OUTLINE: CHARITABLE PLANNING FOR INDIVIDUALS AND TAX EXEMPT ORGANIZATION CONSIDERATIONS

Presentation by:

Jamie T. Katzen, Esq.
Brian A. Clark, Esq.

PART I
CHARITABLE PLANNING

I. Synopsis of Section 170.

1. Income Tax Aspects of Charitable Contributions and Gifts – § 170 Overview:

   a. Contributions by Individuals.

      i. Below the Line. Charitable deductions are "from AGI" or" below the line".

      ii. Charitable Contributions Have Five Elements:

         1. Transfers.

            a. Substance Over Form. The transfer must be "real"; donor parts with something, donee receives something. The IRS will not respect "memo" entries (where donor internally "earmarks" donations on his or her own books) or "circular transactions" (where donor contributes something but gets cash or property back).

         2. Money or Property.

            a. Checks. Date of mailing subject to conditions. (Discussed below).

            b. Credit cards. Cash equivalent on date of charge. Rev. Rul. 78-38.

            c. Promissory notes. General rule is if unsecured, treat as a mere promise to pay and no deduction until note is paid. Rev. Rul. 68-174.

            d. Property. The IRS can challenge donations of property that are not in good used or serviceable condition. Notwithstanding that, most any type of property that is usable for a tax exempt organization's exempt purpose can qualify. There are a host of issues regarding property contributions, including specific rules on gifts of intangibles (including family limited partnership interests) and intellectual property.

3. Permissible Donees.

   a. Five Classes of Donee. There are five categories of permissible donees. Domestic § 501(c)(3) organizations are the key donee group.

   b. Other groups. Governmental units, qualifying cemetery companies, certain war veteran organizations, and certain domestic fraternal societies.

   c. IRS Database. The IRS maintains an online database of eligible donees (formerly "EO Select Check"). There is guidance on the extent a donor can rely on the listing. Rev. Proc. 2018-32.

4. Voluntarily Made Without Receipt of Economic Benefit.

   a. Returns to Donors. Look out for sales or "quid pro quo" arrangements. If the donor receives something for a contribution, only the excess of the contribution amount over the fair value of what the donor receives is deductible.

   b. Proposed Regulation for States with Work-Around to SALT Deduction Limit. For contributions made after August 27, 2018, reduce a qualifying § 170 deduction by any state or local tax credit or deduction the donor receives or expects to receive that exceeds 15% of the contribution.

      i. IRS Posted Example. "If a state grants a 70 percent state tax credit and the taxpayer pays $1,000 to an eligible entity, the taxpayer receives a $700 state tax credit. The taxpayer must reduce the $1,000 contribution by the $700 state tax credit, leaving an allowable contribution deduction of $300 on the taxpayer's federal income tax return. The proposed regulations also apply to payments made by trusts or decedents' estates in determining the amount of their contribution deduction."

5. Proper form.

   a. Donative Intent. Must be a "contribution or gift". § 170(c). Requires donative intent.

   b. Contributions of Partial Interests. *Generally* no deduction for donations of "partial interests" not in trust. § 170(f)(3). Look for finite life gifts, or gifts of individual "strands" of rights.

i. Exceptions to General Rule for Partial Interests. It is possible to get a donation for contributions of partial interests if: (1) donor contributes an undivided portion of his or her entire interest in property (e.g. ¼ of Blackacre); (2) where a charitable deduction would have been allowed had the interest been transferred in trust; (3) remainder interests in personal residences or farms; or (4) for qualified conservation contributions.

ii. Remainder Interests in Trust. An income tax deduction is allowed for a charitable contribution of a remainder interest in trust only if the trust is a charitable remainder annuity trust, a charitable remainder unitrust, or a pooled income fund. § 170(f)(2)(A); Treas. Reg. § 1.170A-6(a)(1).

iii. Partial Interest Example.

1. Donor owns an office building. During 2018, Donor allows a charitable organization to use a floor of the building rent-free. The charity uses the space to administer its exempt programs. Donor's contribution of the use of the building is a nondeductible gift of a partial interest. Treas. Reg. § 1.170A-7(d), Ex. 1.

c. Substantiation.

i. Minimum General Standards. Obtain written acknowledgment from donee stating donee's name, contribution date, and amount of contribution. For cash contributions, maintain bank records, card statements, and cancelled checks.

ii. Select Substantiation Issues. If noncash donations exceeding $500 are claimed, the donor's tax return preparer has to complete Section A of Form 8283. Noncash donations that exceed $5,000 generally require an appraisal. Substantiation is discussed in § 170(f) and the appurtenant regulations.

iii. Nature and Value of Property. Substantiation requirements vary depending on the nature and value of contributed property. For high dollar items consider an appraisal. When gifting intangibles, closely held securities, or IP, consult the donor's estate planning and tax team.

iv. Burden. Burden of proof is on the donor.

iii. Amount of Deduction.

1. General Rule. General rule is property's FMV, reduced under the rules of § 170(e)(1) for appreciated property.

2. Defining Fair Market Value. FMV is defined by regulation: "[t]he fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts." Treas. Reg. § 1.170A-1(c)(2).

3. General Deduction Rules. See contribution deduction rule checklist for contributions to public charities, private operating foundations, private non-operating foundations, and donor advised funds ("DAF").

b. Contributions by Partnerships.

i. Separately Stated Items. Donating partners separately take their distributive share of the partnership's charitable contribution on the partner's individual return. § 702(a)(4).

2. Certain Section 170 Limitations:

a. AGI Thresholds.

i. Cash contributions - TCJA Change. For 2018-2025, cash contributions to public charities are limited to 60% of contribution base. Contribution base for individuals is AGI without regard to charitable deductions and NOL carrybacks.

ii. Other Thresholds. There are 50%, 30%, and 20% contribution base limits depending on the type of donee organization and whether the contribution is "for the use of" or simply "to" the organization. The mechanics of the threshold limitations are beyond the scope of this presentation.

b. Payments by check. Treas. Reg. § 1.170A-1(b); Rev. Rul. 54-465.

i. Mailing Date Rule. Deductible when check is mailed or unconditionally delivered to donee if two conditions are met. First, check must be honored in due course, and second, there can be no restrictions as to the time and manner of payment.

ii. USPS. "Date of mailing" regulation historically only applies if the check is sent by USPS. Delivery date rule applies to donations sent by UPS or FedEx.

iii. Mailing Date Example. Check made and mailed by donor on 12/31/2018. If conditions are met, donor takes § 170 deduction in 2018, the year of mailing, even though funds did not leave donor's account until 2019.

c. Foreign Donees.

i. Direct Contributions to Foreign Donees. Contributions made directly to foreign charitable organizations by U.S. donors are generally not deductible. § 170(c)(2)(A).

ii. Treaty Modification. Tax treaties can modify the general rule.

iii. Care is Warranted for Cross-Border Giving. OFAC, money laundering, and anti-terrorism laws must be considered in addition to tax compliance. If you have a client that wants to create a cross-border charity, consult both CPAs and lawyers that are well versed in those issues.

iv. Some Options for Making Deductible Cross-Border Donations.

1. Give to Operating Domestic Charity. Contributing to a U.S. public charity experienced in making foreign donations is the simplest route. There are also "friends of" organizations which are U.S. 501(c)(3)s that are "affiliated with" foreign organizations.

2. Donate to a Cross-Border DAF. U.S. charities can sponsor DAFs that focus on foreign grants.

3. Private Foundations. Certain private foundations have foreign operations. Vetting is key, because the expenditure responsibility rules generally require organizations to have an infrastructure and personnel that can follow complex legal requirements.

II. Charitable Tools for Personal Planning.

1. Client Goals. The purpose for using charitable trust structures is to allow a donor to make charitable donations while retaining an income stream or residual assets that can benefit the donor's loved ones.

2. Section 170 Overlap. Section 170 was discussed first, because in order for an inter vivos charitable trust to meet the client's estate planning goals, the portion of a trust being transferred to a charitable beneficiary must satisfy the basic § 170 requirements.

3. Charitable Trust Structure Overview. Various trust structures can be used to facilitate charitable giving in furtherance of a client's estate plan. These trusts are "split-interest" trusts, in the sense that a charitable beneficiary and non-charitable beneficiary both benefit from the trust's existence. The references to "remainder" or "lead" identifies what interest the trust's charitable beneficiary receives.

a. Charitable Remainder Trusts ("CRT"). CRTs are governed by § 664 and Treas. Reg. §§ 1.664-1, -2, and -3. In general, a CRT is a trust where a fixed amount, or fixed percentage of trust assets is paid at least annually to a non-charitable beneficiary for a statutory term. At the end of the CRT's term, the remainder interest passes to one or more qualified charities. There are two types of qualified CRTs: CRUTs and CRATs.

i. Charitable Remainder Unitrusts ("CRUT"). A CRUT is a trust that provides a non-charitable beneficiary with a *fixed percentage* of the net fair market value of the trust's assets as determined on an annual basis.

ii. Charitable Remainder Annuity Trust (“CRAT”). The CRAT is a CRT where the non-charitable beneficiary gets a *fixed annuity* amount at least annually.

b. Charitable Lead Trusts (“CLT”). The CLT is a variation on the CRT, except that annual payments are made to the charitable organization first (the “lead” portion), with the remainder passing to one or more non-charitable beneficiaries. All other requirements applicable to CRTs apply to CLTs.

c. Net Income with Makeup Charitable Remainder Unitrust (“NIMCRUT”). A NIMCRUT is a variation on the basic CRUT where a trustee pays the lesser of the trust’s income or the amount normally required to be paid (a fixed percentage of the value of the trust’s assets) to the non-charitable beneficiary. If the trust’s income is less than the “normal amount”, then in later years, when the trust’s income is greater than the amount required to be paid to the non-charitable beneficiary, the excess income is paid to the non-charitable beneficiary to “make-up” for the amount that would have been paid in the earlier year when trust income was less than the required distribution amount.

i. Flip CRUT. A Flip CRUT begins as a NIMCRUT but is settled with a non-productive asset. The trustee can make small or no payments to the non-charitable beneficiary in years the trust assets generate little income. When the trustee sells the non-productive asset the trust “flips” and becomes a traditional CRUT.

4. Pooled Income Funds (“PIF”). A PIF is an arrangement used for obtaining charitable deductions where two or more donors agree to contribute property to a single fund administered by a charity. The PIF pays an income interest to one or more persons and at the end of the PIF term, the remainder passes to charity. A PIF does not have to qualify as a trust under local law, but it is taxed as a trust for federal income tax purposes. The grantor trust rules do not apply to a PIF. The general requirements for PIFs are set forth in § 642(c)(5) and appurtenant regulations.

III. Detailed Review of CRTs.

1. CRUT.

a. Unitrust Amount to Non-Charitable Beneficiary.

i. Amount of Distributions. Trust gives at least one non-charitable beneficiary a fixed percentage of the net fair market value of the CRAT’s assets (valued annually pursuant to § 664(d)(2)(A)) (sometimes called the “unitrust amount”). The fixed percentage cannot be less than 5% or more than 50% of the net FMV of the trust’s assets for the year.

ii. Frequency of Distributions. Payments made at least annually.

iii. Term of Distributions. The interest of the non-charitable recipients can be for a term not to exceed 20 years, or for the life or lives of individual recipients.

iv. No Trustee Discretion and No Additional Payments. The trustee cannot have discretion as to whether to make the unitrust amount payments. Other than the unitrust amount, no amount may be paid from the trust to any recipient who is not a permissible charitable donee.

b. Remainder Interest to Charity.

i. Qualifying Charity. The charity receiving the remainder should be a "good" § 170 donee.

ii. Minimum Remainder Value. The value of the remainder interest must be at least 10% of the net fair market value of the property placed in trust. § 664(d)(2)(D).

iii. Timing of Remainder Transfer. When the non-charitable beneficiary's unitrust amount interest terminates, the remainder of the trust corpus must be transferred to or for the use of, or continued in trust for the use of, a permissible donee. § 664(d)(2)(C); Treas. Reg. § 1.664-3(a)(6).

2. CRAT.

a. Annuity Amount to Non-Charitable Beneficiary.

i. Amount of Distributions. A CRAT pays a sum-certain "annuity amount" to the non-charitable beneficiary. The annuity amount cannot be less than 5% or more than 50% of the initial net fair market value of the trust's assets.

ii. Frequency of Distributions. Payments made at least annually.

iii. Term of Distributions. The interest of the non-charitable recipients can be for a term not to exceed 20 years, or for the life or lives of individual recipients. § 664(d)(1)(A).

iv. Other CRAT Issues.

1. Probability of Exhaustion Test. No § 170 deduction is allowed if there is greater than a five percent probability that a life beneficiary will survive exhaustion of the CRAT's assets. In other words, it must be unlikely that a life annuity amount beneficiary will outlive distribution of all of the assets.

2. Alternative to Exhaustion Test. For trusts created after August 8, 2016, the IRS provided a sample provision that could be used as an alternative to satisfying the exhaustion test. Rev. Proc. 2016-42.

3. One-Time Contributions. No contributions can be made to a CRAT after initial settlement. The trust instrument must prohibit future contributions.

b. Remainder Interest to Charity.

i. Qualifying Charity. The charity receiving the remainder should be a "good" § 170 donee.

ii. Minimum Remainder Value. The value of the remainder interest must be at least 10% of the net fair market value of the property placed in trust. There is some relief for trusts that do not meet the 10% test. (see the exhaustion test above)

iii. Timing of Remainder Transfer. When the non-charitable beneficiary's annuity amount interest terminates, the remainder of the trust corpus must be transferred to or for the use of, or continued in trust for the use of, a permissible donee.

3. Issues Common to CRTs.

a. Taxation of the CRT. CRATs and CRUTs are generally exempt from income tax. § 664(c). If unrelated business taxable income ("UBTI") exists, the trust is subject to a 100% excise tax on such UBTI, payable out of trust corpus. Forms 4720 and 5227 are used to report UBTI.

b. Treatment of CRT Beneficiaries. The annuity amount or unitrust amount is treated by the non-charitable beneficiaries as provided by § 664(b). In general this means the beneficiaries take their piece of ordinary income for the current year and undistributed ordinary income from prior year, capital gains for current and prior (undistributed) years, other income for current and prior years, and finally from corpus. A detailed recitation of the § 664(b) mechanics is beyond the scope of this presentation.

c. Reporting. The CRT files Form 5227. The trustee may be required to file other returns for excise and UBTI. Additionally, the excise taxes on private foundations apply to CRTs. Form 5227 is filed on or before the 15^{th} day of the fourth month after the close of the CRT's tax year. Rev. Proc. 83-32.

d. Special NIMCRUT Issues. The remainder interest is computed on the basis that an amount equal to 5% of FMV of trust corpus (or higher if the trust instrument specifies more) is distributed each year with net income limits disregarded. § 664(e). The NIMCRUT is really a special statutory rule provided by § 664(d)(3). It allows a CRUT to pay the trust's income to a non-charitable beneficiary where the unitrust amount is less than what a standard CRUT would require, and in later years, when trust income exceeds the unitrust amount, to make up for prior years.

e. Other Issues. The foregoing covers key issues relative to forming a CRT. Additional requirements apply.

4. When to Consider a CRT. The answer may depend on whether the client wants income tax or estate tax benefits (§ 170 v. § 2055) and what types of assets the client has.

a. CRUT or CRAT Scenarios.

IV. **Detailed Review of CLTs**.

1. Strict Requirements. If a donor wants to receive an income tax deduction for contributing property to a trust that pays income to a charitable beneficiary and the remainder to a non-charitable beneficiary, the CLAT or CLUT is the only vehicle that can be used. Failure to meet even one technical requirement can cause the deduction to be lost.

a. IRS Samples. The IRS provided sample forms for both inter vivos grantor CLATs and testamentary CLATs in Rev. Proc. 2007-45; CLUT guidance followed in Rev. Proc. 2008-45. The focus of this presentation is inter vivos CLATs.

i. Private Foundation Rules. Section 4947(a)(2) results in a CLT having to satisfy the requirements of § 508(e), specifically meaning the trust instrument has to expressly prohibit violating the private foundation rules regarding annual distributions, self-dealing, and other excise tax issues.

ii. Other Required Governing Document Inclusions.

1. Deduction Requirements. To obtain an income, estate, or gift tax deduction, the charitable lead trust must provide for: (i) an annual payment; (ii) to a qualified charitable organization; (iii) in the form of either a guaranteed annuity or unitrust interest. The definitions of guaranteed annuity and a unitrust interest for a CLT are almost entirely similar under the income, estate, and gift tax regulations. *See generally* §§ 170(f)(2), 2055(e)(2)(B), 2522(c)(2)(B); Treas. Reg. §§ 1.170A-6(c)(2)(i), 1.170A-6(c)(2)(ii), § 20.2055-2(e)(2)(vi), 20.2055-2(e)(2)(vii), 25.2522(c)-3(c)(2)(vi), 25.2522(c)-3(c)(2)(vii).

2. Measuring Lives. If the lead interest (to the charitable beneficiary) is measured in lives of specific individuals, the value has to use actuarial expectancy rules as of the date of transfer, so some actuarial expertise may be required. Additionally, each such measuring life has to be living on the date the trust is funded. Treas. Reg. § 1.170A-6(c)(2)(i)(A).

a. Limited Pool of Measuring Lives. Only the donor, donor's spouse, and an individual who with respect to all remainder beneficiaries (excepting charitable organizations) is either a lineal ancestor or the spouse of a lineal ancestor of those beneficiaries can be used as a measuring life for purposes of valuing an income interest as a guaranteed annuity. Treas. Reg. § 1.170A-6(c)(2)(i)(A).

3. RAP Violations. CLTs have to comply with each jurisdiction's version of the rule against perpetuities.

4. Power of Invasion. CRTs cannot be subject to a power of invasion. Rev. Rul. 77-58. CLTs likely mirror this treatment, where the power of invasion could infringe upon payment of the lead interest.

5. CRT Rules and Other Issues. All other rules applicable to CRTs apply to CLTs. The foregoing covers key issues relative to forming a CLT. Additional requirements apply.

2. When to Consider a CLT.

a. CLT Scenarios.

PART II
TAX EXEMPT ORGANIZATION FORMATION
AND
OPERATIONAL ISSUES

I. Tax Exempt Organizations Overview.

1. Nonprofits and Tax Exemptions. “Nonprofit” denotes a form of organization under state law. “Tax exempt” is a status bestowed on a nonprofit organization after filing Form 1023 with the IRS and receipt of a 501(c) determination letter.

2. The Code’s Exemption Structure. Section 501(a) supplies an entity level tax exemption. Organizations described in §§ 501(c), (d), and 401(a) are exempt from tax unless an exemption is denied under §§ 502 or 503.

   a. Types of Exempt Organizations. Section 501(c) is a global list of exempt organizations – there are 29 separate types of organizations listed in § 501(c). Other types of organizations have certain tax exemptions under Subchapter F of the IRC. See, e.g., §§ 527 for political organizations. The focus of this presentation is necessarily limited to § 501(c)(3) organizations.

   b. Code Section 501(c)(4) Organizations. These are civic leagues or organizations not organized for profit but operated exclusively for the promotion of social welfare. In other words § 501(c)(4) organizations operate for a public purpose just like 501(c)(3)s. The promotion of social welfare is the 501(c)(4) ‘charitable’ purpose.

      i. Differences Between 501(c)(3) and 501(c)(4) organizations. The main difference is there is no lobbying restriction for § 501(c)(4)s. 501(c)(3)s can only do insubstantial lobbying. Lobbying is a social welfare activity done by 501(c)(4)s. Those organizations can do political campaign activity without terminating the 501(a) exemption.

      ii. Issues and Trends. If 501(c)(4)s do the same things as 501(c)(3)s without lobbying restrictions, why use a 501(c)(3)? The main reason is § 170 deductions are not usable for § 501(c)(4). Since many wealthy persons do not benefit from § 170, a trend is that more and more of the wealthy use § 501(c)(4)s.

      iii. Section 527 Organizations. These are generally organized to raise money for political parties and campaigns.

3. Categorizing Exempt Organizations.

   a. Public Serving Organizations. These serve a broad indeterminable charitable class. Examples include the Susan G. Komen Foundation, Ford Foundation, and the Metropolitan Museum of Art. Public serving organizations can have members.

   b. Member Serving Organizations. These organizations exist to serve their members. Examples include labor unions (§ 501(c)(5)), social clubs (§ 501(c)(7)), and fraternal organizations (§ 501(c)(8)).

c. Overlap. Whether an organization serves the public or its members deals with what type of entity is at issue within 501(c)(3). Organizations can do both public and member services. For instance, houses of worship, like the Catholic Church both benefits its members, and provides public services to the needy. Constitutional concerns provide churches with additional protections.

d. Public Charity Versus Private Foundation. The classification of a tax exempt organization as a public charity or private foundation affects how the organization operates, § 170 thresholds, and what sanctions apply.

II. **Eligibility for Section 501(c)(3) Treatment and Nonprofit Policy**.

1. Eligibility Overview. The requirements for federal income tax exemption are in § 501(c)(3) (for both private foundations and public charities). Most § 501(c)(3) organizations are eligible donees under § 170 and for transfer taxes under § 2522. There are *seven requirements for exemption* under § 501(c)(3) - five are statutory, one is regulatory, and the last is from common law (not in the statute or regulations).

   a. Form 1023. When a client considers setting up a charitable organization, the eligibility requirements are key. Walk-through each statutory, regulatory, and judicial element, because completion of Form 1023 and the organizational documents will require detailed knowledge of each component. For instance, if a client wants to provide political campaign support, you are immediately scoped out of § 501(c)(3).

2. Statutory Eligibility Requirements.

   a. Requirement 1 - Proper Organizational Form. § 501(c)(3). The organization must be a:

      i. Corporation;

      ii. Community chest;

      iii. Fund;

      iv. Foundation; or

      v. Trust.

         1. A Note on Trusts. Trusts are not listed within § 501(c)(3), but are allowed by regulation and case law. *See* Treas. Reg. § 1.501(c)(3)-1(b)(2) (Referring to the "trust instrument" for the organizational test) and *Fifty-Third Union Trust Co. v. Commissioner*, 56 F.2d 767 (6th Cir. 1932) (A trust is treated as a fund or foundation for federal tax purposes and is thus a qualifying entity).

   b. Requirement 2 - Exempt Purpose. The organization must be organized and operated exclusively for a specified exempt purpose:

      i. Religious;

ii. Scientific;

iii. Charitable;

iv. Testing for public safety. Treas. Reg. § 1.501(c)(3)-1(d)(4). Testing of consumer products, such as electrical products, to determine whether they are safe for use by the general public;

v. Literary;

vi. Educational;

vii. Foster national or international amateur sports competitions (but no part of the activity can be for the provision of equipment or athletic facilities).

1. Statutory Override. Section 501(j) allows exactly what the parenthetical does not. Therefore the parenthetical in § 501(c)(3) is irrelevant. Additionally, § 501(j) allows for local or regional amateur sports organizations.

viii. Prevent cruelty to children or animals.

c. Requirement 3 – No Private Inurement. No portion of the organization's earnings can inure to any private shareholder or individual.

d. Requirement 4 – No Substantial Part of Organization's Activities can be Lobbying. "Some" lobbying is ok – that which is insubstantial.

e. Requirement 5 – No Political Campaign Activities. Unlike lobbying this is an absolute prohibition.

3. Regulatory Eligibility Requirement – Indeterminable Charitable Class.

a. Scope of Benefitted Class Must be Public, not Private. Treas. Reg. § 1.501(c)(3)-1(d)(1)(ii):

> "An organization is not organized or operated exclusively for one or more of the purposes specified in subdivision (i) of this subparagraph unless it serves a public rather than a private interest. Thus, to meet the requirement of this subdivision, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests."

b. Unpacking the Regulation. The charitable organization cannot be operated for the benefit of private interests, designated individuals, the creator of the entity or his or her family members, shareholders of the organization, or persons controlled directly or indirectly by such private interests. The result is the class of charitable beneficiaries has to be indeterminable; the size of the class is irrelevant.

i. Distinguishing Charitable Classes. Some classes are so large the class is virtually indeterminable: e.g. educational bills for all persons born in New York in 1997. That class is determinable, but is so large it is virtually indeterminable. *See, e.g.*, IRS Publication 3833 on disaster relief situations; benefitting a class of 100,000 is a charitable class. Notwithstanding this, the size of class can be too small: i.e. all persons who live on the fifth floor of Building 1, when each floor has 3 units. The class is indeterminable because anyone can live in the apartment, but it is too small.

ii. Focus on Policy. No designated persons should benefit, public benefit is required.

iii. Payments to Class Members. If after a disaster an employer's private foundation gave money to rebuild homes, etc. to its employees, the size of the class matters for whether the payments are taxable compensation or charitable giving. E.g. if the class is 30,000 people that is likely large enough to be charitable.

c. Private Benefit Issues. Charities can't be formed to provide private benefits unless the private benefit is quantitatively and qualitatively incidental to the public purpose.

i. Example 1: Organization formed to raise money to pay medical bills of a particular child with cancer. Not exempt. If it was all children in Texas it would be exempt.

ii. Example 2: Organization to assist widows and orphans from 9/11 attacks. Not exempt. If it said 9/11 or "*any other natural or civic disaster*" it would be exempt. The IRS allowed the "other disaster" language even if the charity said it would distribute all funds in the current year – i.e. it was obvious all the money would be for 9/11 survivors.

4. The Common Law Requirement.

a. Fundamental Public Policy. From *Bob Jones University v. United States*, 461 U.S. 574 (1983). Bob Jones University was dedicated to "fundamentalist Christian beliefs" which included prohibitions against interracial dating and marriage. In 1970, the Internal Revenue Service (IRS) changed its formal policy to adopt a district court decision that prohibited the IRS from giving tax-exempt status to private schools engaging in racial discrimination. The Court found that the IRS was correct in its decision to revoke the tax-exempt status of Bob Jones University and the Goldsboro Christian School. These institutions did not meet the requirement by providing "beneficial and stabilizing influences in community life" to be supported by taxpayers with a special tax status.

b. Result of Bob Jones. No part of the purposes of the organization or its activities can be illegal or violate public policy. *Bob Jones* made two major changes to the definition of exempt purpose under § 501(c)(3):

i. First: SCOTUS concluded organizations encouraging illegal activity or violating public policy cannot qualify for exemption under § 501(c)(3).

ii. Second: Being educational or literary or religious or scientific is not enough to pass the organizational and operational tests. The organization must meet: (i) the organizational test; (ii) the operational test **and** must meet a common law definition of "charitable". *See* Treas. Reg. § 1.501(c)(3)-1(d)(2).

1. Charitable Requirement for § 501(c)(3): Treas. Reg. § 1.501(c)(3)-1(d)(2). T**he charitable requirement is effectively a separate § 501(c)(3) requirement.**

c. IRS is the Arbiter for Determining What is a violation of Fundamental Public Policy. Abuse of discretion is the standard. Other than racial discrimination (Bob Jones) we do not know what would be a violation.

d. Public Policy Violation Determination Tests Provided by Bob Jones. (i) Those acts defined by Congress as public policy violations and (ii) whether the three branches of government have agreed something violates fundamental public policy. (In *Bob Jones* the 1st Amendment argument was knocked down; SCOTUS effectively said you can worship however you want, but U.S. taxpayers will not pay for it with a tax exemption.)

III. The Organizational and Operational Tests.

* Meet the seven § 501(c)(3) requirements above plus these two tests:

1. Organizational Test. Draft proper organizational documents. Certificates, articles, etc. (not bylaws). The organizational test focuses on the purpose for which the organization was formed – must be a § 501(c)(3) purpose (the purpose test in the 7 part test). The organizational test relies on the language set forth in the articles of organization (or trust agreement) defined in Treas. Reg. § 1.501(c)(3)-1(b)(1), (2).

   a. Formation Document Issues. Articles cannot expressly empower the organization to engage *except insubstantially* in any activity that does not further the charitable purpose. Treas. Reg. § 1.501(c)(3)-1(b)(1)(ii) (The purposes in the organizing documents can be narrower than the statutory § 501(c)(3) requirements but not more broad).

   b. Dissolution requirement. The organization must be obligated in its organizing documents to dedicate its assets on dissolution to charitable or public purposes.

      i. State law distribution at dissolution. Some states require a charity's assets to be distributed at dissolution. In states with such a requirement, the organization's governing document can be silent (the IRS lost several cases on this). It is prudent to include the dissolution language in the articles or trust instrument however, because the IRS may "delay" the application for not doing so.

      ii. Section 508(e). If the organizer believes the organization will be a private foundation, insert the statutory language of § 508(e) regarding a private foundation's distribution requirements and Chapter 42 prohibitions.

2. Operational test. Organizations have to be operated exclusively for exempt purposes. § 501(c)(3). The focus is on the organization's activities. The regulations treat "*exclusive*" to mean *primarily* engaged in exempt purposes. Treas. Reg. § 1.501(c)(3)-1(c)(1). Rule: insubstantial unrelated business activities are allowed (otherwise Congress would not have passed UBIT rules).

IV. **<u>Form 1023</u>.**

1. <u>Set-Up</u>. The eligibility requirements were discussed in depth first, because completion of Form 1023, the "Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code", and in particular, the Form's attachments, requires a fairly comprehensive understanding of § 501(c)(3)'s statutory, regulatory, and jurisprudential requirements.

2. <u>The Form</u>. Form 1023 is divided into eleven parts. Most of the parts address at least one of the eligibility requirements. As an example, Parts II and III request the type of entity, along with a copy of the entity's organizational documents. In most cases, simply supply the Certificate of Formation and Bylaws for a corporation.

    a. <u>Review the Certificate of Formation Carefully</u>. Check the following:

        i. <u>Purpose Statement</u> (the raison d'être for the organization's existence under § 501(c)(3)). Common errors: inclusion of a statement that allows for "any lawful business under state law" (too broad for federal tax law) or not including a § 501(c)(3) savings clause (not necessary but helpful);

        ii. <u>Dissolution Clause</u> (regulatory and statutory requirement). This dovetails with private inurement – if the organization has members, they should not receive distributions of earnings or assets.

            1. <u>Inurement Policy – The Ultimate Sanction</u>. Private inurement is the dividing line between nonprofit and for profit status, because inurement is what provides the non-distribution constraint. Inurement has a statutory hair trigger – one dollar of inurement is enough to fail § 501(c)(3) status and lose tax exempt status. *See, e.g.*, *Church of Scientology of California v. Commissioner*, 823 F.2d 1310 (9th Cir. 1987). (Payment of excessive compensation to a founder, trustee, or employee is a private inurement flag).

            2. <u>Inurement Factors</u>. Treas. Reg. § 1.501(c)(3)-1(f)(ii). Intermediate sanctions under § 4958 exist because revocation of exemption is a drastic remedy. The foregoing regulation includes factors to determine whether revocation of exempt status is appropriate when § 4958 excise taxes also apply. Note*:* Section 4958's tax on excess benefits provided to DQPs only applies to § 501(c)(3) public charities and § 501(c)(4) social welfare organizations; it does not apply to private foundations. *See* § 4958(e). Intermediate sanctions target insiders who receive excess economic benefits and organizational managers who approve those benefits.

            3. <u>Revocation Appears to be Rare</u>. Case law suggests that the *most* egregious cases receive exemption revocation. *See, e.g.*, *Caracci v. Commissioner*, 118 T.C. No. 25 (2002); 456 F.3d 444 (5th Cir. 2006). Family caused a for-profit entity to vastly underpay for nonprofit hospital assets; after the sale, the family owned the for-profit entity and ran the nonprofit seller. The IRS revoked the seller's exemption and applied penalties of over $11 million. The tax court agreed on the penalties but not the revocation of exemption. The takeaway is that this was a very egregious set of facts and the ultimate sanction was not

applied (on appeal the Fifth Circuit eliminated the penalties). It appears that for public charities doing excess benefit transactions, exemption revocation is rare.

iii. Private Foundation Versus Public Charity. Potentially § 508(e) requirements should be inserted – if the entity will be a private foundation, it must comply with Chapter 42's requirements (minimum distributable amount – often called the 5% rule) and sanction constraints (taxable expenditure rule, excess business holdings, self-dealing, etc.)

iv. Dangers. If the basic formation requirements are not met, the applicant will fail. If mistakes are found early enough, it is often more expedient to terminate an existing entity and start over rather than amending an existing certificate.

3. Compensation Issues. Because compensation misuse can be a sanction trigger, Form 1023 pays particular attention to it. Part V of the current Form 1023 requires input of the names, titles, and addresses of certain directors, employees, and contractors. The IRS wants up-front information about DQPs and insiders.

a. Good Practices. Request that the organization adopt or complete the following before filing to account for related party / DQP problems: (1) a conflict of interest policy; (2) resolution or approval process for adopting compensation plans (including bonuses); (3) form compensation plans; (4) research regarding compensation paid by similarly situated organizations; and (5) planned purchase arrangements (is the organization going to buy from related parties, etc.)

4. Charitable Joint Ventures.

a. Control Requirements. Which party has control of the JV, the charitable partner or the for profit partner, is key.

b. UBIT. The charitable partner must consider UBIT rules.