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DECODING THE PUBLIC SUPPORT TEST

How the IRS Distinguishes Public Charities from Private Foundations

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EXECUTIVE SUMMARY

- **CHARITABLE NONPROFITS ARE DIVIDED INTO TWO MAIN CATEGORIES BY THE INTERNAL REVENUE SERVICE (IRS): PUBLIC CHARITIES, WHICH RECEIVE SUPPORT FROM A RANGE OF SOURCES, AND PRIVATE FOUNDATIONS, WHICH ARE PRIMARILY FUNDED BY ONE, OR FEW, SOURCES.**

- **PUBLIC CHARITIES AND PRIVATE FOUNDATIONS BOTH PLAY AN IMPORTANT ROLE IN THE CHARITABLE SECTOR, BY SUPPORTING CIVIL SOCIETY AND SERVING COMMUNITIES IN NEED. COMBINED, INDIVIDUAL DONATIONS TO CHARITIES AND GRANTS FROM PRIVATE FOUNDATIONS MAKE UP ALMOST 90 PERCENT OF TOTAL CHARITABLE GIVING.**

- **WITH A DIFFERENT SET OF RULES FOR EACH, THE IRS DETERMINES WHETHER AN ENTITY IS A PUBLIC CHARITY OR PRIVATE FOUNDATION BY EMPLOYING THE PUBLIC SUPPORT TEST. TO QUALIFY AS A PUBLIC CHARITY, A NONPROFIT ORGANIZATION MUST RECEIVE AT LEAST ONE THIRD OF ITS CONTRIBUTIONS FROM THE GENERAL PUBLIC, GOVERNMENT SOURCES, OR NONPROFIT FUNDING INTERMEDIARIES.**

- **ORGANIZATIONS DETERMINED BY THE PUBLIC SUPPORT TEST TO BE PRIVATE FOUNDATIONS HAVE LOWER TAX DEDUCTIBLE GIVING LIMITS, MORE ONEROUS REGULATORY RESTRAINTS, AND MORE RESTRICTIONS ON FUNDS.**

- **PROPOSALS TO REFORM THE PUBLIC SUPPORT TEST COME WITH IMPORTANT CONSEQUENCES FOR THE CHARITABLE SECTOR, INCLUDING OVERCOMPLICATING DETERMINATION REQUIREMENTS AND SHUTTING OUT CERTAIN CHARITABLE VEHICLES FROM BEING COUNTED TOWARD THE PUBLIC SUPPORT TEST.**

INTRODUCTION

Philanthropy Roundtable supports the longstanding American tradition of establishing nonprofit organizations that serve communities in need and advance diverse causes. The U.S. charitable sector is an ever-changing landscape that includes a wide range of organizations structured in different ways. While all charitable organizations play an important role in their communities, public charities remain a critical vehicle for providing direct services to vulnerable individuals and families as well as supporting a myriad of other charitable missions.

Public charities are distinct from private foundations, as they typically receive a significant portion of their funding from the general public. They also often have a broader mission than private foundations, which may focus their grantmaking efforts on more specific causes or projects. Public charities can be further broken down into "donative," "commercial," and "per se" public charities. For simplicity's sake, we will cover the importance of these distinctions, including per se charities, in more depth later in the policy primer. According to the latest available IRS data, there are almost 1.4 million public charities registered in the United States.[1] Some public charities, such as the Red Cross or a local food bank, focus on providing relief to communities, while other charities focus their efforts on providing services such as zoos, museums, and hospices.

Unlike public charities, which typically receive a significant portion of their funding from public sources, private foundations are often established and funded by a single individual, family, or corporation and funded by a smaller number of donors or in some instances a single donor. This means donors to private foundations may have more control over how the funds are used and may be able to direct their donations to specific causes or organizations that align with their interests or values. According to the latest available data, there are almost 125,000 domestic grantmaking foundations registered in the United States.[2]

Private foundations can be further broken down into operating versus nonoperating foundations. Operating foundations actively engage in the day-to-day operations of their charitable work such as running educational programs, conducting research, or providing services related to their mission. Nonoperating foundations provide financial support to other organizations that align with their mission through grantmaking efforts. For purposes of this primer, we are primarily referring to nonoperating foundations when we discuss the difference between private foundations and public charities. Nonoperating foundations make up 93 percent of all private foundations and foundation assets.[3]

The distinction between public charities and private foundations matters because public charities benefit from their status in several ways. Public charities qualify for more favorable tax exemptions and deductible donations, while private foundations are subject to more stringent regulatory requirements such as self-dealing rules and minimum payout requirements.

While these descriptive distinctions sound simple enough, the Internal Revenue Service has a complex set of provisions in the Internal Revenue Code to determine whether a nonprofit organization is a public charity or a private foundation. This is where the public support test comes into play.

1 Author's calculations based the Internal Review Service Exempt Organizations Business Master File.

2 IRS, Exempt Organizations Business Master File.

3 "Key Facts on U.S. Nonprofits and Foundations." Candid. Last modified June 2021. https://www.issuelab.org/resources/38265/38265.pdf.

HISTORICAL CONTEXT FOR THE PUBLIC SUPPORT TEST

While the definitive government distinction between public charities and private foundations was first provided under the Tax Reform Act of 1969, the public charity versus private philanthropy debate had been developing since the early 20th century. In the early years of the 20th century, several charitable organizations secured federal charters, being incorporated by Congress. Among these were the Rockefeller-funded General Education Board (1903) and the Carnegie Foundation for the Advancement of Teaching (1906).[4]

However, this period was also marked by growing political populism, the rise of antitrust law, and skepticism of philanthropic foundations with large endowments. For example, when John Rockefeller Sr., a distinguished philanthropist who by 1909 had given away $158 million of personal funds to various causes, applied for a federal charter to establish the Rockefeller Foundation in 1910, Congress rejected the application.[5] Congressional proceedings and media coverage were both dominated by populist apprehensions about foundation assets growing "beyond the control of ordinary government restrictions."[6]

During the next four decades, policymakers focused little attention on the operations of private foundations. It wasn't until the economic boom period following World War II that policymakers once again turned their focus to scrutinizing philanthropic foundations.

The number of philanthropic foundations, and especially small family foundations, had increased from some twenty-seven organizations in 1915 to 4,162 in 1955.[7] This growth combined with the rise of reactionary thinking provoked congressional scrutiny. While populist anxieties in the early 20th century were fueled by fears of concentrated private wealth, in the 1950s populist anxieties were rooted in the idea that foundations had "swung far to the left," accused of supporting communist efforts, and stirring up "class and race dissension."[8]

A series of congressional and Treasury reports, notably spearheaded by southern Democratic politicians, stirred up political skepticism and ill feeling toward charitable foundations. For example, Representative Edward Cox (D-GA) launched a select committee to investigate foundations in 1952. Cox was a segregationist who accused the Rockefeller Foundation, which was engaged in social reform and international relations, of helping to lose China to communism and accused the Rosenwald Fund of stirring up racial tensions in the south.[9]

The 1960s brought another surge of congressional testimony when Representative Wright Patman (D-TX) led an investigation as chair of the House Committee on Banking and Small Business. Patman was a signee of the "Southern Manifesto" and led this investigation in 1961 based on his concern that foundations were a tool of the wealthy employed to preserve their own class interest.[10] Specifically, Patman opposed liberal foundations, such as the Ford Foundation, because he believed they promoted internationalism and civil rights. Patman was also the first to testify before the House Committee

4 Lankford, James E. *"Congress and the Foundations in the Twentieth Century." Wisconsin State University,* 1964.

5 "John Rockefeller Sr." Philanthropy Roundtable (blog). n.d. https://www.philanthropyroundtable.org/hall-of-fame/john-rockefeller-sr/.

6 *The New York Times.* "Rockefeller Charter: Conceives that it might safeguard control of standard oil." 1910.

7 Lankford. "*Congress and the Foundations.*" 1964.

8 Lankford. pp 34-36.

9 Lankford. pp 34.

10 Brilliant, Eleanor L. Private Charity and Public Inquiry: A History of the Filer and Peterson Commissions. Bloomington: Indiana University Press, 2001.

on Ways and Means on the tax reform bill. Chief among concerns raised in testimony was the Ford Foundation's support for civil rights organizations, including registering African American voters and decentralizing school districts.

With growing political pressures to investigate foundations, the Treasury Department issued its own report in 1965. The report found six major problems associated with foundations: self-dealing, the delay in benefit to charity, foundation involvement in business, family use of foundations to control corporate and other property, financial transactions unrelated to charitable functions, and donor involvement in foundation management.[11]

Treasury lawyer Thomas Troyer sums up how proposed regulations on foundations in 1969 seemed to spring, "from a penumbra of congressional mistrust of foundations".[12]

While the 1965 Treasury report found the vast majority of organizations were fully compliant with the law, Congress nevertheless pursued legislation to address the potential problems outlined by Treasury. The 1969 Tax Reform Act included a new set of restrictions and regulations on these organizations. Notably, this law provided a government definition of "private foundation" for the first time. The act defined private foundations as 501(c)(3) organizations that do not meet the criteria of broad-based public support that determined "public charity" status.[13] To make this distinction between private foundation and public charity, the IRS created the public support test.

WHY THE DISTINCTION BETWEEN PUBLIC CHARITY AND PRIVATE FOUNDATION MATTERS

Nonprofit organizations that meet the requirements of the public support test benefit from public charity status in several ways. For example, private foundations must adhere to strict rules that prohibit transactions with insiders, such as board members and major donors, while public charities are subject to less stringent rules in this regard. As well as a prohibition on self-dealing, private foundations are generally prohibited from engaging in any non-charitable expenditures, such as lobbying activities or donations to non-U.S. charities.

11 United States Senate Committee on Finance. Treasury Department Report on Private Foundations. 1965.

12 Troyer, Thomas. "1969 Private Foundation Law: Historical Perspective on its Origins and Underpinnings." *Exempt Organization Tax review 27,* no 1 (2000), 61.

13 Labovitz, John R. "*The Impact of the Private Foundation Provisions of the Tax Reform Act of 1969: Early Empirical Measurements." The Journal of Legal Studies 3,* no. 1 (1974), 63105.

Another important requirement for private foundations that originated from the 1969 Tax Reform Act is the mandatory payout requirement. While public charities are not subject to a minimum distribution requirement, private foundations are required to distribute funds in an amount equal to at least 5 percent of their assets each year. Specifically, section 4942 of the Internal Revenue Code requires private foundations to distribute 5 percent of the fair market value of their endowment each year for charitable purposes.[14] Studies on foundation asset growth find that a 5 percent minimum threshold balances the perpetuity of private foundations with the objective of benefiting communities and society.[15]

Private foundations are also subject to excess business holdings rules. These rules limit the amount of stock or other ownership interests that a private foundation can hold in a for-profit corporation. Under the Excess Business Holdings rules, a private foundation is generally not allowed to hold more than 20 percent of the voting stock of a for-profit corporation. If the foundation does acquire more than 20 percent of the voting stock, it has a five-year grace period to divest the excess holdings. If the foundation fails to divest the excess holdings within the five-year period, it may be subject to excise taxes on the excess holdings.

Public charities also have higher donor tax-deductible giving limits than private foundations. While private foundation donors can only deduct up to 30 percent of adjusted gross income, public charity donors can typically deduct up to 50 percent of their adjusted gross income.[16] However, under IRS Publication 526 the contribution limit has been raised to 60 percent for contributions made between tax years 2018 and 2025.[17] For example, if a donor with an adjusted gross income (AGI) of $1,000,000 donates $600,000 to a public charity, they can deduct up to 60% of their AGI, which means they could get a tax deduction on the full amount donated, significantly reducing their taxable income. If the same donor gave an equal amount to a private nonoperating foundation, they could only deduct up to 30 percent of their AGI, meaning they could get up to a $300,000 tax deduction, leaving them with a heavier tax burden compared to the option of donating to a public charity.

In addition to differences in tax exemption limits, private foundations are subject to a 1.39 percent excise tax on investment income. This tax on investment income typically covers dividends, interest, capital gains, rents, royalties, and income earned through stocks, bonds, and real estate investments. When the tax was first applied as part of the 1969 tax reform law, the tax rate was set at 4 percent, but was subsequently reduced to 1-2 percent in the late 1970s.

The following table outlines some of the key differences in regulatory requirements between public charities and private foundations.

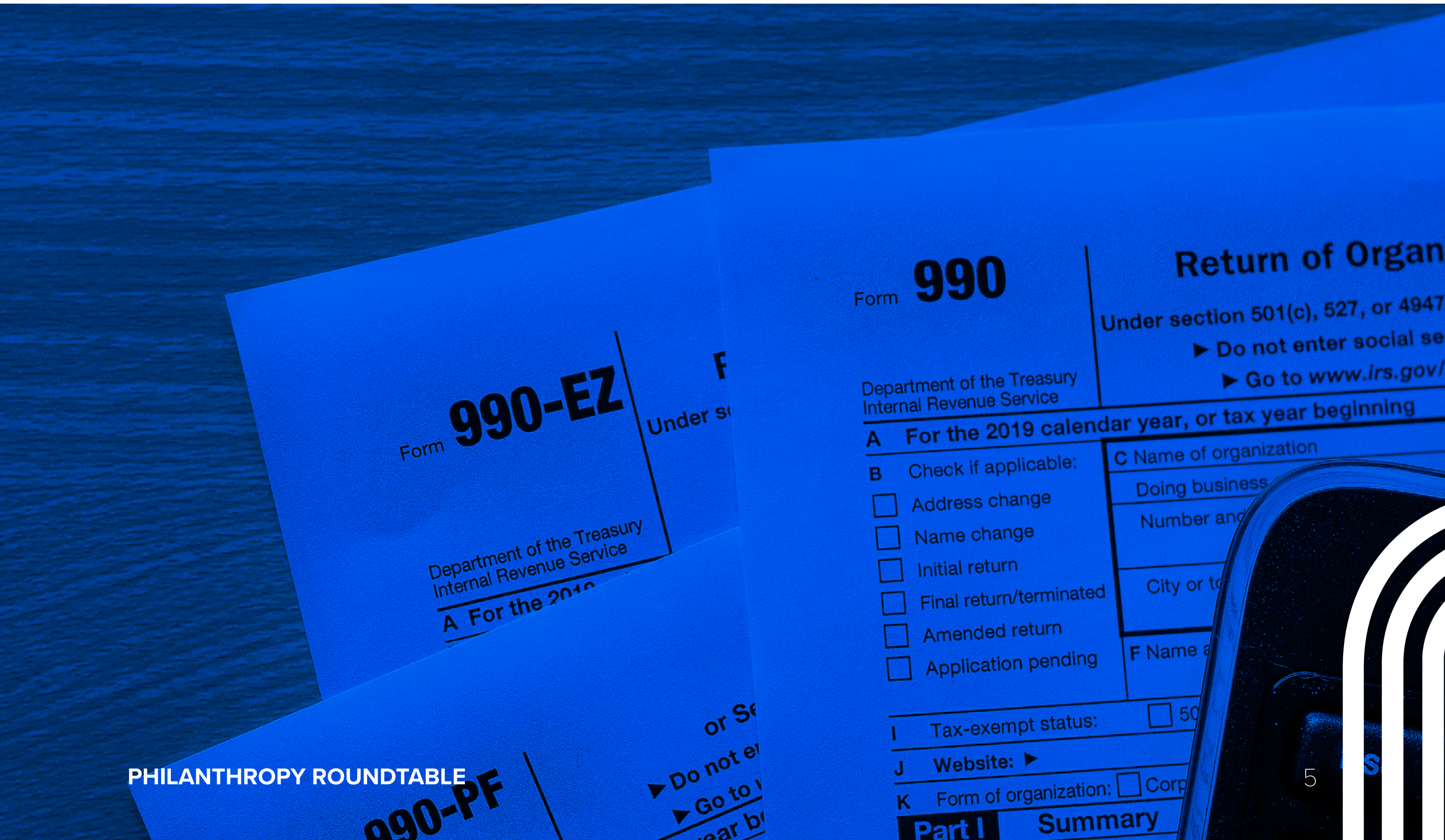
14 Farish, Carl. "The 5% Rule Explained." Pacific Foundation Services. Last modified January 20, 2020. https://pfs-llc.net/resource/the-5-rule-explained/#:~:text=In%20short%2C%20the%20U.S.%20government,each%20year%20for%20charitable%20purposes.

15 "Sustainable Payouts for Private Foundations." Council of Michigan Foundations, 2016. https://www.michiganfoundations.org/resources/sustainable-payout-foundations-2016-update-study.

16 "Charitable Contribution Deductions." Internal Revenue Service. Last modified August 25, 2022. https://www.irs.gov/charities-non-profits/charitable-organizations/charitable-contribution-deductions.

17 "Publication 526." Internal Revenue Service. Accessed June 23, 2023. https://www.irs.gov/pub/irs-pdf/p526.pdf.

Regulatory Requirement	Private Foundation	Public Charity
Minimum distribution	Must distribute at least 5 percent of assets annually	No minimum distribution requirement
Self-dealing rules	Prohibited from engaging in transactions with disqualified persons i.e., board members, donors, founders etc.	Similar restrictions, but less stringent
Excess business holdings	Limited in the amount of stock (20 percent) they can hold in a for-profit corporation	No restrictions on holding stock in a for-profit corporation
Restrictions on non-charitable activities	Prohibited from engaging in lobbying or supporting political activities	Allowed to engage in limited lobbying activities and advocacy/ education efforts
Excise taxes	Subject to excise taxes on activities such as self-dealing and failure to distribute income	Generally, not subject to excise taxes
Annual reporting requirements	Must file Form 990-PF annually with the IRS	Must file Form 990, 990EZ, or 990N annually with the IRS
Tax on net investment income	Subject to a 1.39 percent excise tax on net investment income	Generally, not subject to a tax on net investment income



MECHANISMS FOR MEASURING PUBLIC SUPPORT

Before delving into the mechanics of the public support test, it is important to consider some basic definitions of nonprofit organizations and various types of public charities. The table below breaks down these definitions with examples for each.

Type	Definition	Examples
Nonprofit organization	An organization that is organized and operated exclusively for charitable, educational, religious, scientific, literary, or other similar purposes	• Charitable organizations • Churches & religious organizations • Private foundations
Donative public charity	A public charity that receives the bulk of its support from charitable donations	• The Red Cross • A local food bank
Commercial public charity	A public charity that receives most of its public support in the form of fees for services	• Zoos • Museums • Hospices
Per-se public charity	Organizations exempt from the public support test because their institutional types are automatically exempt in the IRS code.	• Houses of worship • Educational institutions • Charitable support organizations • Hospitals

The public support test is a set of complex provisions outlined in the Internal Revenue Code, which determines the public charity designation of nonprofit organizations under section 501(c)(3). According to academic research published in 2017, roughly six-in-seven or 85 percent of public charities are subject to the public support test.[18] The remaining 15 percent of charities are defined as "per se" public charities which are exempt from the public support test because their institutional types—houses of worship, educational institutions, hospitals, and charitable support organizations—are automatically exempt in the IRS code.

There are two versions of the public support test described in the tax code: one test defined in Internal Revenue Code section 170 and another in section 509. While section 170 applies to organizations that are defined as donative public charities, section 509 applies to commercial public charities. Other than these differences, the support test for both types of charities **requires that at least one-third of revenues come from the public broadly**, including nonprofit funding

18 Horne, Christopher S. "*The Democratizing Role of the Public Support Test in the Determination of Nonprofits' Public Charity Status." Nonprofit and Voluntary Sector Quartely 46,* no. 6 (2017), 1293-1309.

intermediaries, and government funding sources. The public support test is based on a five-year computation period that consists of the current year and the four years immediately preceding the current year.[19]

Public Charity Determination: Support from General Public and Government, Divided by Total Support, Must be Greater than or Equal to One-Third

In its calculation of total support for a charitable organization, the IRS includes: gifts, grants, contributions, membership fees, net income from unrelated business activities, gross investment income, tax revenues levied for the benefit of the organization, and the value of services furnished by a government unit to the organization.[20] Once the IRS determines the total support a charity received in a given year, it then calculates what share of this total support came from the public broadly. The public support test considers any contribution by an individual, trust, or corporation to be public support, so long as the contribution does not exceed 2 percent of the organization's total support. For *commercial public charities*, any contribution from individuals or non-501(c)(3) organizations must not exceed $5,000 or 1 percent of total revenues (whichever is larger). Specifically, a nonprofit organization must receive at least 33-1/3 percent (one-third) of its support from the general public and government support to be considered a public charity.

If, on the other hand, the percentage of public support remains below 33-1/3 percent for two consecutive years, the organization risks losing its public charity status and may have to file as a private foundation. New charitable organizations are exempt from the public support test, with a five-year grace period.[21] Once this grace period has passed, those organizations will be subject to the same test.

Example of Calculation in Practice

The figures below illustrate how this calculation works in practice. In this scenario, Charity A qualifies as a public charity as it only received 10 percent of total contributions from individuals and non-501(c)(3) organizations whose donations exceeded 2 percent of total revenue.

With 90 percent public support, Charity A comfortably exceeds the 33-1/3 percent minimum requirement.

Charity A	
Total contributions	$1,000,000
Amount from individuals or non-501(c)(3) organization that exceeds 2 percent of total revenue	$100,000
Amount from individuals or non-501(c)(3) organizations that don't exceed 2 percent of total revenue or contributions from other 501(c)(3) organizations	$700,000
Government grants	$200,000
Percent public support	**90 percent**

19 "Advance Ruling Process Elimination - Public Support Test." Internal Revenue Service. Last modified October 5, 2022. https://www.irs.gov/charities-non-profits/charitable-organizations/advance-ruling-process-elimination-public-support-test.

20 Reilly, John F., and Jones, David W. *Basic Determination Rules for Publicly Supported Organizations and Supporting Organizations*. Internal Revenue Service, 1993.

21 Advance Ruling Process Elimination - Public Support Test. Internal Revenue Service.

A separate entity, Charity B, received 70 percent of its total contributions from individuals and non-501(c)(3) organizations whose donations exceeded 2 percent of total revenue. In this case, Donor A made a gift of $250,000, Donor B made a gift of $400,000, and Donor C made a gift of $50,000 for a total of $700,000. With only 30 percent public support, Charity B fails to reach or exceed the 33-1/3 percent to qualify as a public charity and therefore risks being reclassified as a private foundation.

Charity B	
Total contributions	$1,000,000
Amount from individuals or non-501(c)(3) organization that exceeds 2 percent	$700,000
Amount from individuals or non-501(c)(3) organizations that don't exceed 2 percent or contributions from other 501(c)(3) organizations	$100,000
Government grants	$200,000
Percent public support	**30 percent**

Alternative: The 10 Percent Facts and Circumstances Test

For charitable organizations that fail to meet the minimum requirements of 33-1/3 of public support under sections 170 and 509 of the Internal Revenue Code, there is a second test that may allow an organization to qualify as a public charity if it meets certain conditions. A charitable organization that fails to meet the 33-1/3 public support test requirement can still qualify as a public charity if it can provide enough evidence that "under all the facts and circumstances, it normally receives a substantial part of its support from governmental units or the general public."[22]

This is known as the **10 percent facts and circumstances test.**

As a starting point, organizations must meet two threshold requirements to rely on the 10 percent test as an alternative to the 33-1/3 of public support test:

1. The first requirement is that having failed to reach 33-1/3 public support, the organization must have at least 10 percent public support, which is calculated in the same manner as the standard public support test.
2. The second requirement says charitable organizations must uphold a "continuous and bona fide program" for the solicitation of funds from the general public, its membership, governmental entities, or other public charities. In other words, the charity must prove that although it failed the 33-1/3 test, it is engaged in a sincere and ongoing effort to raise its organizational funds from the general public, government, or other nonprofit organizations.

Under the facts and circumstances test, an organization is viewed more favorably depending on how much higher its level of public support is above the 10 percent minimum.[23] For example, a charity with 30 percent public support would be viewed more favorably than a charity with only 15 percent public support. If the organization can prove it typically engages in fundraising from the general public and has consistently received small donations in the past, this will also favor the organization opting for public charity status.

The composition of the representative governing body of the organization is also an important factor in the determination of public support. In this regard, the IRS stipulates that an organization will be viewed more favorably if it can demonstrate it "has a governing body which represents the broad interests of the public, rather

22 "Exempt Organizations Annual Reporting Requirements - Form 990, Schedules A and B: "Facts and Circumstances" Public Support Test." Internal Revenue Service. Last modified February 27, 2023. https://www.irs.gov/charities-non-profits/exempt-organizations-annual-reporting-requirements-form-990-schedules-a-and-b-facts-and-circumstances-public-support-test.

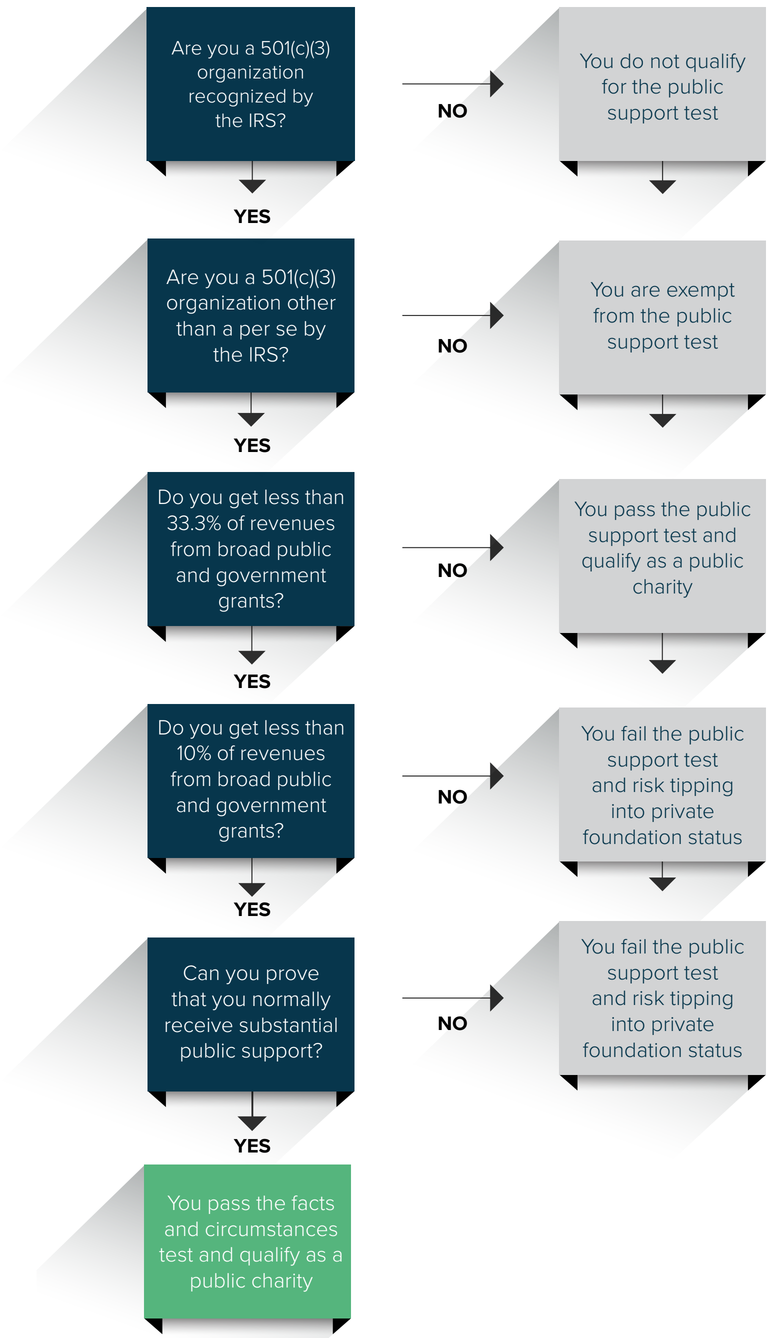
23 *Internal Revenue Service, Treasury | §1.170A–9*. Code of Federal Regulations, 2012. https://www.govinfo.gov/content/pkg/CFR-2012-title26-vol3/pdf/CFR-2012-title26-vol3-sec1-170A-9.pdf.

than the personal or private interests of a limited number of donors [or their family members or related business entities]."[24]

A final circumstance that would increase favorability under the facts and circumstances test is if an organization "provides facilities or services directly for the benefit of the general public on a continuing basis," for example operating a library or museum that is open to the general public.

By receiving more than 10 percent public support and proving through facts and circumstances that it is a publicly supported and public-serving organization, a charity can qualify as a public charity, even if it had failed the initial 33-1/3 public support test.

The following flow chart offers a simplified example of the public support test process.



24 "26 CFR § 1.170A-9 - Definition of section 170(b)(1)(A) organization." Cornell Law School | Legal Information Institute. Accessed April 5, 2023. https://www.law.cornell.edu/cfr/text/26/1.170A-9#:~:text=For%20purposes%20of%20this%20paragraph%20(f)(3)%2C%20an,normally%20received%20by%20such%20organization.

PUBLIC SUPPORT AND THE RISK OF TIPPING

When a public charity fails to meet the IRS public support test requirements for two consecutive years it risks losing its status as a public charity—this is referred to as tipping. A common cause of an organization tipping is when a public charity receives a large grant from a private foundation which tips the organization into private foundation status. For example, a public charity with $1,000,000 in revenue that typically receives half ($500,000) of its funding through "public support" would tip below the 33-1/3 public support threshold if it received a large grant of $600,000 from a private foundation for two consecutive years. Unless the public charity can prove through the facts and circumstances test that it normally receives a substantial part of its support from the general public or government grants, the organization would risk being reclassified as a private foundation.

This reclassification comes with significant risks and limitations. As outlined earlier in this primer, private foundations are subject to much stricter regulations regarding their spending and investment activities, they are required to pay a 1.39 percent excise tax on their net investment income each year and must pay out at least 5 percent of their assets in charitable grants annually. Private foundations are also limited in their ability to lobby or engage in political activities, and they are subject to more stringent rules regarding the types of grants they can make. In short, the risk of tipping status from public charity to private foundation comes with more stringent regulatory requirements and more burdensome annual return filing.

Another notable problem with tipping is it tends to impact smaller public charities which may not properly complete or be required to complete Schedule A. Schedule A is the part of the IRS's tax form 990 where exempt organizations provide the required information about public charity status and public support. Failing to fill out or improperly completing this task can result in a discovery of the classification change in a tax year that is several years after the actual tipping.[25] This delay can result in tax penalties, legal compliance issues, and various operational challenges.

To avoid the risks of tipping into private foundation status, organizations must take care to ensure they are meeting the public support test. This requires ongoing attention to fundraising and donor relations, as well as careful management of the organization's finances and activities. Charitable organizations should closely collaborate with their grantmakers to ensure funds are diversified, determining whether grants should be paid out as separate installments over time, and to carefully consider how payments are classified.[26]

RATIONALE AND EXTENT OF THE PUBLIC SUPPORT

Aside from the historical context that provides some rationale for why the IRS seeks to make a distinction between public charities and private foundations, the question remains, why does public policy provide these specific mechanisms for determining public charity status? One possible rationale is the public support test offers reassurance by ensuring a significant portion of the public perceives an organization to be fulfilling a charitable mission

25 Taxation of Exempts. Thomson Reuters, 2018. https://www.afslaw.com/sites/default/files/2018-08/Exempts0918.pdf.

26 "Tipping from Public Charity to Private Foundation Status." *NGO Source* (blog). January 2018 ,11. https://www.ngosource.org/blog/tipping-from-public-charity-to-private-foundation-status.

the public supports. Thus, the test promotes a democratic approach to determining which organizations qualify for public charity status.

This, in turn, aligns with the donative theory.[27] The donative theory holds that charitable gifts are motivated by the donor's desire to benefit a particular cause or community, rather than by any legal obligation or duty to do so. Therefore, the laws interpret and enforce charitable gifts in a way that gives effect to the donor's intent, if the gift meets certain requirements, such as being for a charitable purpose, and the recipient organization meets certain legal qualifications as a public charity.

Another potential rationale for the public support test is it fosters accountability for charitable organizations to the public, by encouraging multiple individuals to closely monitor whether an organization fulfills a wide range of charitable goals. A final potential rationale for the support test is it serves to proportionally measure a nonprofit's size against its public backing. In simpler terms, a charitable organization cannot retain its public charity status if its expansion is primarily attributed to the contributions of a single donor or a select few donors.

If donative and commercial nonprofit organizations are required to meet the 33-1/3 public support threshold, then another important question to consider is, to what extent do these organizations typically receive public support? While the existence of comprehensive data on this question is quite limited, there is one notable study using a sample of over 14,000 public charities that attempts to answer this question.[28] The research finds the vast majority of both donative and commercial public charities exceed the minimum requirements of the public support test. Specifically, the median percentage of revenue from public support is found to be 98 percent for commercial charities and 96 percent for donative charities. When breaking donative organizations down by age, organization size, and charitable issue focus, the median percentage of public support across all categories is uniformly high, from 89 percent to 100 percent.

27 Hall, Mark A., and Colombo, John D. "The Donative Theory of the Charitable Tax Exemption." *Ohio State Law Journal 52 (1991), 307-411.*

28 Horne. *The Democratizing Role of the Public Support Test*, 1293-1309.

PROPOSED CHANGES MAY RISK COMPLICATING THE PUBLIC SUPPORT TEST

As this primer illustrates, the public support test already represents a complex set of rules and requirements for qualifying public charities to abide by. However, potential regulatory changes to the public support test could risk making these regulatory requirements even more complicated, increasing the risks of tipping for public charities that strive to comply with existing regulations, and making it harder for charities to meet the parameters of the test.

Last year the U.S. Department of the Treasury and the Internal Revenue Service issued their Priority Guidance Plan Joint Statement.[29] The plan details more than 200 priorities, but chief among proposed changes to tax exempt organizations is a proposal to alter the guidance around the public-support computation with respect to distributions from donor-advised funds (DAFs). This follows the issuance of notice 2017-73 by the IRS and Treasury in December 2017 requesting comments on whether transfer of funds from private foundations to DAFs should be treated as qualifying distributions. While the language of the proposed regulatory change remains vague in its intent, many of the subjects under focus may cover similar principles as those introduced in the 117th session of Congress under the Accelerating Charitable Efforts Act (ACE Act).[30] One of those proposals involved treating anonymous DAF contributions received from sponsoring organizations as coming from one individual person, whether that is the case or not.

DAFs receive contributions from the general public and are themselves public charities. As a result, distributions from DAFs are typically considered public support.[31] This means that public charities can count contributions coming from DAFs as unique donations for the purpose of meeting the public support test. While some DAF grants may be made anonymously, there is no evidence that charities abuse the system to skirt the public support test in its current form.

Grants from DAFs to qualified charities totaled an estimated $45.74 billion in 2021 or over 9 percent of all charitable contributions.[32] Any proposed regulatory changes that seek to treat DAF contributions from multiple sources as coming from one individual person simply because they are given anonymously would hurt charities and the causes and communities they support. By further complicating the public support computation and effectively increasing the threshold to demonstrate public support, this change would make it harder for charities to obtain and retain their legitimate public charity status.

29 Batchelder, Lily, Rettig, Charles P.,and Paul, William M. 2022–2023 Priority Guidance Plan. Department of the Treasury, 2022. https://www.irs.gov/pub/irs-utl/2022-2023-pgp-initial.pdf.

30 *What's in the ACE Act, S.1981/H.R.6595?* Philanthropy Roundtable, 2022. https://www.philanthropyroundtable.org/wp-content/uploads/03/2022/Whats-In-The-ACE-Act-Overview.pdf.

31 Donor-Advised Fund Guide Sheet Explanation. Internal Revenue Service, 2008. https://www.irs.gov/pub/irs-tege/donor_advised_explanation_073108.pdf.

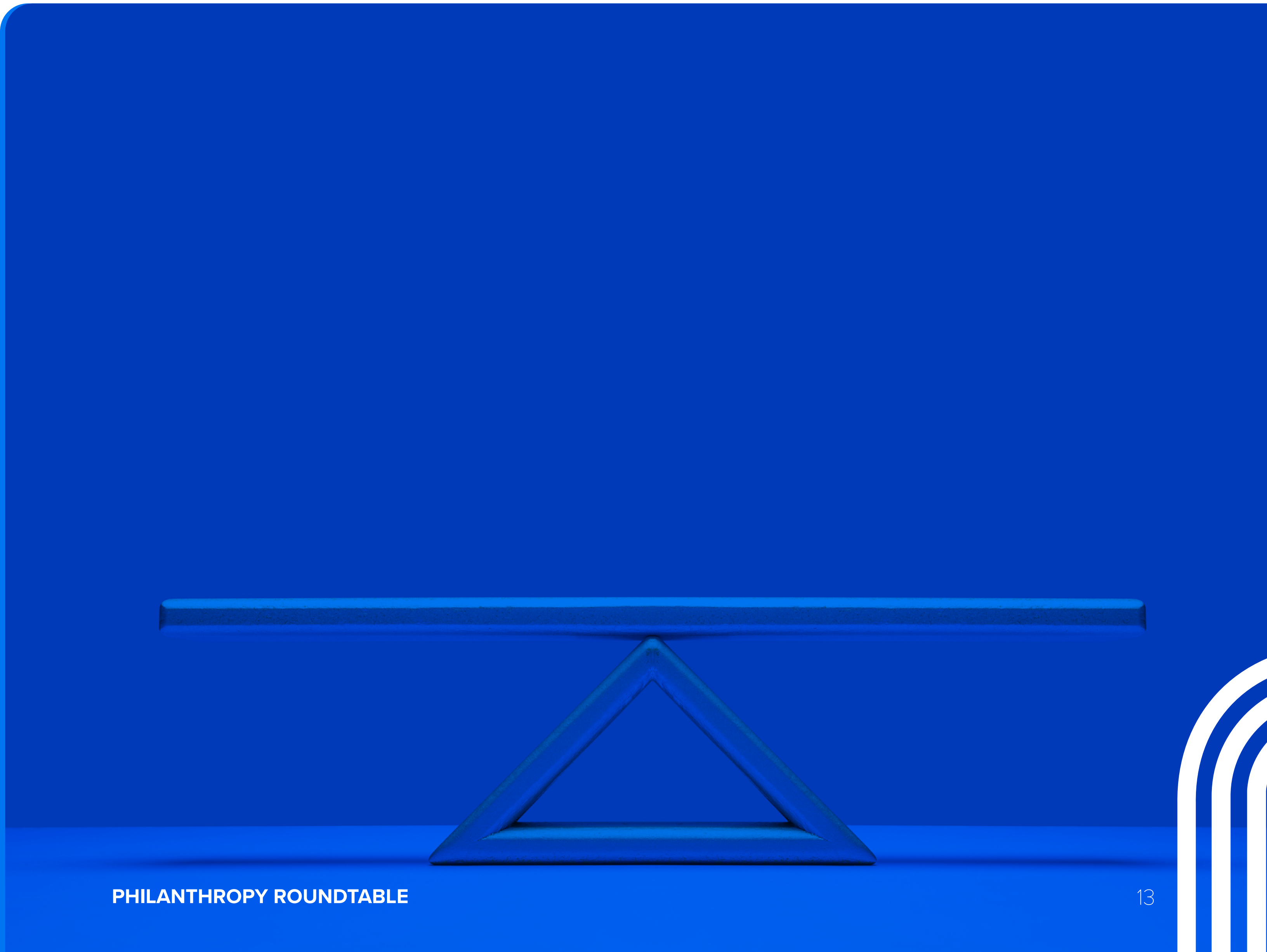
32 The 2022 DAF Report. National Philanthropic Trust. 2022. https://www.nptrust.org/reports/daf-report/.

CONCLUSION

The public support test is a complicated yet critical provision in the Internal Revenue Code that determines the public charity designation of nonprofit organizations under section 501(c)(3). It is vital for charitable organizations to understand and comply with the public support test to maintain their public charity status and continue to receive benefits such as tax exemptions and deductible donations.

While weak proposals to reform the public support test exist, they carry inherent risks to the charitable sector, including overcomplicating determination requirements and shutting out certain charitable vehicles from measures of public support. Specifically, treating anonymous DAF contributions as coming from one individual person would increase the risk of tipping for public charities that rely heavily on DAF grants.

It remains to be seen whether such changes will be implemented, but they serve as a reminder that nonprofits must stay vigilant and adaptive to changing regulations and requirements. It is important to balance the need for oversight with the need to maintain a robust charitable sector that can effectively serve communities in need.



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Jack Salmon is the director of policy research at Philanthropy Roundtable. Prior to joining the Roundtable, Jack served as program manager and researcher at the Mercatus Center at George Mason University, where he oversaw policy relating to budgets, taxation, institutions and economic growth. His research and commentary have been featured in a variety of outlets, including The Hill, Business Insider, RealClear Policy and National Review.

In Jack's current role, he supports the Roundtable's policy and government affairs team with research, commentary and analysis on issues facing the charitable sector and philanthropic freedom. Originally from the U.K., Jack graduated from King's College London in 2015 with a Master of Arts in political economy.

ABOUT PHILANTHROPY ROUNDTABLE

Philanthropy Roundtable is a nonprofit organization dedicated to building and sustaining a vibrant American philanthropic movement that strengthens our free society. To achieve this vision, the Roundtable pursues a mission to foster excellence in philanthropy, protect philanthropic freedom and help donors to advance liberty, opportunity and personal responsibility.

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