

## **“Tipping” - Impact on the Public Charity**

### ***Tipping and Public Charity Status***

"Tipping" refers to a large grant (made by a private foundation or individual contributor) to a tax-exempt not-for-profit organization that qualifies as a “public charity” under IRS rules and regulations. Public charity status is beneficial to tax-exempt organizations since it avoids numerous excise taxes and maximizes the tax deductions for contributions made by donors to the organization.

Tipping can interfere with the public charity status of the recipient organization because the large dollar amount may cause certain IRS tests to be violated.

Public charity status generally requires one-third of the organization's support to come from the general public and/or governmental sources (the “public support test”). Large grants can easily upset this ratio, causing a loss of public charity status. In a year when a large grant is received which would otherwise violate this one-third public support test, an alternative test (called the "facts and circumstances" test) may be used to can preserve public charity status. This test drops the public support to 10% and requires certain other subjective factors to be met. The subjective aspect of the test is whether the charity’s operational and fund-raising activities are designed to attract support from the government, the general public and other charitable organizations.

### ***Applying the Tests***

Both the “public support test” and the “facts and circumstances test” are determined by adding up the support received over the organizations’ first 4 years (or the life span of the charity, whichever is less). If either test is met based on years 1 through 4, the organization qualifies as a public charity for *years 5 and 6*, unless substantial changes in its character, purposes, or method of operations have occurred during years 5 and 6. Under both tests, a single donor's contributions, no matter how large, can only be counted as part of public support in an amount not exceeding 2% of the organization's total support. Amounts received from one donor in excess of this 2% figure are not counted as public support. Also, “unusual grants”, if certain criteria are met, may be entirely ignored in these calculations.

If the tests are met during this initial 4 to 6 year period, the organization will retain public charity status unless a “material change” in support occurs so that the organization no longer “normally” meets either test.

### ***Impact of Tipping on The Charity***

Failing these tests and losing public charity status could impact the level of deductibility of individual donor contributions and would cause other charitable donors (foundations) to potentially have "taxable expenditures". In addition, tipping a public charity would terminate the charity’s exemption from excise taxes (the 2% or 1% tax on investment income, the tax on failure to distribute 5% of assets annually year; and the taxes on taxable expenditures).

### ***Advance Ruling Available for New Organizations***

New organizations can generally request an advance ruling from IRS that can offer protection to donors during the advance ruling period, which can be as long as six years, depending on the situation. The benefit of an advance ruling is that the charity is deemed to be a public charity *from its inception*, and donors will get public charity treatment for their donations, even if ultimately the organization does not qualify. The benefit to the charity is the extended period of time it is afforded to qualify as a public charity, which will protect its early years when support may have been primarily from the one or two major sources or donors.

### ***Tests Reapplied at End of Advance Ruling Period***

At the end of the advance ruling period, the charity either qualifies as a public charity (based on its activities during the ruling period), in which case there is no problem, or it does *not* qualify, in which case certain taxes that apply to private foundations would be imposed upon the charity (including the 2% or 1% investment income tax). New charities should strongly consider applying for an advance ruling, giving it up to six years to plan for these "tipping" issues, and allowing potential donors to participate from the outset without any adverse consequences.

### ***Consult Your Tax Advisor***

Every public charity should regularly consult its tax advisor to ensure that its public charity status is protected. If your charity is presented with large contributions and/or your pool of contributors is small, this ongoing qualification process could create challenging planning issues that must be continually be monitored.

Charitable Leadership Foundation is providing this general information as a courtesy only, and recommends that you contact your tax or legal advisor to determine the impact on your organization.

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