



CLIENT MEMORANDUM

Temporary Regulations Regarding Public Charity Classification and Advance Ruling Periods Following the Redesign of IRS Form 990

September 29, 2008

On September 9, 2008, the Internal Revenue Service (the "IRS") issued temporary regulations (the "Temporary Regulations") that (i) substantially revise the rules governing public charities' advance ruling periods and public support tests, (ii) prescribe a new rule for determining the accounting method used by public charities in calculating public support, and (iii) clarify the rules regarding donor reliance on IRS determination letters. These changes were necessary to implement the recently-redesigned IRS Form 990, "Return of Organization Exempt from Income Tax." They are important to charities that utilize the public support tests and to grantmakers that perform diligence to identify public charities. This memorandum summarizes certain of these changes.

BACKGROUND

Organizations exempt from federal income tax under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"), are classified as either public charities or private foundations. Private foundations are generally subject to stricter operating rules than public charities and a mandatory excise tax on net investment income. Donors to private foundations are subject to less favorable rules regarding deductibility of their contributions.

The tests for determining whether "fundraising" public charities have raised the required amount of public support are called the "public support tests."¹ In general, if these types of public charities do not raise the required amount of public support, they

¹ See Code sections 509(a)(1) and 170(b)(1)(A)(vi), and Code section 509(a)(2).

fail the test and may be reclassified as private foundations.² An organization's public support in any given year is computed based on the prior four years.³

Previously, an organization seeking to be a public charity requested in its IRS Form 1023 application either a definitive or an advance determination letter, based on its anticipated public support. An organization could request a definitive determination letter only if it had completed its first full tax year (of at least eight months) at the time it filed its application with the IRS. All other organizations had to request an advance determination letter. In the case of advance determinations, the IRS would review the charity's expected sources of support and usually classified the organization as a public charity during an "advance ruling period" of five years. At the end of the advance ruling period, the organization had to file IRS Form 8734 demonstrating that it had actually met a public support test during that period. If that was the case, the IRS issued a definitive determination letter classifying the organization as a public charity. If that was not the case, the organization was reclassified as a private foundation and had to pay excise taxes on the net investment income it received during its advance ruling period.

ELIMINATION OF THE ADVANCE RULING PROCESS

With the recently-redesigned IRS Form 990, the IRS has determined that it will be able to monitor organizations' levels of public support without the advance ruling process; hence the Temporary Regulations eliminate this process.

Specifically, an organization will now receive a definitive "public charity" determination letter if it can demonstrate, in its application for tax exemption, that it can reasonably be expected to meet one of the public support tests during its first five years.⁴ The organization's definitive IRS determination letter will be effective for the entire five-year period, regardless of the amount of actual public support that it receives during this time. The organization will no longer need to file IRS Form 8734 after five years to demonstrate that it has received sufficient public support

during that period.⁵ In addition, the organization will not owe excise taxes on the net investment income it received during that five-year period, regardless of whether the organization meets the public support test.

CHANGE IN THE COMPUTATION PERIOD FOR PUBLIC SUPPORT TESTS

The Temporary Regulations also change the computation period for the determination of an organization's public support from four to five years so that the computation period now includes the organization's current year.⁶ If an organization meets the public support test for each year

² An organization will be classified as a public charity if it either: (i) receives one-third of its support through contributions from other public charities, governmental agencies, and/or the general public (see Code sections 509(a)(1) and 170(b)(1)(A)(vi)); or (ii) receives no more than one-third of its support from gross investment income and more than one-third of its support from contributions, membership fees, and gross receipts from its tax-exempt activities (see Code section 509(a)(2)). If an organization does not meet either of these tests, it may still qualify as a public charity if (i) at least ten percent of its total support comes from diverse public sources, (ii) there is broad public interest in its programming, (iii) it has an on-going fundraising program intended to reach a broad cross-section of the public, and (iv) its Board of Directors is representative of public interests.

³ The prior regulations permitted new organizations and organizations that experienced "substantial and material changes" in sources of support to use a five-year computation period.

⁴ The factors used by the IRS to determine whether an organization has demonstrated a high likelihood that its organizational structure and programming can be expected to attract broad support from the general public include: (i) whether the organization anticipates receiving support from a representative number of persons and governmental sources, rather than from a limited number of donors; (ii) whether the organization plans to have a governing body which represents the broad interests of the public, rather than the interests of a few; and (iii) whether the organization provides facilities or services directly for the benefit of the general public on a continuing basis. See Treas. Reg. § 1.170A-9T(f)(4)(v)(B).

⁵ An organization classified as a private foundation may terminate its private foundation status under Code section 507(b)(1)(B) and may request reclassification as a public charity if it meets one of the public support tests for a continuous sixty-month period. An organization in its sixty-month termination period will still have to file IRS Form 8734 under the Temporary Regulations to demonstrate that it qualifies as a public charity.

⁶ This five-year computation period applies to all organizations, eliminating the former exceptions for new organizations and organizations experiencing substantial and material changes.

during the five-year computation period, it is considered to be a public charity for the current year and the immediately succeeding year.

NEW RELIEF PROVISION FROM IMPOSITION OF EXCISE TAXES ON NET INVESTMENT INCOME

If a public charity fails the public support test for two consecutive years beginning in its sixth year of existence or later, it will be classified as a private foundation and will be liable for the taxes on net investment income and any other applicable private foundation excise taxes for that year. The Temporary Regulations include a relief provision, however, for organizations which may not immediately realize that they have failed the public support test. Under this provision, the IRS will not impose private foundation excise taxes for all or part of the first year in which a public charity is reclassified as a private foundation because it has failed to meet a public support test if imposition of those taxes would lead to unfair or inequitable results.⁷

DONOR RELIANCE ON IRS DETERMINATION LETTERS

Donors may continue to rely on an organization's IRS determination letter stating that it is a public charity until notice is given to the public of a change in its classification or unless the donor is aware of the act that results in the organization's loss of public charity classification.

Donors to an organization that received an advance determination letter expiring on or after June 9, 2008 may rely on the organization's advance determination letter as if it were a definitive determination letter. The IRS has suggested that, to assure donors of its public charity classification, an organization may show donors its advance determination letter, and refer them to IRS Publication 78, which identifies public charities. Donors may also contact the IRS directly for confirmation of an organization's public charity classification by calling the Exempt Organizations Customer Account Services hotline toll-free at (877) 829-5500.⁸

ACCOUNTING METHOD FOR CALCULATING PUBLIC SUPPORT

An organization will now be required to compute public support using the same accounting method that it uses in keeping its books and reporting on IRS Form 990, rather than the cash method. This change may impact public charities in two ways: (1) if the organization uses the accrual method, it will not be able to use financial data reported on previous IRS Forms 990 for the public support test, since that data was computed using the cash method of accounting, and (2) an organization which receives a large, multi-year grant may fail the public support test if the entire amount of the grant is required to be reported in a single year.⁹

EFFECTIVE DATE AND TRANSITION RULES

The Temporary Regulations are effective as of September 9, 2008, and apply to taxable years beginning on or after January 1, 2008.

The Temporary Regulations provide two transitional provisions. First, an organization which cannot meet a public support test for its first taxable year following the effective date of the Temporary Regulations will continue to be classified as a public charity during that year if it satisfied a public support test during the prior year. Second, an organization with an advance determination letter that expires on or after June 9, 2008 will be considered a public charity regardless of the actual public support it received

⁷ The Treasury Decision accompanying the release of the Temporary Regulations describes unfair or inequitable results as those situations in which a tax is imposed even though the public charity was unable to foresee that it would fail the public support test or the charity's failure of the test was beyond its control.

⁸ See "Advance Ruling Process Elimination Frequently Asked Questions: Advance Ruling Is Definitive Ruling for Affected Organization" available on the Charities and Non-Profits section of the IRS's official website at www.irs.gov.

⁹ An organization should consult its legal and/or financial advisor if it anticipates that a large, multi-year grant will need to be accrued in a single tax year and may cause the organization to fail its public support test.

during its first five years of existence. These organizations will not be required to file IRS Form 8734.

All organizations which filed IRS Form 1023, "Application for Recognition of Exemption," prior to the effective date of the Temporary Regulations, but which have not received a determination letter, will have their applications processed under these new rules and will receive a definitive determination letter.

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