THE CATHOLIC FOUNDATION

Back to Basics: A Look at Charitable Organizations

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Back to Basics: A Look at Charitable Organizations

"This is a football."

Imagine a professional coach telling his team—a team that almost won it all the year before—about the ball that was at the center of their professional lives. Crazy! Yet, this is exactly what the legendary Vince Lombardi did in his early years with the Green Bay Packers. Lombardi believed that to achieve success, his players needed to revisit the basics that made them professional players in the first place.

Lombardi was exactly right. Following his strict emphasis on fundamentals and execution of the basics, the Packers went on to win five NFL championships, including the first two Super Bowls. The legend of Lombardi's leadership lives on today, and his influence was so predominant that the National Football League named the Super Bowl trophy after him.

Revisiting and mastering the basics may feel like a step backward. However, whether the task is making a tackle or providing transactional advice to a client who wants to make a gift, it is essential that we remember the basics, take the proper approach, and follow through to an effective conclusion.

In this issue, we will look at the differences between charitable organizations, because differentiating between the various types of charities can impact the advisability and deductibility of gifts.

Nonprofits, Tax-Exempt Organizations, and Qualified Charities

Nonprofits, tax-exempt organizations, and qualified charities are all entities created to achieve social good. It is possible that an entity could be all three at once, but for the purposes of the Internal Revenue Code (IRC), these are distinct types of organizations.

Nonprofits

As the name indicates, a nonprofit is created for purposes other than generating profit, so no part of the organization's income can be distributed to its members, directors, or officers. Nonprofit status is conferred under state statute rather than federal law, so the requirements of and benefits to these organizations vary from state to state.[1] As an entity formed under state statute, a nonprofit must follow all state requirements and entity organizational filing requirements.

Tax-exempt organizations

A tax-exempt organization is a nonprofit that is exempt from federal income taxation—a clear advantage indeed.[2] To qualify for tax-exempt status, a nonprofit must be organized and operated exclusively for one or more exempt purposes as identified in the Internal Revenue Code. The types of organizations that can claim tax-exempt status are listed in IRC Sec. 501(c).

Qualified charitable organizations

For a donor to receive a charitable tax deduction for a contribution, the charity must not only be tax-exempt, it must be "qualified." A charity may be qualified for income tax purposes, but not necessarily qualified for gift and/or estate tax purposes—IRC Secs. 170(c), 2522, and 2055(a) individually list the categories of qualified charities that allow a donor to deduct contributions for income, gift, and estate tax (respectively).

501(c)(3) organizations

There are 29 categories of tax-exempt organizations under IRC Sec. 501(c). A 501(c)(3) organization includes any corporation, community chest, fund, or foundation organized and operated for one of these purposes:

- Religious
- Charitable
- Scientific
- Testing for public safety
- Literary
- Educational
- Fostering athletic competition at the national or international level (if no funds go towards the facilities or equipment)
- Preventing cruelty to children or animals[3]

No net earnings generated by a 501(c)(3) organization, in whole or in part, may benefit private shareholders or individuals. Furthermore, the organization is prohibited from participating in political elections or devoting a substantial part of its activities to influencing legislation (by propaganda or otherwise).

To become a 501(c)(3) organization, the charity must meet these IRC requirements and file IRS Form 1023. If the organization files Form 1023 within 27 months after the end of the month of legal formation and the IRS approves the filing, the organization's tax-exempt status will be retroactively recognized to the date of formation.[4] If the organization files Form 1023 after 27 months, the tax-exempt status will only be recognized starting at the date of IRS approval.

Income Tax Deductions for Gifts to Qualified Charities

Donors make charitable donations for any number of reasons—a personal connection to the charity, a desire to help a specific cause, a family tradition of support or a tradition of charitable giving in general. Though it may not be the primary reason donors give, the income tax charitable deduction plays a role in philanthropic decisions and is the nexus between philanthropic intentions and tax planning.

Under IRC Sec. 170(c), a contribution or gift must be to or for the use of:

- The United States, a State, a possession of the United States, or any political subdivision, or the District of Columbia, but only if made for public purposes
- A corporation, trust, or community chest, fund, or foundation organized for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports, or for the prevention of cruelty to children or animals
- A post or organization of war veterans
- A domestic fraternal society, order, or association, operating under the lodge system, but only if contributions are used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals
- A cemetery company owned and operated exclusively for members and not for profit, with no part of the earnings benefitting any private shareholder or individual

50% or 30%? That Is the Deductibility Question

Not every charitable contribution will be deductible in the same way for income tax purposes. There are distinctions to draw between the deductibility of contributions made to a 50% organization as opposed to a 30% organization.

50% organizations are the qualified charities expressly described under IRC Sec. 170(b)(1)(A):

- Churches
- Hospitals and medical research organizations
- Educational organizations
- Governmental units
- Publicly supported charities
- Certain private foundations
- Supporting organizations

Concerning Publicly Supported Charities

There are two ways that an entity may be considered a publicly supported charity for purposes of IRC Sec. 170(b)(1)(A):

1. A charity that normally receives a substantial part of its support from governmental units and/or direct or indirect contributions from the general public. This support does not include income received in the exercise or performance of its tax-exempt purpose.[5]
2. A charity that normally receives more than one-third of its support annually from any combination of gifts, grants, contributions, or membership fees and gross receipts from admissions, sales of merchandise, performance of services, or the furnishing of facilities in an activity which is not an unrelated trade or business, and normally receives not more than one-third of its support from gross investment income and net unrelated business taxable income.[6]

30% organizations are all the qualified charities not described under IRC Sec. 170(b)(1)(A). Generally speaking, this refers to private foundations as defined under IRC Sec. 509(a).

Deductibility Distinctions

A fundamental understanding of the differences between a 50% organization and a 30% organization provides the basis for looking at how donors may deduct charitable contributions. For the sake of clarity, 50% organizations and 30% organizations will be referred to as public charities and private foundations, respectively.

The contribution base is the donor's adjusted gross income without regard to any net operating loss carryback to the taxable year.[7]

Cash Gifts

- A cash contribution to a public charity is deductible up to 60% of the donor's tax contribution base. The Tax Cuts and Jobs Act of 2017 increased this from the original 50% for any taxable year beginning after December 31, 2017, and before January 1, 2026.[8] Starting January 1, 2026, a cash contribution to a public charity is scheduled to revert to being deductible up to 50% of the donor's tax contribution base.[9] The Coronavirus Aid, Relief, and Economic Security (CARES) Act allowed individuals to deduct cash gifts to public charities up to 100% of their adjusted gross income in 2020, and the recently passed stimulus package has extended that for 2021.
- A cash contribution to a private foundation is deductible up to 30% of the donor's contribution base.[10]

Property Gifts

- A contribution of property to a public charity is deductible up to 30% of the donor's tax contribution base.[11] Appreciated property is deductible at its full fair market value if the sale of the property would have resulted in long-term capital gain.[12]
- A contribution of property to a private foundation is deductible up to 20% of the donor's contribution base.[13] It is deductible only at its tax basis as ordinary income property,[14] with one significant exception—a gift of qualified appreciated stock (defined as publicly traded stock that would produce long-term capital gain if sold) can be deducted at its fair market value.[15]

An Option When Giving to a Public Charity

A donor who gives appreciated property to a public charity may choose to value the property at its income tax basis rather than its fair market value, as if the donor were giving the property to a private foundation rather than a public charity. In doing so, the donor gains the advantage of deducting the contribution at 50% of his or her tax contribution base as if it were a gift of cash.[16] This would be a sensible choice if the property had little appreciation and/or the donor wanted to deduct a greater percentage of the contribution base in that particular tax year.

Gifts "for the use of" a Charity

In most instances, a donor makes a gift directly to a charity. However, occasionally a donor may make a gift "for the use of" the charity instead. A gift made for the use of a charity has the same applicable percentage limitations as those for 30% organizations.[17]

For example, Alicia owns a life insurance policy, which she gives to her favorite charity. Alicia still owes a few additional premium payments on the policy, but she is concerned about making a gift that will require the charity to make a payment. To further benefit the charity, Alicia decides to make the necessary premium payments herself.

- If Alicia sends a check in the amount of the premium to the charity, that is a gift to the charity, subject to the 60% limit (as previously noted).
- If Alicia sends a check for the premium directly to the insurance company, that is a gift *for the use of* the charity, and therefore subject to the lower 30% limit.

Supporting Organizations

Supporting organizations are 501(c)(3) entities created to support a public charity (or charities).[18] Although a single donor or a family may establish the supporting organization, it is classified as a public charity rather than a private foundation. The close relationship between the supporting organization and a public charity (or charities) engenders a greater degree of supervision by the overseeing charity, which reduces improprieties.[19]

Qualifying as a Supporting Organization

A supporting organization must pass a three-part test to qualify.

1. Organizational and Operational Tests

A supporting organization must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the supported public charity or charities.[20]

Generally, the supporting organization meets the organizational test if its purposes are as broad as (though not broader than) the charitable purposes of the supported public charity or charities.[21] The tax regulations list several specific requirements an organization must fulfill to meet this test.[22]

The supporting organization meets the operational test if it operates exclusively to support or benefit the supported public charity or charities.[23] Examples of such support include extending services, making payments, offering facilities, or creating grants for the advancement of the charitable purposes of the supported public charity.[24]

2. Control Test

A supporting organization may not be controlled directly or indirectly by a disqualified person.[25] Under the IRC, a disqualified person is any one of the following:[26]

- A substantial contributor, defined as an individual or entity that contributes more than the greater of $5,000 or 2% of the total contributions received by the supporting organization during its existence
- An owner of a 20% or greater voting interest in a corporation that is a substantial contributor
- An owner of a 20% or greater profit interest in a partnership that is a substantial contributor
- An owner of a 20% or greater beneficial interest in a trust or estate that is a substantial contributor
- An individual who could be controlled or influenced by a disqualified person (for example, an employee of a disqualified person)
- A family member of a disqualified person

It is important to note that the definition of a disqualified person does not include a foundation manager or a public charity.

A disqualified person holds control over a supporting organization if the disqualified person possesses one or more of the following:

- The power to veto actions of the organization[27]
- The right to designate who receives the income or principal from contributions[28]
- A larger than 50% voting power on the supporting organization's governing body[29]

3. Relationship Test

A supporting organization must maintain one of three types of relationships with a public charity:

- <u>Operated, Supervised, or Controlled By</u>

  This relationship compares to a parent company and its subsidiary, with the public charity holding a large degree of control over the policies and actions of its supporting organization. A majority of the governing body of the supporting organization is appointed or elected by the public charity it supports.[30]

- <u>Supervised or Controlled in Connection With</u>

  This relationship requires the supporting organization to be "supervised or controlled in connection with" the public charity. There is common control and supervision since the same person (or persons) is in charge of both entities.[31]

- <u>Operated in Connection With</u>

  This relationship is the most dynamic since it contains two subtests. The **responsiveness test** requires the supporting organization to be responsive to the needs and demands of the public charity or charities it supports.[32] The **integral part test** requires the supporting organization to maintain "a significant involvement in the operations of one or more publicly supported organizations, and such publicly supported organizations in turn depend on the supporting organization for the type of support which it provides."[33]

Advantages to the Donor

For a donor, creating a supporting organization provides advantages over creating a private foundation. A supporting organization:

- Is a 50% organization
- Is not burdened with the restrictions associated with private foundations

- Can achieve greater economic efficiencies by sharing staff and facilities with the public charity it supports
- Can better maintain the donor's philanthropic wishes in perpetuity (with a private foundation, the donor's philanthropic goals may not be what surviving family members eventually pursue)

Donor-Advised Funds

Donor-advised funds (DAFs) are restricted funds maintained by the donee charitable organization. The donor makes an irrevocable contribution to the fund. In turn, the donor receives an immediate tax deduction and still retains the power to make recommendations or provide advice on the fund's distribution. To meet the statutory definition of a DAF, the fund must:

- Be solely owned and controlled by the sponsoring organization
- Be sequestered and separated from the sponsor's general fund and specifically identified by reference to a specific donor (or group of donors) in that all contributions must be attributable to the named donor (or group)
- Offer the donor advisory privileges with respect to distributions from the fund[34]

Restrictions

Although the donor may provide advice on distributions, the donor may not place any material restrictions on the fund's distribution, since restrictions would cause the gift to be incomplete[35] and therefore not deductible. What constitutes a material restriction is a question that must be determined by looking at all the facts and circumstances. However, the following questions should be considered in determining whether a donor has placed a material restriction or condition on a contribution:

- Who owns the assets received from the donor?
- Are the assets held and administered by the donee charitable organization for the purposes of furthering the charitable organization's exempt purposes?
- Does the donee charitable organization's governing body have the ultimate control over the assets?
- Is the donee charitable organization's governing body organized and operated independently from the donor?[36]

Factors used to identify an independent governing body include the selection of the governing body, the terms of service for governing board members, and terms of renewal of service time for governing board members.[37]

Advantages to the Donor

Donating by means of a DAF offers advantages to the donor:

- A DAF is a 50% organization.
- Income tax deductions are allowed in the year of the contribution to the DAF, even if no distribution is made from the DAF.
- The donor has a great deal of flexibility and control over fund distributions.

Community Foundations

A community foundation provides help in grantmaking and has knowledge of both the potential grant-recipient charitable organizations and the community's charitable needs. Donors should be aware that some community foundations place geographic restrictions on distributions from the funds.

Types of Funds

Community foundations make charitable distributions from separate funds based on the donor's instructions. These funds may be divided into the following categories:

- **Unrestricted fund** that makes distributions to charities at the foundation's discretion
- **Designated fund** that makes distributions only to the public charity named by the donor at the time of the donation
- **Field-of-interest fund** that makes distributions only to the charitable purpose designated by the donor
- **Donor-advised fund**, in which the donor makes recommendations for distributions at any time

Advantages to the Donor

Community foundations are attractive to donors because they offer many of the same benefits as private foundations, but without some of the drawbacks. Compared to a similar gift to a private foundation, a gift to a community foundation generally:

- Provides a larger charitable tax deduction
- Requires less in administrative and set-up costs
- Avoids certain restrictions (along with the accompanying penalties for non-compliance)

Private Foundations

Generally, the term "private foundation" refers to a 30% organization. However, as noted earlier, certain private foundations qualify as public charities for the purpose of deducting charitable contributions:

- A **private operating foundation** spends (substantially) all of its income directly on activities that constitute its exempt purpose.[38] Further, it must qualify through one of three tests—the asset test (most of its assets are devoted directly to its exempt purpose),[39] the endowment test (most of its investment return is used for its exempt purpose)[40] or the support test (most of its support comes from the general public).[41]
- A **pass-through foundation** is a private non-operating foundation that must distribute out of corpus an amount equal to 100% of the contributions it received in a tax year.[42] The distributions must be made by the 15th day of the third month following the end of that tax year leaving no remaining undistributed income for the year. Qualifying distributions may not be made to an organization controlled (directly or indirectly) by the foundation or one or more disqualified persons, or to a private foundation that is not an operating foundation.
- A **pooled fund foundation** is another type of private non-operating foundation. Donor contributions are pooled into a common fund that is organized and operated exclusively for the support of one or more public charities.[43] Each year, donors have the right to designate the public charity that will receive the income attributable to each contribution, and this income must be distributed by the 15th day of the third month following the end of that tax year in which the income is earned.[44] Each donor has the right to designate the recipient of the principal following the donor's death. The principal must be distributed within one year of the donor's death.[45]

Restrictions on Private Foundations

In addition to the lower 30% deduction limit, private foundations are also subject to stringent and complicated tax rules governing operations. These rules are primarily in place to prevent private individuals from personally benefiting from the existence of the qualified charity rather than the public at large. The prohibitions (which trigger excise tax penalties if disregarded) disallow the following activities:

1. Self-dealing between foundations and contributors. A private foundation and a disqualified person (creators, substantial contributors, trustees, directors, members of their families, controlled corporations and trusts) cannot engage in self-dealing, which is any one of the following activities:[46]

- Sales, exchanges, or leases of property
- Loans
- Furnishing of goods, services, or facilities
- Paying compensation
- Transferring income or assets from the foundation to the donor
- Payment to government officials

2. Failure to distribute at least a minimum amount of the foundation's income for exempt purposes. The law requires a foundation to distribute annually the greater of (1) the foundation's adjusted net income for the tax year, or (2) a minimum percentage of its investment assets (as valued for each tax year).[47]

3. Holding business enterprises in excess of specified maximum ceilings. Disqualified individuals are prohibited from owning more than 20% of the voting stock of any corporation (or more than 35% of the voting stock of any corporation if an unrelated party has effective control).[48] If disqualified persons do not own more than 20% of the voting stock, the private foundation may own the corporation's non-voting stock.

4. Investments that jeopardize tax-exempt status. A private foundation is prohibited from investing either principal or income in a way that would jeopardize its exempt purposes.[49] Although there is not a list of categories naming investments that violate the rules per se, the IRS will scrutinize the following activities:[50]

- Trading securities on margin
- Trading in commodity futures
- Investing in working interests in oil and gas wells
- Buying warrants
- Selling short

5. Expenditures for lobbying. A private foundation must not engage in "taxable expenditures," including:[51]

- Influencing legislation
- Influencing the outcome of a public election
- Making grants for non-charitable purposes
- Making grants to non-public charitable organizations (unless the foundation exercises "expenditure responsibility")
- Making grants to any individual for study or travel (unless the IRS approves in advance the grant-making procedures)

Back to the Basics

Because of COVID-19, many of us have spent more time at home than ever before. More people are spending time cooking and baking from scratch, creating their own at-home fitness routines, even tackling home improvement projects. In many areas of life, we are rediscovering the fundamentals of doing things on our own.

In the spirit of returning to basics, advisors can also take their professional lives "back to the basics" by revisiting the fundamental concepts of charitable organizations. After all, this foundational knowledge holds the key to using techniques and planning tools that will best benefit charitably inclined clients.

ENDNOTES

1 The first resource for researching nonprofit law will be the state statues of the state in which the entity is organized. Another resource may be the Revised Uniform Unincorporated Nonprofit Association Act—a law promulgated by the National Conference of Commissioners on Uniform State Laws—which governs all unincorporated nonprofit associations that are formed or operate in a state that adopts the act.

2 IRC Sec. 501(a).

3 Reg. Sec. 1.501(c)(3)-1.

4 IRC Sec. 508.

5 IRC Sec. 170(b)(1)(A)(vi). There are two tests to determine if a charity normally receives a substantial part of its support from governmental units and/or contributions from the general public. Meeting either test qualifies the charity. One, the charity normally receives at least one-third of its total support from governmental units and/or the general public. And two, the support from governmental units and the general public is at least 10% of the organization's total support, and the charity is organized and operated so as to attract new and additional support from the government and the general public, and the charity can show a substantial degree of public support by various sources of support, the breadth of interests represented by the governing body, and the availability of public facilities and services.

6 IRC Sec. 170(b)(1)(A)(viii). See also IRC Secs. 509(a)(2) and (3).

7 IRC Sec. 170(b)(1)(G).

8 IRC Sec. 170(b)(1)(G).

9 IRC Sec. 170(b)(1)(A).

10 IRC Sec. 170(b)(1)(B).

11 IRC Sec. 170(b)(1)(C)(i).

12 IRC Sec. 170(b)(1)(C)(iv).

13 IRC Sec. 170(b)(1)(D)(i).

14 IRC Sec. 170(e)(1)(B)(ii).

15 IRC Sec. 170(e)(5).

16 IRC Sec. 170(b)(1)(C)(iii).

17 Reg. Sec. 1.170A-8(a)(2).

18 IRC Sec. 509(a)(3).

19 IRC Sec. 509(a)(3)(C).

20 IRC Sec. 509(a)(3)(A).

21 Reg. Sec. 1.501(c)(3)-1(b).

22 Reg. Secs. 1.501(c)(3)-1(b)(ii-v).
23 Reg. Sec. 1.501(c)(3)-1(c).
24 Reg. Sec. 1.501(c)(3)-1(c)(3).
25 IRC Sec. 509(a)(3)(C).
26 IRC Sec. 4946.
27 Reg. Sec. 1.509(a)-4(j)(1).
28 IRC Sec. 170(b)(1)(E)(iii).
29 Reg. Sec. 1.509(a)-4(j)(1).
30 Reg. Sec. 1.509(a)-4(g).
31 Reg. Sec. 1.509(a)-4(h).
32 Reg. Sec. 1.509(a)-4(i)(2)(i).
33 Reg. Sec. 1.509(a)-4(i)(3)(i).
34 IRC Sec. 4966(d)(2)(A).
35 IRC Sec. 170(f)(18)(B).
36 Reg. Sec. 1.507-2(a)(7)(i).
37 Reg. Sec. 1.507-2(a)(7)(ii).
38 Reg. Sec. 53.4942(b)-1(a).
39 Reg. Secs. 53.4942(b)-2(a)(1)-(5).
40 Reg. Sec. 53.4942(b)-2(b).
41 Reg. Sec. 53.4942(b)-2(c).
42 IRC Secs. 170(b)(1)(A)(vii) and (b)(1)(F)(ii).
43 IRC Secs. 170(b)(1)(A)(vii) and (b)(1)(F)(iii).
44 Reg. Sec. 1.170A-9(i)(2)(i).
45 Reg. Sec. 1.170A-9(i)(2)(ii).
46 IRC Sec. 4941(d).
47 IRC Sec. 4942.
48 IRC Sec. 4943.
49 IRC Sec. 4944.
50 Reg. Sec. 53.4944-1(a)(2)(i).
51 IRC Sec. 4945.

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