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New Schedule A Reflects Change in Public Support Rules

Test is now based on five-year rolling average and reporting is on same basis as other accounting

The new Schedule A required for the Form 990 tax information return reflects the change in method of calculating "public support" for a charitable organization that seeks classification as a public charity rather than a private foundation.

A 501(c)(3) organization that is neither a hospital, a church, or an educational institution (or certain related entities) or a supporting organization to a public charity avoids being a private foundation by satisfying a "public support" test in generating its revenue from a wide variety of sources. It is generally advantageous to avoid private foundation status because a private foundation is subject to the more stringent self-dealing rules, the 2% excise tax on net investment income, the 5% annual payout requirement, severe limits on lobbying activity, and less favorable deductions for its donors.

The two public support tests are intended to ensure that the organization has broad public support. One of the tests—called the 509(a)(1) test—is intended to be used by organizations that receive most of their support from donations. The other—the 509(a)(2) test—is intended to be used by fee for service organizations such a nursing homes. (See Ready Reference Page: "Calculating Public Support.")

Prior to September 9, 2008, when a newly formed organization expected to qualify as a public charity under one of the two public support tests, it would request in its Form 1023 Application for Recognition of Exemption that the IRS issue either a definitive ruling or an advance ruling that the organization was not a private foundation.

If the IRS issued an advance ruling, at the end of the four or five year advance ruling period, the organization had to file a Form 8734 demonstrating that it met a public support test for the period. Thereafter, the organization was required to meet a public support test on a rolling four year test period. If the organization met the test for a four year test period, it qualified as a public charity for the two years following the test period. The test was applied on a cash method of accounting, even if the organization kept its books and filed its Form 990 on the accrual method.

Effective for tax years beginning on or after January 1, 2008, the IRS changed the method of calculating public support. The 2008 rules do away with the advance ruling period. If the information submitted on the organization's Form 1023 demonstrates that it is likely to meet one of the public support tests, the determination letter will classify the organization as a 509(a)(1) or 509(a)(2) public charity. The organization will not be subject to the private foundation rules for its first five years, even if as a matter of fact it fails to meet either public support test for that five year period.

Beginning with its sixth year, however, the organization must meet one of the two tests in order to maintain status as a public charity. It must demonstrate that it meets one of the tests with the information it provides on Schedule A to its Form 990, the annual information return it files with the IRS. The new Schedule A calls for the information for the most recent five year period, including the year of the return.

(Organizations with an advance ruling outstanding for which the five year period had not yet expired do not need to submit the Form 8734 to confirm their public support status, and will be judged by the information on the Schedule A.)

Under the new rules, if the organization has sufficient public support for the five year period ending with the current tax year, it will qualify as a public charity for the current year (the year of the report) and the following year. For example, if a calendar year organization passes one of the tests for the years 2005 through 2009, it qualifies as a public charity for 2009 and also for 2010. It qualifies in 2010 even if it does not pass one of the tests for the five year period 2006 through 2010. If it fails the test for 2010, however, it will then be classified as a private foundation for 2011 unless it passes one of the tests for the five year period 2007 through 2011.

Under the prior rules, if the organization met one of the tests for the four year period preceding the current year (which was all that was reported on the old Schedule A) it qualified as a public charity for the current year and the following year. The IRS recognizes that the change to include the current year in the test period may put an organization that fails to pass for a particular period, say 2005 through 2009, in the position at the end of 2010 of not knowing until after the end of the year whether it will be a private foundation or a public charity beginning in 2011, because it will not have all of its financial results for the year 2010 until after the end of the year.

The IRS helpfully suggests that an organization in this position monitor its public support closely.

In the other major change in calculating public support, an organization is now required to use the method of accounting that it uses in keeping its books and that it otherwise uses in reporting on its Form 990. Under the old rules, the Schedule A was a cash basis calculation, regardless of the general method of accounting.

The change will bring a degree of simplicity for organizations keeping books on the accrual basis, because they will be able to use the accrual method for reporting contributions and other items on the Schedule A as well as elsewhere on the Form 990. On the other hand, multi-year grants to accrual basis organizations will now be included in the support fraction in the year awarded without regard to the year actually paid, and, unless such a grant can be excluded from the calculation as an unusual grant, the acceleration of inclusion could make it more difficult to pass a public support test.

The charts provided on the Schedule A and the explanation of the requirements for filling in the figures generally do a good job in helping the preparer calculate the public support percentage correctly if the preparer follows the instructions carefully.

There are two areas, however, in which errors are very common, and can cause an organization to appear to flunk the test when it actually passes.

One is a failure to include the value of services (including the value of the use of property) provided by the government at no charge as qualifying public support. A rent-free office in City Hall, for example, would qualify in this category.

This figure does not usually show up on financial statements, and is frequently overlooked by the preparer of the return. But since the value qualifies as public support (in the numerator of the public support fraction), omitting it from the calculation would reduce the reported percentage of public support and could show it below the amount necessary to qualify as a public charity.

The other common error is the inclusion of capital gains in gross investment income (the denominator of the public support fraction), which reduces the reported percentage of public support by improperly increasing the denominator of the fraction. In some cases, an organization that appears to be a private foundation based large capital gains qualifies as a public charity after capital gains are excluded. Since capital gains or losses are excluded entirely from the definition of "support," they should not be included in the calculation.

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