

Charity Issues—Threshold for Foundations

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Charity Issues—Threshold for Foundations

I. Why is Charitable Planning So Important?

II. Charitable Gift Planning Strategies:

There are many different charitable vehicles that can be used, but the choice depends upon the client's needs and circumstances.

- ❖ Give to charitable programs that align with personal interests
- ❖ Share personal success with the community
- ❖ Dispose of property
- ❖ Maximize personal benefit
 - Need a tax deduction—income, gift, or estate
 - Retain an interest in the gift
 - Maintain control of the gift
 - Transfer assets to next generation
 - Anonymity of donor
- ❖ Complexity of the transaction
- ❖ Commitment of donor's time
- ❖ Donor's nonprofit business acumen

III. Determining what is the best vehicle to meet the client's needs

A. Do not need to create a structure for donation

1. **Outright Gift to Charity:** Donor is considering disposing of entire interest in property and does not want to retain any control.
2. **Donor-Advised Fund:** Donor is considering disposing of entire interest in property but it is acceptable to maintain advisory privileges that are not legally enforceable. He or she does not want a complicated structure. The donor-advised fund can be structured so that the gift will be given anonymously or it can be given in the

donor's name. The donor-advised funds are usually done at a community foundation.

B. Need to create a structure for making the donation

1. **Private Foundation:** Donor is considering disposing of entire interest in property but wants to maintain control of the charity. Four different kinds of private foundations will be discussed below.
2. **Charitable Trusts--(Charitable Remainder Trusts and Charitable Lead Trusts):** Donor is considering giving away a partial interest in property to charity and personally retaining an interest. A charitable deduction can be taken for the present value of the remainder interest of a charitable remainder trust, subject to the section 170 limitations. The trust can be either inter vivos or testamentary. Some of the trusts are not subject to the section 170 limitations.
3. **Supporting Organization:** Donor either wants to give to an organization that supports his or her favorite charity or wants to create an organization to support his or her favorite charity. This organization is similar to a private foundation.
4. **Create a Public Charity:** Donor wants to create an organization to address an unmet need in the community.

IV. Maximizing and Calculating the Tax Deduction:

The amount of the deduction depends on:

- Type of organization
- Type of property contributed
- Whether the contribution was "to" or "for the use of"

A. Type of organization receiving the contribution: Percentage limitations Section 170 (b)(1)

There are certain limitations---50%, 30%, or 20%-- that must be applied to compute the amount of a charitable contribution that an individual can deduct on his or her personal income tax return. The limitation is a percentage of the individual's contribution base, which is defined as adjusted gross income without taking into account any net operating loss carryback.

1. **50% limitation (Section 170(b)(1)(A))** -- If a charitable contribution of non-appreciated property was made to a public charity (also known as a 50% charity), then the charitable deduction will be allowed up to 50% of that individual's contributions base. A gift of non-appreciated property to a private operating foundation is deductible up to 50%.
 - a. **Church:** 170(b)(1)(A)(i): a church or a convention or association of churches,
 - b. **School:** 170(b)(1)(A)(ii): an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of

pupils or students in attendance at the place where its educational activities are regularly carried on,

- c. **Hospital:** 170(b)(1)(A)(iii): an organization the principal purpose or functions of which are the providing of medical or hospital care or medical education or medical research, if the organization is a hospital, or if the organization is a medical research organization directly engaged in the continuous active conduct of medical research in conjunction with a hospital, and during the calendar year in which the contribution is made such organization is committed to spend such contributions for such research before January 1 of the fifth calendar year which begins after the date such contribution is made,
- d. **Publicly Supported Organization:** 170(b)(1)(A)(iv): 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 under section 501(a)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public, and which is organized and operated exclusively to receive, hold, invest, and administer property and to make expenditures to or for the benefit of a college or university which is an organization referred to in clause (ii) of this subparagraph and which is an agency or instrumentality of a State or political subdivision thereof, or which is owned or operated by a State or political subdivision thereof or by an agency or instrumentality of one or more States or political subdivisions,
- e. **Government:** 170(b)(1)(A)(v): a governmental unit referred to in subsection (c)(1),
- f. **Publicly Supported Organization:** 170(b)(1)(A)(vi): an organization referred to in subsection (c)(2) 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 under section 501(a)) from a governmental unit referred to in subsection (c)(1) or from direct or indirect contributions from the general public,
- g. **Private Foundation:** 170(b)(1)(A)(vii): **a private foundation described in subparagraph (F), --a private operating foundation, a distributing foundation, and a common fund**
- h. **Supporting Organization:** 170(b)(1)(A)(viii): an organization described in section 509(a)(2) or (3), or
- i. **Agricultural Research:** 170(b)(1)(A)(ix): an agricultural research organization directly engaged in the continuous active conduct of agricultural research (as defined in section 1404 of the Agricultural Research, Extension, and Teaching Policy Act of 1977) in conjunction with a land-grant college or university (as defined in such section) or a non-land grant college of agriculture (as defined in such section), and during the calendar year in which the contribution is made such organization is committed to spend such contribution for such research before January 1 of the fifth calendar year which begins after the date such contribution is made,

2. 30% limitation

- a. if a charitable contribution was made with non-appreciated property to non-50% charities, including **private non-operating foundations**, then the **charitable deduction is limited to 30% of AGI**. –Section 170(b)(1)(B)
- b. The 30% limitation also applies to gifts of **capital gain property** to a 50% charity, including a **private operating foundation**. –Section 170(b)(1)(C). This does not include gifts of tangible personal property or gifts of long-term capital gain property to a private non-operating foundation.
- c. The 30% limitation applies to contributions “for the use of” the organization. However, if the donor chooses to limit the deduction to tax basis, then the 50% limitation applies.

3. 20% limitation

- a. The 20% limitation applies to gifts of **capital gain property** to non-50% charities (including **private foundations**). –Section 170(b)(1)(D)

4. Carry Overs

Any contribution in excess of the limitation can be carried forward for five years to be deducted, subject to the 50%, 30%, or 20% limitations in such carryover years.

5. Ordering of limitations

There is an ordering of contributions subject to 50%, 30% and 20% limitations so that they do not exceed 50% of the donor’s adjusted gross income in the year of contribution or in the carry over years.

B. Type of Property Contributed: The Reduction Rules

1. **Ordinary income property and short-term capital gain property**— (Section 170(e)(1)(A)) the contribution must be reduced by the amount of ordinary income and short-term capital gain as if the donor had sold the contributed property at its fair market value on the date of contribution. This limits the deduction to the property’s cost basis. This rule also applies to contributions of inventory and recapture property.
2. **Tangible personal property**— (Section 170(e)(1)(B)(i))-- if the use of the property by the donee is unrelated to its exempt purpose, the amount of the charitable deduction must be reduced by 100% of the long-term capital gain as if the donor sold it at its fair market value on the date of contribution.
3. **Long-Term Capital gain property**—(Section 170(e)(1)(B)(ii))--If long-term capital-gain property of any kind is contributed to a private non-operating foundation, the contribution deduction must be reduced by the amount of long-

term capital gains as if the property had been sold at its fair market value on the date of contribution.

- **Exception for Qualified Appreciated Stock**— (Section 170(e)(5)) If qualified appreciated stock is given to any private foundation the contribution deduction is the full fair market value of the stock. Qualified appreciated stock is any stock of a corporation for which market quotations are readily available on an established securities market as of the contribution date and the stock was long-term capital gain property for the donor. This exception does not apply if the donor or his or her family give more than 10% of the value of all outstanding stock of a corporation to non-operating private foundations.

C. Contributions “to” or “for the use of”

1. Contributions “to” public charities are subject to the 50% limitation
2. Contributions “for the use” of public charities are subject to the 30% limitation.

V. Types of Private Foundations: Section 170(b)(1)(F)

There are four types of private foundations:

- Non-Operating Foundation
- Private Operating Foundation
- Distributing Foundation
- Common Fund

A. Non-Operating Foundation- This organization provides grants to public charities and can have some direct charitable activities. These organizations pay tax on their income at the rate of 1% or 2%. They must also make qualifying charitable distributions of approximately 5% of the fair market value of their assets annually.

B. Private Operating Foundation –This organization engages directly in the active conduct of charitable, religious, education, and similar activities. Providing grants to individuals or other tax-exempt organizations is not considered engaging directly in the active conduct of charitable activities. Sections 170(b)(1)(F)(i) and 4942(j)(3).

This organization is treated as a 50% organization and a charitable contribution deduction is limited to 50% of adjusted gross income, unlike the 30% limitation for private non-operating foundations. In addition, contributions of capital gain property are subject to the 30% of adjusted gross income limitation, rather than the 20% limitation imposed on private non-operating foundations.

1. Establishing a Private Operating Foundation

- a. To create a new private operating foundation:
Apply for tax exempt status by submitting Form 1023 to the IRS.
Form 1023 Part X lines 1 through 4 apply specifically to private operating foundations. A private operating foundation cannot file for tax exempt status using Form 1023-EZ.
- b. To convert an existing private foundation to a private operating foundation:
File Form 8940 Request for Miscellaneous Determination to request reclassification as a private operating foundation as described in section 4942(j)(3).

2. Threshold to Remain a Private Operating Foundation-- Section 4942(j)(3)

In order to meet the requirements to be an operating foundation, the organization must meet:

- a. the Income Test, and
- b. at least one of three alternative requirements
 - i. Asset Test
 - ii. Endowment Test
 - iii. Support Test

3. Income Test (4942(j)(3)(A))

The organization must:

- a. make qualifying distributions directly for the active conduct of activities constituting the purpose or function for which it is organization and operated
- b. equal to substantially all of the lesser of
 - its adjusted net income (4942(j)(3)(A)(i)), or
 - its minimum investment return (4942(j)(3)(A)(ii)).

4. Alternative Requirements

a. Asset Test: 4942(j)(3)(B)(i)

The asset test requires that substantially more than half of the foundation's assets are held for use in its exempt function activities. "Substantially more than half" is defined to be 65% or more. (Reg. 53.4942(b)-2(a)(5)).

The assets must be devoted directly to either:

- the active conduct of activities constituting the foundation's charitable, educational, or other exempt purposes
- functionally related businesses, or
- any combination of the two.

b. Endowment Test: 4942(j)(3)(B)(ii)

The endowment test requires that the organization make qualifying distributions directly for the active conduct of its exempt functions in the amount of at least two-thirds of the foundation's minimum investment return---or 3-1/3% of its endowment.

c. Support Test: 4942(j)(3)(B)(iii)

The support test requires:

- at least 85% of its support (other than gross investment income) is normally derived from the general public and from five or more exempt organizations that are not related to each other or to the recipient foundation
- not more than 25% of its support is normally received from any one such exempt organization, and
- not more than one half of its support is normally received from gross investment income.

Calculate these tests early in the year so that enough expenditures are made to meet the threshold at the end of the year.

5. Failure to Meet Threshold

If a private operating foundation fails to meet the threshold requirements, it becomes a private non-operating foundation, which means it will have to pay a 1% or 2% tax on its income and make qualifying distributions of approximately 5% of its assets.

c. Distributing Foundation- Section 170(b)(1)(F)(ii):

This organization is a private non-operating foundation that can elect to be a distributing foundation on a yearly basis. It does not have to be done for consecutive years. The private non-operating foundation makes this election to benefit its contributors. This changes the deduction limit only. It does not change any of the other rules that apply to private foundations. It is still a private foundation.

It must distribute:

1. an amount equal in value to 100% of the contributions received that year,
2. it cannot have any remaining undistributed income for that year, and

3. it must make the distribution no later than the 15th day of the third month after the close of the taxable year in which the contributions were received.
4. The distribution must be a qualifying distribution, as defined in Section 4942(g).
 - a. A qualifying distribution is any amount (including that portion of reasonable and necessary administrative expenses) paid to accomplish one or more of its charitable purposes. The distribution should not be made:
 - to an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons (as defined in Section 4946) with respect to the foundation.
 - To a private non-operating foundation
 - However, if distributions are made to these entities, Section 4942(g)(3) provides they will count as qualifying distributions if the distributee makes a qualifying distribution of an amount equal to this contribution by the end of its next taxable year and the distribution is treated as if it is made from corpus under Section 4942(h).
 - b. A qualifying distribution includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's charitable purposes. Section 4942(g)(1)(B).
 - c. A qualified distribution also includes a distribution to a public charity--a 50% limitation organization.
 - d. A qualified distribution also includes a distribution:
 - from the foundation made no later than the close of its first taxable year after its taxable year in which such contribution was received,
 - that is equal to the amount of the contribution and treated as a distribution out of corpus, and
 - the private foundation making the contribution obtains adequate records or other sufficient evidence from the recipient organization that the qualifying distribution was made.
 - e. For purposes of determining whether 100% of the contributions received during the year were distributed, do not include any bequests, legacies, or transfers under Section 2055 for which a deduction was not taken under Section 170.
 - f. Any qualifying distribution made during the taxable year is treated as made from the undistributed income of the immediately preceding taxable year, then from the undistributed income for the current taxable year, and then from corpus.
 - g. An election can be made by the foundation to treat any portion of the qualifying distribution as made out corpus for the current tax year instead of the undistributed income of a designated prior taxable year.
 - h. The election is made by attaching a written statement to the Form 990-PF for the year and it must be filed by the filing deadline for the return, including extensions.
 - i. An election can be made to treat any of its excess qualifying distributions for its preceding five taxable years as made out of its corpus for the current year.

In order to obtain a deduction using the 50% of AGI limitation, the donor must:

1. Obtain adequate records or other sufficient evidence from the foundation showing that the foundation made such qualifying distributions
2. These records or evidence must be attached to the taxpayer's return for the taxable year the deduction was taken.

D. Common Fund. Section 170(b)(1)(F)(iii)

1. This private foundation pools all of its contributions to it in a common fund.
 - a. Any substantial contributor or his spouse has the right to designate annually the public charities that will receive income attributable to his portion of the fund.
 - b. Any substantial contributor or his spouse has the right at death to designate the public charities that will receive his portion of the corpus attributable to his contribution.
2. Its governing instrument must require it to distribute and it must actually distribute:
 - a. All of its adjusted net income to one or more public charities by the 15th day of the third month after the close of the taxable year in which it realizes the income, and
 - b. The entire corpus attributed to a substantial contributor must be distributed not later than one year after his or her death, or the death of the surviving spouse, if that spouse has the right to designate the recipients of the corpus. (Section 170(b)(1)(F)(iii)).

VI. Pitfalls for Private Foundations & Public Charities:

A. Excise Taxes for Private Foundations

1. IRC section 4940 Excise Tax Based on Investment Income

Section 4940 imposes a tax on private foundations equal to 2% of the net investment income of the foundation each taxable year. If the private foundation meets certain distribution requirements, the tax is reduced to 1%. Foundation will be subject to this tax and it will be

required to be paid annually. This tax will be calculated on the annual Form 990-PF that is required to be filed with the IRS.

2. IRC section 4941 Taxes on Self-Dealing

Section 4941 imposes an initial tax of 10% and an additional tax of 200% of the amount involved when a disqualified person engages in an act of self-dealing with a private foundation. It also imposes an initial tax of 5% and an additional tax of 50% up to a maximum of \$20,000 for a foundation manager who participated in an act of self-dealing between a disqualified person and a private foundation.

The self-dealing transactions, which can be direct or indirect, are outlined in Section 4941(d):

- a. The sale, exchange, or leasing of property between a private foundation and a disqualified person;
- b. The lending of money or other extension of credit between a private foundation and a disqualified person;
- c. The furnishing of goods, services, or facilities between a private foundation and a disqualified person;
- d. The payment of compensation or expenses by the foundation to a disqualified person;
- e. The transfer to, or use by or for the benefit of, a disqualified person of the income or assets of a private foundation; and
- f. Certain payments to government officials.

There are special rules that apply with respect to these transactions:

- a. The transfer of real or personal property by a disqualified person to a private foundation shall be treated as a sale or exchange if the property is subject to a mortgage or similar lien which the foundation assumes or if it is subject to a mortgage or similar lien which a disqualified person placed on the property within the 10-year period ending on the date of the transfer;
- b. The lending of money by a disqualified person to a private foundation shall not be an act of self-dealing if the loan is without interest or other charge and if the proceeds of the loan are used exclusively for purposes specified in section 501(c)(3);
- c. The furnishing of goods, services, or facilities by a disqualified person to a private foundation shall not be an act of self-dealing if the furnishing is without charge and if the goods, services, or facilities so furnished are used exclusively for purposes specified in section 501(c)(3);
- d. The furnishing of goods, services, or facilities by a private foundation to a disqualified person shall not be an act of self-dealing if such furnishing is made on a basis no more favorable than that on which such goods, services, or facilities are made available to the general public;
- e. The payment of compensation (and the payment or reimbursement of expenses) by a private foundation to a disqualified person for personal services which are reasonable

and necessary to carrying out the exempt purpose of the private foundation shall not be an act of self-dealing if the compensation (or payment or reimbursement) is not excessive; if the compensation is excessive, only the amount that is excessive will be subject to the tax on self-dealing; and

- f. Any transaction between a private foundation and a corporation which is a disqualified person (as defined in section 4946(a)), pursuant to any liquidation, merger, redemption, recapitalization, or other corporate adjustment, organization, or reorganization, shall not be an act of self-dealing if all of the securities of the same class as that held by the foundation are subject to the same terms and such terms provide for receipt by the foundation of no less than fair market value.

The term “amount involved” means, with respect to any act of self-dealing, the greater of the amount of money and the fair market value of the other property given or the amount of money and the fair market value of the other property received.

3. IRC section 4942 Taxes on Failure to Distribute Income

Section 4942 imposes a 30% initial tax and an additional tax of 100% on the amount of remaining undistributed income that was required to be distributed. The distributable amount, which is computed annually, is approximately 5% of the aggregate fair market value of all assets of the foundation, including illiquid assets.

4. IRC section 4943 Taxes on Excess Business Holdings

Section 4943 imposes an initial tax of 10% and an additional tax of 200% on business holdings of any private foundation in a business enterprise that exceed the permitted holdings.

Business holdings are defined as the holdings of a private foundation, or a disqualified person (as defined in section 4946) with respect thereto, in any business enterprise, any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries.

The term “business enterprise” does not include a trade or business at least 95% of the gross income of which is derived from passive sources. Gross income from passive sources is defined as dividends, interest, annuities, royalties, certain rents, and certain gains or losses from sales other than inventory or in the ordinary course of trade or business.

The permitted holdings of a private foundation in an incorporated business enterprise are 20% of the voting stock, reduced by the percentage of the voting stock owned by all disqualified persons. In the case in which all disqualified persons together do not own more than 20% of the voting stock of an incorporated business enterprise, nonvoting stock held by the private foundation shall be treated as permitted holdings.

Regulation 53.4943-8 states that “in computing the holdings in a business enterprise of a private foundation, or a disqualified person (as defined in section 4946), any stock or other interest owned, directly or indirectly, by or for a corporation, partnership, estate or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries except as otherwise provided in paragraphs (b), (c), and (d) of this section. Any interest in a business enterprise actually or constructively owned by a shareholder of a corporation, a partner of a partnership, or a beneficiary of an estate or trust shall not be considered as constructively held by the corporation, partnership, trust or estate.”

For a corporation actively engaged in a trade or business Regulation 53.4943-8 states that “any interest (whether or not in a separate entity) owned by a corporation which is actively engaged in a trade or business shall not be deemed to be constructively owned by such corporation’s shareholders.” A corporation shall not be considered to be actively engaged in a trade or business if the corporation is not a business enterprise by reason that it is a functionally related business or a trade or business at least 95% of the gross income of which is derived from passive sources.

If a corporation has been involved in a prohibited transaction, as defined in regulation 53.4943-7(d)(2), any interest in a business enterprise owned by such corporation shall be treated as constructively owned by its shareholders, whether or not such corporation is actively engaged in a trade or business.

Regulation 53-4943-8 states that “for an affiliated group, as defined by section 1504(a), the assets and activities of the affiliated group shall be treated as the assets and activities of the common parent.”

For a partnership Regulation 53-4943-8 states that “any interest in a business enterprise which is owned by a partnership shall be deemed to be constructively owned by the partners in such partnerships.”

5. IRS section 4944 Taxes on Investments Which Jeopardize Charitable Purpose

Section 4944 imposes on a foundation an initial 10% tax and an additional 25% on an investment that is considered jeopardizing. Section 4944 also imposes on the management an initial 10% tax and an additional 5% tax up to a maximum of \$20,000. This liability is joint and several for the management.

Regulation 53.4944-1 states that “an investment shall be considered to jeopardize the carrying out of the exempt purposes of a private foundation if it is determined that the foundation managers, in making such investment, have failed to exercise ordinary business care and prudence, under the facts and circumstances prevailing at the time of making the investment, in providing for the long-and short-term financial needs of the

foundation to carry out its exempt purposes.” This regulation goes on to state that “in the exercise of the requisite standard of care and prudence the foundation managers may take into account the expected return (including both income and appreciation of capital), the risks of rising and falling price levels, and the need for diversification within the investment portfolio (for example, with respect to type of security, type of industry, maturity of company, degree of risk and potential for return). The determination whether the investment of a particular amount jeopardizes the carrying out of the exempt purposes of a foundation shall be made on an investment by investment basis, in each case taking into account the foundation’s portfolio as a whole.”

Regulation 53.4944-1 states that “Section 4944 shall not apply to an investment made by any person which is later gratuitously transferred to a private foundation. If such foundation furnishes any consideration to such person upon the transfer, the foundation will be treated as having made an investment (within the meaning of section 4944(a)(1) in the amount of such consideration.”

This regulation also states that “the determination whether the investment of any amount jeopardizes the carrying out of a foundation’s exempt purposes is to be made as of the time that the foundation makes the investment and not subsequently on the basis of hindsight. Therefore, once it has been ascertained that an investment does not jeopardize the carrying out of a foundation’s exempt purposes, the investment shall never be considered to jeopardize the carrying out of such purposes, even though, as a result of such investment, the foundation subsequently realizes a loss.”

6. IRS section 4945 Taxes on Taxable Expenditures

Section 4945 imposes on a foundation an initial 20% tax and an additional 100% on the amount of a taxable expenditure. Section 4945 also imposes on the management an initial 5% tax and an additional 50% tax up to a maximum of \$20,000. This liability is joint and several for the management.

The term “taxable expenditure” means any amount paid or incurred by a private foundation:

- a. To carry on propaganda, or otherwise to attempt, to influence legislation
- b. To influence the outcome of any specific public election, or to carry on, directly or indirectly, any voter-registration drive with certain exceptions.
- c. As a grant to an individual for travel, study, or other similar purposes by such individual, unless the individual grant is awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the IRS and:
 - i. The grant constitutes a qualified scholarship or fellowship grant and is to be used for study at an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of

- pupils or students in attendance at the place where its educational activities are regularly carried on.
- ii. The grant constitutes a prize or award that is not taxable to the recipient because the recipient was selected without any action on his part to enter the contest or proceeding and the recipient is not required to render substantial future services as a condition to receiving the prize or award.
 - iii. The purpose of the grant is to achieve a specific objective, produce a report or other similar product, or improve or enhance a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.
 - iv. (More information on scholarship programs can be found in regulation 53.4945-4.)
- d. A grant to an organization that is not tax-exempt under section 501(c)(3), unless it exercises expenditure responsibility to exert all reasonable efforts and to establish adequate procedures:
- i. To see that the grant is spent solely for the purpose for which it was made
 - ii. To obtain full and complete reports from the grantee on how the funds are spent, and
 - iii. To make full and detailed reports with respect to such expenditures with the foundation's tax return.

B. Excise Taxes for Public Charities:

1. Intermediate Sanctions (Internal Revenue Code Section 4958)

- a. Excise tax can be imposed:
 - i. on any disqualified person involved in each excess benefit transaction equal to 25 percent of the excess benefit. If the excess benefit involved in such transaction is not corrected within the taxable period, there is imposed a tax equal to 200 percent of the excess benefit involved, and it shall be paid by the disqualified person.
 - ii. on any organization manager in the excess benefit transaction, knowing that it is such a transaction, a tax equal to 10 percent of the excess benefit,
 - with a cap of \$20,000;
 - unless such participation is not willful and is due to reasonable cause;
 - This tax is to be paid by the organization manager who participated in the excess benefit transaction; and
 - This excise tax is imposed on individuals only – not on the organization; reimbursement by the organization is an excess benefit.
- b. Rebuttable presumption that a tax-exempt organization can rely on that the transaction is not an excess benefit transaction. (IRS regulations 53.4958-6)

- i. payments under a compensation arrangement are presumed to be reasonable, and presumed to be at fair market value, if:
- ii. The compensation arrangement or the terms of the property transfer are approved in advance by an authorized body of the applicable tax-exempt organization (or an entity controlled by the organization) composed entirely of individuals who do not have a conflict of interest with respect to the compensation arrangement or property transfer;
- iii. The authorized body obtained and relied upon appropriate data as to comparability prior to making its determination; and
- iv. The authorized body adequately documented the basis for its determination concurrently with making that determination.

C. Unrelated Business Income

Usually tax-exempt organizations are not taxed on their income, except for private non-operating foundations. However, for certain types of transactions charities were perceived as having an unfair competitive advantage over for-profit businesses. In an attempt to eliminate this unfair advantage Congress enacted the statutes to tax unrelated business income (“UBI”):

- ❖ Section 511 imposes a tax on the exempt organization’s UBI at the regular corporate income tax rates.
- ❖ Section 512 outlines how unrelated business taxable income (“UBTI”) is identified and calculated.
- ❖ Section 513 defines an unrelated trade or business as a trade or business not substantially related to the organization’s charitable purpose.
- ❖ Section 514 includes in unrelated business taxable income an amount of income produced by debt-financed property and outlines how to calculate it.

1. Unrelated Business Income Definitions & Rules

- If an exempt org has UBI, it will be subject to tax at the corporate rates.
- If the unrelated activity is substantial in relation to the exempt org’s charitable activities, it can jeopardize its tax-exempt status. The IRS reasons that if an exempt organization derives excessive revenues from taxable activities, it is subject to revocation of its exemption because its primary purpose is to conduct an unrelated taxable business, rather than to operate exclusively for an exempt purpose.

- a. In order to be subject to UBI rules, the activity must be:
 - i. A trade or business
 - ii. Regularly carried on
 - iii. Not substantially related to the exempt purposes of the org.

- b. Substantially Related
 - i. Where there is a sufficient causal relationship between the particular activity and accomplishing the org's exempt purposes---it contributed importantly to the accomplishment of such exempt purposes---then it is not UBI.
 - ii. If only partly related to performance of its exempt functions and conducted on a larger scale than is necessary, the excess is UBI.

- c. Income can be excluded from UBI if:
 - i. The income is investment income---interest & dividends;
 - ii. The income is derived from royalties---The income is rental income from real property and certain rents from personal property leased with real property if the rents attributable to the personal property are incidental; or
 - iii. The income is from certain types of research activities.

- d. Income will not be excluded if:
 - i. Interest, annuities, royalties or rents are paid by a controlled organization.
 - ii. If an exempt org is actively involved in the development and management of a right or has considerable control over such activities, the payment is unlikely to be characterized as a royalty because of the services rendered. Royalties do not include payments for services rendered.
 - iii. It is from debt-financed property.