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Mathematical Prescriptions for Relief of the Public Charity Status Blues

by William T. Hutton

Years ago, as a bar review lecturer charged with communicating the essence of taxation to a hostile audience in three hours, I was advised loudly to inject the words “Bar Examination” into the presentation at frequent intervals, however irrelevant to the general theme. The point, of course, was to shatter the mass torpor with adrenalin jolts.

For a land trust audience, the phrase “public charity status” ought to have the same jarring effect. Most understand that attainment of that status is a life-and-death objective—the land trust that falls from grace is, for all practical purposes, out of business, since it no longer qualifies to receive tax-deductible conservation easement donations (not to mention the grievous wounds it suffers in other vital areas upon reclassification as a private foundation). Yet the requirements of that favored status are but dimly apprehended by most land trust managers, and from long experience I can attest to the instantaneous glaze produced by even the most general attempt to explicate the rules.

But fear is a considerable motivator, and by providing this little exegesis on the rules governing qualification as a public charity in written form I shall at least avoid the most painful visible and audible reactions.

So here we go. Try to take the entire prescribed dose. It is very good for you. It may SAVE... YOUR... LAND TRUST.

A deceptively brief statute describes the organization commonly called a “public charity”:

An organization...which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption...) from a governmental unit...or from direct or indirect contributions from the general public...” IRC 170(b)(1)(A)(vi).

The interpretation of that paragraph is left to some twelve pages of dense, double-columned Treasury regulations (1.170A-9(e)(1)-(9).

Our quest begins with a determination of the land trust’s total support for a particular measuring period. For a new organization, the original expectation of meeting the public charity test (upon which the IRS’ initial grant of public charity status is premised) must be confirmed upon the basis of the first five years’ operations. At the end of that period, the IRS must be provided with data sufficient to make a determination as to the continuation of public charity status.

Once a land trust has survived its five-year probationary period, the support test is applied in four-year “moving average” increments; e.g., 1986 through 1989, 1987 through 1990, etc. Satisfaction of the test for any such four-year period insures continuation as a public charity for the succeeding two years. Thus, if the Lotus Blossom Land Trust has satisfied the statute based on

TABLE OF CONTENTS

Mathematical Prescriptions for Relief of the Public Charity Status Blues 1
Unrequited Gifts: The Tax Fallout 6
Federal Claims Court Awards Millions in Damages to Landowners for Regulatory Taking 7
The Back Forty
The newsletter of land conservation law

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We welcome your comments, suggestions, and questions. Please address them to the Land Conservation Law Institute, c/o The Land Trust Alliance, Suite 410, 900 Seventeenth Street NW, Washington, DC 20006.

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its support for the years 1986 through 1989, it will be deemed to be a public charity for 1990 and 1991, even though it might not meet that test for the 1987-90 period. The thrust of the regulations’ approach to the measurement of support is, first, to determine the totality of support for the applicable period, and then, to determine how much of that total should be favorably considered; i.e., placed in the numerator of the “support fraction.” For a typical land trust, the principal elements of support are apt to be gifts and bequests (including gifts of land and interests in land), and, possibly, investment income. It is less likely to have income from government grants or unrelated business activities, but if it does, those too are support items. But if it derives revenue from a function or activity that advances its exempt purposes, that revenue is entirely irrelevant to the support calculation (see the parenthetical statement in the statute quoted above). At first blush, it may seem slightly perverse that seminar fees or profits from the sale of educational items do not factor into the support calculation, but remember that we are trying to measure the relative significance of disinterested public generosity, and goods and services offered for sale as an aspect of a land trust’s charitable mission have no relevance to that determination. (Neither are such revenues harmful in the support calculation, however; they are simply ignored.)

Before confronting the intricacies of the calculation of public support in a hypothetical case, we should further observe that satisfaction of the public charity test may be attained under either of two alternative measures: (1) an entirely mathematical approach, pur-
suant to which one-third of favorable (“good”) support is achieved, or (2) a so-called “facts and circumstances” test, based upon numerous indicia, but available only if good support constitutes at least 10% of total support.

Now, in the interest of avoiding a tiresome recitation of abstract rules, let us put the rest of this primer into the context of a fictitious case. The Carp Creek Land Trust was established in early 1986. It reports the results of its operations on a calendar-year basis, and thus the end of its five-year advance ruling period is fast approaching. Its entitlement to continuing public charity status will depend upon the aggregate of its support from the date of its establishment through December 31, 1990.

Carp Creek’s total receipts to date are as follows:

<table>
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<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
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<tr>
<td>Bernie Bernally</td>
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Foundation Grants
Zane Sturdley Family Fund 10,000
Bullwinkle Trust 5,000
15,000 15,000

Government Grant (Town of Halcyon) 20,000

Investment Income
Savings account interest 4,300
Capital gains 18,000
22,300 22,300

Exempt-Function Revenues
Seminar fees 2,800
Camping permits (Carp Pond) 5,600
8,400 8,400

Donations of Land
Carp Pond (from Perry Purple by outright donation) 52,000
Antelope Ridge (from Zane Sturdley, bargain purchase for $35,000; fair market value $60,000) 25,000
77,000 77,000

Donations of Easements
Alma and Harry Brugel 90,000
Jason Cadwalader 415,000
Modray Gucci 150,000
Sam Thump 225,000
Nimby Wunch 270,000
1,150,000 1,150,000

Use of Office Space (Donated by Town of Halcyon) 10,000

Total (Apparent) Gross Receipts $1,311,400

We say “apparent” for two reasons. First and foremost, you will readily acknowledge that the dollar amounts ascribed to donations of easements, presumably derived from the donors’ properly asserted charitable contributions, bear no relevance whatsoever to Carp Creek’s operating budgets or true asset values. To consider them “support” may, therefore, seem egregiously misleading. Second, the capital gains, derived upon the immediate sale of securities received as donations from board members, very likely involves double counting. That is, a donation of such appreciated property will cause the land trust to realize gain upon sale, since the donor’s low basis carries over to the trust, but that appreciation in value is also reflected in the donation totals. But not to worry, since capital gains, whether attributable to pre-donation appreciation or not, are not only exempt from tax, but are entirely excluded from the support calculation.

Before we can establish the “support fraction” to determine the percentage of our good support, we must determine what other items are properly or permissibly excluded. The following facts may be relevant:

1. Although Burley Brugel’s bequest was his only donation, he was Alma’s father.

2. Zane Sturdley and his wife Thalweg are two of the three directors of the Zane Sturdley Family Fund.

3. Perry Purple, donor of Carp Pond, was instrumental in the establishment of the land trust, and served on the board at the time of his gift.

4. The Town of Halcyon grant was made in 1986 in order to assist the land trust in purchasing Antelope Ridge from Zane Sturdley.

5. Of the easement donors, only Alma and Harry Brugel have had any connection to the land trust; none of the other easement donors have otherwise contributed. Under the regulations, “unusual grants” from “disinterested parties” may be excluded from the support calculation if they (1) are attracted by reason of the publicly supported nature of the land trust; (2) are unusual or unexpected with respect to the amount thereof; and (3) would, if required to be included, adversely affect the status of the land trust. Generally speaking, “all pertinent facts and circumstances” are taken into consideration in determining whether the exclusionary circumstances are present.

Fortunately, the IRS has published additional guidance (Revenue Procedure 81-7, 1981-1 C.B. 621), in the form of a list of six factors categorically determinative of “unusual grant” classification. That is, if each of those six factors is satisfied, a particular grant—whether of cash, securities, or assets directly related to the organization’s charitable purposes—is absolutely entitled to be excluded from the support measure. The importance of that revenue procedure justifies a (somewhat edited) recitation of the six factors here:

1. The contribution is made by a person other than a creator of the organization or a person who had attained “substantial contributor” status prior to the subject contribution. (A “substantial contributor” is a person who, as of the end of any year, has made total [historical] contributions in excess of $5,000 and whose total contributions exceed 2% of the land trust’s total [historical] support to that date.) Persons related to creators and substantial contributors, within the meaning of certain detailed attribution rules, are also disqualified.

2. The contribution is not made by a foundation manager (director or officer) or by anyone who otherwise is able to exercise control over the organization, nor by a person who attains such a position of authority on
account of the contribution itself. The same related-party proscription mentioned in paragraph 1 applies here; e.g., Bernie Brugel’s bequest will be denied the protection of the revenue procedure on account of Alma’s managerial role.

3. The contribution is in the form of cash, readily marketable securities, or assets that directly further the exempt purposes of the organization. (The IRS has ruled privately that a conservation easement donation to a land trust satisfies this factor.)

4. The land trust has received either an advance or final ruling classifying it as a public charity and, once beyond its advance ruling period, is “actively engaged” in a program of activities in pursuit of its exempt purposes.

5. No material restrictions or conditions have been imposed by the contributor upon the land trust in connection with the grant or contribution. (The attributes of ownership retained by the donor of a conservation easement will not be deemed to be restrictions or conditions on the easement gift.)

6. If the contribution is intended to underwrite operating expenses, as opposed to financing capital expenditures, the contribution may cover no more than one year’s operations.

Having determined that all of the easement contributors, save the Brugels, meet the requirements of Revenue Procedure 81-7, we gratefully eliminate those donations from the support calculation. (Note that our entitlement to the exclusion of those gifts is entirely without reference to the issue of their proper treatment as “support,” to be discussed below.)

After excluding the unusual easement grants, the capital gains, and the exempt-function income, we derive a denominator for the support fraction of $225,000. That figure includes both the Perry Purple donation of Carp Pond and the Burley Brugel bequest. Neither of those gifts meets the tests of Revenue Procedure 81-7, and it seems unlikely that either will be entitled to exclusion under the more general “facts and circumstances” approach of the regulations. Note also that Carp Creek’s total support includes the $10,000 rental value of the town-provided office. Although contributions of use value, like contributions of services, produce no charitable contribution deduction, the statute specifically permits the value of services or facilities furnished by a “governmental unit” to be taken into account as a support item.

We are now prepared to determine those elements of the total support denominator that may enter into the numerator as good support. Both the government grant applied towards the purchase of Antelope Ridge ($20,000) and the rental value of the town-provided office ($10,000) are good support in their entirety; no limitation applies as to either government grants or support received from other public charities.

As to donations from private sources (individuals, partnerships, for-profit corporations, estates and trusts), the regulations impose a 2% ceiling; i.e., not more than an amount equal to 2% of total support for the measuring period may be taken into account as good support from any single source. For this purpose, all contributions made by a donor and any related person or persons (see footnote 1) are aggregated. Thus, the Brugel family donations ($3,000), bequest ($50,000), and easement donation ($90,000) will be limited by the 2% rule to a single $4,500 good support item (2% of $225,000).

The following describes the application of the 2% limit to the various amounts that have entered into the denominator of our support fraction:

**Good Support**

**Board of Directors Gifts**

The Bernally, Replevin, and Sturdley donations are reduced, to $4,500 each. Accordingly, the total $30,400 of directors’ gifts yields $18,000 in good support. $18,000

**Other Cash Donations**

Since none of these exceeds $500, the entire aggregate of such donations will reach the numerator of the fraction. Even if a contributor had donated $500 in each of the years at issue, his or her aggregate contributions would exceed $4,500. 24,300

**Cash Bequest**

Alma Brugel’s $3,000 gift has already used two-thirds of the Brugel family’s overall limitation of $4,500. Accordingly, a mere $1,500 of this bequest reaches the numerator. 1,500

**Foundation Grants**

On the assumption that both of the foundation grants come from private foundations, $4,500 of each will be considered good support. Somewhat surprisingly, the grant from the Sturdley Family Fund is not aggregated with the direct donations from members of the Sturdley family for purposes of applying the 2% limit. 9,000

**Government Grant and Office Space**

As previously noted, government and public charity grants reach the numerator of the support fraction without reduction. Note, however, that fees derived from services to a government agency are exempt-function revenue, and as
such would be ignored entirely in the support calculation. It thus becomes crucial to determine that a particular item of government support is not attributable to services rendered. In our case, the grant toward Carp Creek’s purchase of open space property can hardly be linked to services provided, and the entire amount should count favorably. 25,000

Investment Income
The savings account interest is a support item but not, of course, an element of the numerator. (The capital gains are ignored, as noted above.) 0

Donations of Land
Perry Purple’s donation of land counts as good support only to the extent of $4,500. Since Zane Sturdley’s cash donations exceed the 2% limit for the Sturdley family, none of the bargain element of his Antelope Ridge sale may be considered good support. 4,500

Donations of Easements
Leaving aside for the moment the question of whether Alma and Harry Brugel’s easement constitutes support at all, none of this gift reaches the numerator, since the Brugel family’s 2% limit has already been surpassed. 0

Total “Good” Support $87,300

Our evaluation is now complete, and the resulting fraction—$87,300/$225,000, or 38.8%—is comfortably in excess of the one-third required for a favorable ruling based entirely on the mathematical measure. Had the analysis produced a fraction less than one-third but more than one-tenth, Carp Creek would have been required, in making its plea for continuation of public charity status, to demonstrate that it is constituted so as to attract substantial public support. The regulations provide considerable guidance as to the factors that are likely to influence that determination, including the existence of a board broadly representative of the public interest, the provision of public facilities or services, the means by which public solicitations are conducted, and so forth. But no doubt the most powerful argument for success on the facts and circumstances is the attainment of a level of support that comes considerably closer to one-third than one-tenth public.

It is sometimes alleged that the attainment of the minimum (10%) level of support necessary to make a facts-and-circumstances plea is adequate to assure maintenance of public charity status. To be sure, it would not appear that the IRS has acted aggressively to challenge the continued exemption of organizations that meet that threshold. But existing at a level of support only slightly above the threshold is hardly a comfortable way to go, and the quest for a higher level of good support is entirely consistent, in most cases, with sound fundraising policies.

Note also, with reference to our example, that reaching the comfort of one-third public support is by no means beyond reasonable aspirations. Even leaving aside the (decidedly atypical) government support, reducing the total support denominator to $200,000, the commitment of 34 people, each to provide not less than $2,000 over the 5-year advance ruling period, would guarantee that Carp Creek would pass the one-third test ($68,000/$200,000 equals 34%). As that example illustrates, the “general public” is perhaps not such an unmanageable crowd after all.

Finally, a word or two about the effect of easements in this weighing game. Clearly, our preferred strategy is to eliminate easement donations as unusual grants, under the provisions of Revenue Procedure 81-7. Making the most of that strategy may require some foresight. The fledgling land trust, looking ahead to the likelihood that persons most concerned with its creation and nourishment are also apt to be potential easement donors, ought perhaps to discourage such participation in land trust management as will defeat the application of the revenue procedure. But in the absence of such prescience, we might well argue for elimination of typical conservation easements from the support calculation, as not representing “support” at all.

We have elsewhere contended at some length for such an exclusion (The Conservation Easement Handbook, The Trust For Public Land/Land Trust Exchange, 1988, Chapter 12). The essence of that argument is that the transfer of a conservation easement cannot reasonably be said to demonstrate any disinterested generosity towards the donees land trust, nor to amplify its resources. In point of fact, the typical easement, carrying no rights of affirmative use or access except for monitoring purposes, constitutes a very real liability, and land trusts not infrequently carry easements at a nominal value for financial accounting purposes. Moderately reliable anecdotal evidence has it that certain IRS examiners have accepted the “zero-value” approach in audit situations, but published guidance on this is entirely lacking.

And now we’re done. You have demonstrated admirable persistence. Go have a beer (or the alternative antidote of choice). You deserve it.

4Attribution through family relationships is far-reaching, including spouses, ancestors, children, grandchildren, and great grandchildren. Corporations, partnerships, trusts, and estates are deemed related to their beneficial owners (based upon a 35% ownership standard), and...
the owner of more than 20% of a corporation's voting stock, a partnership's profits interest, or the beneficial interest of a trust is tainted by the substantial contributions of that entity.

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Unrequited Gifts: The Tax Fallout

Tax cases, dealing as they do with well-aged transactions and strategies, may not often provide a source of creative inspiration, but they certainly offer both object lessons and useful maxims. Take the 885 Investment Company, subject of a recent Tax Court exegesis on defeasible gifts, jurisdictional collisions, and the tax benefit rule. (If any of those subjects seems less than self-defining, hang in there, and all will be explained anon.)

The 885 Investment Company was a California limited partnership, which in 1987 acquired some 178 acres in Sacramento. A few months prior to 885's acquisition, the Sacramento city council had adopted a land use plan providing for the maintenance of a scenic corridor along Interstate Highway 5. A small portion of 885's property lay within the proposed scenic corridor, and the partnership was soon approached about its willingness to donate that portion to the city.

Lesson One: A partnership is not a taxable entity; its charitable contributions flow through to the partners, and each takes as his own deduction a share of the total contribution, based upon his entitlements under the partnership agreement.

The city appeared to be serious about establishing the scenic corridor, and towards that end it purchased, in June 1979, some 2.33 acres within the corridor for $73,820. All other parcels thereafter acquired within the corridor were contributed, however, among them a slice measuring .664 acres contributed by the 885 partnership on December 21, 1979. That gift was conditioned, however, at the city's insistence, on ultimate use of the land as part of the scenic corridor; in the event that such use was not accomplished, the city had the right to "deed said real property back to the owner...." In respect of that gift, 885 claimed a $115,695 charitable contribution.

Maxim One: Beware of donees looking gift parcels in the mouth. This is hardly a typical reaction, and, at the least, the partnership should have asked, "What if...?" and played through the possible outcomes.

In February 1981, 885 agreed to donate an additional 5.523 acres. That donation was subject to the same possibility of reconveyance, should the scenic corridor plans come to naught.

Not long thereafter, the city began to have second thoughts about the whole scenic corridor idea. The prospect of state funding had evaporated, and liability concerns had arisen. Hence it was determined in 1982 to reconvey to 885 the 1979 and 1981 gift parcels.

Lesson Two: Governments often change their minds. (This is a lesson, falling somewhat short of the maxim "Governments are not to be trusted.")

But the reconveyance was complicated by further negotiations. 885 agreed to develop and maintain the returned parcels as a scenic corridor and to contribute to a fund to ensure their maintenance, and, in return, the city approved increased density for the partnership's developable property adjacent to the corridor. Under those conditions, the reconveyance was effected in 1983. As returned, the gift parcels were subject to use restrictions that left no alternative but maintenance as a "scenic landscaped corridor."

Lesson Three: The properties returned to 885 were far different from the parcels donated in 1979 and 1981. The newly imposed use restrictions drastically reduced their values (a circumstance astonishingly ignored in the Tax Court's analysis), and in gaining density approvals as a condition of its maintenance obligation, 885 obviously extracted consideration that would have defeated the original deductions entirely, had it been bargained for in connection with the 1979 and 1981 gifts.

The procedural setting for this adjudication was peculiar. Owing to the IRS' failure to assert in a timely manner a deficiency on account of the (allegedly flawed) 1979 deduction, the tax benefits attributable to that gift were not in issue, but the effect to the taxpayer of the return of the 1979 gift parcel was very much in focus. As to the 1981 gift, 885's asserted deduction of $962,328 was entirely denied by the Service on the ground that, on the date of the gift, the "possibility of occurrence" of a reversion of the property to the partnership was "not so remote as to be negligible," under applicable (and venerable) regulations. The court agreed, as it had little choice but to do. The "so remote as to be negligible" standard has been applied in dozens of cases, and an assistant Sacramento city manager testified for the government that, at the time of the 1981 donation, prospects for public funding of the scenic corridor were gloomy.

Maxim Two: Tax benefits at which large donations are aimed must be impervious to attack, except on valuation grounds. The 1981 donation was the main-event issue in this case, involving a challenge to federal income tax benefits (i.e., dollars saved on account of the 1981 donation) aggregating approximately $480,000 to the 885 partners. Had the partnership's advisors refused to accede to the city's requested reverter provision, the deduction