WHAT IS A CHARITABLE ORGANIZATION?

Charities are a large and diverse group of nonprofit institutions that play a key role in American society and help to form and strengthen communities. With the help of millions of volunteers and the generosity of countless donors, they provide many services and perform many functions that in some countries are largely performed by government. Organizations that only operate charitable activities are classified under Section 501(c)(3) of the Internal Revenue Code.

Many types of organizations are tax-exempt, but not all qualify for 501(c)(3) status. The 501(c)(3) designation is a legal designation reserved for organizations that are exclusively charitable. Other organizations exempt from federal income tax can be found under Section 501(c) of the Tax Code, but they do not qualify as 501(c)(3) organizations because they are permitted to operate programs that are both charitable and non-charitable.

A few basic legal characteristics of 501(c)(3) organizations:

- Contributions to 501(c)(3) organizations are generally tax deductible.
- Grants and activities may not assist election campaigns that support or oppose candidates for public office.
- Grants, compensation, and other payments must be made within specific guidelines, and for a charitable purpose, not for personal or private benefit.

The IRS classifies all 501(c)(3) organizations into two distinct types: private foundations and public charities.

The IRS is a good source of general information on the different types of tax-exempt organizations, all of which are under 501(c) of the Tax Code.


In the nonprofit sector, the term foundation has no precise meaning. The Council on Foundations defines a foundation as an entity that supports charitable activities by making grants to unrelated organizations or institutions or to individuals for scientific, educational, cultural, religious, or other charitable purposes. While foundations are often primarily engaged in grantmaking activities, some may engage in their own direct charitable activities or programs. When thinking about foundations in the charitable context, it is helpful to see how the IRS describes private foundations and public charities. Visit the Charities and Nonprofits section of the IRS website at www.irs.gov.
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**WHAT IS A FOUNDATION?**

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**WHAT IS A PRIVATE FOUNDATION?**

Private foundations are generally financially supported by one or a small handful of sources—an individual, a family, or a corporation. There are a few different kinds of private foundations: independent, family, and corporate. These categories are not legally defined. Rather, they are commonly used in the field of philanthropy to distinguish the different kinds of private foundations. Private foundations must pay out at least 5 percent of their assets each year in the form of grants and operating charitable activities. A private operating foundation is a kind of private foundation, and must operate under similar rules. However, it does not have to pay out 5 percent or more of its assets each year in grants. Instead, it must carry out its own charitable purposes. All private foundations are 501(c)(3) organizations. Under the Internal Revenue Code, a charity is presumed to be a private foundation unless it can prove that it is a public charity.

**WHAT IS A PUBLIC CHARITY?**

Public charities include a wide variety of charitable organizations, including hospitals, schools, churches, and organizations that make grants to others. Charities that primarily make grants are commonly referred to as public foundations. Most of these foundations are publicly supported charities, meaning they receive their funds from multiple sources, which may include private foundations, individuals, government agencies, and fees they charge for charitable services they provide. Some foundations are public charities because they meet at least one of the IRS tests for qualifying as a public charity. One kind of public charity, known as a supporting organization, is recognized by the IRS as charitable simply because of its legal relationship to one or more other public charities. A community
foundation is yet another kind of public charity. In some cases, corporate foundations are set up as public, rather than private, foundations.

The IRS’s “Compliance Guide for Public Charities” provides an overview of the compliance requirements public charities must meet in order to stay tax-exempt.

DO CHARITIES PAY TAXES?

Charities generally do not pay state or federal income tax. They also may be exempt from paying state sales tax on their purchases and from local property tax on property they use to carry out their charitable activities. The extent and nature of exemptions from state taxes will vary from state to state. These generous exemptions recognize the important principle that organizations that act voluntarily to further the public good should be freed from the obligation to support government through the payment of taxes. Exemptions maximize the ability of charities to help others.

WHAT ARE SOME KEY DIFFERENCES BETWEEN A PUBLIC CHARITY AND A PRIVATE FOUNDATION?

The distinction between public charities and private foundations is a matter of federal tax law.

Public charities, unlike private foundations, are heavily supported by the public. For this reason, public charities are more subject to public scrutiny, which can help ensure adherence to appropriate standards of conduct in the absence of the more strict rules and regulations governing private foundations.

Since 1969, private foundations have been subject to stricter and more extensive federal rules than public charities, including strict prohibitions on self-dealing, and limits on the amount of stock they can hold in any one company. Examples of the various regulated private foundation activities include:

- financial transactions between the foundation and its largest contributors, officers and other insiders
- amounts paid out toward operating costs, grants, and charitable programs
- reasonableness of the types and amounts of expenses incurred to operate the foundation
- compensation of foundation staff and board members
- business holdings of the foundation
- engaging in overly risky investments with charitable assets
• grants or other payments to individuals, other private foundations, certain kinds of charities, and organizations that are not charities

These more stringent rules were less applicable in the public charity context, but in recent years have been applied in some degree to charities that administer funds that are considered donor advised. Although public charities were traditionally not as heavily regulated as private foundations, it has been and is still recommended that charities follow the private foundation rules closely as guidance. Indeed, more and more, the IRS is requiring that public charities adhere to many of the private foundation rules when making certain kinds of grants or payments to individuals, charities, and non-charities. In addition, private foundations, supporting organizations, and organizations that administer donor-advised funds or scholarship funds must also stay in compliance with the charitable grantmaking provisions of the Pension Protection Act of 2006 [www.cof.org/ppa](http://www.cof.org/ppa).

WHAT ARE SOME DIFFERENT KINDS OF PRIVATE FOUNDATIONS?

Once a foundation has been classified by the IRS as a private foundation, there are ways to describe it based on how the foundation is funded and governed. Most of the following terms are not legal classifications, but rather descriptive terms used within the field of philanthropy to help others understand how the foundation operates. What these foundations have in common is that they are established to aid social, educational, religious, or other charitable needs. Generally, there is a board of directors that makes discretionary giving decisions, often within specific guidelines as to charitable field of interest and/or geographic area.

• **Independent foundations** are distinct from other kinds of private foundations like family or corporate foundations, in that they are not governed by the benefactor, the benefactor’s family, or a corporation. They are usually funded by endowments from a single source such as an individual or group of individuals.

• **Family foundations** are usually funded by an endowment from a family. With family foundations, the family members of the donor(s) have a substantial role in the foundation’s governance.

• **Corporate foundations (or company-sponsored foundations)** are philanthropic organizations that are created and financially supported by a corporation. The foundation is created as a separate legal entity from the corporation, but with close ties to the corporation. Companies establish corporate foundations and giving programs to have a positive impact on society. Corporate foundations tend to make grants in fields related to their corporate activities or in communities where the corporation operates, or where their employees reside. Corporate foundations are usually set up as private foundations, but can be created as public foundations,
particularly if they will be largely publicly supported. Rather than establish a separate foundation, a company can also make gifts and grants directly to charitable organizations through a program within the company itself. This is called a corporate giving program.

- **International foundations** typically are foundations based outside the United States that make grants in their own countries and overseas. The term “international foundations” also can refer to foundations in any country that primarily engage in cross-border giving. Not all foundations that engage in cross-border giving are private foundations; many are established as public charities. Under U.S. law, contributions from U.S. donors and corporations are not eligible for a charitable deduction if the organization is not formed in the United States or recognized by the United States as charitable.

- **Private operating foundations** are private foundations that primarily operate their own charitable programs, although some also make grants. Private operating foundation is a legal classification under the Internal Revenue Code, and these foundations must follow many of the private foundation rules. Unlike private foundations that are not operating, a private operating foundation is required to spend a certain portion of its assets each year on charitable activities. By contrast, private non-operating foundations are required to pay out 5 percent or more of their assets each year in grants.

**WHAT ARE THE DIFFERENT TYPES OF PUBLIC CHARITIES?**

- **Statutory public charities** are considered charities as a matter of law and generally perform charitable activities rather than issuing grants. Some examples of statutory public charities are churches, universities, schools, nonprofit hospitals, and medical research institutions. Statutory public charities are classified under Sections 170(b)(1)(A) (i) through (v) of the Internal Revenue Code.

- **Public charities supported through donations** are organizations that can show that a minimum percentage of their financial support comes from a broad cross-section of the public, rather than from just one source. These charities fall under Section 170(b)(1)(A)(vi) of the Internal Revenue Code. The charity or foundation must satisfy one of two tests, both of which measure public support as a fraction of the total support the organization receives. This test is referred to as the public support test. Examples of charities that are publicly supported are community foundations, the American Red Cross and the YMCA.

- **Public charities receiving exempt function income** get a substantial portion of their support from program service revenue. These organizations earn revenue from activities like selling tickets, or by charging admission or other fees for the charitable services they provide. These public charities fall under Section 509(a)(2) of the
Internal Revenue Code. Charities in this category must ensure their investment income does not normally exceed one-third of their total support. An example of this kind of charity would be a museum or opera that charges for admission.

- **Supporting organizations** are public charities classified under Section 509(a)(3) of the Internal Revenue Code. A supporting organization is an organization that attaches itself to or supports another public charity (or charities) and—in effect—acquires the public charity status of the organization it supports. An example of a supporting organization is the philanthropic arm of a university or hospital. Certain grants to specific kinds of supporting organizations are prohibited or can only be made within strict guidelines.

**ARE CONTRIBUTIONS MADE TO FOUNDATIONS TAX DEDUCTIBLE?**

Contributions made to public and private foundations may be deducted from the donor’s federal income tax if the donor is an individual or corporation. The amount of the deduction is subject to certain limits under federal tax law.

Generally, gifts to public charities receive more favorable tax treatment than gifts to private foundations. For example, charitable cash donations are deductible at up to 50 percent of the taxpayer’s adjusted gross income (AGI) when given to public charities, but the same gift to a private foundation is deductible at a rate of only 30 percent of AGI.

The best resource for finding out if you can take a charitable tax deduction and the applicable limits is the IRS website, [www.irs.gov](http://www.irs.gov), and [IRS Publication 526](https://www.irs.gov/publications/irs_pub526), as well as your tax and other professional advisors.