

# Determining Private Foundation or Public Charity Status under the

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## **PRACTICE AREAS**

Business Law

Non-Profit Corporate Law

Tax Exempt Organizations

Tax Law

A hypothetical state law for-profit company, which may be a bank, credit union, insurance company, healthcare organization, or other entity (**Company**) intends to establish a charitable organization (**Foundation**) to carry out some exempt purpose (defined under the Internal Revenue Code), consistent with Companys goals and mission.

Company is unsure whether it is better for the Foundation to be treated as a public charity or private foundation. Company also wonders whether the Foundation will qualify as a public charity based on its support from Company, and the consequences of the Foundation being classified as either a public charity or private foundation.

These questions will have important consequences related to Foundations reporting and operating requirements. This post outlines the thresholds that determine public charity or private foundation status and why Companys status matters.

In most cases, public charity status is preferable to private foundation status when available. But public charity status will not be available to every nonprofit organization. Whether an organization can qualify as a public charity will mainly depend on its sources of funding, planned activities, and relationships to and dealings with other tax-exempt organizations.

To establish and maintain public charity status, Foundation must meet one of several tests recognized by the Internal Revenue Service (IRS), include necessary language in organizational documents and federal filings, and document donations as outlined below.

## **I. Disadvantages of Private Foundation Classification**

The distinction between a private foundation and a public charity is a federal tax distinction.

Although both private foundations and public charities are charitable organizations and tax exempt under Internal Revenue Code Section 501(c)(3), private foundations are less efficient from a tax perspective,

and administratively burdensome because they are subject to additional legal requirements, reporting responsibilities, and non-compliance risks.

Here is a summary of key differences between private foundations and public charities:

- Unless they have sufficient direct charitable operations, private foundations are required to make minimum distributions each year for charitable purposes, beginning after the founding year. A private foundation must distribute roughly 5% of its investment assets, subject to certain adjustments.
- Private foundations are subject to strict self-dealing prohibitions that restrict transactions between the Foundation and its disqualified persons, which would include Company; the Foundations officers, directors, and substantial contributors; and their family members. Self-dealing transactions include excessive compensation, unnecessary or excessive reimbursement, free or discounted tickets to fundraising events, property leases other than no-charge leases, expense sharing relationships, recusal requirements for Company directors and officers who also serve for the Foundation, and other transactions. Significant penalties are imposed for self-dealing, requiring a careful and robust process to identify and manage potential self-dealing transactions and conflicts of interest.
- A private foundation generally may not provide grants for non-charitable purposes or non-charities (subject to exceptions) and is subject to more stringent rules than a public charity regarding political activities (lobbying) and certain other activities.
- Private foundations are subject to more burdensome reporting and disclosure obligations than public charities, including that private foundations must file a Form 990-PF annually that is more detailed than a standard Form 990 filed by a public charity.
- Most private foundations are subject to an annual 2% tax on their net investment income.
- A private foundation must invest its funds cautiously and avoid jeopardy investments.
- A private foundation may not control a business or own more than 20% of any business.
- Donations to private foundations are subject to limitations for individuals and corporations. For individuals, deductions are limited to up to 30% of adjusted gross income (AGI) for cash contributions, instead of 60% to a public charity; 20% of AGI for publicly traded stock; and cost basis for privately held stock.[1] Business entities are subject to different limits on deductibility.

## **II. Public Charity Qualification**

### ***Public Support Test (Quantitative)***

To be classified as a public charity, an organization must satisfy one of three IRS tests: (1) the support test, (2) the gross receipts test, or (3) the supporting organization test. Of these, the public support test applies to the most common types of public charities, so we focus on the support test here.

*The support test generally requires that at least 1/3 of the Foundations annual financial support comes from unrelated donors and government support.* Treas. Reg. 1.170A-9(f)(6)(2). This test is applied on a five-year rolling basis. Too much support from Company will cause the Foundation to be classified as a private foundation.

Donations by Company employees; gifts, grants, contributions from the public; and membership fees from Donor Members may all qualify as public support of the Foundation. As a result, it is common for foundation sponsors to focus their employee giving programs on the Foundation early on in its development to help satisfy the public support test. The Foundations Company-supported charitable activities could also be gradually increased to maintain a 2:1 ratio with publicly supported charitable activities, after excluding certain contributions by Company (see discussion of unusual grants below).

To ensure that the Foundation meets the public support test, it is important that the Foundation maintains appropriate written records for all donations, both public and private. Generally, this requires that gifts be tracked and acknowledged with a receipt or pledge form, which should be tailored to the Foundations activities. Significant contributions will generally be documented through more formal gift agreements. Consistent documentation will help the Foundation prove that it satisfies the public support test and certain other requirements.

### ***Public Support Test (Qualitative)***

Note that, if the Foundation cannot meet the 1/3 test above, it may still meet the public support test on a facts-and-circumstances basis, determined by applying a set of factors.

The Foundation would be a public charity under this qualitative test if:

(1) it normally *receives a substantial part of its financial support from donations made directly or indirectly by the public*, unless the total amount of public support normally received equals less than 10 percent of the total support normally received by the organization;

(2) the organization is operated and organized to *attract new and additional support from the public* on a continuous basis, as demonstrated by a bona fide program for solicitation of public funds; and

(3) the organization is in the nature of an organization that is *publicly supported based on the following factors*: (i) the percentage of support above the 10 percent requirement from public sources; (ii) the sources of support being numerous, as opposed to receiving almost all financial support from one donor; (iii) the existence of a governing body representing the broad interests of the public, rather than the personal or private interests of a limited number of persons; (iv) the continuity of the organizations provision of services directly for the benefit of the general public; (v) whether the solicitation for dues-paying members, if applicable, is designed to enroll numerous persons in a community, or limited to a particular profession or field of special interest, the dues are affordable for the general public, and the activities provided by an organization have broad community appeal.<sup>[2]</sup>

### ***Unusual Grant Safe Harbor***

An unusually large, one-time donation by a major donor may not cause the Foundation to fail the public support test, provided the initial contribution is an unusual grant.

The unusual grant provision is considered a safe harbor that will not result in an organizations loss of public charity classification.<sup>[3]</sup> The receipt of an unusual grant will not cause the Foundation to lose its classification as a public charity and become a private foundation because an unusual grant is disregarded (*i.e.*, excluded from both the numerator and the denominator of the applicable support fraction) for purposes of determining whether the organization is publicly supported. See 1.170A-9(f)(6)(ii); 1.509(a)-3(c)(3).

In the relatively common scenario where Company expects that it will meet the public support thresholds except after considering a large donation that could cause it to fail, Company should analyze whether that donation would qualify as an unusual grant, thus allowing the Company to disregard it. If so, Company may be entitled to receive the donation and still rely on the organizations classification as a publicly supported organization (in determining whether its contributions to the Foundation are deductible).

If you have questions about organizing, operating, or tax reporting as a charitable organization under state or federal law, **contact Nick Stock at [nstock@fosterswift.com](mailto:nstock@fosterswift.com).**

[1] If charitable contributions exceed the annual limit in a given tax year, a donor may carry over the excess amount for up to five years and deduct those amounts in future years, subject to limits in those years.

[2] Treas. Reg. 1.170A-9(f)(6)(3)(i)-(iii).

[3] Rev. Proc. 2018-32, 1.