of private foundations. Particular emphasis was placed on the various ways a tax-exempt charitable organization can qualify as a publicly supported entity and on the types of supporting organizations. The chapter included a comparative analysis of publicly supported charities and explained the significance of the private foundation–public charity dichotomy. The chapter concluded with a summary of the IRS’s statistics concerning private foundations and nonexempt charitable trusts.

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