AVOIDING PRIVATE FOUNDATION STATUS
Escape Routes Based on Operations and Income

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I. Introduction

This paper will discuss the various ways in which organizations exempt from tax under section 501(c)(3) of the Internal Revenue Code\(^1\) may escape private foundation status, either completely by qualifying as organizations described in sections 509(a)(1) or (2), or partially by qualifying as private operating foundations under section 4942(j)(3).\(^2\) Included as part of this discussion will be a summary of the rules governing qualification under these various sections, a brief review of the legislative intent behind each section, as expressed in the committee reports, a summary of the demographic changes that have taken place in the size, sources of revenues and amount of expenditures of various kinds of organizations, as set forth in the recent SOI Report of the Internal Revenue Service and, finally, an attempt to evaluate the effectiveness and consistency of these various rules.

\(^1\) Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986, as amended.

\(^2\) Charitable organizations may also escape private foundation status if they qualify as "supporting organizations" under section 509(a)(3) or are organized and operated exclusively for testing for public safety under section 509(a)(4). The particulars of the first of these categories are being dealt with by other presenters, and those relating to the second are not really germane to the issues under consideration at this symposium.
II. Escape Routes

A. Operations

A charitable organization meeting the requirements of section 501(c)(3) may avoid private foundation status, irrespective of its sources of support, if it qualifies as one of the following:

1. A church or a convention or association of churches (section 170(b)(1)(A)(i)).

There is relatively little case law or precedent construing these words, and the Treasury Regulations and legislative history provide little if any guidance as to their meaning. The discussion in the Internal Revenue Manual, while helpful, is far from authoritative. It cites several low-level court decisions for the proposition that a church must, at a minimum, include a body of believers that assembles regularly in order to worship and that it must be reasonably available to the public in its conduct of worship. A "convention of churches" includes an organization the members of which may be churches of differing denominations. The Internal Revenue Manual also includes a list of 14 "criteria" which

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3 See, generally, Whalen, Church in the Internal Revenue Code: The Definitional Problems, at 45 Fordham Law Review 885 (1977). Also, for an excellent discussion of the many special tax provisions that apply to churches, see, Halloran, Churches Are the Square Pegs of the Tax-Exempt World, at 10 JTEO 177 (Jan/Feb 1999).

4 I.R.M. 7752, Ch. 220.


6 Rev. Rul. 74-224, 1974-1 CB 61.

7 The criteria listed include the following:
   (a) a distinct legal existence
   (b) a recognized creed and form of worship
   (c) a definite and distinct ecclesiastical government
   (d) a formal code of doctrine and discipline
   (e) a distinct religious history
the Service "applies as the circumstances warrant" in determining whether a religious organization qualifies as a church, but to date courts have not viewed those criteria as dispositive. Religious organizations that fail to qualify as churches under section 170(b)(1)(A)(i) do not easily fall into any other kind of public charity, although they may occasionally meet the requirements of an educational organization under section 170(b)(1)(A)(ii) or a hospital under section 170(b)(1)(A)(iii). The private foundation status of non-qualifying religious organizations will, therefore, normally turn on whether their sources of support are public or private.8

2. A school which meets the requirements of section 170(b)(1)(A)(ii). To satisfy these requirements, the primary function of the organization must be the presentation of formal instruction,9 and, in addition, it must have:

- a regular faculty,
- a curriculum,
- a regularly enrolled body of pupils or students, and

(f) a membership not associated with any other church or denomination
(g) ordained ministers ministering to its congregations
(h) ordained ministers selected after completing prescribed studies
(i) a literature of its own
(j) established places of worship
(k) regular congregations
(l) regular religious services
(m) Sunday schools for religious instruction of the young
(n) schools for the preparation of its ministers

8 C.f. TAM 9624001, holding that although a missionary society failed to qualify as a church under section 170(b)(1)(A)(i), it nevertheless avoided classification as a private foundation because it met the requirements of sections 170(b)(1)(A)(vi) and 509(a)(1).

a place where its educational activities are regularly carried on.

Although these requirements have been in place without substantive change for some period of time, their application has changed to some extent to take into account changing needs, technology and pedagogy. Institutions providing on-the-job training have normally been denied classification as schools, but the presentation of training courses in industrial skills and crafts has been held to qualify.\textsuperscript{10} There have been recent indications in several private lettering rulings that the Service is willing to accord "educational institution" status to organizations that have suitable curricula, faculty and student bodies but conduct their educational activities in changing places. Thus, even though correspondence schools have continually failed to meet these requirements on the ground that they have no place where their educational activities are regularly carried on,\textsuperscript{11} the Service has held that a school that operated over the summer using the facilities of another school met the "campus" requirement\textsuperscript{12} and, in a private letter ruling, that educational and instructional activities carried on at a cattle ranch for students interested in wildlife and ecology satisfied the "campus" requirement;\textsuperscript{13} and in an earlier revenue ruling, it was held that the teaching of survival skills in a natural environment would also qualify.\textsuperscript{14}

\textsuperscript{10} Rev. Rul. 72-101, 1972-1 CB 144.

\textsuperscript{11} Rev. Rul. 75-492, 1975-2 CB 80.

\textsuperscript{12} Rev. Rul. 69-492, 1969-2 CB 36.

\textsuperscript{13} PLR 8624008.

\textsuperscript{14} Rev. Rul. 73-434, 1973-2 CB 71.
Because education in its general sense is a charitable activity, organizations whose programs are primarily educational but that fail to meet the specific requirements of section 170(b)(1)(A)(ii) will normally continue to be exempt under section 501(c)(3) but will have to depend on sections 170(b)(i)(A)(vi) or 509(a)(2) for their public charity status or else will revert to private foundation status, either operating or non-operating depending on their program activities and expenditures.

In addition to the specific requirements contained in the statute, organizations that otherwise meet the requirements of section 170(b)(1)(A)(ii) must also be able to establish that they have in place an admissions policy that is racially nondiscriminatory with respect to students.15 Although failure to meet this nondiscrimination requirement will normally deprive a school of its charitable status under section 501(c)(3) – not simply its "public" status under section 170(b)(1)(A) – it's not altogether clear that an organization that has educational purposes but fails to meet the specific requirements as a "school" under section 170(b)(1)(A)(ii) will fail to qualify as charitable under section 501(c)(3) if it cannot establish that it maintains and enforces a racially nondiscriminatory policy with respect to the beneficiaries of its educational programs. Most United States educational institutions experience comparatively few problems in complying with this nondiscrimination requirement; however, foreign educational institutions that are seeking grants from United States private foundations and wish to be classified, under the regulations under sections 4942

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and 4945\textsuperscript{16} as the equivalent of organizations described in section 170(b)(1)(A)(ii), frequently experience difficulty establishing that they maintain such a policy in that racial discrimination, in many foreign countries, is simply not a fact of political or social life. Nevertheless, most private foundations engaged in foreign grant-making have found that the senior administrative officials of a foreign educational institution will experience little if any difficulty making a representation that a racially nondiscriminatory policy exists at their institution, although most will have considerably greater difficulty certifying that they have complied with the Executive Order that spells out the requirements of such policy.\textsuperscript{17}

3. A hospital or medical research organization (section 170(b)(1)(A)(iii)). Organizations otherwise satisfying the requirements of section 501(c)(3) may qualify as "hospitals" under section 170(b)(1)(A)(iii) if their principal purpose or function is the provision of hospital or medical care, defined in the regulations\textsuperscript{18} to "include the treatment of any physical or mental disability or condition, whether on an inpatient or outpatient basis, provided that the cost of such treatment is deductible under section 213 by the person treated. "Rehabilitation organizations" and "skilled nursing facilities" may or may not

\textsuperscript{16} Reg. Secs. 53.4942(a)-3(a)(6) and 53.4945-5(a)(5).

\textsuperscript{17} The Service has recognized that there may be situations where foreign law or practice may render compliance with certain provisions of Rev. Proc. 75-50 illegal or impractical in a particular country. In those cases, compliance with the provisions of Rev. Proc. 75-50 giving rise to the illegality or impracticality may be excused, but only after showing by the foreign school of a reasonable basis for excusing compliance. The burden is on the organization to show such a reasonable basis.\textsuperscript{17} G.C.M. 37867 (Feb. 27, 1979). See, generally, Dale AForeign Charities,\textsuperscript{17} 48 Tax Lawyer 657 (1995) at 685.

\textsuperscript{18} Reg. Sec. 1.170A-9(c)(1).
qualify as "hospitals" under section 170(b)(1)(A)(iii) depending on whether or not their principal purpose is the provision of hospital or medical care. Convalescence homes and homes for children or the aged will not normally qualify. An organization whose principal purpose in the provision of medical education or medical research will qualify as a hospital under section 170(b)(1)(A)(iii) if it is also actively engaged in providing patient care as an integral part of its educational or research activities. In addition, section 170(b)(1)(A)(iii) includes medical research organizations that are operated in conjunction with one or more hospitals and are "committed" to spend any contribution they receive for medical research prior to the beginning of the fifth year following the year in which the contribution is received.19

In addition to having to show that they provide hospital or medical care, organizations seeking to qualify under section 170(b)(1)(A)(iii) must also be able to establish that they provide a community benefit.20 Because the provision of health care is not in and of itself a charitable activity,21 the requirement that an organization provide a community benefit goes to exempt status and not just to the organization's ability to qualify as a "public charity." Thus, organizations that appear to be hospitals but that fail to provide a

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19 Reg. Sec. 1.170A-9(c)(2). The tests for qualification as a medical research organization under this section are similar (but not identical) to the tests for a private operating foundation. Thus, more than one half of the organization's assets must be devoted to, and at least 3.5 percent of its endowment income must be expended for, the "continuous active conduct of medical research."


community benefit will frequently fail to qualify for charitable exemption under section 501(c)(3). On the other hand, organizations that provide a community benefit but fail to qualify as a "hospital" because their principal purpose is other than the provision of hospital or medical care, may still qualify for charitable status under section 501(c)(3) and become either publicly supported organizations or private foundations, operating or non-operating, depending on their sources of support and the nature of their activities and expenditures.

4. An endowment organized to benefit a state university (section 170(b)(1)(A)(iv)). To qualify as university endowment under section 170(b)(1)(A)(iv), an organization must be (i) organized and operated exclusively to receive, invest, and administer property and to make expenditures to or for the benefit of (ii) a college or university which meets the requirements of section 170(b)(1)(A)(ii) and which is, or is owned or operated by, a State or one of its political subdivisions or agencies. In addition, the organization must (iii) meet "publicly supported" tests similar to those applicable to section 170(b)(1)(A)(vi) organizations.22

Section 170(b)(1)(A)(iv) remains in the statute today more as a matter of historical accident than anything else, having been added two years prior to section 170(b)(1)(A)(vi), which is of considerably broader scope. In most cases, an organization that meets the requirements of section 170(b)(1)(A)(iv) will also meet those of either or both of section 170(b)(1)(A)(vi) or section 509(a)(3).

22 Reg. Sec. 1.170A-9(b)(2). For a description of the support tests applicable to section 170(b)(1)(A)(vi) organizations, see Part B-2 infra.
5. A governmental unit (section 170(b)(1)(A)(v)). An organization qualifies as a governmental unit under section 170(b)(1)(A)(v) if it is an organization described in section 170(c)(1): the United States and its possessions, the District of Columbia, States, and their political subdivisions. Indian tribal governments are also excluded from private foundation status as governmental units under section 7871(a)(7)(B). Not included under section 170(b)(1)(A)(v) are governmental instrumentalities, even though such organizations are frequently exempt from income taxation. The distinction between a governmental unit and its subdivisions, on the one hand, and a government instrumentality, on the other, is not always easily drawn. Normally the most important factors are the presence or absence of the three "sovereign powers" that are the hallmarks of a governmental unit: the police power; the power of eminent domain; and the power to tax.23

B. Sources of Support

In addition to the escape routes based on operations, an organization may also avoid private foundation status if its financial support is derived from suitably "public" sources. Included in this category are:

1. Organizations that normally receive a substantial portion of their support from governmental units and contributions from the general public (section 170(b)(1)(A)(vi)). Organizations may qualify for "non-private foundation" status under section 170(b)(1)(A)(vi) if an acceptable portion of their "support" is "normally" derived from gov

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ernmental units and contributions from the general public. Qualification under this section may be based on either the strictly numerical "33-1/3 percent-of-support test" or the "facts and circumstances test."25

(a) "Support from a governmental unit or from direct or indirect contributions from the general public." To meet the requirements of section 170(b)(1)(A)(vi), an organization must receive a substantial portion of its support from some combination of support from governmental units and contributions from the general public. To constitute "support from a governmental unit" the amount received cannot be in exchange for something of value which is primarily to benefit the governmental unit making the payment. Instead, it must be in the nature of a grant, to enable the recipient organization to carry out its charitable programs, or in the nature of a payment under a government contract to enable the organization to provide a service primarily to benefit the public as opposed to the governmental unit itself.26 Amounts received from a governmental unit in exchange for services or other items of value which are furnished by the organization in the course of performing its exempt activities, which are often critical to the "public status" of an organization attempting to qualify under section 509(a)(2), are excludible in their entirety from both the numerator and the denominator of the public support fraction under section 170(b)(1)(A)(vi).

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24 Reg. Sec. 1.170A-9(e)(2).
26 Treas. Reg. Sec. 1.170A-9(e)(8).
It is also important to note that for purposes of determining "publicly supported" status under section 170(b)(1)(A)(vi) there is no need to draw any distinction between support received from a governmental unit and one or more of its "bureaus" or "agencies" as is true under section 509(a)(2). Once an organization has been determined to be a part of a "governmental unit," be it a bureau or agency or be it the governmental unit itself, the support received from such organization is includible in its entirety in both the numerator and the denominator of the section 170(b)(1)(A)(vi) fraction.

Because a "governmental unit" is defined in section 170(c)(1) as "A State, a possession of the United States, or any political subdivision of the foregoing, or the United States or the District of Columbia...," payments received from government instrumentalities that are not integral parts of governmental units do not qualify as "support from governmental units." Similarly, payments received from foreign governments do not qualify as "support from governmental units," at least when received by charities organized in the United States. The result is somewhat harder to justify in the case of foreign charities that receive such payments from their home governments,27 and the Service is apparently willing to treat foreign government

27 Rev. Rul. 75-435, 1975-2 CB 215, holding that foreign governmental support qualifies as support from a governmental unit when paid to a foreign charity for purposes of qualifying under section 170(b)(1)(A)(vi). One year later the Service refused to extend this principle to foreign governmental support received by a domestic section 501(c)(3) organization (G.C.M. 37001, Feb. 10, 1976). Subsequently, when challenged in the context of a private letter ruling application, the Service refused to retreat from this position and indicated that it believed that Rev. Rul. 75-435 had been incorrectly decided and that it should be revoked (G.C.M. 38327, Mar. 31, 1980). However, that G.C.M. concluded that no final recommendation was being made at that time, and none has been made since. Rev. Rul. 75-435 therefore remains in existence as reliable precedent.
support as "support from a governmental unit" in these circumstances. Payments from international organizations, such as the United Nations and World Health Organization would also fail to qualify as "support from a governmental unit" (although such organizations may possibly qualify as "publicly supported charities" under section 170(b)(1)(A)(vi)), even though such organizations are entitled to be treated as section 509(a)(1) organizations for purposes of the expenditure responsibility rules of section 4945.28

(b) "Direct or indirect contributions from the general public." To constitute "direct or indirect contributions from the general public," a contribution must be from either (i) another organization qualifying under section 170(b)(1)(A)(vi), or (ii) from another "person,"29 except that with respect to such "other person" support received from any single source during the applicable four-year measuring period30 which exceeds 2 percent of the total support received by the organization for such period will be treated as "non-public" and thus included in the denominator but excluded from the numerator of the section 170(b)(1)(A)(vi) support fraction.31 For these purposes, support received from different individuals or organizations that are related to one another within the meaning of section 4946(a)(1)(C)-(G) is

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28 See, Treas. Reg. Sec. 53.4945-5(a)(4)(iii), which provides that foreign governments, their agencies and instrumentalities and international organizations designated as such by Executive Order under 22 U.S.C. 288 are to be treated as section 509(a)(1) organizations for purposes of section 4945.

29 Which definition would exclude governmental units. See section 7701(a)(1).

30 See text related to footnote 36, infra.

treated as having been received from a single "person." Support received from other tax exempt organizations, including both private foundations and public charities (other than those described in section 170(b)(1)(A)(vi)) are all subject to this 2 percent limitation. Essentially, the only sources from which contributions may be received which are not subject to this 2 percent limitation is support from governmental units and contributions received from other section 170(b)(1)(A)(vi) organizations. Contributions received from churches, educational institutions, hospitals, etc. may qualify for unlimited treatment, but only if the organization making the contribution also qualifies as "publicly supported" under section 170(b)(1)(A)(vi).

(c) "33-1/3 percent-of-support test": Under this test, an organization must "normally" receive at least 1/3 of its "support" from governmental units and contributions from the general public. As long as this threshold is met, it is normally irrelevant where the remainder of the organization's support comes from.

(d) "Facts and circumstances test": Under this test, an organization must

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32 Id.

33 The "stigma" attached to this limitation for public charities described in sections 170(b)(1)(A)(ii)-(v) differs markedly from the status of contributions received by organizations attempting to qualify under section 509(a)(2). See discussion in Part 2 (a), infra.

34 The meanings of the terms "normally" and "support" are discussed in the text associated with footnotes 36 and 42, infra.

35 Obviously there are limits. An organization with a small amount of contributions from the general public and large amounts of operating receipts but which cannot meet the requirements of section 509(a)(2) will not be permitted to qualify as a "pseudo" section 170(b)(1)(A)(vi) organization. Reg. Sec. 1.170A-9(e)(7)(ii).
(i) normally receive a minimum of (and possibly more than) 10% of its support from governmental units and contributions from the general public,

(ii) be so organized and operated as to attract new and additional public or governmental support on a continuous basis, and

(iii) establish a sufficiently "public tinge" by such indicia as having a governing body that is representative of public rather than private interests and providing services and facilities that directly involve, and are of a direct benefit to, the public.

The more clearly an organization is able to show a public orientation by satisfying the various factors referred to in (iii), above, the closer its public support fraction may come to the 10% minimum without disqualifying it.

(e) "Normally" -- the four-year rolling average test: In applying both the 33-1/3 percent-of-support test and the facts and circumstances test, the support that an organization is deemed "normally" to have received from various sources for any taxable year is the aggregate support that it received from such sources during the preceding four years.\(^{36}\) Unless there has been a material change in the organization's sources of support,\(^ {37}\) an organization that satisfies either test based on the four-year period immediately preceding the taxable year will also satisfy the test for the next year as well. Thus, an organization whose aggregate sources of support in years 1-4 are sufficient to qualify it as being "publicly" supported for year 5 will also be so qualified for year 6, even though its aggregate sources of support for years

\(^{36}\) Reg. Sec. 1.170A-9(e)(4)

\(^{37}\) Reg. Sec. 1.170A-9(e)(4)(v)
2-5 may not meet the appropriate levels. If there is a material change in an organization's sources of support, then the measuring period converts from the four-year period immediately preceding the taxable year to the five-year period that includes as its last year the year in which the material change occurs.38

What constitutes a "material change" in an organization's sources of support used to be an extremely worrisome subject for donors, and particularly private foundation grantors. The regulations promulgated shortly after the 1969 Reform Act provided that donors and grantors were entitled to rely on a grantee's "publicly supported" determination letter unless the donor or grantor "was responsible for, or was aware of, the substantial and material change [in the grantee's sources of support]" which would deprive it of its publicly supported status.39 As a result, private foundation grantors were faced with what was referred to as a "tipping" problem -- the prospect of making a grant that was sufficiently large in relation to the grantee's normal sources of support so that the grantor would be "responsible for" a material change in the grantee's sources of support and would thus "tip" the grantee out of its publicly supported status. Were that to happen, the grantor could suffer adverse consequences under sections 4942 (in that the grant would not constitute a "qualifying distribution") and 4945 (in that the grant would be a taxable expenditure because the grantor had failed to exercise expenditure responsibility). This issue was

38 Id.
39 Reg. Sec. 1.170A-9(e)(4)(v)(b)
clarified and largely resolved some years later when the Service issued Revenue Procedure 89-23,\(^{40}\) permitting donors and grantors to rely on a grantee's "publicly supported" determination letter, irrespective of the size of the proposed gift or grant in relation to the grantee's normal sources of support.\(^{41}\)

(f) **Support**: For purposes of applying the publicly supported tests of section 170(b)(1)(A)(vi), "support" (i.e., the denominator of the fraction) includes all of the items enumerated in section 509(d) except for (i) gross receipts from admissions, sales or services in connection with the performance by the organization of activities constituting the basis for its exemption, (ii) the value of contributed services for which a deduction is not allowed, and (iii) any "unusual grants" received during the applicable measuring period.\(^{42}\)

2. **Organizations receiving more than one-third of their support from public contributions and revenues from the performance of their exempt functions and not more than one-third of their support from investment income and unrelated business taxable income (section 509(a)(2)).**

A second way in which organizations described in section 501(c)(3) may qualify for "publicly supported" status is under section 509(a)(2), which requires that the organization

\(^{40}\) Rev. Proc. 89-23, 1989-1 CB 844. This Revenue Procedure liberalized the earlier holding of Rev. Proc. 81-6, 1981-1 CB 620, which had permitted grantor foundations to rely on existing determination letters if the grant in question did not exceed 25% of the grantee's support for the four preceding years (or such shorter period as the grantee may have been in existence).

\(^{41}\) Interestingly, there are anecdotal reports that a few large grant-making organizations still perform the Atipping@ analysis in order to protect the Apublicly supported@ status of their grantees.

\(^{42}\) Reg. Sec. 1.170A-9(e)(6)(ii) and (7)(i).
"normally" receive more than one-third of its support in each taxable year from any combination of:

(i) gifts, grants, contributions or membership fees, and

(ii) gross receipts from the performance of activities or sales of merchandise constituting the basis for its exemption (not including in such receipts, any receipts from activities that constitute an unrelated trade or business of such organization).

from appropriately "public" sources and which also receives not more than one-third of its support from

(i) gross investment income, and

(ii) net (after-tax) income from any unrelated trade or business.

Although the method for determining whether an organization seeking to qualify under section 509(a)(2) "normally" receives its support from appropriately public sources is computed in the same manner as under section 170(b)(1)(A)(vi), (i.e., the computation is based on aggregate receipts during the four years immediately preceding the taxable year to which the computation applies), the definitions of "public sources" and what constitutes "support" differ in several material respects from those that apply under section 170(b)(1)(A)(vi). Revenues which qualify for inclusion in the numerator of the section 509(a)(2) favorable "support" fraction include:

- gifts, grants, contributions, or membership fees from persons who are not disqualified persons (as defined in section 4946), from governmental units
described in section 170(c)(1) and from organizations described in section 170(b)(1)(A)(i)-(vi) (referred to as "permitted sources"); and

C gross receipts from admissions, sales of merchandise, performance of services and furnishing of facilities in any activity which is not an unrelated trade or business provided that (1) all such receipts are from "permitted sources" and (2) there shall be excluded any receipts "from any person, or from any bureau or similar agency of a governmental unit ... to the extent such receipts exceed the greater of $5,000 or 1 percent of the organization's support in such taxable year."

Reasonably comprehensive and sensible distinctions are drawn in the regulations in illustrating whether payments constitute "gifts or contributions" as distinguished from "gross receipts," and "grants" as distinguished from "gross receipts." Similarly, the regulations illustrate the difference between "membership fees" and "gross receipts."

(a) Contributions as sources of public support under section 509(a)(2). The specific rules governing what receipts are includible in the numerator of the section 509(a)(2) support fraction are complex and not necessarily consistent with the the

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43 Section 509(a)(2)(A)(ii).

44 Reg. Sec. 1.509(a)-3(f), drawing the basic distinction between transfers made for no consideration and with a donative intent as opposed to transfers made in return for something of value.

45 Reg. Sec. 1.509(a)-3(g), in which the basic distinction goes to whether the payment is made primarily to encourage and enable the grantee to fulfill its own programs and activities in furtherance of its exempt purposes or it is intended, instead, to "serve the direct and immediate needs of the payor."

46 Reg. Sec. 1.509(a)-3(b), the principal line of distinction being, once again, whether the primary purpose of the membership fees are for the support of the organization or whether they are made primarily to enable the payor to receive something of value from the organization.
ory governing the support requirements of section 170(b)(1)(A)(vi) organizations. Thus, gifts and contributions from persons who are "disqualified persons" with respect to the organization are excludible from the numerator in their entirety, as disqualified persons are not "permitted sources" under section 509(a)(2). However, contributions from persons who are not disqualified persons are includible in the numerator in their entirety and without regard to any restriction similar to the 2 percent of support limitation that applies to organizations qualifying under section 170(b)(1)(A)(vi). Similarly, contributions received from organizations described in sections 170(b)(1)(A)(i)-(iv) are includible in their entirety in the numerator of the support fraction even though such contributions are subject to the 2 percent limitation under section 170(b)(1)(A)(vi). However, contributions from other charitable organizations (including private foundations, private operating foundations and organizations described in section 509(a)(2), (3), or (4)) are includible in the numerator of the fraction only if such organizations are not "substantial contributors" with respect to the recipient organization and are not otherwise "disqualified persons" within the meaning of section 4946(a).

(b) Limitations applicable to gross receipts of section 509(a)(2) organizations. "Gross receipts" from admissions, sales of merchandise, the performance of services and furnishing of facilities and activities constituting the basis for an organization's exemption are includible in the numerator of the section 509(a)(2) support fraction provided that (1) they are not net income from an unrelated trade or business, (2) they are received from "permitted sources," and (3) with respect to amounts re
ceived from any single source, they do not exceed, for any taxable year, the greater of $5,000 or 1 percent of the organization’s support for such year. Thus, even though a section 509(a)(2) organization’s support fraction is based on a four-year rolling average, the application of the 1 percent limitation is applied to gross receipts on a taxable year basis. For instance, if an organization receives total support in each of years one through four of $600,000 and receives $25,000 in year one from A, $25,000 in year two from B, $25,000 in year three from C, and $25,000 in year four from D, the amount includible in the numerator of the section 509(a)(2) fraction from each source will be limited to $6,000 (1 percent of total support for the year in which it was received), or a total of $24,000 over the four years. On the other hand, if the $5,000/1 percent limitation were applied on a four-year rolling average basis, as is true of the support computation under section 170(b)(1)(A)(vi) and the rest of the support computations under section 509(a)(2), the numerator would include $24,000 of the amounts received from each organization. (Note that this more favorable result would also obtain if the support from each of A, B, C and D had been received in even increments over the four year period, suggesting that to the extent operating considerations permit, a section 509(a)(2) organization would do well to spread its receipts from contracts over an extended period of years.)
The $5,000/1 percent limitation also applies to any "bureau or agency" of a governmental unit. As construed by the regulations\(^\text{47}\) any receipts from a governmental unit that includes one or more "bureaus" or "agencies" will be treated as coming from as many different sources as there are "bureaus" or "agencies," including the governmental unit itself. Thus, if a section 509(a)(2) organization that receives total support of $600,000 in a given year receives payments of $25,000 under each of four contracts--two with governmental unit A and one with each of B and C, which are bureaus or agencies of A, a total of $18,000 may be included in the numerator of the support fraction. Such amount is made up of $6,000 (1 percent of the total support for the year, received from each of B and C and a total of $6,000 received from A (which is treated for these purposes as a separate bureau or agency of itself)). Under the regulations, the distinction between a "governmental unit" and an "agency" or "bureau" thereof depends on whether the governmental office is operating at a "policy-making" level or is a subordinate unit functioning "at the operating" level. Within the federal government, the regulations provide that any governmental subdivision headed by a presidential appointee holding a position at or above Level V of the Executive Schedule under 5 U.S.C. 5316 will normally be considered as a policy-making, rather than an operating unit. The Departments

\(^{47}\) Reg. Sec. 1.509(a)-3(i)(1).
of the Air Force, Army and Navy are also considered to be policy-making departments, and therefore different "governmental units" for these purposes.\(^{48}\)

(c) **Negative limitations on receipts.** Section 509(a)(2) also imposes negative limitations on "receipts," providing that an organization will lose its status under that section if more than one-third of its support "normally" is derived from a combination of gross investment income and the excess of any unrelated business taxable income from businesses acquired after June 30, 1975 over the amount of tax imposed under section 511. For purposes of this negative restriction, "gross investment income" is defined as income from interest, dividends, payments with respect to security loans, rent and royalties, to the extent that such items are not otherwise includible in the organization's unrelated business taxable income. Such amount would therefore not include income from short or long-term capital gains.\(^{49}\)

Although net income (after tax) from an unrelated trade or business has always been included as an item of "support" under section 509(d), the inclusion of that particular item in the one-third of support "negative restriction" did not appear in the statute until 1975.\(^{50}\) Prior to that time, a few enterprising organizations with significant amounts of investment income from endowment had attempted to qualify under section 509(a)(2) by acquiring one or more unrelated trades or businesses,

\(^{48}\) Id.

\(^{49}\) Section 509(e); Reg. Sec. 1.509(a)-3(a)(3).

\(^{50}\) Section 509(a)(2)(B)(ii) was added by P.L. 94-81, Sec. 3 (1975).
thus enlarging the denominator of their support fractions to the extent necessary to reduce their gross investment income to less than one-third of total support. In order to prevent such organizations from qualifying as "public charities" under section 509(a)(2), the inclusion of net income from an unrelated trade or business was added as a negative restriction.

III. Partial Escape Route --Private Operating Foundations.

A. Regular Operating Foundations.

Charitable organizations that are unable to avoid private foundation status based on their method of operation or sources of support may still avoid the "mandatory distribution requirements" of section 4942\(^{51}\) and qualify for the most favorable percentage limits with respect to individual charitable contributions if they qualify as "private operating foundations." Private operating foundations are subject to most of the remaining provisions of chapter 42 -- self-dealing under section 4941, excess business holdings under section 4943, jeopardizing investments under section 4944 and taxable expenditures under section 4945 -- and except for exempt operating foundations described in section 4940(d)(2), they are subject to the 2% excise tax on net investment income imposed by section 4940. Although grants by private foundations to private operating foundations,

\(^{51}\) Private operating foundations are subject to a somewhat more lenient distribution requirement under which they must make qualifying distribution requirements "directly for the active conduct" of their exempt purposes equal to the lesser of 85% of their adjusted net income (as defined in section 4942(f)) and 2/3rds of their minimum investment return (essentially 3.3% of the average market value of their investment assets).
other than exempt operating foundations\textsuperscript{52} are subject to the expenditure responsibility requirements of section 4945(h), such grants may be treated by the private foundation grantor as qualifying distributions under section 4942 without imposing the redistribution requirements of section 4942(g)(3) on the grantee, unless the private operating foundation grantee is controlled by the grantor.\textsuperscript{53}

In order to qualify as a "private operating foundation" an organization otherwise described in section 501(c)(3) must meet two tests. The first distribution test requires that the organization "normally" make qualifying distributions "directly for the active conduct of the activities constituting the purpose or function for which it is organized and operated" equal to 85 percent of the lesser of (i) its adjusted net income,\textsuperscript{54} increased by any amounts representing prior years' qualifying distributions that were recovered during the year, and (ii) its minimum investment return.\textsuperscript{55} In addition, to qualify as a private operating foundation, the private foundation must satisfy one of the following three alternative tests of section 4942(j)(3)(B):

(1) \textit{Assets Test.} Substantially more than half (65 percent) of the organization's assets are devoted directly (a) to the active conduct of activities constituting

\textsuperscript{52} Section 4945(d)(4)(A).

\textsuperscript{53} Section 4942(g)(1)(A)(i).

\textsuperscript{54} Essentially, the sum of its investment income (excluding long-term capital gains) and any income realized from operations (including both program activities and unrelated trades or businesses).

\textsuperscript{55} Five percent of the average value of its investment portfolio.
the foundation's charitable purposes, (b) to functionally related businesses or (c) to a combination thereof;

(2) *Endowment Test.* The organization expends at least two-third of its minimum investment return (essentially three and one-third percent of the value of its investment assets) for the active conduct of program activities; or

(3) *Support Test.* (i) Substantially all (85 percent) of its support, other than gross investment income, is "normally" received from the general public\(^56\) and from five or more exempt organizations that are unrelated (within the meaning of section 4946(a)(1)(H)), to each other and to the foundation; (ii) not more than 25 percent of its support (other than gross investment income) is normally received from any one such exempt organization; and (iii) not more than one-half its support is normally received from gross investment income.

Unlike the computations for "publicly supported charities" under sections 170(b)(1)(A)(vi) and 509(a)(2), the "normally" tests that apply to expenditures made and support received by private operating foundations are based not on the four years immediately preceding the taxable year in question but rather the four years ending with the year in question. In making these determinations, the private operating foundation will qualify if it is able to satisfy the test either (i) during any three of the four years in that pe

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\(^{56}\) For these purposes, contributions received from any single person or group of related persons are deemed to be received from "public" sources only to the extent that such contributions do not exceed one percent of the foundation's support (excluding gross investment income) during the appropriate measuring period. Treas. Reg. Sec. 53.4942(b)-2(c)(2)(iv).
period or (ii) on an aggregate basis for the entirety of the four years. Whichever test is used must be used consistently for both the adjusted net income test of section 4942(j)(3)(A) and whichever of the three alternative tests under section 4942(j)(3)(B) the private foundation chooses to use.\[^{57}\]

**B. Exempt Operating Foundations.**

Added as a separate classification in 1984, exempt operating foundations receive even more favored treatment than private operating foundations in that they are exempt from the excise tax on net investment income,\[^{58}\] and grants to such organizations by private foundations need not be made subject to the expenditure responsibility requirements of section 4945.\[^{59}\] As set forth in section 4940(d)(2), in order to qualify as an exempt operating foundation for any taxable year, an organization:

1. must be a private operating foundation,

2. must have been either

   (a) publicly supported (under section 170(b)(A)(vi) or section 509(a)(2)) for 10 years or

   (b) a private operating foundation on January 1, 1983,\[^{60}\]

\[^{57}\] Reg. Sec. 53.4942(b)-3(a).

\[^{58}\] Section 4940(d)(1).

\[^{59}\] Section 4945(d)(4)(A).

\[^{60}\] The inclusion in this category of organizations that have never been publicly supported but were private operating foundations on January 1, 1983 is not contained in the statute. It was, however, included in the non-codified portion of the Deficit Reduction Act of 1984 that added the provision having to do with exempt operating foundations. P. L. 98-369, Sec. 302(c)(3).
3. must, at all times during the taxable year, have a governing body that (i) consists of individuals at least 75% of whom are not "disqualified individuals" and (ii) is broadly representative of the general public, and

4. may not have, at any time during the taxable year, an officer who is a disqualified individual.

For these purposes, "disqualified individuals" are defined to include substantial contributors (as defined in section 507(d)(2)), owners of more than 20 percent of the stock or income or beneficial interests in corporations, partnerships or trusts that are substantial contributors, and members of the family of any of the foregoing.

IV. Legislative Intent

"Private foundation" first appeared as a defined term in the Internal Revenue Code when section 509 was added as a result of the Tax Reform Act of 1969. However, even though the changes adopted and the regulatory restrictions imposed on private foundations in the 1969 Act were the subject of extensive explanation, both in the committee reports and in the earlier series of reports prepared by Rep. Wright Patman, Chairman of "Subcommittee No. 1" of the House Select Committee on Small Business, none of those

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63 Tax-Exempt Foundations and Charitable Trust: Their Impact on Our Economy. This document, subtitled "Subcommittee Chairman's Report to Subcommittee No. 1, Select Committee on Small Business" was prepared by Representative Patman and delivered to the Subcommittee in seven installments, beginning in 1962 and ending in 1969.
explanations sheds much light on why "private foundation" was defined the way it was. Instead, the original definition was based on distinctions that existed at that time in section 170 between "20%" and "30%" charities.\textsuperscript{64} The origins for these distinctions must thus be traced to revenue acts adopted at a considerably earlier time when private foundations (or whatever they may have been called at the time) were not viewed as "second class citizens" for contribution purposes.

The first time that distinctions were drawn between classes of charitable donees was in the 1954 Code. As originally enacted, section 170 provided for a charitable contribution deduction not to exceed 20% of an individual's adjusted gross income (as had been provided in section 23(o) of the 1939 Code), and then added a new, additional deduction, not to exceed 10% of adjusted gross income, for organizations described in section 170(b)(1)(A), which at that time were limited to (i) churches or conventions or associations of churches, (ii) educational organizations (described essentially as they are today), and (iii) hospitals. As expressed in the legislative history of the 1954 Code, the reason for allowing an enhanced deduction for contributions to this group of charitable organizations was "... to aid these institutions in obtaining the additional funds they need, in view of

\textsuperscript{64} At the time the 1969 Act was enacted, section 170 limited the charitable contribution deduction available to individuals to 20% of adjusted gross income, except that an additional amount, not to exceed 10% of adjusted gross income, was allowed for contributions to organizations described in section 170(b)(1)(A)(i)-(vii), which read pretty much as it does today. Sections 509(a)(2) and 4942(j)(3) (defining private operating foundations) were new with the 1969 Act, but the basic distinctions between "private foundations" and "public charities" existed well before that time and were not changed in any meaningful way by the 1969 Act.
their rising costs and the relatively low rate of return they are receiving on endowment funds. 65

Two years later, Congress expanded the definition of organizations included in section 170(b)(1)(A)(iii) to include "medical research organizations." 66 No specific reason why these organizations were added is given in the legislative history, but the statutory provision included (perhaps foreshadowing the enactment of the redistribution requirements of section 4945(g)(3)) the requirement that a contribution to a medical research organization would qualify for the enhanced deduction only if it was "... spent by such organization for [medical research] purpose[s] ..." during the five-year period beginning with the year of contribution. In 1962, Congress again amended the section, this time adding what is now section 170(b)(1)(A)(iv) to provide that the enhanced charitable contribution deduction was to be available to endowment funds organized to support colleges and universities that were part of, or owned by, a State or a political subdivision or agency thereof. 67 This amendment was needed because many states had laws restricting the ability of state and land-grant colleges to accept public gifts for specific purposes. To circumvent these restrictions, special purpose endowment funds were created. However, until this amendment, deductions for contributions to these endowments were limited to 20% of adjusted gross income because, technically, they were not organizations described in sec


tion 170(b)(1)(A). The purpose of this amendment, as expressed in the legislative history, was to place these endowment funds "... on the same footing with private institutions [which could form these endowments without creating separate organizations] in the case of the deductibility of charitable contributions and gifts made to them."⁶⁸

The last time section 170(b)(1)(A) was amended before the adoption of the 1969 Reform Act was in 1964, when clauses (v) and (vi) were added. For the first time, Congress gave a justification for this expansion which was based less on the needs of the recipient organization and more on the speed with which these funds found their way into the public charitable stream. Thus, the legislative history contains the statement that:

"Your committee is limiting the additional 10-percent deduction to organizations which are publicly or governmentally supported, however, and is not making this additional deduction available in the case of private foundations. These latter types of organizations frequently do not make contributions to operating philanthropic organizations for extended periods of time and in the meanwhile use the funds for investments. *The extra 10-percent deduction is intended to encourage immediately spendable receipts of contributions for charitable organizations.*" (Emphasis added.)⁶⁹

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The regulations interpreting the 1964 Act amendments\textsuperscript{70} were not markedly different from those promulgated after the 1969 Reform Act, with the following exceptions:

1. contributions from a single individual or corporation could be treated as "public" support only to the extent that they did not exceed 1\% (as opposed to 2\% under the 1969 Act Regulations) of the organization's total support; and

2. an organization would be precluded from using its four preceding years' support as the basis for its publicly supported status if it experienced "substantial changes in ... [its] character, purposes or method of operation" (as opposed to "material changes in its sources of support" under the 1969 Act Regulations).

Shortly after the passage of the 1964 Act, the Treasury issued a Report on Private Foundations.\textsuperscript{71} The Report cited three "broad criticisms" that had been leveled at private foundations (mostly in the earlier series of reports prepared by the Patman Subcommittee): that the interposition of the foundation between the donor and active charitable pursuits entailed undue delay in the transmission of the benefits which society should derive from charitable contributions; that foundations were becoming too large a part of our society; and that foundations represented a dangerous concentration of economic and social

\textsuperscript{70} Treas. Reg. Sec. 1.170-2(b)(1), -2(b)(5) and (g), as added by T.D. 6900, 1966-2 CB72.

power. The Treasury Report concluded that the latter two criticisms were without merit and that only the first required a legislative solution.

With the passage of the 1969 Reform Act, "private foundations" were first legislatively defined. As noted above, the definition includes all section 501(c)(3) organizations other than those described in pre-existing section 170(b)(1)(A)(i) through (vi) and new sections 509(a)(2), (3) and (4). In explaining the rationale behind the new category of organization described in section 509(a)(2), the committee reports state that the requirements that such an organization receive at least $\frac{1}{3}$ of its support from public contributions and gross receipts and not more than $\frac{1}{3}$ of such support from gross investment income were "... designed to insure that the organization is responsive to the needs of the public."\(^{72}\)

No reason is given as to why certain categories of support were to be deemed "public" for section 509(a)(2) but not section 170(b)(1)(A)(vi) and vice versa; nor is there any explanation why no "facts and circumstances" exception was available to allow section 509(a)(2) organizations to lower their "public receipts" to a level such as 10 percent as was (and is still) true for section 170(b)(1)(A)(vi) organizations.

Also new in the 1969 Reform Act was the concept that non-grant making organizations -- officially labeled "operating foundations" for the first time -- that spend substantially all their income on active programs would be entitled to somewhat more favorable treatment than their grant-making brethren. Thus, newly enacted section 4942(j)(3) provided that private operating foundations would qualify for the same favorable contribu

tion deduction treatment that applied to public charities and that grants to such organizations, if they were not controlled by the grantor, did not have to meet the redistribution requirements of section 4942(g)(3) in order to be counted as qualifying distributions to the grantor.

In providing for this partial escape route, Congress provided a surprising degree of latitude to non-grant making organizations as long as they spent at least 85% of their current income on program or on administrative expenses related to charitable activities. Thus, as long as this basic expenditure requirement was met, a private foundation could be classified as an operating foundation as long as

1. most (65 percent) of its assets were related to program; or
2. if it had insufficient operating assets to meet this test, at least 2/3 of the presumed reasonable rate of return on its investment assets was spent on program; or
3. even if it had too great an endowment and too much investment income to meet either of these tests, if not more than half its support was derived from investment income and its contributions came from more than just a few private foundations and the general public.

The first of these alternatives essentially replicated the already existing Code provision for unlimited charitable deductions.73 The second was intended to cover the situation "where an organization's endowment ... is no more than adequate to meet its current oper

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ating expenses."\textsuperscript{74} Included in this group of organizations were charities that operated "functionally related businesses," either directly or through non-exempt subsidiaries, such as Callaway Gardens, Colonial Williamsburg and Jackson Hole Preserve. The third, not at all dissimilar from the "publicly supported" approach taken in section 509(a)(2), was added "because it appears that a number of charitable foundations are regularly used by many private foundations to funnel charitable contributions into certain areas."\textsuperscript{75} Interestingly, foundations that qualified as operating foundations under this last alternative were not required to meet any kind of mandatory distribution requirement, and the only "directly connected" expenditures (which could be administrative expenditures) that were required each year were those equaling 85\% of adjusted net income -- conceivably a very small figure.

V. Changes in Institutional Profiles -- 1975 to 1995

A. Private Foundations

The Statistics of Income Division of the Internal Revenue Service recently published a report on the nonprofit sector,\textsuperscript{76} which report includes statistics comparing the size, revenues and rates of return of both the private foundation and public charities sectors and how they have changed over the 20-year period from 1975 to 1995. Expressed

\textsuperscript{74} Id. at 2089.

\textsuperscript{75} Id.

\textsuperscript{76} The Report is reproduced in The Exempt Organization Tax Review, Vol. 24, No. 3 (June 1999) at pp 553-571.
in constant dollars, the report reveals the following with respect to the private foundation sector:

**Table I**

Private Foundations  
(All $ Figures in '000,000s)

<table>
<thead>
<tr>
<th></th>
<th>1975</th>
<th>1995</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>66,300</td>
<td>244,300</td>
<td>+ 3.7x</td>
</tr>
<tr>
<td>Revenues</td>
<td>8,500</td>
<td>30,000</td>
<td>+ 3.5x</td>
</tr>
<tr>
<td>Grants paid</td>
<td>5,100</td>
<td>11,900</td>
<td>+ 2.3x</td>
</tr>
</tbody>
</table>

The only statistic that may be somewhat surprising in the private foundation sector is the degree to which grant payments have failed to keep pace with the growth in assets and revenues. The most likely explanations for this apparent disparity are the following:

1. Asset growth, at least over the last 5 or 6 years, has been aberrationally high, due to an unusually strong stock market. As a result, prudence requires that spending be held somewhat in check so that it won’t have to be reduced when the market comes back down to earth.

2. Although today’s problems and societal challenges are serious and badly in need of correction, tomorrow’s problems can be expected to be even more serious. Dollars that are spent in future years can therefore be expected to produce a greater public benefit than dollars that are spent today.

3. The level of expenditures in 1975 reflects the pre-1982 statutory requirement that private foundations make annual expenditures equal to the greater
of minimum investment return and adjusted net income.\textsuperscript{77} Now that the spending requirement has been reduced to 5 percent of portfolio value, there's no good reason to push grants out the door any more quickly than that.

In the author's view, neither of the first two rationales is likely to have been a significant force driving those responsible for program decisions in major foundations. Although the first of the three has a good deal of appeal when applied to short-term fluctuations in the financial markets, few sophisticated investors at this point in time seriously envision the Dow Jones Industrials back down at the 4,000 level any time soon; and few if any foundation managers are sufficiently confident of their prescience or possess the intellectual courage to seriously champion the second. Experience and logic both compel the conclusion that by far the most important of the three rationales is the third. Private foundation management, by and large, has no desire or reason to spend more than they are required to; preservation and enlargement of financial assets is a basic part of human nature, and institutions, like individuals, are disinclined to dispose of these kinds of assets until they have to.

The one extremely convincing statistical conclusion regarding private foundations that may be drawn from the SOI study is that size makes an enormous difference in both

\textsuperscript{77} Section 4942(d)(1) as it existed prior to being amended by P.L. 97-34, Sec. 823(a)(1). The amendment deleted the adjusted net income alternative, effective for taxable years beginning after December 31, 1981.
investment performance and program activity. Thus, for 1995, the SOI report shows the following:

### Table II
Type of Foundation

<table>
<thead>
<tr>
<th>Percent of revenue from:</th>
<th>Small</th>
<th>Large</th>
<th>All</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investments</td>
<td>25%</td>
<td>80%</td>
<td>65%</td>
<td></td>
</tr>
<tr>
<td>Contributions</td>
<td>65%</td>
<td>15%</td>
<td>29%</td>
<td>No significant deviation from 1975</td>
</tr>
<tr>
<td>Realized investment income as a percent of assets</td>
<td>4.5%</td>
<td>8.0%</td>
<td>5.8% *</td>
<td>* = median number</td>
</tr>
<tr>
<td>Capital appreciation as a percent of assets</td>
<td>1.8%</td>
<td>19.8%</td>
<td>10.2%</td>
<td>* = median number</td>
</tr>
<tr>
<td>Payout rate</td>
<td>10.5%</td>
<td>5.1%</td>
<td>*</td>
<td>Average rate for all foundations from 1986 to 1995 fluctuates between 6.1% and 7.2%</td>
</tr>
</tbody>
</table>

#### B. Public Charities

Using the same 20-year span as a frame of reference, and once again using constant dollars, the SOI Report shows the following with respect to public charities:

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78 "Small" foundations are those with less than $100,000 in assets. "Large" foundations are those with more than $100,000,000.

79 This rate of return on capital is computed using the following formula:

Capital Appreciation + [Ending fair market value of assets - Beginning fair market value of assets - Contributions received + Grants paid + Operating and administrative expenses + Excise tax on investment income] divided by [Beginning fair market value of assets + 50 percent of contributions received]
Table III
Public Charities
(All $ Figures in ’000,000s)

<table>
<thead>
<tr>
<th></th>
<th>1975</th>
<th>1995</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>258,000</td>
<td>1,063,000</td>
<td>+ 4.1x</td>
</tr>
<tr>
<td>Revenue</td>
<td>129,000</td>
<td>617,000</td>
<td>+4.8x</td>
</tr>
<tr>
<td>Contributions received</td>
<td>41,000</td>
<td>119,000</td>
<td>+ 2.9x</td>
</tr>
<tr>
<td>Cont'bns as a pct of revenue</td>
<td>31.8%</td>
<td>19.3%</td>
<td>- 0.4x</td>
</tr>
</tbody>
</table>

Percent of contributions from
- Government sources | 42%     
- Non-government sources | 58%     

As may be seen from this table, public charities have grown at only a slightly faster rate over the twenty-year period ending with 1995 than have private foundations. However, unlike private foundations, revenues have grown faster than assets. Of perhaps more significance is that this growth in revenues has been achieved even though contributions have failed to keep pace with the growth in either assets or revenues. Thus, in the public charity sector, it would appear that most of the rather considerable growth that has occurred over the last twenty years has been attributable to the expansion of program revenue, not success in fund-raising. It is tempting to speculate that as a result of this phenomenon an increasing proportion of fund-raising charities should be represented by section 509(a)(2) organizations and a correspondingly smaller proportion by those qualifying under section 170(b)(1)(A)(vi). However, because the data contained in the SOI Report do not contain separate statistics on these two categories of publicly supported charities, it
is also possible that this disproportionate growth in program revenues is primarily (or ex-
clusively) attributable to one or more categories of organization whose public charity
status is attributable to their activities and not their ability to attract contributions.80

The SOI Report reveals the following rather dramatic differences in the sources of
support that were received in 1995 by public charities engaged in various kinds of pro-
gram activities:

Table IV
(All $ Figures in '000,000s)

<table>
<thead>
<tr>
<th>Kind of Organization81</th>
<th>Revenues</th>
<th>% of Total Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Contributions</td>
<td>Programs</td>
</tr>
<tr>
<td>Arts, culture and humanities</td>
<td>$7,359</td>
<td>$4,418</td>
</tr>
<tr>
<td>Education82</td>
<td>32,512</td>
<td>66,305</td>
</tr>
<tr>
<td>Environment animals</td>
<td>2,490</td>
<td>1,481</td>
</tr>
<tr>
<td>Health</td>
<td>28,674</td>
<td>314,437</td>
</tr>
<tr>
<td>Human Services</td>
<td>33,366</td>
<td>36,268</td>
</tr>
<tr>
<td>International foreign affairs</td>
<td>5,442</td>
<td>706</td>
</tr>
</tbody>
</table>

80 Thus, as may be seen from Table IV, if the support figures for the health care industry are excluded from the totals, contributions received by all other public charities in 1995 comprise 33% of the total revenues received by those organizations, a percentage that is almost identical to that which applied to all public charities in 1975.

81 These are the Amajor@ field areas of a classification system known as Athe National Taxonomy of Exempt Entities,® developed by the National Center for Charitable Statistics.

82 Excludes most colleges and universities operated by state and local governments.
Table continued from previous page.

<table>
<thead>
<tr>
<th>Kind of organization</th>
<th>Contributions</th>
<th>Programs</th>
<th>Contributions</th>
<th>Programs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mutual member benefit</td>
<td>123</td>
<td>10,981</td>
<td>0</td>
<td>31</td>
</tr>
<tr>
<td>Public society benefit</td>
<td>14,450</td>
<td>7,820</td>
<td>47</td>
<td>25</td>
</tr>
<tr>
<td>Religion-related</td>
<td>3,260</td>
<td>637</td>
<td>68</td>
<td>13</td>
</tr>
<tr>
<td>Total for all Public Charities</td>
<td>$127,743</td>
<td>$443,052</td>
<td>19%</td>
<td>67%</td>
</tr>
<tr>
<td>Total for all Except Health</td>
<td>$99,069</td>
<td>$128,615</td>
<td>33%</td>
<td>43%</td>
</tr>
</tbody>
</table>

VI. Do the Rules Make Any Sense?

An assessment of the various criteria for avoiding private foundation status should probably be divided into two separate questions:

1. Is there any justification for retaining the distinction between private foundations, on the one hand, and public charities and private operating foundations on the other?

2. If there is a basis for retaining such a distinction, are the current rules under sections 170(b)(1)(A)(vi), 509(a)(2) and 4942(j)(3) the right ones to use?

A. Is There a Justification for Retaining the Distinctions Between These Categories of Organization?

In assessing the desirability of retaining the current distinctions between private foundations, on the one hand, and public charities and private operating foundations, on

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83 Because these data are drawn from Forms 990, they exclude most churches.
the other, it is appropriate to recall the three rationales for these distinctions as articulated in the various committee reports:

1. To assist existing operating charities (churches, hospitals and educational organizations) "... in obtaining the funds they need, in view of their rising costs and ... relatively low rate of [investment] return."\(^{84}\)

2. To ". . . encourage immediately spendable receipts of contributions for charitable organizations."\(^{85}\)

3. To ". . . insure that the organization is responsive to the needs of the public."\(^{86}\)

Turning to the first of these rationales, it seems logical to assume that the enhanced percentage limits, and particularly the favorable treatment that applies to contributions of capital gain property, that apply to section 170(b)(1)(A) organizations, results in some marginal amount of charitable contributions being allocated to the public charity sector that would otherwise find their way into the hands of private foundations if the difference in contribution limits didn't exist. However, given the number of different ways in which one may circumvent these differences,\(^ {87}\) it is tempting to conclude that the actual difference in where contribution dollars finally end up isn't nearly as great at logic would first lead one to believe. Nevertheless, as long as the difference in deductibility has the poten

\(^{84}\) See footnote 65, supra.

\(^{85}\) See footnote 69, supra.

\(^{86}\) See footnote 72, supra.

\(^{87}\) The widespread use of donor-advised and donor-directed funds and the creation of section 509(a)(3) organizations are just a few of the more obvious examples.
tial to make a difference, that's probably an adequate reason for leaving it in place. The other part of the first rationale -- that charities with public programs such as churches, universities and hospitals, are facing "rising costs and relatively low rates of return," is at best only half right. The costs incurred to carry on these programs -- particularly the costs of health care and a college education -- do appear to be rising at rates that are well above the national inflation rate, but it's not at all clear that the performance of the endowments held by these organizations are under-performing funds of similar size and with similar calls on the returns that they are able to produce. 88 Nevertheless, it's certainly not indefensible to maintain that charitable organizations with programs that directly serve and affect the public are "more worthy" than grant-making organizations, at least in terms of the charitable contribution rules that apply to them, and that the distinctions that exist in section 170(b)(1)(A) should therefore be retained.

The second of the three reasons for distinguishing between public charities and private foundations may have a good deal more appeal than the first. As shown by the recent SOI Report, charitable expenditures by private foundations are only slightly higher than the legal minimum imposed by section 4942, and there's no particularly credible reason to believe that even this level of expenditure would be maintained if that requirement were to be relaxed. Indeed, there may be reason to believe that the ways in which this particular goal are being circumvented have become so effective that the requirement needs to be

tightened up, but that's an issue that is beyond the scope of this paper.\textsuperscript{89} Whether the status of an organization as a church, a school, a hospital or a university endowment fund is sufficient to ensure that its assets will be devoted reasonably quickly to the active conduct of charitable activities is not necessarily assured.\textsuperscript{90} Certainly, the Kamehameha Schools Bishop Estate provides a vivid example of how an organization can theoretically meet the requirements of section 170(b)(1)(A)(ii) and avoid the expenditure of any significant part of its income or assets for educational purposes.

Nevertheless, most practitioners would probably acknowledge that the Hawaiian experience provides a highly unusual, perhaps even a unique, example and that the application of section 4958 or revocation proceedings in the isolated case is a more effective way of dealing this kind of a situation than to impose an expenditure requirement on section 170(b)(1)(A) organizations.\textsuperscript{91}

\textsuperscript{89} Charitable donees that are currently the giving vehicles of choice for the wealthy, particularly donor advised funds and charitable remainder trusts, are frequently marketed on the basis that they enable the donor to take a current charitable deduction but defer the transfer of the funds to the ultimate charitable beneficiary to a considerably later time. Section 664, of course, addresses this issue by requiring that contributions to remainder trusts be discounted to reflect this deferral, but the exemption from capital gain tax that results from a transfer of property to such a trust is immediate and complete. And in the case of contributions to donor advised funds, an immediate deduction for the full value of the contribution is available even though the ultimate distribution of funds to operating charities may be postponed for a considerable number of years.

\textsuperscript{90} See the articles by Karen Arenson, cited in note 88, supra, in which the author indicates that many universities are applying no more than four or five percent of their assets each year to program expenditures each year, even though the average rates of return on their endowments are as great as 20 or 25 percent.

\textsuperscript{91} Interestingly, section 170(b)(1)(A)(iii) actually imposes this sort of a requirement on medical research organizations that are operated in conjunction with, but are unable to qualify as, hospitals. The section provides that contributions to such an organization will be entitled to the enhanced deduction limit of section 170(b)(1)(A) only if the recipient, during the year in which the contributions are received, “is committed to spend such contributions for ... research” within the following five years.
Similarly, the goal of ensuring that charitable funds are released into the public charitable stream with reasonable dispatch would also seem to be effectively promoted by at least most of the requirements that apply to private operating foundations. The forced expenditure "directly for the active conduct" of an organization's exempt programs of substantially all of one's adjusted net income and the collateral requirement that substantially more than half of an organization's assets be devoted to or, alternatively, that two-thirds of its minimum investment return be expended for, such purposes are well-focused, and it's difficult to imagine how one could formulate requirements that would be any more effectively oriented than those currently contained in section 4942(j)(3). The one glaring exception in the operating foundation arena is the so-called "support test" of section 4942(j)(3)(B)(iii), which effectively permits organizations that are able to attract funding from as few as five other private foundations to qualify as private operating foundations as long as they make "directly connected" expenditures equal to at least 85 percent of adjusted net income. For organizations qualifying under that test, there would appear to be an opportunity to hoard charitable funds for an extended period of time while offering donors the maximum charitable contribution deduction and providing friendly (but admittedly non-controlling) private foundation grantors a vehicle into which to deposit qualifying distributions that may not be redistributed to public charities for a considerable length of time.

The argument for maintaining the distinction between public charities described in sections 170(b)(1)(A)(i) through (v) and private operating foundations, on the one hand, and private foundations, on the other, on the ground that the former ensure a quick re
lease of contributed funds into the public charitable stream loses a good deal of its force when applied to the so-called "publicly supported" categories of organizations described in sections 170(b)(1)(A)(vi) and 509(a)(2). There's no particularly appealing reason to think that an organization that obtains its funding from broad public sources will, for that reason alone, expend its funds for programs of direct public benefit any more quickly than a charity that obtains its funding from a small number of private donors. Museums and public libraries engaged in capital fund drives are unlikely to expend any of the contributions that they are able to raise; nor is there reason to believe that the additional investment income earned by their enhanced endowments is more likely to be applied to charitable expenditures than to reduce future years' fund-raising goals. Community trusts, as another example, frequently accept contributions to donor advised funds that are allowed to accumulate and grow their portfolios without significant contributions' being made for a number of years. Indeed, a number of community trusts reportedly accept donor advised contributions from private foundations that are seeking ways to satisfy the distribution requirements of section 4942 without losing control over the ultimate distribution and application of those funds. And for those publicly supported funds that are sponsored by commercial concerns in the business of managing mutual funds or providing investment advisory services, there is a clear motivation to minimize charitable contributions and maximize the investable corpus, which is the source of the sponsor's fee income.

Somewhat similar considerations apply to the third of the articulated rationales for distinguishing public charities from private foundations: that the former are "responsive to the needs of the public." Initially, it must be recognized that structures designed to ensure
that an organization is "responsive to the needs of the public" may be considerably different from those that are designed to ensure that an organization is "responsive to the public." The former appears to contemplate that the organization in question will structure its programs in ways that fulfill public needs; the latter suggests that the organization is one that is accountable to the public. Stated differently, the former requires responsiveness to the public sector that it serves; the latter requires responsiveness to the public sector from which it derives funds. For section 509(a)(2) organizations, which frequently derive significant portions of their funding from those for whom they perform services, the two sectors of the public may be substantially similar; for that reason, it is at least logical to assume that sensitivity to the organization's source of funding will, per force, lead to the desired sensitivity in formulating program. For a section 170(b)(1)(A)(vi) organization, however, there will frequently be a complete dichotomy between the sector of the public that provides the organization's funding and the sector that receives the benefit of its programs. To maintain that a broad contribution base will result in the organization's being responsive to the needs of its charitable constituents is a non sequitur.

Does it make sense to preserve the distinctions between public charities and operating foundations, on the one hand, and private foundations, on the other? If the goals are directing funds where they are most deserved and assuring responsiveness to the needs

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92 It is, of course, possible that the authors of the committee reports in which this language is found failed to focus on this distinction. However, that is not an assumption that should be made lightly; and in any event the differences are instructive for purposes of the discussion at hand.
of charitable beneficiaries, then the distinctions between private foundations and organizations described in sections 170(b)(1)(A)(i) through (v) and 509(a)(2) probably make sense. If the goal is to speed the application of contributions to their ultimate charitable use, then the distinction between private foundations and operating foundations certainly makes sense. But unless the goal is heightened accountability to contributors, the distinctions between private foundations and section 170(b)(1)(A)(vi) organizations is hard to justify, and it would seem that some sort of expenditure requirement ought to apply to this kind of organization.

B. If the Distinctions are to be Retained, Which of the Specific Rules Need to be Changed?

Assuming that the existing distinctions between public charities and private operating foundations, on the one hand, and private foundations, on the other, are to be retained, there would appear to be a number of respects in which the existing rules are in need of change. In some cases the rules are inconsistent or illogical; in others they may actually produce results which are counterproductive to the legislative intent expressed by Congress at the time the provisions were enacted.

Set forth below in tabular form is a summary of how various kinds of support are treated for purposes of section 170(b)(1)(A)(vi) and section 509(a)(2):
### Table V
Comparison of Publicly Supported Organizations

<table>
<thead>
<tr>
<th></th>
<th>Section 170(b)(1)(A)(vi)</th>
<th>Section 509(a)(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Support:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>(other than capital gains and debt financed)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital gains (other than debt-financed)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Debt-financed income (including capital gains)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>(pre-tax)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Gifts, grants, contributions &amp; membership fees</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Services (non-deductible)</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Services received from a governmental unit</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Gross Receipts from exempt activities</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Net income from unrelated businesses (pre-tax)</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Earmarked tax revenues</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Public Support:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Contributions from a governmental unit</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Gross receipts from a governmental unit</td>
<td>Not applicable</td>
<td>Yes</td>
</tr>
<tr>
<td>Contributions from a govt’ bureau or agency</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Gross receipts from a govt’ bureau or agency</td>
<td>Not applicable</td>
<td>$5K/1% limit</td>
</tr>
<tr>
<td>Contributions from 170(b)(1)(A)(i)s and (vi)s</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Contributions from 170(b)(1)(a)(ii)-(v)s</td>
<td>2% limit</td>
<td>Yes</td>
</tr>
<tr>
<td>Contributions from disqualified persons</td>
<td>2% limit</td>
<td>No</td>
</tr>
<tr>
<td>Gross receipts from disqualified persons</td>
<td>Not applicable</td>
<td>No</td>
</tr>
<tr>
<td>Contributions from all other persons</td>
<td>2% limit</td>
<td>Yes</td>
</tr>
<tr>
<td>Gross receipts from all other persons</td>
<td>Not applicable</td>
<td>$5K/1% limit</td>
</tr>
<tr>
<td><strong>Disqualifying Support:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment income</td>
<td>Not applicable</td>
<td>1/3 support limit</td>
</tr>
<tr>
<td>(excluding capital gains and debt-financed)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt-financed (including capital gains)</td>
<td>Not applicable</td>
<td>1/3 support limit</td>
</tr>
<tr>
<td>(after-tax)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net income from unrelated business</td>
<td>Not applicable</td>
<td>1/3 support limit</td>
</tr>
<tr>
<td>(after-tax)</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1. Rules Relating to Total Support

The difference in the treatment of gross receipts from the performance of an organization's exempt activities is obviously attributable to the essential distinction between sections 170(b)(1)(A)(vi) and 509(a)(2) and must be retained. There are, however, a number of other inconsistencies that are not so obviously justified. In no particular order, they include the following:

(a) Treatment of Unrelated Business Receipts of Section 509(a)(2) Organizations. If section 509(a)(2) organizations are to be classified based on their gross receipts from related activities, the analogous amount from unrelated business activities (i.e., gross receipts rather than net income) should also be included in the denominator of their support fractions. If gross receipts are the appropriate measure of an organization's overall contact with its public constituents, there is no good reason why the revenues from an unrelated activity should be treated any differently from one that's related. This is not to say that any part of the receipts from an unrelated business activity -- even those that otherwise meet the $5,000/1 percent test of section 509(a)(2)(A)(ii) -- should be included in the numerator of the support fraction; the test of whether an organization is "responsive to the needs of the public" should be based exclusively on what it does to serve those needs, and the revenues derived from an unrelated trade or business, no matter how broadly based, would not seem to fulfill that goal. The consequences of such a change would be threefold: (i) the denominator of the support fraction would be larger, thus making it more difficult to meet the 1/3 public support test; (ii) unrelated
business receipts would be larger, thus increasing the likelihood that the organization would be disqualified because more than 1/3 of its total support came from improper sources; and (iii) the $5,000/1 percent limit would increase (because total support would have increased), thus increasing, at least marginally, the amount of the organization's qualified receipts from public sources.

(b) Treatment of the Unrelated Business Income of Section 170(b)(1)(A)(vi) Organizations. Conversely, because exempt function income received by an organization described in section 170(b)(1)(A)(vi) is excludible in its entirety from both numerator and denominator of the applicable support fraction, it would appear logical to exclude any items (whether net or gross) received by such an organization from the conduct of an unrelated trade or business from both parts of its support fraction. Stated differently, if the public support fraction of a section 170(b)(1)(A)(vi) organization is to be based on contributions, government support and investment income, there would appear to be no reason to include either gross receipts or net income from any activity, whether related or unrelated, in such an organization's support fraction.

(c) Capital Gains from Debt-Financed Property. Capital gains (both long- and short-term) have historically been excluded from the numerator and denominator of the public support fraction applicable to both section 170(b)(1)(A)(vi) and 509(a)(2) organizations. However, because "support" is defined to include "net income from an unrelated trade or business," the result is to include net capital gains from debt-financed property as part of the total support received by either kind of
organization. If capital gains are properly excluded from "support" (presumably because they produce aberrational swings in an organization's investment income), then there's no good reason for treating debt-financed gains differently.

2. Rules Relating to Public Support

(a) International Organizations. International organizations designated as such by Executive Order under 22 U.S.C. 288 are treated as "public charities" and exempt from the expenditure responsibility requirements of section 4945. It would seem logical to treat support furnished by such organizations as support from "governmental units" for purposes of section 170(b)(1)(A)(vi) and from "permitted sources" for purposes of section 509(a)(2).

(b) Private School Guidelines. The application of the racially non-discriminatory standards of Revenue Procedure 75-50 to foreign organizations that seek classification as "educational institutions" under section 170(b)(1)(A)(ii) is questionable at best. In many countries, racial discrimination is simply not a fact of life, and requiring such institutions to comply with policies and procedures that have no relevance to their political and social structure makes little sense. For

93 Section 509(e) defines "gross investment income" (which is includible in the "support" of these organizations under section 509(d)(4)) as "the gross amount of income from interest, dividends, payments with respect to security loans ..., rents, and royalties, but not including any such income to the extent included in computing the tax imposed by section 511." Thus, debt-financed investment income is includible in support under paragraph (3) of section 509(d) as "net income from unrelated business activities" and not under paragraph (4). Unlike the definition in paragraph (4), there is no basis, under section 509(d)(3) for excluding capital gain income. It may be noted that capital gains were also excluded from the definition of "support" that applied to section 170(b)(1)(A)(vi) organizations prior to the 1969 Reform Act (see, Reg. Sec. 1.170-2(b)(5)(ii)(b)(2) as in effect prior to 1969), but the issue of debt-financed capital gains was moot, as the current version of section 514 was not added to the Code until 1969.

those countries in which racial discrimination is an issue, requiring the policy may be appropriate, but there would appear to be no justifiable reason to require universities in such countries to comply with the public notice and other procedural requirements of Rev. Proc. 75-50 as the price for being classified as a public charity for U.S. grant-making purposes.

(c) "Permitted" and "Disqualified" Sources of Public Support. There is no readily apparent justification for the relatively significant differences in the kinds of support that are considered to be "public" for purposes of sections 170(b)(1)(A)(vi) and 509(a)(2) and those that are considered either wholly or partially disqualified from that category. Thus, for purposes of section 170(b)(1)(A)(vi), support from other than a governmental unit is considered to be "public" and thus includible in the numerator of the organization's public support fraction only if it (a) comes from another organization described in section 170(b)(1)(A)(vi) or (b) from other sources, but then only to the extent that the total contributions from such sources do not exceed the 2% of total support limit prescribed in the regulations. No distinctions are drawn, for purposes of section 170(b)(1)(A)(vi), between support received from substantial contributors or other disqualified persons, on the one hand, and individuals that are not disqualified persons, on the other. For purposes of section 509(a)(2) however, contributions are includible in the numerator of the public support fraction in their entirety as long as they are received from an organi
zation qualifying under any of the first six clauses of section 170(b)(1)(A),\textsuperscript{95} or from any other non-exempt person who is a “permitted source” with respect to the organization. Thus, contributions from those who are not disqualified persons with respect to a section 509(a)(2) organization are includible entirely in the numerator of the public support fraction even though the contributions received from one or more of those persons may be considerably in excess of 2% of the organization’s total support during the applicable measuring period. Conversely, contributions from anyone who is a "disqualified person" with respect to the organization are excludible in their entirety from the numerator, even though such contributions may be considerably less than 2% of total support during such period. Although either set of standards would be reasonably logical for purposes of measuring "public support", there is no easily discernable reason why the standards should differ so markedly between one kind of publicly supported organization and the other. Thus, the author would urge that, at least for contribution purposes, either the "disqualified person" standard, or the "2% public support" standard, or some combination of both be applied to both kinds of organizations and that contributions from organizations described in section 170(b)(1)(A)(i)-(v) be treated consistently for purposes of both kinds of organizations as well.

\textsuperscript{95} Strangely, contributions from other organizations meeting the qualifications of section 509(a)(2) are not treated in the same way. Contributions from section 509(a)(2) organizations are includible in the organization’s "public support" fraction only if the donor would not constitute a "substantial contributor" with respect to the recipient organization.
(d) "Facts and Circumstances" Test. The conspicuous absence of any "facts and circumstances" test that would allow an organization that arguably meets the general profile of what section 509(a)(2) was intended to include is puzzling. One would think that an organization that operates facilities in the nature of a museum or library, which facilities are made available for the use of the general public, ought not to lose its section 509(a)(2) status simply because it is fortunate enough to have a large percentage of its support furnished from an endowment, thereby reducing the need for it to charge admission fees to the members of the public using its facilities. Indeed, in many respects, it would appear that a "facts and circumstances" exception is more easily and logically applied to an organization described in section 509(a)(2) than it is to an organization described in section 170(b)(1)(A)(vi).

Irrespective of which kind of organization one is dealing with, the acceptable minimum level of support that an organization must receive in the form of contributions from the "general public," as currently set forth in the regulations under section 170, seems unduly lenient. As currently structured, the regulations make it possible for an organization to meet the "facts and circumstances" standard under section 170(b)(1)(A)(vi) if it has at least five contributors, each of whom furnishes at least 2% of its total support during the applicable measuring period. Opinions can obviously differ as to what the appropriate measure of "public support" ought to be, but whatever the answer, there is a strong appeal in setting the same standard for both kinds of organizations.
(e) The $5,000/1% Limitation Applicable to Section 509(a)(2) Organizations

- Quantification. The current one percent limit on the amount of "receipts" that a section 509(a)(2) organization may treat as "public" with respect to amounts received from a single source seems ridiculously low. Why an organization that receives as much as five percent, or even ten percent, of its total receipts from a single source would feel improperly beholden to that source in terms of being responsive to public needs is difficult to comprehend, and there is nothing in the legislative history that accompanied the enactment of section 509(a)(2) that indicates why such a low level was chosen. It would seem that a more realistic level is called for and would easily be justified.

(f) The $5,000/1% Limitation Applicable to Section 509(a)(2) Organizations

- Basing the Computation on a Single Taxable Year. As noted earlier, the "public support" computations applicable to both sections 170(b)(1)(A)(vi) and 509(a)(2) organizations are both based on a four-year rolling average. For each kind of organization, the numerators and denominators of the fraction are based on aggregate amounts received during the four preceding years rather than on a year-by-year basis. However, in determining whether or not a section 509(a)(2) organization's gross receipts have been received from appropriate publicly sources, the "$5,000/1 percent limitation" is applied on a single taxable year basis, so that even if an organization's receipts from a single person are substantially less than one percent of its total receipts for the four-year measuring period, a portion of the receipts from such person will be excluded from the numerator of the fraction if they
exceeded one percent of the organization's receipts for the particular taxable year in which they were received.96 No reason is given in the legislative history accompanying the 1969 Reform Act why a one year rather than a four year rolling average approach was used, and it appears at least likely that the inconsistency was not intentional but was instead caused by inadvertence in the course of drafting the statute.97

(g) The $5,000/1% Limitation Applicable to Section 509(a)(2) Organizations - Application to Governmental Units, Bureaus and Agencies. The application of the $5,000/1% limitation of section 509(a)(2)(A)(ii) to governmental units, agencies and bureaus seems particularly inappropriate, when compared to the approach under section 170(b)(A)(1)(vi), which permits support from governmental units to be included in the numerator of the public support fraction in their entirety. It is not clear, from reading the committee reports that accompanied the 1969 Reform Act why the tax-writing committees of Congress were so suspicious of large amounts of revenues being derived from a single governmental unit, bureau or agency. To limit the support from such entities that may be included as "public" to a mere one percent of the year's total receipts seems unnecessarily restrictive; and if there is a

96 See earlier discussion in the text immediately preceding footnote 47, supra.

97 This rationale goes only so far. The requirement that the limitation on gross receipts with respect to any particular person or governmental unit be computed on a taxable year basis is statutorily required, to be sure (see section 509(a)(2)(A)(ii)); but so is the requirement contained in the flush language of section 509(a)(2)(A), that the organization Anormally receives more than one-third of its support [from the required sources] in each taxable year. (Emphasis added.) For some unexplained reason, adherence to a taxable year computation was thought to be required in the first case but not the second.
justification for viewing the overabundance of receipts from a single governmental unit as "private" rather than "public," the same principle should presumably apply to governmental support received by section 170(b)(1)(A)(vi) organizations.

3. **Rules Relating to Private Operating Foundations.**

Generally, the rules for qualification as a private operating foundation under section 4942(j)(3) make relatively good sense. There are, however, a few respects in which clarification and simplification could be helpful.

(a) The "Support Test" of Section 4942(j)(3)(B)(iii) Should be Repealed. Because the principal thrust of the operating foundation provisions is to ensure that charitable funds are not impeded for an undue length of time in getting into the public charitable stream, the support test of section 4942(j)(3)(B)(iii) seems particularly inappropriate. Under that test, all that is necessary is that the organization receive 85% of its support, other than gross investment income, from the general public and from five or more exempt organizations that are unrelated to it, with the further proviso that not more than 25% of its support normally be received from any one exempt organization. Taking into further account that contributions are excluded from adjusted net income, the "support test" would appear to permit the creation of a private foundation that could act as a repository for grant payments from as few as five private foundations without being subject to any further requirement that it redistribute such grant payments within any particular future time. The reason given in the committee reports that accompanied the 1969 Reform Act, that “it appears that a number of charitable foundations are regularly
used by many private foundations to funnel charitable contributions into certain areas,\(^98\) is unconvincing at best. If there is a degree of expertise in "funneling" grant payments to specific organizations, as the committee report suggests, then there ought to be some requirement that such "funneling" take place within a reasonably short period of time after the original grants are received.

(b) *The Time Periods for Measuring Compliance with a Private Operating Foundation Tests Should Correspond to those Used to Test "Public Support."* The regulations governing the qualification of an organization as a private operating foundation currently provide that the "adjusted net income" test and one of the three alternative tests of section 4942(j)(3)(B) must be met either for any three out of the four taxable years ending with the taxable year in question or on the basis of the aggregate amounts received and expended during such four year period.\(^99\) Whichever test (i.e. the three-out-of-four year test or the aggregate four year test) is used for the adjusted net income expenditure test must also be used for whichever alternative test is applied. For purposes of qualifying for publicly support status, on the other hand, the regulations under sections 170(b)(1)(A)(vi) and 509(a)(2) require that an organization meet the required publicly supported standards on a four year rolling average basis, using the four year period ending with the year preceding the year to which the computation applies. Although there is no particular


\(^{99}\) Reg. Sec. 53.4942(b)-(3)(a).
difficulty in applying the rules of the regulations currently existing under section 4942(j)(3), simplicity and consistency suggest that the use of the same four year rolling average method would be preferable.

(c) *The Exempt Operating Foundation Test Serves No Ascertainable Policy Objective and Should be Repealed.* The exempt operating foundation provision currently found in section 4940(d) serves no purpose that is consistent with the overall objectives of chapter 42 or section 509 in distinguishing between private foundations on the one hand, and public charities and private operating foundations on the other. The reason for this new classification, as expressed in the committee reports was that "private operating foundations which exhibit certain characteristics reflecting substantial public involvement should be exempted from [section 4940].... These changes will assist such operating foundations in making direct expenditures for the active conduct of their charitable activities."\(^{100}\) The reason given is less than compelling, and one suspects that the enactment of the provision was attributable to special interests who were able to meet a reasonably unique set of facts and thus qualify as an exempt operating foundation. Whatever the historical reason for the insertion of this provision, there seems no particular justification for its continuation. Clearly, the fact that "disqualified individuals" constitute no more than 25% of the governing committee and none of the officers of such an organization does not provide a compelling reason why the organization it

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self should be excused from paying the net investment income tax under section 4940 or complying with the expenditure responsibility provisions of section 4945 with respect to grants that it may receive from other private foundations. Section 4940(d) serves only to complicate unnecessarily the provisions of chapter 42.

C. Conclusions

Based on the foregoing, the author respectfully suggests that even though some bases exist for retaining the distinctions between private foundations, on the one hand, and public charities and private operating foundations, on the other, there is room for substantial simplification of these provisions and distinctions. The author also believes that whichever of these rules do remain be consistent with one another instead of having a variety of different rules which are arguably attempting to achieve the same general result.

Specifically, the following changes are suggested:

1. Expenditure requirements similar to those in section 4942 should be imposed on all charitable organizations, public or private. The continued need for a distribution requirement applicable to private foundations is amply demonstrated by the SOI Report, indicating that the annual expenditures of private foundations are not exceeding by any material amount the statutorily required minimum. The imposition of such a requirement on public charities should result in little if any burden on most, the only possible exception being public charities with large amounts of financial assets (such as commercially sponsored trusts with donor advised funds, and the occasional over-endowed public charity such as the Bishop
Estate in Hawaii). More importantly, to the extent that any such requirement does prove to be problematic for a public charity, the imposition of a requirement is probably desirable.

2. There should only be one set of restrictions on dealings between charitable organizations and their disqualified persons. Whichever of sections 4941 and 4958 is determined to be the more sensible approach should be adopted and applied to both categories of charitable organizations.

3. Retain the separate classification of private operating foundation, but repeal the support test as an alternative way in which to qualify for this classification.

4. Repeal section 4940(d) in its entirety, as there appears to be no reason for the current provision allowing special treatment to "exempt operating foundations."

5. Simplify the rules applying to the computation of "publicly supported" status and "private operating foundation" status to provide that all computations be made on the four year rolling average basis that currently apply to "publicly supported organizations." Consistent with the foregoing, the application of the $5,000/1% test (or whatever it ultimately becomes) of section 509(a)(2)(A)(ii) should be applied based on the same four-year rolling average rather than on the separate taxable year basis.

6. Provide a "facts and circumstances" alternative test for section 509(a)(2) organizations, but provide for a somewhat more realistic minimum percentage (e.g.,
20% or 25%) of public support in order to qualify for this exception under both sections 170(b)(1)(A)(vi) and 509(a)(2).

7. Provide that "governmental support" received by any kind of publicly supported organization is includible in full in the numerator of the publicly supported fraction and provide further, that support from international organizations designated as such by Executive Order under 22 U.S.C. 288 is to be treated as "governmental support" for these purposes.

8. Provide as an administrative exception that foreign organizations seeking classification as "educational institutions" under section 170(b)(1)(A)(ii) need not comply with the notice-giving and other procedural requirements of Rev. Proc. 75-50.

9. Establish a unified minimum percentage limit for purposes of determining, on a per-person basis the amount of contributions and, in the case of section 509(a)(2) organizations, gross receipts that may be included as public support in the numerator of the appropriate support fraction. As an initial proposition, it is suggested that 5% of total support would be an appropriate figure.

10. Provide that all support received from organizations described in sections 170(b)(1)(A)(i)-(v) and section 509(a)(2) may be treated as public support.

11. Treat unrelated trade or business receipts consistently with those that are related. For purposes of section 509(a)(2), include all receipts (not just the net income) from an unrelated trade or business as part of an organization's support;
and for purposes of section 170(b)(1)(A)(vi), provide that all such receipts (and the net income therefrom) be excluded from the definition of support.

12. Treat all items of investment income consistently, irrespective of whether or not they're debt-financed.