NONPROFIT PERSPECTIVES

Public Charities and Private Foundations—What's the Difference?

When starting a 501(c)(3) organization, the IRS will generally classify it one of two ways—either as a public charity or a private foundation. Public charities are known to perform charitable work, while private foundations are typically grant-making organizations. The main difference between public charities and private foundations is the source of their financial support.

Public charities

Public charities generally have greater interaction with the public and receive the majority of their financial support from the general public and/or governmental units. Organizations such as churches and religious organizations, schools, hospitals and medical research organizations automatically qualify as public charities while other organizations must prove to the IRS that they are publicly supported.

An organization is considered publicly supported if:

1. It normally receives one-third of its support from a governmental unit or from contributions from the general public or at least 10 percent public support, and facts and circumstances that show the public nature of the organization; or,
2. It normally receives more than one-third of its support from gifts, grants, contributions or gross receipts from activities related to its exempt purposes, and not more than one-third of its support from gross investment income.

An organization can also achieve public charity status if it is a supporting organization of another charity that derives its public charity status under one of the tests stated above.

The IRS will automatically presume an organization to be a private foundation unless it can show that it is a public charity. After an organization's initial five years, its public support test is based on a five-year computation period that consists of the current year and the four years immediately preceding the current year.

Private foundations

A private foundation is typically controlled by members of a family or by a corporation, and receives much of its support from a few sources and from investment income. Because they are less open to public scrutiny, private foundations are subject to various operating restrictions and to excise taxes for failure to comply with those restrictions.

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The IRS recognizes two types of private foundations: Private non-operating foundations and private operating foundations. The key difference between the two is how each distributes its income: A private non-operating foundation grants money to other charitable organizations, while a private operating foundation distributes funds to its own programs that exist for charitable purposes.

Benefits of public charities over private foundations

Classification is important because private foundations are subject to strict operating rules and regulations that do not apply to public charities. Some advantages public charities have over private foundations include higher donor tax-deductible giving limits, 50 percent of adjusted gross income (AGI) versus a private foundation's 30 percent of AGI limit, and the ability to attract support from private foundations. Public charities also have three possible tax filing requirements based upon annual revenue: Form 990 (> $200,000), Form 990-EZ ($50,000 – $200,000), and Form 990-N e-postcard (<$50,000). All private foundations, regardless of revenue, must annually file Form 990-PF. Additionally, a private foundation must annually distribute at least 5 percent of the fair market value of its net investment assets for charitable purposes. The penalty for failure to meet the 5 percent required minimum distribution is 30 percent of the shortfall or the remaining amount that should have been spent to meet the required minimum level. Private foundations are also subject to strict self-dealing rules, a 1 percent or 2 percent tax on investment income and certain expenditure responsibilities.

Public charities may engage in limited amounts of direct and grassroots lobbying. Private foundations that spend money on lobbying will incur an excise tax on those expenditures; this tax is so significant that it generally acts as a lobbying prohibition.

Conclusion

When deciding whether to operate as a public charity or a private foundation, the decision should depend on the organization's programs and objectives. Once an organization is classified as a public charity, it must demonstrate annually that it meets the public charity tests. Once an organization is classified as a private foundation, it remains a private foundation.

If an organization fails the public support test two years in a row, it is at risk of reclassification as a private foundation, which can have significant implications for sustainability and mission accomplishment. To regain status as a public charity, the organization must notify the IRS in advance that it intends to make a qualifying 60-month termination. Only if it meets one of the public support tests at the end of a 60-month (five-year) period can the organization again operate as a public charity.

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