

PUBLIC SUPPORT CALCULATIONS: IMPORTANT CHANGES IN STORE IN THE 2008 FORM 990

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A revised Form 990 (the annual information return that most tax-exempt organizations are required to file) was released by the Internal Revenue Service (the “Service”) in December 2007. The revised form includes significant changes to the public support schedule found in Schedule A to the Form 990. The public support schedule serves as the method through which many Code Section 501(c)(3) organizations demonstrate their continued qualification as public charities rather than as private foundations. Because many of the changes on the revised Form 990 were inconsistent with the existing Treasury Regulations, the Treasury Department recently issued final and temporary regulations (the “Temporary Regulations”) that make the regulations consistent with the revised public support schedule on the Form 990.

The Temporary Regulations eliminate the “advance ruling period” for new organizations, change the accounting method required to be used in calculating an organization’s public support, and change the public support computation period. This update discusses the change in accounting method and the change in computation period. A discussion of the elimination of the advance ruling period can be found in our [January 2009 update](#). Detailed information regarding the revisions to the Form 990 can be found in our [February 2008 update](#).

Background: Prior Law

Through the 2007 Form 990, an organization that had been determined by the Service to be a public charity on the basis of a public support test was required to complete a public support schedule that considered the organization’s sources of support during the prior four-year period (e.g., the 2007 Form 990 public support schedule considered the filing organization’s sources of support for 2003–2006). The organization could maintain its public charity status as long its annual support schedules showed that more than one-third of its support came from the “public” and, in the case of a public charity described in Code Section 509(a)(2), that not more than one-third of its support came from investment income. (In limited circumstances

some organizations described in Code Section 509(a)(1) could qualify even with public support percentages below the one-third level.)

For purposes of the public support schedule, contributions from government sources and many other public charities are counted in full as “public” support. Contributions from other donors are also generally counted as “public” support, subject to certain important exceptions. Under the Code Section 509(a)(1) public support test, large contributions from single donors and groups of related donors only count as “public” support to the extent that they do not in the aggregate exceed two percent (2%) of the organization’s total support during the period under review. Under the Code Section 509(a)(2) public support test, contributions and program service revenue received from disqualified persons with respect to the organization do not count as “public” support, and program service revenue from other individuals, private foundations, and groups of related donors only counts to the extent that it does not in the aggregate exceed the greater of \$5,000 or one percent (1%) of the organization’s total support for the period under review. It may be possible under either public support test to exclude a large contribution from the calculation of public support completely, but only under limited circumstances.

In completing the public support schedules on its annual Forms 990, a filing organization was required to use the cash method of accounting. Thus, even if the organization kept its books and records on the accrual method of accounting, the public support schedule had to be completed on the cash method of accounting.

Public Support Test: Accounting Method Change

For taxable years beginning on or after January 1, 2008, the Temporary Regulations and the Revised Form 990 require the filing organization to complete the public support schedule using the same method of accounting used for the rest of the organization’s return. Accordingly, if a filing organization keeps its books and records on the accrual method of accounting, then the organization must complete the public support schedule using the accrual method. Further, if a filing organization keeps its books and records on the accrual method, then the organization will not be able to transfer public support numbers from prior schedules into the current year’s schedule because the earlier numbers would have been generated using the cash method. The organization instead must revise all of the prior years’ numbers to reflect the accrual method of accounting.

This change presents several planning considerations for filing organizations. First, a filing organization that completes a public support schedule should determine whether the remainder of its Form 990 is completed using the accrual method of accounting. If the accrual method is used for the remainder of the Form 990, then the accrual method must also be used for the public support schedule beginning with the

2008 Form 990. In contrast, if the organization completes the remainder of its Form 990 using the cash method of accounting, then no change will be needed with respect to the public support schedule.

Next, if the organization needs to change the method of accounting used to complete its public support schedule, then it should determine whether the change will affect its public support percentage. An organization that must begin using the accrual method for the public support schedule on its 2008 Form 990 will need to use the accrual method for each year on the schedule (e.g., 2004–2008). A change in the information reported on the schedule could result in significant changes to the organization's public support percentage. The two examples below highlight the manner in which changing the accounting method used for the public support schedule may affect an organization's public support percentage:

1. Organization X qualifies as a public charity because at least one-third of its total support comes from the public. X is a member of a partnership that issues an annual Schedule K-1 to X. The K-1 indicates that \$75,000 of the partnership's annual ordinary income is attributable to X, even though none of the income is actually distributed to X. Further, X receives \$100,000 in contributions from small, unrelated donors annually. These levels of support remain consistent through each year of the public support computation period.

Completing the public support schedule on the cash method of accounting results in a public support percentage equal to 100% (\$500,000 in total support during the computation period, all of which constitutes public support). This is because the \$75,000 reflected on the K-1 each year will not be included in the public support schedule until it is actually distributed or made available to the organization.

In contrast, completing the public support schedule on the accrual method of accounting results in a public support percentage of 57% (\$875,000 total support during the computation period, of which only \$500,000 constitutes public support). This is because, under the accrual method of accounting, the \$75,000 reflected annually on the K-1 must be included in the public support schedule even though it is not actually distributed to X.

2. Organization Z receives \$100,000 in annual contributions from small, unrelated donors. Z does not generate investment income. Z applies for and is awarded a five-year, \$500,000 grant from Private Foundation, payable in \$100,000 installments over the five-year period. The only condition for each annual \$100,000 payment is that Z must submit a report on the use of the prior year's funds to Private Foundation.

If the public support schedule is completed using the cash method of accounting, Z is required to reflect \$100,000 in contributions from Private Foundation each year that the funds are actually received.

If the public support schedule is completed using the accrual method of accounting, however, Z is required to reflect the entire \$500,000 grant in the year that the grant is approved, because no significant restrictions are in place to limit Z's access to the grant funds. As a result, and if the \$500,000 grant from Private Foundation is subject to the two-percent limit discussed above and depending on Z's public support in prior years, Z's public support percentage may fall below the requisite level unless Z is able to quickly develop other sources of public support.

Finally, a filing organization that will experience a decrease in its public support percentage as a result of using the accrual method of accounting may wish to consider whether a change in the organization's overall method of accounting is advisable. Organizations, including tax-exempt organizations, are permitted to change to the cash method of accounting only after filing a Form 3115, *Application for Change in Accounting Method*, with the Service. It also may be possible for the organization to change its method of accounting for only a few discrete items of revenue and expenses (e.g., for contributions received or grants made). In either case, the organization should closely evaluate its options with its tax advisors, as a change in accounting method will have unique consequences for each organization.

Organizations are advised to consult with their tax advisors to determine whether the Temporary Regulations will require a change in the method under which their public support schedules are completed. Organizations and their advisors should also consider any consequences and planning opportunities that may result from such a change. For example, and as discussed above, the organization may wish to consider changing its overall method of accounting from the accrual method to the cash method so that it can continue to complete the public support schedule using the cash method. The organization may even wish to request that its larger funders build additional criteria and requirements into grant awards so that the entire amounts awarded are not required to be reflected in a single year.

Five-Year Public Support Computation Period

The Temporary Regulations and the revised Form 990 provide that, for taxable years beginning on or after January 1, 2008, the public support tests must now be computed on the basis of a five-year period that includes both the current reporting year *and* the prior four-year period. Thus, the 2008 Form 990 will include a public support schedule that considers the filing organization's sources of support for 2004–2008. If the organization meets the public support test on the basis of its support for those years, then the organization will be considered to be a public charity for both 2008 (the reporting year) and 2009 (the

immediately subsequent year). This means that even if the organization fails to meet a public support test in 2009, based on its five-year computation period from 2004 through 2009, it will still be a public charity for the 2009 taxable year because of its support in 2004–2008. If the organization does not meet a public support test in 2010 based on support received from 2005 through 2010, however, then it will be reclassified as a private foundation as of the beginning of taxable year 2010.

As a result of including the current year in the public support computation period, organizations may be unaware that they have failed to qualify as public charities until several months after the year in which the failure occurred. If, for example, an organization fails to satisfy the public support tests on its 2008 Form 990 (for years 2004–2008) and its 2009 Form 990 (for years 2005–2009), then the organization will be classified as a private foundation as of January 1, 2010. The organization may not know, however, that it failed the public support test on its 2009 Form 990 until some point in 2010, when the return is completed.

In these circumstances, the Service has indicated that it will not assess private foundation excise taxes for all or part of the first year in which the organization was reclassified as a private foundation if the imposition of those taxes would lead to “unfair or inequitable results.” The Service has specifically identified situations where the failure to meet a public support test was unforeseeable or due to circumstances beyond the organization’s control as being inappropriate circumstances in which to assess private foundation excise taxes.

Quarles & Brady Comment

Notwithstanding this potential relief, the inclusion of the current year in the public support computation period requires that organizations qualifying as public charities on the basis of a public support test exercise heightened vigilance with respect to trends in their sources of support in order to avoid inadvertently falling into private foundation status.

Inclusion of the current year in the public support computation period also creates planning considerations for donors, including grant-making private foundations. Under the prior regulations, a public charity would use a five-year computation period only when it experienced a substantial and material change in its sources of support. Donors were permitted to rely on the Service’s initial determination that a grantee satisfied a public support test, provided that (1) the donor was not aware of or responsible for a substantial and material change in the grantee’s sources of support that caused the grantee to fail its public support test; and (2) the Service had not published a notice of the grantee’s change in public charity status.

Initial guidance from the Service with respect to these rules (Revenue Procedure 81-6) stated that any donor, including a private foundation, generally would not be responsible for a substantial and material change in a grantee’s sources of support if the aggregate contributions from the donor during a taxable

year were 25% (or less) of the aggregate support received by the grantee from other sources during the four immediately preceding years. The Service later expanded this guidance only with respect to grants from private foundations (Revenue Procedure 89-23) by providing private foundations with an alternative to the 25% test. The alternative states that a private foundation will not be considered to be responsible for, or aware of, a substantial and material change in a grantee's sources of support that results in the grantee's failure to meet a public support test as long as (1) the grantee has received a ruling or determination letter from the Service, stating that the grantee satisfies a public support test; (2) the Service has not published a notice that the grantee's public charity status has changed; (3) the private foundation has not otherwise acquired knowledge that the Service has informed the grantee of such a change; and (4) the grantee is not controlled directly or indirectly by the private foundation and its disqualified persons.

All public support computations under the Temporary Regulations will be based on a five-year period. Accordingly, the Temporary Regulations do not include provisions regarding substantial and material changes in sources of support or alternate public support computation periods. The Temporary Regulations do, however, include provisions regarding a donor's reliance on the Service's initial determination that a grantee satisfies a public support test. A donor may continue to rely on the initial determination as long as (1) the donor is not responsible for, or aware of, an act or failure that causes the grantee to fail to satisfy the public support test; and (2) the Service has not published a notice that the grantee fails to satisfy the public support test.

Although the Service's earlier guidance with respect to whether a donor was responsible for a substantial and material change in a grantee's sources of support was based on provisions of the regulations that no longer exist, we believe that the principles expressed in that guidance continue to apply: A donor, including a private foundation, should not rely on a determination letter that states that a grantee is a public charity on the basis of a public support test if the Service has published a notice that the grantee's public charity status changed, or if the donor is responsible for, or aware of, an act or failure that causes the grantee to fail its public support test. We also believe that it is reasonable for private foundations to continue to rely upon Revenue Procedure 89-23 until further guidance is issued by the Service.

Accordingly, it is our view that private foundations may continue to rely on a grantee's determination letter as long as the Service has not published a notice that the grantee's public charity status has changed, as long as the private foundation is not otherwise aware that the Service has informed the grantee of such a change, and as long as the private foundation does not directly or indirectly control the grantee. The potential of a change in public charity status is one reason that private foundations generally should re-check a grantee's tax status shortly before making each payment to the grantee.

Despite the fact that we believe that private foundations may continue to rely on Revenue Procedure 89-23, we also think it advisable for a private foundation to consult with a grantee prior to making a very large grant, as it is generally in the best interests of the grantee to confirm that a large grant will not cause the grantee to lose its public charity status. Donors other than private foundations who wish to rely on the grantee's status as a public charity generally should restrict their grants and contributions to 25% or less of the aggregate support reflected on the grantee's public support schedule for its most recently completed year until further guidance is issued by the Service.

We also believe that it is advisable for private foundations making equivalency determinations on the basis of a public support test to use a five-year public support computation period that includes the grantee's most recently completed year. Equivalency determination is a process through which a private foundation may be able to treat a grant to a foreign organization as a grant that was made to a public charity and therefore forego exercising expenditure responsibility with respect to the grant. If the equivalency determination is based upon the foreign organization's sources of support, then Revenue Procedure 92-94 currently requires that the foreign organization provide a schedule of its support for the prior four-year period. It is reasonable to expect that the Service will update this guidance to require a five-year computation period under the equivalency determination rules so that it is consistent with the Temporary Regulations.

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This update is intended as a general summary of legal matters and not as specific advice to any particular client. If you have any questions concerning the subject matter of this update, please contact one of the authors of this update, Elaine Waterhouse Wilson, at 312-715-5141 or elaine.wilson@quarles.com, Norah L. Jones, at 312-715-5052 or norah.jones@quarles.com, Krupa Shah, at 312-715-5027 or krupa.shah@quarles.com, or your Quarles & Brady LLP attorney.