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Taxation of Exempts

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FROM PUBLIC CHARITY TO PRIVATE FOUNDATION: HOW TO HANDLE THE “TIPPING” PROBLEM

CHRISTOPHER M. HAMMOND

Something is in the water. Whether the catalyst was a bull market, evolving charitable sentiment, an uptick in the number of organizations operating through nonexempt forms of social enterprise, or a combination of a whole host of factors, instances of “tipping” into private foundation status are on the rise. Moreover, even organizations that run through the unusual grant analysis in the applicable year and reach a favorable result may find themselves tipping in the wake of the generally-excluded contributions.

When the threat is recognized, options are typically available to mitigate the more adverse consequences of tipping (or even the result of tipping itself). However, tipping is often not discovered until Schedule A to the Form 990, Return of Organization Exempt From Income Tax, for the problem tax year is prepared, which, in many instances, means that the organization first learns of the change in classification over ten months after the tax year ends. To further complicate the issue, tipping often affects smaller public charities that, while certainly attempting to do so, may not properly complete or be required to complete Schedule A, resulting in a discovery of the change in classification in a tax year that is several years after the occurrence.

The purposes of this article are to outline the warning signs for the ways through which tipping is more regularly occurring, detail the downsides for a public charity that tips, describe planning opportunities for public charities that proactively recognize the potential for tipping, and suggest considerations for organizations that first discover the change in classification after a meaningful period has elapsed.

Setting the table: Public support

Although perhaps over-simplified, it may be helpful to start with the general bifurcation that the world of organizations that are tax-exempt via Section 501(c)(3)¹ consists of: (1) private foundations, and (2) 501(c)(3) organizations other than private foundations.² When the practitioner dives into the latter, he is met with four general routes,³ with the emphasis in this case being on organizations that generally receive sufficiently broad public support from contributions from the general public (outside of exempt-function income).⁴ These are generally referred to as “publicly supported public charities.”

Publicly supported public charities depend on mathematical tests for their classification. The first alternative test is purely mathematical, requiring that the total support that the organization normally receives from governmental units, contributions

Instances of “tipping” from public charity to private foundation status are increasing, but problems arising from such tipping can be reduced with proper planning.

CHRIS HAMMOND, Esq., is an Associate in the Columbus, Ohio office of Dinsmore & Shohl LLP.

made directly or indirectly by the general public, or a combination of these sources, equals at least 33¹/₃% of the total support normally received by the organization.⁵ The second alternative test consists of a necessary, but insufficient, mathematical component requiring the first alternative test to result in at least 10%, as well as a facts and circumstances test to analyze whether the organization is in the nature of an organization that is publicly supported.⁶ An organization calculates these tests on Part II of Schedule A to the Form 990 and, if successful, the organization checks box 7 on Part I of Schedule A.

Historically, the tipping problem is most generally associated with a required adjustment to the mathematical tests. When determining if the 33¹/₃% or 10% analysis is satisfied, contributions by an individual, trust, or corporation are only included in the numerator to the extent that the total contributions by such individual, trust, or corporation during a five-year period do not exceed 2% of the organization's total support for such period.⁷ This limitation does not, however, generally apply to amounts received from the government or from a publicly supported public charity.⁸ An organization excludes the relevant portion on Line 5 of Part II of Schedule A to the Form 990. For example, if over the applicable period, an organization receives total support consisting of \$75,000 of donations from an individual donor and \$25,000 of aggregate donations from a group of donors contributing no more than \$20 each, the numerator would be: \$2,000⁹ + \$25,000 = \$27,000. This would result in 27% public support, meaning that the organization must rely on the 10% test combined with satisfactory facts and circumstances.

Also, publicly supported public charities would often rely on the unusual grant exception to entirely exclude certain amounts from the mathematical tests. When a contribution meets the definition of an unusual grant, the contribution need not be taken into account in calculating public support.¹⁰ The exclusion for unusual grants is generally intended to apply to substantial contributions or bequests from disinterested parties, which contributions or bequests are attracted by reason of the publicly supported nature of the organization, are unusual or unexpected with respect to the amount thereof, and would, by reason of their size, adversely affect the public support status of the organization.¹¹ Assume that, in the example discussed in the preceding paragraph, the \$75,000 was a lump sum bequest from a donor who had no prior connection with the organization. If the amount could be excluded as an unusual grant, both the numerator

and the denominator would be \$25,000, resulting in 100% public support and satisfaction of the 33¹/₃% test.

Thus, the table is set: publicly supported public charities must satisfy a mathematical test, which is subject to varying adjustments depending on the amounts/proportions of support and the usual/unusual nature of the support.

Warning signs

The non-obvious signs: Unusual grants. The unusual grant exclusion is a powerful tool in avoiding a tipping problem. Many publicly supported public charities first encounter a tipping threat as a result of a large bequest from a generous community member or a disproportionately large grant from a well-intentioned philanthropist or private foundation. When the facts and circumstances suggest that the receipt is not "normal" for public support purposes, the organization entirely excludes the receipt (i.e., it does not factor into the public support test).¹² Moreover, the Regulations are sensitive to unusual grants that are received over a period of years, making reference to a year-by-year exclusion based on the organization's method of accounting.¹³

However, an unusual grant can also be the proverbial butterfly flapping its wings on the other side of the world if the receipts generate denominator-only income. Importantly, the unusual grant exclusion does not apply to exclude any items of gross investment income.¹⁴ Clearly, substantial income from interest, dividends, rents, royalties, and similar sources that is generated from the investment of an unusual grant could result in the tipping of an organization with an investment strategy involving the production of income without broker transactions.¹⁵

For example, a small publicly supported public charity makes small scholarships each year in the name of a community hero with applicable period contributions of \$15,000 (i.e., \$3,000 per year) and already-existing investment income from interest and dividends of \$5,000 (i.e., \$1,000 per year). The organization has no issues satisfying the public support test, which yields 75%. Enter a \$500,000 unusual grant from a decedent who learned of the organization during his lifetime, but waited until his death to make a bequest. Beneficially, the \$500,000 does not need to run through the 2% test, since it satisfies the unusual grant criteria. Accordingly, the public support test result is no different: the numerator remains \$15,000 and the denominator remains \$20,000.

Continuing the example, the organization changes neither its approach to making scholarships

that average \$7,500 per year nor its income-focused investment strategy. As a result of a large amount of money remaining in the organization's income-generating investment account, the account, thanks in part to the \$500,000 unusual grant, starts generating income from interest and dividends of \$40,000 per year, most of which is reinvested, thereby generating additional income.

In the first year of the increased investment income, the numerator would remain \$15,000, but the denominator would include four years of \$1,000 worth of investment income and one year of \$40,000 worth of investment income, resulting in a total of \$44,000. The resulting public support percentage is just over 25%. The organization, if the facts and circumstances are present, satisfies the alternative 10% analysis and may continue as a publicly supported public charity. This result could persist in years two (15%) and three (11%), but, in year four (8%), the organization will fail the public support test.

To make this example even more interesting, the amounts used are sufficiently low that the organization may be qualified to file the Form 990-N, Annual Electronic Notice for Small Organizations, meaning that the organization may not go the extra step of independently running the public support test. This could lead to discovery in a year much later than the year in which the tipping occurred.¹⁶

The evolving organization: Change in character of numerator items. While the 2% donor limitation is a common frustration experienced by publicly supported public charities, an exclusion to the mathematical tests and an adjustment to an entirely different test can also wreak havoc. As it pertains to publicly supported public charities, the public support test does not include any amounts received from the exercise or performance of the organiza-

tion's charitable, educational, or other purpose or function constituting the basis for its exemption.¹⁷ These amounts received from any activity that is substantially related to the furtherance of the organization's tax-exempt purpose are generally referred to as "gross receipts." For practical purposes, this distinction is most obvious by comparing Section A of Part II of Schedule A to the Form 990 to Section A of Part III of Schedule A to the Form 990. The former excludes any mention of gross receipts within the public support test,¹⁸ while the latter places gross receipts on Line 2, directly below contributions.

With the emphasis placed on determining how 501(c)(3) organizations "normally" receive support,¹⁹ it is technically possible for an organization to shift from a publicly supported public charity to a gross receipts public charity given a demonstrable track record that support has evolved. Each category is specifically excluded from private foundation classification, with the former satisfying Section 509(a)(1) and the latter satisfying Section 509(a)(2).

For some organizations, however, the shift to gross receipts public charity status actually results in an even more onerous mathematical limitation. Gross receipts public charities are not permitted to count gross receipts from admissions, sales of merchandise, performance of services, or furnishing of facilities from any one person, or from any bureau or similar agency of a governmental unit, in any tax year to the extent such receipts exceed the greater of \$5,000 or 1% of the organization's support in such tax year.²⁰ While the insinuated comparison between the 2% limitation applicable to publicly supported public charities and the 1% limitation applicable to gross receipts public charities is not a perfect fit,²¹ the purpose of casting these limitations in a comparable light is to demonstrate that publicly

¹ This article will refer to such tax-exempt organizations as "501(c)(3) organizations."

² See Section 509(a) (defining a private foundation by specifically excluding organizations meeting certain criteria).

³ Sections 509(a)(1)-(4).

⁴ These organizations satisfy Section 509(a)(1) through their satisfaction of Section 170(b)(1)(A)(vi).

⁵ Reg. 1.170A-9(f)(2).

⁶ Reg. 1.170A-9(f)(3). Relevant facts include the level of the mathematical test, the variety of sources of support, the breadth of the governing body, and public participation. Reg. 1.170A-9(f)(3)(iii)(A)-(E).

⁷ Reg. 1.170A-9(f)(6)(i).

⁸ *Id.*

⁹ This is because the \$75,000 contribution is limited to 2% of total support.

¹⁰ Reg. 1.170A-9(f)(6)(ii).

¹¹ Regs. 1.170A-9(f)(6)(ii)(A)(1)-(3). Factors suggesting an unusual grant may be found in Reg. 1.509(a)-3(c)(4). Reg. 1.170A-9(f)(6)(iii).

¹² Reg. 1.170A-9(f)(6)(ii)(A).

¹³ Reg. 1.170A-9(f)(6)(ii)(B).

¹⁴ *Id.*

¹⁵ Line 8 of Part II of Schedule A to the Form 990 specifically identifies these items in the denominator of the public support test. While Reg. 1.170A-9(f)(6)(ii)(B) generically uses the term "investment income," the mirroring provision in Reg. 1.509(a)-3(c)(3)(iii) specifically points to Section 509(a)(2)(B), which, via Section 509(e), provides only for certain items of income and does not include any reference to gain from the sale of capital assets.

¹⁶ The effective date of the tipping for purposes of certain sections depends on whether the organization is "new." See Reg. 1.170A-9(f)(4)(vii).

¹⁷ Reg. 1.170A-9(f)(7)(i)(A).

¹⁸ However, such amounts are listed just below the public support test on Line 12.

¹⁹ See Reg. 1.170A-9(f)(4) and Reg. 1.509(a)-3(c).

²⁰ Section 509(a)(2)(A)(ii); Reg. 1.509(a)-3(b)(1).

²¹ The Regulations make clear that an organization does not have a choice with respect to characterizing receipts as either contributions or gross receipts. See Reg. 1.509(a)-3(f).

supported public charities that are at risk of tipping under the standards in Section 509(a)(1) are not guaranteed refuge if they have gross receipts that can be taken into account under Section 509(a)(2).

An example may be helpful. The organization in the prior example instead provides job-training services to disabled military veterans. The organization struggled to be awarded governmental contracts reserved for similarly situated organizations in its earlier years, due to its lack of historic funding. However, after the organization received the \$500,000 unusual grant, governmental contracts followed quickly.

In the year of the unusual grant, the organization has gross receipts from three governmental contracts, all with Bureau ABC, that total \$100,000. If the organization continues to take the position that it is a publicly supported public charity, there is no effect on the 75% public support result.²² In the first year following the unusual grant (i.e., when the public support percentage is just over 25%), the three governmental contracts aggregate to \$250,000. The organization is not worried—it notices that Part I of Schedule A to its Form 990 provides that a result greater than 10% can be acceptable. After all, the organization’s mission is noble and the government, as suggested by the contracts, clearly agrees. In the second year following the unusual grant (i.e., when the public support percentage is 15%), the three governmental contracts aggregate to \$400,000. In the third year following the unusual grant (i.e., when the public support percentage is 11%), the three governmental contracts aggregate to \$500,000. As it has historically done, the organization stands by its position that it is a publicly supported public charity.

However, in the fourth year following the unusual grant, when the three governmental contracts aggregate to \$600,000, the organization’s public support will dip to 8%. Enter the gross receipts test as the organization’s saving grace, right? Wrong. Because the revenue from the contracts is all coming from the same Bureau ABC, it is only included in

the numerator to the extent it does not exceed the greater of \$5,000 or 1% of the organization’s support in such tax year. With this trajectory, the organization fails the gross receipts test this year, with a final percentage of 21%.^{22.1} In fact, the final year contracts would have needed to aggregate around \$4.5 million to minimally satisfy the gross receipts test. As demonstrated by this example, an organization that misinterprets substantial gross receipts as an unqualified blessing may be in for a rude awakening.

Trendy contributors: Grants from social enterprises and other taxable philanthropic entities.

This article is not intended to be an empirical analysis of donation-making models or an overview of the evolution of philanthropic structures. However, to fully explore the concepts discussed herein, it is important to recognize that the involvement of taxable social enterprises and other philanthropic entities within the charitable ecosystem is on the rise.²³

Moreover, the primary concern for publicly supported public charities in this regard is the 2% limitation discussed in “Setting the table: public support” above. Contributions from these organizations are just like contributions from private foundations or any taxable entity and will be limited to 2% of the organization’s total support for the applicable period.²⁴

However, drawing an emphasis to these entrants into this ecosystem serves an important purpose. Private foundations, including a publicly supported public charity that has tipped into private foundation status, have significant limitations, commonly referred to as the private foundation excise taxes. Because of their nature, social enterprises in particular present a prickly obstacle when attempting to navigate the private foundation excise taxes post-tip.

Tip me over

Things are about to get messy. The first layer of the analysis is dependent on the organization’s age.

²² Exempt function income does not factor into this test. Reg. 1.170A-9(f)(7)(i)(A). Moreover, the characterization of the grant as an unusual grant will continue through the time when this example organization attempts to argue that it is a gross receipts public charity under Section 509(a)(2), because unusual grants receive similar treatment under that test. Reg. 1.509(a)-3(c)(3).

^{22.1} Unlike publicly supported public charities, gross receipts tests are not afforded the 10% alternative test and must satisfy a modified 33 1/3% public support test. Reg. 1.509(a)-3(a)(2).

²³ See, generally, Campbell, “Social Enterprise for Tax-Exempt Organizations,” 29 *Taxation of Exempts* 20 (May/June 2018).

²⁴ Reg. 1.170A-9(f)(6)(i).

²⁵ Reg. 1.170A-9(f)(4)(vii)(A).

²⁶ *Id.*

²⁷ Reg. 1.170A-9(f)(4)(vii)(B).

²⁸ *Id.*

²⁹ An involuntary termination under Section 507(a)(2) requires acts or omissions involving relatively high standards of culpability, seemingly requiring some knowledge (at least constructively) of the tip and the bad acts or omissions themselves.

³⁰ See Section 507(c) (providing that the termination tax applies to organizations referred to in subsection (a), which itself excludes organizations referred to in subsection (b)).

³¹ Section 4940(a).

³² Section 4940(c)(1).

³³ Section 4940(a).

³⁴ Section 4940(e)(1).

If the organization cannot meet the 33 $\frac{1}{3}$ % or 10% standards for its sixth tax year of existence (referred to by the Regulations as a “new publicly supported organization”): (1) it will be treated as a private foundation as of the first date of its sixth tax year only for purposes of Sections 507, 4940, and 6033, and (2) it will be treated as a private foundation for all purposes for all succeeding years.²⁵ Starting with its sixth tax year, the organization must file Form 990-PF, Return of Private Foundation, instead of Form 990.²⁶ Organizations other than new publicly supported organizations that cannot meet the 33 $\frac{1}{3}$ % or 10% standards for any two consecutive tax years will be treated as a private foundation: (1) as of the first day of the second consecutive tax year only for purposes of Sections 507, 4940, and 6033, and (2) for all other purposes for all succeeding years.²⁷ Starting with the second consecutive failed tax year, the organization must file Form 990-PF instead of Form 990.²⁸

The failures to meet the applicable tests laid out in “Warning signs” above do not necessarily cause an immediate tipping. However, one can easily imagine how an organization—particularly an organization with an inexperienced tax preparer, a substantially extended information return, or a Form 990-N obligation—may fail to take “corrective” action in the subsequent year, thereby causing a second failed year and a tipping effective as of the first day of such second year. For the remainder of this article, references to the “tipping year” mean the first year that the organization must file Form 990-PF under the Regulations discussed above, which is the first year that the organization is treated as a private foundation for all purposes.

Assuming that the tip is discovered, the tipping year consequences are not generally regarded as overwhelming. Section 507(c) provides for a private foundation termination tax. A termination can happen in a variety of circumstances, but, during the tipping year, a termination should only occur voluntarily (or at least through some voluntary action like a liquidation, merger, or other transaction).²⁹ However, not all terminations result in the termination tax. In effect, terminations occurring under Section 507(b), including certain transfers to public charities or other private foundations, are not captured by the termination tax.³⁰ Accordingly, for any public benefit organization that is statutorily required to maintain purpose and dissolution provisions that are compliant with Section 501(c)(3) generally, the organization is unlikely to cease existence or otherwise take an action that results in something other than the transfer of the organization’s assets to a public charity or a private

foundation. Moreover, with minimal additional provisions applicable to private foundations specifically, Section 6033, which relates to the filing of information returns by exempt organizations, already applied in all material respects to the organization prior to the tip. The reference to Section 6033 appears to be essentially an “incorporation by reference” of sorts with respect to the consequences for failing to file the Form 990-PF for the tipping year, as required by the Regulations.

Publicly supported public charities depend on mathematical tests for their classification.

With Sections 507 and 6033 mostly set aside, this brings the tipping year emphasis to Section 4940. Section 4940 imposes an excise tax on private foundations that is based on net investment income.³¹ For excise tax purposes, the definition of “net investment income” includes regular income items like interest and dividends, as well as capital gains.³² The tax rate is generally 2%,³³ provided that private foundations that meet certain distribution requirements may use a reduced rate of 1%.³⁴

Timing issues

Although not a seemingly overwhelming burden, organizations should consider three timing issues. These problems are best demonstrated by an example. A calendar-year-end organization first fails the public support test in 2017. As is the case for most organizations, the organizational leaders are busy in the first quarter of 2018, so they send off a Form 8868, Application for Automatic Extension of Time to File an Exempt Organization Return, to request an automatic six-month extension for the 2017 Form 990, effectively delaying the due date until mid-November 2018. A calendar reminder in October 2018 reminds the organization of its filing obligation, so the leaders start putting pencil to paper. In early November 2018, the leaders first figure out the failure on Schedule A. One of the volunteer leaders is an employment lawyer, so he takes a look to find the consequences. He finds that the organization would need to fail again in 2018 to tip. Thus, the organization has approximately 46 to 61 days (i.e., the balance of 2018) to take actions to avoid the tip.

The first timing issue is that, if the discovery is too late into what will become the tipping year, there may not be a sufficient opportunity to avoid capsizing. If the organization fails again in 2018, 2018 will be the tipping year and the organization will be liable for the excise tax on net investment

income for all of 2018. However, the volunteer leader conducts some additional research and learns that the tax rate is comparatively small and that the organization is capable of making the payment.

This leads to the second timing issue, which occurs because, much like the prior year, the organizational leaders are busy in the first quarter of 2019. Again, they send off a Form 8868 to request an automatic six-month extension for the 2018 Form 990-PF, effectively delaying the due date until mid-November 2019. Much to their surprise, the Form 8868 for a private foundation is much less simplistic than the Form 8868 they filed when the organization was a publicly supported public charity. For filers of the Form 990-PF, the Form 8868 serves as an extension of time to file, but it does not serve as an extension of time to pay.³⁵ If the organization does not use Line 3 of the Form 8868 to report its anticipated excise tax liability for 2018 and the organization fails to submit a corresponding payment, the organization will start to incur interest and penalties on its late payment.³⁶ If the organization submits its excise tax payment with its November-filed Form 990-PF, the payment will be six months late.

The third timing issue can surface even if an organization realizes that it must submit its excise tax payments by the regular due date for the Form 990-PF. A private foundation that owes excise tax on its net investment income must make quarterly estimated payments in a manner and time similar to that required of regular corporations.³⁷ Accordingly, an organization that does not extend its Form 990-PF for the tipping year and timely pays its excise tax on net investment income for the tipping year must also realize the need to independently file its first quarter estimate for the first year following the tipping year. However, it is easy to see how an organization that extended its Form 990-PF for the tipping year might not discover any excise tax liability until after the first three estimated payments are due.

The private foundation rules

Following the tipping year, the organization must navigate all of the specialized private foundation rules. The purpose of this article is not to outline all of such rules,³⁸ but several of these rules are worthy of independent discussions. This article will focus on four rules that apply to private foundations.

Based on the author's experience, it is common for organizations—even publicly traded public charities—to ask the following question during consultation: How much do we need to distribute via grants each year? Specifically, with respect to private foundations, Section 4942 establishes a bright line test. Although the calculation itself bobs and weaves a reader through a tangled web, the general rule is that a private foundation must make annual distributions of at least 5% of its nonexempt assets.³⁹

Without diminishing the significance of complying with this rule, a tipped organization should consider two planning points. First, as is stated above, only nonexempt assets factor into the analysis. Assets that are used or held for use directly in carrying out the private foundation's exempt purposes are excluded.⁴⁰ Second, more than just grants count towards satisfying the 5% requirement. In addition to grants, the private foundation will have made a "qualifying distribution" in making payments to accomplish a charitable purpose, including payments for reasonable and necessary administrative expenses paid to accomplish exempt purposes.⁴¹ Moreover, certain set-asides for charitable projects are eligible, even if not actually expended.⁴² Therefore, while it is important to always abide by the rules governing the excise tax on the failure to distribute income, many organizations are pleasantly surprised to learn that they are already doing so indirectly.

Switching gears from one of the more obvious rules to a much less obvious rule, private foundations are subject to an additional hurdle under the "orga-

³⁵ Section 6601(b)(1).

³⁶ Page 2 of the Form 8868 instructions details the interest and late payment penalty parameters.

³⁷ Section 6655(g)(3). Applicable modifications to the rules apply, including a modification to allow the first payment to be due on May 15, instead of April 15. *Id.*

³⁸ To learn more about the specialized private foundation rules, see Fox and Blattmachr, "Plan Now to Avoid the Private Foundation Excise Tax Rules," 29 *Taxation of Exempts* 28 (May/June 2018).

³⁹ Section 4942(e)(1). This mathematical statement is simplified (significantly) in the interest of keeping this article on point.

⁴⁰ Section 4942(e)(1)(A). For illustrations, see Reg. 53.4942(a)-2(c)(3)(ii).

⁴¹ Section 4942(g)(1)(A).

⁴² Section 4942(g)(2).

⁴³ Reg. 1.501(c)(3)-1(b).

⁴⁴ Rev. Rul. 75-38, 1975-1 CB 161, recites the states that have adopted such provisions and includes summary qualifications for certain exceptions.

⁴⁵ Section 4941.

⁴⁶ Section 4941(a)(1).

⁴⁷ Section 4941(d)(1).

⁴⁸ Section 4946(a)(1).

⁴⁹ Section 4941(d)(2)(C).

⁵⁰ Sections 4941(a)-(b).

⁵¹ Section 4945.

⁵² Section 4945(d)(4).

⁵³ One of the expenditure responsibility requirements obligates the private foundation to conduct a pre-grant inquiry. Section 4945(h); Reg. 53.4945-5(b)(2).

⁵⁴ Section 4945(g).

nizational test” that can act as a proverbial snake in the grass. The organizational test for all 501(c)(3) organizations is right in front of their faces—Section 501(c)(3) provides that an organization must be organized and operated for one or more qualifying purposes. The Regulations dive into the general organizational test, providing that the organization’s governing document (usually articles of incorporation) must contain all of the essentials, including a qualifying purpose limitation, a ban on private inurement, a ban on political campaign activity, a limitation on lobbying, and a qualifying dissolution provision.⁴³

However, that component is only half the battle for a private foundation. In the year following the tipping year, the private foundation will be subject to Section 508(e). Under Section 508(e), a private foundation “shall not be exempt” from federal income tax unless its governing instrument requires compliance with the minimum distribution requirements under Section 4942 and prohibits: (1) self-dealing under Section 4941; (2) retaining any excess business holdings under Section 4943; (3) making any investments that violate Section 4944; or (4) making any taxable expenditures under Section 4945.

For many organizations that recognize the tip—even organizations that figure it out when preparing an extended return late into the tipping year—the obstacles to compliance with Section 508(e) by the first day of the year following the tipping year may not be overwhelming. Consider an organization that fails to discover the tip, either because it incorrectly prepared its Forms 990 or because, as a Form 990-N filer, it was not independently running a public support test. Reg. 1.508-3(d) provides that a private foundation’s governing instrument is deemed to conform with the requirements of Section 508(e) if valid provisions of state law have been enacted that require a private foundation to comply with Section 508(e) or otherwise read the provisions into the organization’s organizational document.⁴⁴

The third rule of focus is commonly known, but not necessarily in this application. Above, this article highlighted the proliferation of social enterprise as a potential tipping catalyst. In navigating the private foundation excise taxes post-tip, a private foundation must generally avoid incurring any excise taxes on self-dealing.⁴⁵ Self-dealing may result when there are transactions between a disqualified person and a private foundation.⁴⁶

Provided that all of the parties adhere to state law fiduciary duty obligations and bans that generally apply to 501(c)(3) organizations, public charities often become comfortable with interacting with related third parties, including as it may pertain to sales or exchanges, provision of services, and

lending. However, “self-dealing” is triggered on direct or indirect interactions between requisite parties, including the sale or exchange, or leasing, of property between a private foundation and a disqualified person; the lending of money or other extension of credit between a private foundation and a disqualified person; and the furnishing of goods, services, or facilities between a private foundation and a disqualified person.⁴⁷ For self-dealing to arise, the private foundation must interact with a “disqualified person,” which would include a substantial contributor, a foundation manager, and entities owned by such individuals.⁴⁸ If a taxable entity running a social enterprise model were to become a substantial contributor, the entity would be a disqualified person.

Many publicly supported public charities first encounter a tipping threat as a result of a large bequest from a generous community member or a disproportionately large grant from a well-intentioned philanthropist or private foundation.

Imagine that the entity has historically provided either a good or service to the tipped-to private foundation. The Code would only permit such transactions if the entity provides the good or service to the private foundation free of charge.⁴⁹ Because social enterprise can be maintained through taxable entities and because social enterprise generally consists of a business purpose, it is easy to see how the tipping could destroy an existing relationship or, if not considered, result in organizational and personal liability.⁵⁰

The fourth and final rule discussed in this article commonly serves as a “gotcha” for tipped organizations. Another private foundation excise tax exists for “taxable expenditures.”⁵¹ Although not an exclusive list, a private foundation could trigger this tax in three important situations. First, if a private foundation is making a grant, it must generally exercise “expenditure responsibility” unless the recipient is a 501(c)(3) organization other than a private foundation or an exempt operating foundation.⁵² Accordingly, if the tipped organization has entered into an installment agreement with an entity requiring expenditure responsibility, the organization may need to breach its agreement if it is to avoid the excise tax.⁵³

Second, if a private foundation will award scholarships, it may only do so following advanced approval of the procedure from the IRS.⁵⁴ Therefore, if the private foundation did not submit Schedule

H to the Form 1023, Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code (e.g., the private foundation submitted Form 1023-EZ, Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code, or developed its scholarship program after application), then, absent a Form 8940, Miscellaneous Determination Requests, being filed and approved in advance of any scholarships (or continuing scholarships), the private foundation may trigger excise taxes.

Third, unlike public charities that have some flexibility with respect to lobbying,⁵⁵ a private foundation will have made a taxable expenditure if it does so.⁵⁶ Consequently, a tipped organization must monitor its own potential lobbying more closely and it must ensure that it does not, through grantmaking to entities that are permitted to lobby, permit indirect lobbying traceable to the private foundation.

Tipping gracefully

When a public charity anticipates tipping into private foundation status, it may have options. There are default rules to manage the tip, including the timing of the conversion itself, but those rules may not be desirable for myriad reasons and those rules, as discussed in this article, do not cure all of the potential issues that may arise from the conversion to the more restricted classification.

Check, re-check, and check again. Before an organization concedes to the tip, it should move heaven and earth to confirm that the tip actually occurred. In the author's experience, even the most sophisticated of tax return preparers may draw up erroneous Schedules A to the Form 990. One of the first things an organization should do is confirm that capital gains are not being counted in Schedule A investment

income. While the private foundation excise tax on net investment income specifically includes capital gains,⁵⁷ the Regulations discussing publicly supported public charities refer to a definition in the Code that includes items like interest, dividends, rents, and royalties, but does not include capital gains.⁵⁸ This is consistent with the omission of capital gains as a line item on Part II of Schedule A to Form 990.

An organization should also carefully analyze if there is a benefit to reclassifying any amount previously listed as an unusual grant. In some situations, the 2% limitation may be more favorable than the complete exclusion of the amount. If the math works out, the organization should be able to reclassify the amount as a general contribution,⁵⁹ subject to the 2% limitation, if applicable.

Avoiding the tip. Because a publicly supported public charity must fail the public support test for two consecutive years to effect a tipping,⁶⁰ some organizations may be able to avoid the tip altogether. In the end, because both the 33 1/3% test and the 10% test include necessary mathematical components, the organization must generally develop a plan to affect either the numerator or the denominator of the public support test if it is to avoid the tip.

If investment income is causing the denominator to remain consistently high during the five-year measuring period, the organization may consider moving out of income-producing assets and into growth assets. Alternatively, the organization could establish a policy of making grants or other qualifying distributions on receipt of unusual grants or large grants from recurring donors.

The organization may also take advantage of time-based planning, by working with donors to spread contributions out over a longer period than originally anticipated. If time is of the essence, the organization could consider requesting a loan from the donor. Although the donor may have income on the back end,

⁵⁵ Section 501(h).

⁵⁶ Section 4945(e).

⁵⁷ Section 4940(c)(1).

⁵⁸ Reg. 1.170A-9(f)(7)(i) (referring to Section 509(d)).

⁵⁹ The definition of "unusual grant" includes a requirement that the grant "[w]ould, by reason of [its] size, adversely affect the status of the organization as normally being publicly supported for the applicable period." Reg. 1.170A-9(f)(6)(ii)(A)(3). If the reclassification would aid in the public support test, the contribution should not technically satisfy the definition and a reclassification would seem warranted.

⁶⁰ Reg. 1.170A-9(f)(4)(vii).

⁶¹ See Reg. 1.509(a)-3(j).

⁶² See Instructions for Form 8940, p. 4 ("A public charity that has become a private foundation can indicate its new private foundation status simply by filing a Form 990-PF . . . and following any procedures specified in the form, instructions, or other published guidance.").

⁶³ While Form 8940 is used for this purpose, an organization that is requesting a classification of private foundation status and is seeking authorization of scholarship procedures must file two separate Forms 8940, although they can be submitted in unison. Instructions for Form 8940, p. 7.

⁶⁴ See Section 4942(j)(3).

⁶⁵ The exception for exempt operating foundations is discussed below.

⁶⁶ Section 4942(a)(1).

⁶⁷ Section 4942(g)(1)(A).

⁶⁸ *Id.* A donor private foundation is still required to exercise expenditure responsibility to avoid the excise tax on taxable expenditures. See Section 4945(d)(4) (creating an exemption for exempt operating foundations, but not typical operating foundations).

⁶⁹ Sections 170(b)(1)(A)(vii) and (b)(1)(F)(i).

⁷⁰ Section 4942(j)(3)(A); Reg. 53.4942(b)-1(c).

⁷¹ Section 4942(j)(3)(B)(i); Reg. 53.4942(b)-2(a).

⁷² Section 4942(j)(3)(B)(ii).

if the support issue is avoided over time, the money (or a portion) could ultimately be “returned” to the organization in the form of a contribution.

An organization should be careful of attempting to channel support through another publicly supported public charity. In some situations, if an individual or a private foundation makes an earmarked gift through a publicly supported public charity, the intermediary charity will be disregarded and the public support test must be conducted by looking through to the original donor.⁶¹

On the other hand, an organization may consider approaching another publicly supported public charity to serve as a fiscal sponsor of a planned program. In the event that substantial grants are diverted away from the fearful organization into an organization that can absorb them, the former may be able to preserve public charity status while contractually obligating the ultimate recipient to aid in performing the identified mission objectives.

Absent the ability to modify the mathematical component, the organization must prepare to tip into private foundation status.

The straightforward tip. The starting point is usually Form 8940. Form 8940 is a miscellaneous determination form that may be used in nine situations, including by an entity seeking a reclassification of foundation status. This reclassification specifically includes a request by a public charity for private foundation status. While a Form 8940 is not generally required,⁶² organizations may choose to obtain a determination for any of several reasons. For example, an organization may desire a determination letter, especially if it has any occasion to enter into any arrangements with respect to which it must make representations or warranties regarding its tax-exempt status or if it is in need of a legal opinion. Additionally, and as alluded to above, an organization that awards scholarships and has not obtained advance approval from the IRS can use Form 8940 to obtain such approval so as not to generate any excise tax for taxable expenditures in that regard.⁶³

Once the tip is effective (whether through a Form 8940 or the default rules), the private foundation will begin filing Form 990-PF. The organization will check the box for “Initial return of a former public charity” in Line G of the biographical lead-in to the form to signal to the IRS that a tip has occurred.

Private operating foundation classification.

Within the generalized private foundation classification exists a sub-classification for certain organizations that serve more active purposes. A private

foundation that devotes most of its resources to the active conduct of its exempt activities can qualify as an operating foundation.⁶⁴ While operating foundations are usually subject to the excise tax on net investment income,⁶⁵ they are not subject to the excise tax on the failure to distribute income.⁶⁶ Although this may be helpful, as discussed above, many exempt purpose expenditures and payments for reasonable and necessary administrative expenses will qualify as qualifying distributions,⁶⁷ meaning that the avoidance of this excise tax could be immaterial.

Private foundations, including a publicly supported public charity that has tipped into private foundation status, have significant limitations, commonly referred to as the private foundation excise taxes.

However, for organizations that tend to be supported by private foundations or through individual donations, this sub-classification could be important. With respect to the first consideration, a private operating foundation can be the recipient of a qualifying distribution from another private foundation.⁶⁸ In other words, a donor private foundation can classify grants to a private operating foundation as amounts in satisfaction of its minimum distribution requirements. With respect to the second consideration, higher deductibility ceilings are available to donors who make contributions to private operating foundations vis-à-vis traditional private foundations, with the sub-classification being essentially a more favorable public charity for such purposes.⁶⁹

For a private foundation to be further classified as an operating foundation, it must meet two tests. The first test, which is mandatory in any situation, is an income test, requiring the foundation to spend at least 85% of its adjusted net income or its minimum investment return, whichever is less, directly for the active conduct of its exempt activities.⁷⁰ Once the first test is satisfied, the foundation must satisfy one of three additional tests. First, a private foundation will satisfy the “assets test” if 65% or more of its assets: (1) are devoted directly to the active conduct of its exempt activity, a functionally related business, or a combination of the two; (2) consist of stock of a corporation that is controlled by the foundation and at least 85% of the assets of which are so devoted; or (3) any combination of (1) and (2).⁷¹ Second, a private foundation will satisfy the “endowment test” if it normally makes qualifying distributions directly for the active conduct of its exempt activities of at least two-thirds of its minimum investment return.⁷² In most cases,

the foundation satisfies the endowment test if it satisfies the mandatory test.⁷³ Third, a private foundation will satisfy the “support test” if: (1) at least 85% of its support (other than gross investment income) is normally received from the general public and five or more unrelated exempt organizations; (2) not more than 25% of its support (other than gross investment income) is normally received from any one exempt organization; and (3) not more than 50% of its support is normally received from gross investment income.⁷⁴

As with the tip to a private foundation, an organization can use Form 8940 to request operating foundation status. An organization should note that the Regulations do not make this sub-classification automatic for a tipped organization, meaning that an affirmative action will be mandatory.⁷⁵ Whereas a request for a general private foundation classification pursuant to a Form 8940 only requires the applicant to submit Schedule A to Form 990, an organization requesting operating foundation status must also submit a completed Form 990-PF to enable the IRS to conduct a full analysis.⁷⁶

One step further: Exempt operating foundations.

If an organization meets the operating foundation criteria, it may be able to push further into exempt operating foundation classification. An operating foundation will be an exempt operating foundation if: (1) it has been publicly supported for at least ten tax years; (2) at all times during the tax year, its governing body: (a) consists of individuals at least 75% of whom are not disqualified individuals and (b) is broadly representative of the general public; and (3) at no time during the tax year does it have an officer who is a disqualified individual.⁷⁷ For these purposes, a “disqualifying individual” means any of the following: (1) a substantial contributor; (2) an owner of more than 20% of certain interests in certain entities and such entity is a substantial contributor; or (3) a member of the family of any individual described in (1) or (2).⁷⁸

If an operating foundation is an exempt operating foundation, it will be exempt from the excise tax on net investment income. While this is beneficial for obvious reasons, it should be specifically noted for organizations that fail to timely realize that a tip has occurred. This observation will be discussed more fully below.

Importantly, a foundation that desires exempt operating foundation classification must obtain a determination letter.⁷⁹ Thus, an organization should use Form 8940 to request exempt operating foun-

ation status instead of making a claim for operating foundation status in Part XIV of its Forms 990-PF.

When tipping becomes spilling

There are many factors that could cause a tipping to go unnoticed. For a significant portion of the participants with respect to 501(c)(3) organizations, their participation is on a voluntary, secondary basis. Moreover, it would seem to be the case that, even if only subconsciously, the IRS usually has less to gain by stringently auditing information returns submitted by 501(c)(3) organizations. Couple these factors with the proliferation of the Form 1023-EZ and the Form 990-N and it is easy to see how an organization may not immediately realize that the tipping year has come and gone. Furthermore, there is no guarantee that even the most sophisticated of tax preparers will perfectly complete these information returns. Accordingly, all organizations should be mindful of the fact that the discovery may occur after a meaningful period has elapsed.

Recall the earlier example of the small scholarship-making organization that received a \$500,000 unusual grant. In the fourth year following the unusual grant, the organization first failed the public support test. Assume that nothing changed, such that the fifth year following the unusual grant became the tipping year. Assume further that, for all years in question (i.e., before, through, and after the tip), the organization filed Form 990 and completed Schedule A. However, when completing Schedule A, the organization listed the \$500,000 as 100% numerator support and, due to the size, the organization reported the contribution on Schedule B.

Now, fast forward to the eighth year following the unusual grant, again without changing the organization’s approach to fundraising, investment, or distributions. The organization’s volunteer treasurer is resigning and the organization decides that it is time to transition the information return preparation to a local accountant who specializes in 501(c)(3) organizations. During the accountant’s review of the filed Forms 990, he notices something that intrigues him—the organization has a significant amount of money in an investment account and one year of contributions totaling \$503,000 on Schedule A, while historically averaging just \$3,000 per year in contributions for other years. So, he inquires, “Where did all of this money come from?”

The accountant quickly runs the numbers on revised Schedules A and realizes that not even the unusual grant analysis can save the organization from tipping.

Starting with the discovery year. The organization might be inclined to let sleeping dogs lie. Even though it improperly listed the \$500,000 in the numerator on all of its Schedules A, it gave the IRS everything it needed to figure out the error by reporting the single-donor amount on Schedule B in the year of the unusual grant.

Under this approach, the organization could first file a Form 990-PF for the eighth year following the unusual grant (i.e., the discovery year). Without otherwise notifying the IRS of the tip, the organization will check the box for “Initial return of a former public charity” in Line G of the biographical lead-in to the form.

It is not clear how significant of a signaling effect such an indication will be; however, once this signaling effect occurs, the organization must consider the potential issues that will arise should the IRS inquire. It should not be a heavy burden for the IRS to quickly assemble the organization’s last Form 990 to check whether the discovery year is the appropriate tipping year. Among the issues that could arise include the following:⁸⁰

1. The organization may have failed to file a tax return for the tipping year, as well as the sixth and seventh years following the unusual grant. As of the tipping year, the organization needed to file Form 990-PF, not Form 990.⁸¹ The organization may try to argue that the filing of any form in the 990-series should constitute a filing; however, a Form 990 is significantly less comprehensive and, at its very core, does not include the information that is uniquely specific to private foundations that can only be reported on Form 990-PF. It is not necessarily a strong argument that the inclusion of the \$500,000 grant on Schedule B started a statute of limitations that has now run—even though this gave the IRS a way through which it could challenge the merits of Schedule A, it does not suddenly cause the filed Form 990 to become a Form 990-PF. Moreover, the tipping happened by virtue of the Regulations and not by virtue of some mandatory action by the IRS.
2. If Section 6033 applies beginning in the tipping year and the organization failed to file a return

for three consecutive years including the tipping year, simply moving forward without ever filing the delinquent Forms 990-PF may have serious consequences. If a 501(c)(3) organization fails to file an annual return for three consecutive years, the organization’s status as an organization exempt from tax will be considered revoked on and after the date set by the IRS for the filing of the third annual return or notice.⁸²

3. Beginning the year after the tipping year, the organization may not have satisfied the organizational test. The only exceptions would be if the organization’s articles of incorporation satisfied Section 508(e) as a backstop or if the organization, as a matter of state law, was entitled to deemed satisfaction through Reg. 1.508-3(d). The consequence for such an organizational failure is a potential loss of exemption.⁸³
4. Beginning with the tipping year, the organization failed to report and pay the excise tax on net investment income. Accordingly, in addition to any potential failure to file penalties, the amounts due will have accrued penalties and interest, which will compound until the years prior to the discovery year are addressed. The only way out of this result would be if the organization qualified as an exempt operating foundation.⁸⁴ However, a foundation that desires exempt operating foundation classification must obtain a determination letter.⁸⁵ Without having filed Form 8940, the organization cannot have such a determination.
5. Beginning in the year after the tipping year (two tax years for which a Form 990 was incorrectly filed in this example), the balance of the private foundation excise taxes would have applied. If the organization engaged in any act of self-dealing, the risk of the excise tax under Section 4941 is magnified, particularly when the blatant disregard for the time when the tip occurred could be seen as a refusal to correct the self-dealing and result in additional taxes.⁸⁶ There is also no calculation of whether the organization satisfied Section 4942 and its minimum distribution requirements. Moreover, as a scholarship organization, the organization could have routinely

⁷³ Only where the minimum investment return is markedly higher than adjusted net income does the endowment test (and thus the other alternative tests as well) have independent significance.

⁷⁴ Section 4942(j)(3)(B)(iii).

⁷⁵ An organization claiming status as an operating foundation may complete Part XIV of the Form 990-PF to claim such status. Instructions for Form 990-PF, p. 32.

⁷⁶ Instructions for Form 8940, p. 7.

⁷⁷ Section 4940(d)(2).

⁷⁸ Section 4940(d)(3)(B).

⁷⁹ See, generally, IRS, “Definition of Exempt Operating Foundation,” www.irs.gov/charities-non-profits/private-foundations/definition-of-exempt-operating-foundation.

⁸⁰ The following list is not intended to be exhaustive. It has been constructed to aid in spotting issues that are otherwise addressed in this article.

⁸¹ Reg. 1.170A-9(f)(4)(vii)(B).

⁸² Section 6033(j).

⁸³ Section 508(e).

⁸⁴ Section 4940(d)(1).

made taxable expenditures in violation of Section 4945 if the organization never received advance approval of its scholarship procedures. Absent the procedures being provided for in the organization's Form 1023 or in a subsequent Form 8940, it seems unlikely that any scholarship was technically permissible.

6. The organization may have received funding from donors to whom it represented that it was a publicly supported public charity, thereby entitling them to a greater deduction. Moreover, the support may have come from private foundations that should have exercised expenditure responsibility and may have inappropriately classified the grant as aiding them in satisfying their own minimum distribution requirements. While the organization may seek refuge by asserting that it is an operating foundation, the nature of the organization (i.e., scholarship making) means that the organization cannot satisfy the first mandatory test for such classification.⁸⁷
7. A professional tax preparer may not sign the Form 990-PF. In this case, the preparer would have to analyze whether the content of the return was specific enough to the year in question, when the organization actually was a private foundation, or whether too much historical information must be reported. If the latter, the preparer may refuse to prepare a return that reflects historical compliance when he knows that a Form 990 was incorrectly filed.
8. Similarly, the organizational leader who signs the Form 990-PF must do so under penalties of perjury. Again, he would have to analyze whether the content of the return was specific enough to the year in question or whether too much historical information must be reported, which causes him to be in the same position as the preparer.

Using the discovery year to build a record. As indicated above, simply switching to Form 990-PF may serve as a signaling effect with the IRS if the IRS did not previously link the organization's employer identification number to private foundation status.

⁸⁵ See Note 79, *supra*.

⁸⁶ See Section 4942(b).

⁸⁷ See generally IRS, "Directly for the conduct of exempt activities", www.irs.gov/charities-non-profits/private-foundations/directly-for-the-conduct-of-exempt-activities.

⁸⁸ Although this example organization is not able to claim exempt operating foundation status, there is an open question as to whether an organization that could qualify would be entitled to seek retroactive classification. While this is not a Form 1023, perhaps there is an argument that at least 27 months of retroactive relief should be permitted. However, given the long-lived mandatory prior history for an exempt operating foundation, there should also be an argument for the classification to be retroactive back to the tipping year.

To work around this issue, the organization may be tempted to again file a Form 990 for the discovery year, showing a failure of the public support test for the first time. Under this two-year plan, the organization would file a Form 990-PF in the year after the discovery and attempt to treat that second year as the tipping year. Seemingly, the organization would have crafted a record that may divert the attention away from the prior incorrect filings.

If the organization uses this methodology without a Form 8940, it could slip through the cracks. If the IRS is only inclined to look back one year, it may assume that the filing of the Form 990-PF in the second year was the correct approach. However, if the IRS inquires, the organization's cover up may be discovered. Using the prior issues as starting points, this alternative may cause the following results:

1. If the organization failed to file a return when it filed Form 990 after the tipping occurred, the filing of another Form 990 for the discovery year will be another failure.
2. While three failures already occurred and only three failures are required to invoke the Section 6033 consequences, an additional failure could cause practical problems if the organization should seek to request relief from revocation.
3. If the trail of noncompliance is not discovered, the organization could use this extra time to bring itself into compliance with the organizational test applicable to private foundations. The provisions of Section 508(e) do not apply until the year following the tipping year. Thus, even if an amendment to the organization's articles of incorporation would trigger a disclosure on Schedule O to the information return, if done in conjunction with the manufactured tipping, this would not separately signal anything to the IRS. This does not correct for the fact that the organization could have been out of compliance with the organizational test much earlier than it represents.
4. Because the excise tax on net investment income applies in the tipping year and thereafter, the organization could be successful in "timely" paying the tax when it first files Form 990-PF. However, if discovered, the organization is willingly incurring this liability (that it does not intend to pay) for an additional year.
5. The same concerns exist with respect to the balance of the excise taxes and, again, the organization is essentially turning a blind eye when simulating that they have not come into play as of the filing of the first Form 990-PF. This may cause the organization's demise—because the organization makes scholarships, if it has never

received approval of its procedures, it must file a Form 8940 to request approval. Accordingly, for a scholarship-making organization, the risk of the IRS figuring out the trail would seemingly be more likely since the organization must offer additional information during the Form 8940 process.

6. The organization will exacerbate this issue by incorrectly identifying itself as a public charity for an additional year.
7. A professional tax preparer most certainly will not sign the Form 990 for the discovery year. In the year following, the preparer may not sign the Form 990-PF for the reasons discussed above.
8. Similarly, the organizational leader who signs the Form 990 for the discovery year will be doing so under penalties of perjury.

Bring the issue to the attention of the IRS. The organization could immediately file Form 8940 and disclose its prior mistakes. The IRS has significant latitude in granting relief and, if the mistake is honest and immediately addressed, the organization may take a few lumps, but otherwise come out a survivor.

While a timely request under Form 8940 can be rather tidy, the organization will likely be required to provide previously-unfiled Forms 990-PF, beginning with the tipping year. The organization would be best to provide as much information as possible to build its case. Using the prior issues as starting points, this alternative may cause the following results:

1. The Forms 990-PF submitted with the Form 8940 are not timely. However, they are filed. The filing of the Forms 990-PF should cut off any future failure to file penalty and interest calculation (provided that the ultimate assessment is paid).
2. Again, the failure to file has seemingly been corrected. Assuming the ultimate assessment is paid, the organization should have a case that Section 6033(j) does not apply.
3. By voluntarily acknowledging that the tipping year was more than two years prior, the organization must rely on its articles of incorporation or Reg. 1.508-3(d) to satisfy Section 508(e). If neither applies, the organization must convince the IRS that it took immediate corrective action to cause compliance with the organizational test upon discovery. Accordingly, it may be prudent to amend the organization's articles of incorporation prior to submitting Form 8940.
4. To the extent that those returns reflect amounts due for the excise tax on net investment income,

the organization can expect to pay those amounts along with penalties and interest. However, a showing of good faith and correction on discovery may go a long way in cutting off second-layer liabilities and could invite the IRS to waive penalties.⁸⁸

5. The Forms 990-PF will tell the tale as to whether the organization's scholarships satisfied Section 4942 in the applicable years. However, the issues of self-dealing and taxable expenditures persist. If the organization had engaged in self-dealing, it must immediately work to correct those instances. As with any changes to its articles of incorporation, the organization would be best served by initiating this process prior to submission of the Form 8940. Turning to taxable expenditures, the organization is generally unable to recapture scholarships that were awarded prior to discovery. In this case, the organization must submit an additional Form 8940 specifically for its scholarship procedures. The organization should be prepared to pay excise tax liability for the scholarships awarded, which, literally, violated Section 4945 beginning in the year following the tipping year.
6. Depending on the facts and circumstances, it is not clear how the organization should approach donors with respect to the retroactive classification change. This may be an issue that has to be worked out with the IRS.
7. There is no issue with a preparer signing the returns.
8. There is no issue with the organizational leader signing the returns.

Conclusion

Tipping into private foundation status is an old problem that may pop up as a concern to publicly supported public charities. In today's ecosystem, organizations should be on the lookout for increasing investment income, adaptations of operations, and nonexempt donors. Moreover, organizations that file Form 990-N would be wise to separately prepare the financial portions of a full Form 990 (including Schedule A) each year to confirm their public charity classification.

When a potential tip is recognized by a prudent organization, one of several options may be available. Many organizations fail in their attempts to properly calculate public support, and Schedule A should serve as an appropriate starting place for this analysis. If the math is confirmed, the organization may be able to avoid the tip altogether—the organization must fail the public support test for two consecutive

years to cause the tip. In addition to old tricks like time-based planning with donors, the organization should look to minimize income-producing assets in favor of growth assets, which do not factor into the denominator of the public support test. An organization may also look to establish a fiscal sponsor relationship to ensure that its program objectives are met even though the organization itself does not receive donations.

If tipping is not to be avoided, the organization can do so gracefully by notifying the IRS. Filing Form 8940 is generally recommended, especially if the organization seeks to confirm that it is an operating foundation or exempt operating foundation. Moreover, if the organization makes grants to individuals that would otherwise be taxable expenditures, the organization must file Form 8940

to ensure that it has pre-approval beginning with the year after the tipping year.

For an organization that does not timely recognize the tip, the results can be more serious. Internally, the organization must decide on the appropriate route to take. Almost any route has negative consequences, some of which are brought to the forefront by virtue of the route selected. However, organizations should consider the IRS's ability to waive certain undesirable consequences when compliance, even if tardy, is attempted.

In the end, while tipping has its risks, an organization that firmly grasps the tea pot and oversees the pour into a cup ready to capture the contents is likely better served than an organization that willingly or negligently leaves itself a mess to clean up in future years. ■

RELIGIOUS ORGANIZATIONS— CONSTITUTIONALITY OF CODE PROVISIONS

BRUCE R. HOPKINS

The housing (parsonage) rental allowance provided by the federal tax law to ministers of the gospel¹ has been struck down as unconstitutional, as a violation of the Establishment Clause.² This is a propitious time to apply constitutional law principles to this and 13 other Code provisions. These Code provisions have been selected because each of them is part of the federal tax law concerning tax-exempt organizations inasmuch as they provide law exceptions for or in connection with various types of exempt religious organizations.

One of the U.S. Supreme Court's fundamental standards in this context is to determine whether the legislation being analyzed has a secular legislative purpose. This standard is part of the tripartite *Lemon*³ test articulated by the Court. To determine

if this purpose exists, the Court first looks at the statute's legislative history. The history of these 14 provisions, to the extent it exists, is thus referenced in this article.

The view expressed in this article is that seven of these provisions are clearly constitutional, six are clearly unconstitutional, and one may be unconstitutional depending on the factual circumstances.

Rationale for tax exemption in general

One of the Supreme Court's most significant holdings related to the rationale for tax exemption is *Walz*,⁴ which was concerned with the constitutionality of a state's real estate tax exemption for religious organizations' real property. The majority opinion in this case focused primarily on the constitutionality of this tax exemption, because the law accorded exemption to churches and other religious entities. However, the Court included observations about tax exemption for nonprofit organizations generally.

The real estate tax exemption at issue came into being, wrote the Court, because the state, "in common with the other States, . . . determined that certain entities that exist in a harmonious relationship to the community at large, and that foster its 'moral

BRUCE R. HOPKINS concentrates on the representation of tax-exempt organizations, practicing with the Bruce R. Hopkins Law Firm, LLC, in Kansas City, Missouri. He is the Professor from Practice at the University of Kansas School of Law. He has authored or coauthored 40 books on nonprofit law subjects, including A Nonprofit Lawyer; The Law of Tax-Exempt Organizations, Eleventh Edition; The Tax Law of Charitable Giving, Fifth Edition; The Law of Fundraising, Fifth Edition; Bruce R. Hopkins' Nonprofit Law Dictionary; Fulfilling a Dream: The Ultimate Law Degree; How to be a Successful Philanthropist; and Beware the Commerciality Doctrine and Other Nonprofit Law Poetry. He writes a monthly newsletter, the Bruce R. Hopkins' Nonprofit Counsel. He is listed in the Best Lawyers in America, for Nonprofit Organizations/Charities Law. He earned his JD and LLM at the George Washington University, his SJD at the University of Kansas, and his BA at the University of Michigan. He is a member of the bars of the District of Columbia and the state of Missouri.

Most of the Code provisions specifically applicable to tax-exempt religious organizations are constitutional, but a few such provisions are constitutionally suspect.

or mental improvement,' should not be inhibited in their activities by property taxation or the hazard of loss of those properties for nonpayment of taxes."⁵ The state granted exemption with respect to a "broad class of property owned by non-profit, quasi-public corporations which include hospitals, libraries, playgrounds, scientific, professional, historical, and patriotic groups."⁶ The Court continued: "The State has an affirmative policy that considers these groups as beneficial and stabilizing influences in community life and finds this classification useful, desirable, and in the public interest."⁷

Overview of Religion Clauses

The First Amendment to the U.S. Constitution provides, in part, that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof. . ." The "Religion Clauses" rest on the "premise that both religion and government can best work to achieve their lofty aims if each is left free from the other within its respective sphere."⁸

The Court stated that "[g]overnment in our democracy, state and national, must be neutral in matters of religious theory, doctrine, and practice," adding that the First Amendment "mandates governmental neutrality between religion and religion, and between religion and nonreligion."⁹

The Court has "struggled to find a neutral course between the two Religion Clauses, both of which are cast in absolute terms, and either of which, if expanded to a logical extreme, would tend to clash with the other."¹⁰ The standard is that the Court "sponsor[s] an attitude on the part of government that shows no partiality to any one group, and that lets each flourish according to the zeal of its adherents and the appeal of its dogma."¹¹

Despite this articulated standard of neutrality, the Court has also offered up the concept of *flexibility*. In one instance, the Court wrote, the "course of constitutional neutrality in this area cannot be an absolutely straight line; rigidity could well defeat the basic purpose of these provisions, which is to insure that no religion be sponsored or favored, none commanded, and none inhibited."¹² It added that "there is room for play in the joints productive of a benevolent neutrality which will permit religious exercise to exist without sponsorship and without interference."¹³

This play-in-the-joints concept thus recognizes the inherent tension between the Religion Clauses. The Court nonetheless often endeavors to avoid *tension* by liberally applying doses of *neutrality*: "Adherence to the policy of neutrality that derives from an accommodation of the Establishment and Free Exercise Clauses has prevented the kind of involvement that would tip the balance toward government control of churches or government restraint on religious practice."¹⁴

Basic Establishment Clause standard

The basic Establishment Clause standard was articulated by the Court in the context of one of many cases concerning the extent to which the states can constitutionally provide aid to church-related schools. The Court's Establishment Clause jurisprudence essentially entails a trilogy of tests, collectively known as the *Lemon* test, named after a Court decision.¹⁵ First, for a statute to be constitutional in this context: (1) it must have a "secular legislative purpose;" (2) its "principal or primary effect must be one that neither advances nor inhibits religion;" and (3) it must not foster an "extensive government entanglement with religion."¹⁶

¹ Section 107(2). See text accompanied by Note 45, *infra*.

² See text accompanied by Notes 8-14, *infra*.

³ *Lemon v. Kurtzman*, 403 U.S. 602 (1971).

⁴ *Walz v. Tax Commission of the City of New York*, 397 U.S. 664 (1970).

⁵ *Id.* at 672.

⁶ *Id.* at 673.

⁷ *Id.*

⁸ *Illinois ex rel. McCollum v. Board of Education*, 333 U.S. 203, 212 (1948).

⁹ *Epperson v. Arkansas*, 393 U.S. 97, 103-104 (1968).

¹⁰ *Walz*, Note 4, *supra*, 668-669.

¹¹ *Zorach v. Clauson*, 343 U.S. 306, 313 (1952).

¹² *Walz*, Note 4, *supra*, 669.

¹³ *Id.*

¹⁴ *Id.* at 669-670.

¹⁵ *Lemon*, Note 3, *supra*.

¹⁶ *Id.* at 612-613, citing *Board of Education v. Allen*, 392 U.S. 236, 243 (1968), and *Walz*, Note 4, *supra*, 674.

¹⁷ *Walz*, Note 4, *supra*, 613.

¹⁸ *Lemon*, Note 3, *supra*, 614.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Walz*, Note 4, *supra*.

²⁴ *Id.* at 669-670.

²⁵ *Id.* at 674.

²⁶ *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1, 11 (1989). This was a plurality decision of the Court; the principal opinion was signed by three Justices, while three Justices concurred.

²⁷ *Id.* at 15, Note 4.

²⁸ *Id.* at 14.

²⁹ *Id.* at 15, citing *Corporation of Presiding Bishops of Church of Jesus Christ of Latter-day Saints v. Amos*, 483 U.S. 327, 348 (1987). A court observed that a "majority of the Court in *Texas Monthly* clearly recognized that tax exemptions that include religious organizations must have an overarching secular purpose that equally benefits similarly situated nonreligious organizations" (*Haller v. Commissioner of the Department of Revenue*, 728 A.2d 351, 354-355 (Pa., 1999)).

The Court recognized that in *Walz*¹⁷ it upheld state exemptions for real property owned by religious organizations and used for religious worship. “That holding,” the Court later wrote in *Lemon*, “tended to confine, rather than enlarge, the area of permissible state involvement with religious institutions by calling for close scrutiny of the degree of entanglement in the relationship.”¹⁸ It added: “The objective is to prevent, so far as possible, the intrusion of either into the precincts of the other.”¹⁹

The Court stated that its “prior holdings do not call for total separation between church and state; total separation is not possible in an absolute sense,” adding that “[s]ome relationship between government and religious organizations is inevitable.”²⁰ The Court continued: “Fire inspections, building and zoning regulations, and state requirements under compulsory school attendance laws are examples of necessary and permissible contacts. Indeed, under the statutory exemption [for real estate owned by religious organizations] the State had a continuing burden to ascertain that the exempt property was, in fact, being used for religious worship.”²¹ The Court added that judicial caveats against entanglement of government and religion must recognize that the “line of separation, far from being a ‘wall,’ is a blurred, indistinct, and variable barrier depending on the circumstances of a particular relationship.”²²

Tax exemption in general

The Court has infrequently reflected on the rationale for tax exemptions for nonprofit organizations under federal law. In *Walz*, the Court focused on the constitutionality of a tax exemption embracing nonprofit religious organizations.²³

The Court ruled that this state real estate tax exemption was constitutional. It stated that government may become involved in matters relating to religious organizations in this regard so as to “mark boundaries to avoid excessive entanglement” and to adhere to the “policy of neutrality that derives from an accommodation of the Establishment and Free Exercise Clauses that has prevented that kind of involvement that would tip the balance toward government control of [c]hurch or governmental restraint on religious practice.”²⁴ Recognizing that either tax exemption or taxation of churches “occasions some degree of involvement with religion,” the Court held that “[g]ranting tax exemptions to churches necessarily operates to afford an indirect economic benefit and also gives rise to some, but yet a lesser, involvement than taxing them.”²⁵

This position is an illustration of the concept of the “play in the joints” as between the two Religion

Clauses. That is, although the Free Exercise Clause does not *require* a government to grant churches and other forms of religious organizations a tax exemption, a government *may* grant such an exemption without violating the Establishment Clause.

Tax exemption solely for religion

As the foregoing analysis explains, a tax exemption that is available to a wide array of nonprofit organizations is constitutional, from an Establishment Clause viewpoint, notwithstanding the fact that the exempted class includes religious organizations. A tax exemption solely for religious entities, however, is, from a constitutional law standpoint, another matter.

The Court held that a state sales and use tax exemption, being “confined to religious organizations,” is a form of “state sponsorship of religion,” and stated that it should be struck down as “lacking a secular purpose and effect.”²⁶ The Court added that “[w]hat is crucial [to sustaining the validity of a tax exemption] is that any subsidy afforded religious organizations be warranted by some overarching secular purpose that justifies like benefits for non-religious groups.”²⁷ This sales tax exemption was held to lack “sufficient breadth to pass scrutiny” under the Establishment Clause.²⁸

The Court stated that “when government directs a subsidy exclusively to religious organizations that is not required by the Free Exercise Clause and that either burdens nonbeneficiaries markedly or cannot be seen as removing a significant state-imposed deterrent to the free exercise of religion, as [this state] has done . . . , it “provide[s] unjustifiable awards of assistance to religious organizations” and cannot but “convey a message of endorsement” to slighted members of the community.”²⁹

Constitutionality of specific religion provisions in Code

The following analysis is of 14 provisions in the Code granting a form of special tax benefit or preference, as part of the federal law of tax-exempt organizations, to or for the benefit of churches and other religious organizations or practices.

Tax-exempt status. The federal tax law includes provision for exemption, from the income tax, for a wide array of organizations, collectively known as charitable entities, including those that are classified as religious, charitable (in a narrower sense), educational, and scientific entities.³⁰ There is no legislative history underlying this body of law.

The federal income tax exemption for charitable organizations (as that term is used generically), including religious organizations, is the easiest of the 14 provisions to analyze and justify, for the simple reason that the Court, in *Walz*, directly addressed the point.³¹

Thus, the federal income tax exemption provided to religious organizations, being on a par with this exemption equally available to all charitable organizations, is clearly constitutional.

Charitable contribution deductions. The federal tax law includes an income tax deduction for contributions to charitable organizations, including those that are classified as religious entities.³² Charitable deductions are also available in the estate tax and gift tax contexts.³³ Again, there is no legislative history underlying this body of law.

The three federal tax charitable deductions are clearly constitutional, in relation to the Religion Clauses, for the same basic reason as the federal income tax exemption, even though these deductions indirectly provide economic benefits to religious organizations. This is because, as explained in *Walz*, the beneficiaries of the funds and property generated by these deductions are charitable organizations of all categories and thus represent the “wide array” of benefited entities that the Court has mandated.

Recognition of tax exemption. To be tax-exempt, nearly all categories of charitable organizations are required to file an application for recognition of exemption with the IRS.³⁴ Churches, integrated auxiliaries of churches, and conventions and associations of churches, however, are excused from this filing requirement.³⁵ The legislative history underlying this body of law, enacted in 1969,³⁶ is silent as to the reason for these exceptions.

The general requirements of neutrality and entanglement-avoiding suggests that the Court would discourage IRS review of the eligibility of religious organizations for tax exemption. The matter of seeking recognition of exemption for charitable organizations usually involves far more than the simple filing of a notice. Generally, a complex application for the recognition must be submitted. Following review of an application, it is common for IRS agents to ask for additional information and documents. The review process usually takes many months.

The Court stated that “[j]udicial caveats against entanglement” of government and religion “must recognize that the line of separation between government and religion is not a wall but is a “blurred, indistinct, and variable barrier,” with the extent and nature of the barrier dependent on the “circumstances of a particular relationship.”³⁷ That status has been deemed by the Court, in *Walz*, to involve less entanglement than taxation. It is clear, therefore, that statutes that minimize entanglement in the exemption process are the preferred approach, from a constitutional law standpoint. The excusal of these four categories of religious entities from this filing requirement, therefore, appears constitutionally sound.

Annual information returns and notices. Most tax-exempt organizations are required to file annual information returns with or submit notices to the IRS.³⁸ Churches (including an interchurch organization of local units of a church), their integrated auxiliaries, and conventions and associations of churches, however, are exempt from this filing requirement.³⁹ The legislative history attending this body of law does not provide any reasoning for this exemption.

³⁰ These are the organizations described in Section 501(c)(3) and thus tax-exempt by reason of Section 501(a).

³¹ See text accompanied by Notes 23-25, *supra*.

³² Section 170.

³³ Sections 2055 and 2155.

³⁴ Section 508(a).

³⁵ Section 508(c)(1)(A).

³⁶ H. Rep’t No. 91-413, 91st Cong., 1st Sess. (1969); S. Rep’t No. 91-552, 91st Cong., 1st Sess. (1969).

³⁷ *Lemon*, Note 3, *supra*.

³⁸ Sections 6033(a)(1) and 6033(i).

³⁹ Section 6033(a)(2)(A)(i).

⁴⁰ Section 6043(b).

⁴¹ Section 6043(b)(1).

⁴² Section 509(a).

⁴³ Section 170(b)(1)(A)(i).

⁴⁴ H. Rep’t No. 91-413, 91st Cong., 1st Sess. (1969); S. Rep’t No. 91-552, 91st Cong., 1st Sess. (1969).

⁴⁵ Section 107(2).

⁴⁶ *Warren*, 282 F.3d 1119, 91 AFTR2d 2003-2736 (CA-9, 2002).

⁴⁷ *Warren*, 114 TC 343 (2000).

⁴⁸ Clergy Housing Allowance Clarification Act of 2002, P.L. 107-181, 5/20/02.

⁴⁹ *Warren*, 302 F.3d 1012, 90 AFTR2d 2002-6058 (CA-9, 2002).

⁵⁰ *Freedom From Religion Foundation, Inc. v. Lew*, 983 F. Supp. 2d 1051, 112 AFTR2d 2013-7103 (DC Wis., 2013).

⁵¹ *Id.* at 1062.

⁵² *Id.*

⁵³ *Id.* at 1068.

⁵⁴ *Id.* at 1072.

⁵⁵ *Id.*

⁵⁶ *Texas Monthly, Inc. v. Bullock*, 489 U.S. 1 (1989).

⁵⁷ *Freedom From Religion Foundation v. Lew*, 773 F.3d 815, 114 AFTR2d 2014-6570, 823 (CA-7, 2014).

⁵⁸ *Caylor v. Mnuchin*, 278 F. Supp. 3d 1081, 120 AFTR2d 2017-6128 (DC Wis., 2017).

This exemption's constitutionality, from filing annual information returns and notices for churches and certain other types of religious organizations, rests on the same grounds as those applicable in connection with applications for recognition of tax exemption. Once again, *Walz* provides the rationale for concluding that this aspect of the federal tax law is not an Establishment Clause violation.

Reporting of dissolution, liquidation, termination, or substantial contraction. In general, tax-exempt organizations are required to report to the IRS when they have dissolved, liquidated, terminated, or substantially contracted.⁴⁰ Churches, their integrated auxiliaries, conventions and associations of churches, and other small public charities are exempt from this requirement.⁴¹ There is no legislative history underlying this body of law.

The law that exempts churches and certain other categories of religious organizations from reporting dissolution, liquidation, termination, or substantial contraction to the IRS is constitutionally sound on the same anti-entanglement grounds as were enunciated in *Walz*.

Public charity status. The federal tax law differentiates, in the realm of charitable organizations, between classification as a public charity and as a private foundation.⁴² Charitable organizations of an institutional nature are automatically classified as public charities. This preferential category of entities includes churches, conventions of churches, and associations of churches.⁴³

The legislative history accompanying enactment of the concept of public charities⁴⁴ is silent as to why these three categories of religious organizations are so designated, except in noting that Congress believed that certain types of "institutional" charitable entities should be regarded as public charities because of their nature and activities. Churches and the like are not singled out in this regard; the class of institutions also encompasses schools (including colleges and universities), hospitals, medical research organizations, and governmental bodies. While this class of organizations is not as broad as those involved in tax exemptions and deductible charitable giving, it appears to involve the requisite "wide array" of preferred entities and thus this law should not be, under *Walz*, a violation of the Establishment Clause.

Parsonage rental allowance. The one of these 14 provisions that has been the subject of the most litigation has been the income tax exclusion for the parsonage rental allowance accorded ministers of the gospel.⁴⁵

The constitutionality of the parsonage rental allowance was first examined in 2002.⁴⁶ The appellate court considered questioning the constitutionality of the allowance, notwithstanding the fact that the issue was not considered by the trial court.⁴⁷ After Congress intervened in the matter, by enacting clarifying legislation,⁴⁸ the appellate court dismissed the appeal.⁴⁹

This matter arose again, more than ten years later, when a federal district court held that this income tax exclusion violates the Establishment Clause.⁵⁰ The merits of this case turned on the distinction between a tax exemption for a wide array of nonsectarian groups as well as religious organizations in pursuit of some legitimate secular end and exemption granted solely to religious organizations.

The court stated that a tax law preference "provided only to religious persons violates the Establishment Clause, at least when the exemption results in preferential treatment for religious messages."⁵¹ The government, the court added, did "not identify any reason why a requirement on ministers to pay taxes on a housing allowance is more burdensome for them than for the many millions of others who must pay taxes on income used for housing expenses."⁵² Moreover, the court held that the parsonage allowance discriminates among religions, observing that this law "discriminates against those religions that do not *have* ministers."⁵³

Having concluded that the parsonage allowance law violates the first two prongs of the *Lemon* test,⁵⁴ the court turned its attention to the third prong, which looks to the presence of excessive entanglement. It saw "little distinction"⁵⁵ between this case and *Texas Monthly*,⁵⁶

This aspect of the litigation ended when an appellate court ruled that the plaintiffs lacked standing to bring the action, in that they had not suffered any "constitutionally cognizable injury."⁵⁷

The plaintiffs thereafter pursued a refund of their taxes paid on their allowances; some refunds were made, some denied. The lawsuit was refiled; the complaint alleges that the ministers' parsonage rental allowance provision "directly benefits ministers and churches, most significantly by lowering a minister's tax burden, while discriminating against the individual plaintiffs, who as the leaders of a non-religious organization opposed to governmental endorsement of religion are denied the same benefit."

The district court late in 2017 again ruled that the law providing for the ministers' rental allowance violates the Establishment Clause, primarily because it does not have any secular purpose or effect.⁵⁸ The government's positions consist of notation of the economic hardship that ministers will suffer

should this exclusion be struck down and the view that the housing allowance poses no threat of government-established religion; both positions are probably true but they are also irrelevant.

This parsonage rental allowance provision is unconstitutional, for the reasons the district court articulated.

Income exclusion for rental value of parsonage. Most individuals must report, as gross income, the fair market rental value of a home furnished to them as part of their compensation. The federal tax law, however, excludes from the gross income of ministers of the gospel the rental value of a home furnished to them as compensation.⁵⁹

The unconstitutionality of the parsonage allowance is also reflected in the law regarding the federal tax law exclusion from the gross income of ministers of the gospel of the rental value of a home furnished to them as part of their compensation. Viewed alone, that provision would also be unconstitutional.

This rental value exclusion must, however, be evaluated in the larger context, because it is related to the convenience-of-the-employer doctrine, which is reflected in the Code.⁶⁰ For example, this exclusion is a part of higher education tax law, where college and university presidents have the rental value of their campus-based housing routinely excluded from their gross income. Therefore, this exclusion is not a tax law preference provided only to religious persons; it is available to all employees, whether in the nonprofit or for-profit sectors, who satisfy the basic requirements of the convenience-of-the-employer doctrine. Thus, from this perspective, this income tax exclusion should be regarded as constitutional.

Charitable gift substantiation rules. A federal charitable deduction is not available if the donor is not in compliance with the gift substantiation requirements.⁶¹ These rules are inapplicable, however, in

connection with an intangible religious benefit that is provided by an organization organized exclusively for religious purposes and that generally is not sold in a commercial transaction outside the donative context.⁶²

The charitable gift substantiation rules are effective with respect to charitable contributions made on or after 1/1/94.⁶³ The legislative history of these rules⁶⁴ is silent on the origins of the intangible religious benefit exception.

Facially, this rule exempting intangible religious benefits provided by religious organizations in the context of obtaining charitable contribution deductions would seem to be a constitutional law violation, because the statutory exception is confined to religious benefits provided by religious organizations.

One of the peculiar aspects of this matter, however, is that the Court addressed this question about five years before this statute was enacted. The Court ruled that an exchange having an “inherently reciprocal nature” was not a gift and thus could not be a charitable gift, even though the recipient was a charitable organization.⁶⁵ In this case, the Court considered the character of payments to the Church of Scientology, which provides “auditing” sessions designed to increase members’ spiritual awareness and training courses at which participants study the tenets of the faith and seek to attain the qualifications necessary to conduct auditing sessions. The church, following a “doctrine of exchange,” set forth schedules of mandatory fixed prices for auditing and training sessions, although the prices varied in accordance with a session’s length and level of sophistication.

Reviewing the history of the charitable contribution deduction, the Court found that “Congress intended to differentiate between unrequited payments to qualified recipients and payments to such recipients in return for goods or services. Only the former were deemed deductible.”⁶⁶ In this case, charitable deductions were not allowed because

⁵⁹ Section 107(l).

⁶⁰ Section 119. This doctrine was added to the Code in 1954 but has been applied by the Treasury Department since 1919 (*Kowalski*, 434 U.S. 77, 40 AFTR2d 77-6128, 84-90 (1977)).

⁶¹ Section 170(f)(8).

⁶² Section 170(f)(8)(B), last sentence.

⁶³ Section 170(f)(8) was enacted as part of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66, section 13172(a), 8/10/93).

⁶⁴ H. Rep’t No. 103-111, 103rd Cong., 1st Sess. (1993).

⁶⁵ *Hernandez*, 490 U.S. 680, 63 AFTR2d 89-1395, 692 (1989).

⁶⁶ *Id.* at 690.

⁶⁷ *Id.* at 691.

⁶⁸ *Id.* at 692-694.

⁶⁹ Section 6115.

⁷⁰ Section 6115(b).

⁷¹ Section 6115 was enacted as part of the Omnibus Budget Reconciliation Act of 1993 (P.L. 103-66, section 13173(a), 8/10/93).

⁷² H. Rep’t No. 103-111, 103rd Cong., 1st Sess. (1993).

⁷³ Section 7602.

⁷⁴ Section 7611.

⁷⁵ Section 7611 was enacted as part of the Deficit Reduction Act of 1984 (P.L. 98-369, section 1033(a), 7/18/84).

⁷⁶ H. Rep’t No. 98-861, 98th Cong., 2nd Sess. (1984) (Conference Report).

⁷⁷ *Id.* at 1101.

⁷⁸ *County of Allegheny v. American Civil Liberties Union, Greater Pittsburgh Chapter*, 492 U.S. 573, 634 (1989).

⁷⁹ *Lemon*, Note 3, *supra*.

the payments “were part of a quintessential *quid pro quo* exchange.”⁶⁷ In so holding, the Court rejected the argument that payments to religious organizations should be given special preference in this regard.⁶⁸

In other aspects of the federal tax law, there are exceptions for incidental benefits that do not cause a reduction in a charitable contribution deduction or cause the transaction to fail as a gift. Thus, overall federal tax law removes incidental benefits, provided by all types of charitable organizations, from those that can diminish a charitable deduction. This aspect of the federal tax law may save this religious-benefit exception from constitutional law infirmity.

Quid pro quo contribution rules. Most charitable organizations are required to comply with the disclosure requirements related to quid pro quo contributions.⁶⁹ Exempt from the definition of these contributions, however, are payments made to an organization, organized exclusively for religious purposes, in return for an intangible religious benefit.⁷⁰

The quid pro quo contribution rules took effect with respect to quid pro quo contributions made on or after 1/1/94.⁷¹ The legislative history of these rules⁷² is silent on the origins of this intangible religious benefit exception.

This exemption, in the quid pro quo contribution rules context, for payments made to a religious organization in exchange for intangible religious benefits may be more constitutionally suspect than the exception in the charitable gift substantiation setting because there is no comparable exception in the charitable giving area generally. There are no other exceptions in the quid pro quo contributions statute.

IRS examinations of religious organizations. Generally, the IRS has the authority to examine tax-exempt organizations, to determine whether they are in compliance with the federal tax law requirements associated with their particular category of exemption.⁷³ Nonetheless, special rules impose restrictions on the IRS in connection with church tax inquiries and church tax examinations.⁷⁴

The church tax audit rules took effect with respect to church tax inquiries and church tax examinations beginning after 12/31/84.⁷⁵ The legislative history of these rules⁷⁶ is remarkably silent as to the reasons for their enactment.

As is always the case, an inquiry as to whether a law presents an Establishment Clause violation begins with an ascertainment of a secular purpose for the law. This silence in the legislative history

of this body of law is noteworthy because this is a major tax statute clearly attempting to favor tax-exempt churches. Thus, one would think a secular legislative purpose (if there was any semblance of one) would be articulated, in an effort to shelter the statute against a constitutional law challenge, given the fact that the primary effect of the statute is intended to be advancement of religion.

The history’s description of the law prior to its enactment consists of a single sentence: “No special requirements are imposed before commencing an investigation or inquiry regarding church tax liabilities.”⁷⁷ This statement thus makes it obvious that Congress thought the church audit rules amounted to “special requirements,” presumably favoring churches.

These rules impose restrictions on the IRS in connection with church tax inquiries and church tax examinations. These rules are unconstitutional because they do not have a secular legislative purpose and their primary effect is to advance religion. In a paraphrasing of a concurring Court opinion, this law “convey[s] a message of endorsement . . . of religion in general.”⁷⁸

The Court observed in *Lemon* that, under the statutory exemption at issue in *Walz* (for real estate owned by religious organizations), the state “had a continuing burden to ascertain that the exempt property was, in fact, being used for religious worship.”⁷⁹ Likewise, inasmuch as churches and other religious organizations are federally tax-exempt, the IRS has a general continuing obligation, pursuant to the federal tax law, in the same way that it does other exempt charitable organizations: determine if they continue to adhere to the requirements of their tax exemption and pay the requisite unrelated business income tax.

Courts agree that the IRS is empowered, when processing an application for recognition of exemption, reviewing an annual information return, or examining an exempt organization to make inquiries and gather information to determine whether the organization’s purposes and activities are in conformity with the statutory requirements. They concluded, therefore, that this type of review is not precluded by the Religion Clauses.

The church audit rules, with their “special requirements,” may have been intended to minimize government entanglement with religion. Yet what has happened in recent years is that the IRS has become incapacitated in connection with administration of these rules, with the result that there are no audits of churches, although examinations of other categories of tax-exempt organizations, including public charities, are ongoing.

Consequently, the church audit rules are actually fostering immense favoring by the federal government in matters of religion. This fact is illustrated in litigation that culminated in 2009. The rules were, as noted, enacted in 1984, well before the massive reorganization of the IRS that took effect in 1999. Under this body of law, a church tax inquiry may be commenced by the IRS only where an appropriate high-level Treasury official reasonably believes that the organization may not qualify for tax exemption as a church, may be carrying on an unrelated business, or otherwise be engaged in nonexempt activities.⁸⁰ The definition of the phrase “appropriate high-level Treasury official”⁸¹ that was originally utilized became unusable because the position referenced in the original definition was abolished as part of the reorganization. Congress neglected to enact a successor definition; on its own, the IRS designated the director of its examinations function as that official.⁸² A federal district court ruled, however, that this director is too low in rank to qualify as a high-level official, and thus that the church tax inquiry involved in the case was improperly commenced.⁸³

The individual who was the director at the time had been the director for many years and launched innumerable church tax inquiries. Because the government decided not to appeal the court’s ruling, all of these inquiries were effectively voided and the church inquiry and examination processes generally ceased. Indeed, the IRS was sued for failing to enforce exempt organizations law in the church setting.⁸⁴

Thus, there has been less entanglement of government with churches when this law stopped being enforced than when it was operational.

Commercial-type insurance exception. The rules concerning commercial-type insurance preclude tax exemption for otherwise exempt charitable (and social welfare) organizations when their primary activity is the issuance of commercial-type insurance, or otherwise treat the insurance activity as an unrelated business.⁸⁵ One of the exceptions to the definition of “commercial-type insurance”⁸⁶ is for property or casualty insurance provided by a church or a convention or association of churches for the church, convention, or association.⁸⁷

The law concerning commercial-type insurance was enacted in 1986.⁸⁸ The legislative history of the exception for insurance provided by certain religious organizations⁸⁹ does not explain why it was added.⁹⁰

There is no stated or otherwise obvious secular justification for property or casualty insurance provided by one of these three types of religious organizations to be carved out of the general definition of commercial-type insurance.⁹¹ The result of this exception is to leave property or casualty insurance provided by any other type of charitable organization (including other types of religious organization) or social welfare organization as a basis for: (1) denial or revocation of tax exemption, or (2) unrelated business income taxation. The principal effect of this statute is to advance religion.⁹² This exception is thus unconstitutional.⁹³

Commercial-type insurance welfare benefits exception. One of the exceptions to the definition of “commercial type” insurance is for the provision of retirement or welfare benefits by a church or a convention or association of churches for the em-

⁸⁰ Sections 7611(a)(1)(A) and (2).

⁸¹ Section 7611(h)(7).

⁸² Delegation Order 193 (rev. 6); IRM section 4.76.7.4.

⁸³ *Living Word Christian Center*, 103 AFTR2d 2009-714 (DC Minn., 2009).

⁸⁴ *Freedom From Religion Foundation, Inc. v. Koskinen*, 114 AFTR2d 2014-5610 (DC Wis., 2014), dismissed on 7/29/14.

⁸⁵ Sections 501(m)(1) and (2).

⁸⁶ The term “commercial-type insurance” generally is any form of insurance of a type provided by commercial insurance companies (H. Rep’t No. 99-841, 99th Cong., 2nd Sess. II-345 (1986)).

⁸⁷ Section 501(m)(3)(C).

⁸⁸ Section 501(m) was enacted as part of the Tax Reform Act of 1986 (P.L. 99-514, section 102, 10/22/86).

⁸⁹ H. Rep’t No. 99-841, 99th Cong., 2nd Sess. (1986) (Conference Report).

⁹⁰ This history states, however, that this exception “does not apply if the insurance is provided not only to the church, convention or associations, but also to other persons” (*id.* at 345).

⁹¹ It thus violates the first prong of the *Lemon* test.

⁹² It thus violates the second prong of the *Lemon* test.

⁹³ *School District of Abington Township v. Schempp*, 374 U.S. 203, 225 (1963), quoting from James Madison’s *Memorial and Remonstrance Against Religious Assessments* (1785).

⁹⁴ Section 501(m)(3)(D). There has not been any litigation concerning the constitutionality of this provision.

⁹⁵ H. Rep’t No. 99-841, Note 88, *supra*.

⁹⁶ There has not been any litigation concerning the constitutionality of this provision.

⁹⁷ Section 514.

⁹⁸ Section 512(b). These rules are particularly applicable in connection with income such as interest, rent, and annuities; they also apply with respect to capital gain (Section 512(b)(5)).

⁹⁹ This is real property located in the neighborhood (not defined) of other property owned by a tax-exempt organization.

¹⁰⁰ Sections 514(b)(3)(A)-(C).

¹⁰¹ Section 514(b)(3)(E).

¹⁰² *Id.*

¹⁰³ Section 514(b) was enacted as part of the Tax Reform Act of 1969 (P.L. 91-172, section 121(d)(1), 12/30/69).

¹⁰⁴ H. Rep’t No. 91-413, 91st Cong., 1st Sess. (1969), at 28; S. Rep’t No. 91-552, 91st Cong., 1st Sess. (1969), at 64.

¹⁰⁵ The Senate report accompanying this legislation contains the observation that the special rule for churches is “more liberal” (S. Rep’t No. 91-552, Note 103, *supra*, at 64).

¹⁰⁶ This reference to a “wider array” of entities is based on the Court’s observation that a tax exemption is constitutionally permissible where the exemption is “conferred upon a wide array of nonsectarian groups as well as religious organizations” (*Texas Monthly*, Note 26, *supra*, at 14).

employees of the church, convention, or association or for the employees' beneficiaries.⁹⁴ The legislative history of the provision⁹⁵ is silent as to its origins.

This exception to the commercial-type insurance rules likewise has no stated secular legislative purpose and it does not appear possible that one can be constructed. The principal effect of this exception is to advance religion. This exception is thus unconstitutional.⁹⁶

Neighborhood land rule. Income from property that a tax-exempt organization, including a religious entity, has acquired by means of debt-financing generally is taxable, in whole or in part, as unrelated business taxable income.⁹⁷ This is the case even though, if the property were not debt-financed, the income would not be taxable.⁹⁸

An exemption is provided from these debt-financed property rules (and thus from unrelated business income taxation) for interim income received by a tax-exempt organization from neighborhood real property⁹⁹ acquired for an exempt purpose; there must be a plan to devote the property to one or more exempt uses within ten years of its acquisition.¹⁰⁰ A more generous 15-year rule, however, is available for churches.¹⁰¹ Also, it is not required that the property be in the church's neighborhood.¹⁰²

This neighborhood land rule took effect as of 1/1/70.¹⁰³ This rule's legislative history¹⁰⁴ says nothing about why the special rule for churches was enacted, although the special rule is summarized in one sentence.¹⁰⁵

The enhanced church component of the neighborhood land rule is the most blatantly unconstitutional of the 14 provisions. Indeed, the caption to this rule, which openly signals a constitutional law violation, is "Special Rule for Churches." This special rule provides tax-exempt churches two huge carve-outs from the unrelated business tax law—exceptions that are not available to any other cat-

egories of public charities or, for that matter, any other forms of tax-exempt organizations.

For example, if a tax-exempt scientific research institution acquired, completely with debt-financing, a parcel of rental real property, intending to use it for research purposes, but did not convert the property to an exempt use until the passage of 12 years, it would be taxable on any net rental income during the 12-year period. A church in that identical position, however, would not be taxed.

Likewise, if a tax-exempt hospital acquired, completely with debt-financing, a parcel of rental real property, located 20 miles from its campus, intending to ultimately use it for health care purposes, but did not convert the property to an exempt use for five years, it would be taxable on any net rental income during the five-year period. Again, a church in that identical position would not be taxed.

This enhanced component of the neighborhood land rule, designed only for the benefit of churches, is a type of income tax exemption that exists solely for religious organizations and violates the Establishment Clause as being a form of government sponsorship of religion.

Conclusion

The Code contains several provisions that are beneficial for tax-exempt churches and other religious organizations. Most of these Code sections pass Establishment Clause muster because the benefits, some economic and some exceptions to regulatory requirements, are simultaneously provided to a much wider array¹⁰⁶ of exempt nonprofit organizations. Even the range of categories of public charities is sufficiently broad to constitutionally accommodate tax law preferences for religious entities. There are, nonetheless, a few provisions favoring religious groups that are constitutionally suspect. ■

IDENTIFYING AND NAVIGATING IMPERMISSIBLE PRIVATE BENEFIT IN PRACTICE

JOHN TYLER, EDWARD DIENER, AND HILLARY BOUNDS

As Section 501(c)(3) organizations pursue their charitable mission objectives, they must seek to avoid problems of impermissible private benefit.

Organizations and people from within the charitable sector are increasingly engaging in historically non-traditional activities and with other than Section 501(c)(3) organizations in their efforts to generate revenue and investment/donations and to more aggressively pursue their charitable mission objectives. Examples include ventures with or from other than charitable-oriented businesses and investors, combined public-private fund arrangements, pay-for-success, impact investing, opportunity zones, micro-lending for business, and other finance-oriented relationships. These efforts are changing the ways in which 501(c)(3) organizations must identify and manage against impermissible private benefit.

One aspect of these activities is intentional awareness that the brand and reputation of many 501(c)(3) organizations can have independent value on which others might want to trade, with or without providing commensurate value. At one extreme might be blatantly disingenuous “greenwashing,” while across the spectrum might be efforts of non-501(c)(3) people and entities wanting to attract millennials as employees, investors, or consumers

given their reported commitment about engaging “meaning” in what they do and how they do it.

Another area in which private benefit problems arise is within more garden-variety, day-to-day operations. Consider operation-oriented pursuits by which 501(c)(3) organizations carry on their programs and missions, often by contracting for delivery of goods and services. In current times, such contracting might require increased attention to the financial and non-monetary values of data collected by or for the 501(c)(3) and the tools used to collect, store, secure, and analyze that data. This might be as simple as lists of donors, volunteers, or beneficiaries—which have long had a hard copy counterpart. However, most 501(c)(3)s are entrenched in the world of data and associated technologies, whether they are conscious of it or not, just by virtue of having a website and visitors to it.

Finally, “new” philanthropists and social change actors are engaging in historically non-traditional activities by structuring these activities without regard to (or at least with much less regard for) the incentives of tax deductions and exemptions. While there may be private foundations and charitable entities within an enterprise, these structures sometimes are complemented by a Section 501(c)(4) organization and angel investment fund or a larger investment pool with heightened pursuit of social returns—which may or may not qualify as “chari-

JOHN TYLER is general counsel, secretary, and chief ethics officer for the Kauffman Foundation, and a lecturer and course designer for Columbia University. EDWARD DIENER is general counsel for the Skoll Foundation. HILLARY BOUNDS is lead counsel for the Chan Zuckerberg Initiative.

table” under the Code—balanced against awareness of greater financial risks.

Before generally discussing each of the above topics through the private benefit lens, this article provides a primer on private benefit and its private inurement sibling. In doing so, the article includes their relationship to “exclusively” charitable purposes under the Code and the permissibility of “incidental” private benefit, which is part of what distinguishes corporate structures and associations from charitable trusts, in which even incidental private benefit to insiders can be problematic.

Intersections between mandatory “exclusively” charitable purposes and permissible “incidental” private benefit

Section 501(c)(3) generally allows organizations recognized thereunder to be exempt from paying income taxes.¹ Section 170(c) allows such organizations to receive donations for which donors may take charitable deductions.² Many states provide similarly and extend tax exemptions to property, sales, and other taxes. Under both Code sections and accompanying federal regulations, recognized organizations must be organized and operated exclusively or primarily for one or more specified exempt purposes.³ In addition, no part of the net earnings of such an organization may inure to the benefit of any private shareholder or individuals,⁴ or stated slightly differently, the organization must be organized and operated to serve public rather than a private interest.⁵

In quasi lay person terms, then, tax exemptions and charitable deductions are available for/from organizations: (1) that are organized and operated exclusively or primarily for exempt purposes, and (2) that do not serve private interests. These two requirements might be interpreted such that the second is rendered superfluous because an organization arguably cannot be exclusively or primarily devoted to exempt purposes while simultaneously serving private interests.

However, such a singularly one-dimensional reading could tolerate exemption of and deductible contributions to a school that happens to exclusively enroll a donor’s children or relatives. After all, education is an acknowledged and valued exempt purpose, and the primary purpose of such a school could be education even in the face of a relatively limited student body. As a functional matter, therefore, the private benefit prohibition helps mitigate arguments about the relative weight or merit of the respective possible purposes.⁶ As such, the second component appropriately com-

plements the first mandate while also having independent merit, relevance, and application.

However, in deference to reality, the private benefit prohibition is not absolute. For example, the prohibition does not mean that organizations exempt under Section 501(c)(3) cannot pay for goods, services, facilities, or other transactions from which they benefit or that the individual members of the charitable class it targets cannot improve their lot. Quite the contrary, even payments that might (or even are likely to) include a profit margin for the provider are allowed, even though intentionally engaged and technically a private benefit to an outsider and private inurement to an insider. Such payments are generally permissible private benefits/inurement as long as they are not unreasonable or a substantial purpose for establishing or operating the 501(c)(3) entity.⁷

The law recognizes that such entities may have limited nonexempt purposes as long as they are not “substantial in nature.”⁸ In some ways, this is where private inurement and private benefit begin distinguishing themselves because the law explicitly prohibits any nonexempt purpose that contemplates net earnings inuring to the benefit of or otherwise intending to benefit designated persons, the creator or his family, an organization’s shareholders, or those controlled by such private interests.⁹ Thus, even insubstantial purposes of providing such benefits—which by definition are private rather than public—will undermine or defeat exemption,¹⁰ and reasonableness or excessiveness of the compensation will not likely matter.¹¹

Even so, organizations exempt under Section 501(c)(3) may hire and compensate their personnel, as long as compensation is otherwise reasonable and not the reason for the entity.¹² Implicit in that relationship is that the compensation must be in-

¹ Section 501(c)(3). Exemption does not extend to unrelated business taxable income (Section 511). Also, private foundations pay an excise tax under Section 4940 on net investment income, and Section 4968 imposes an excise tax on net investment income of certain college and university endowments.

² Sections 170(c)(2)(B) and (C).

³ Sections 501(c)(3) and 170(c)(2)(B); Reg. 1.501(c)(3)-1(a)(1).

⁴ Sections 501(c)(3) and 170(c)(2)(C); Reg. 1.501(c)(3)-1(c)(2).

⁵ Reg. 1.501(c)(3)-1(d)(1)(ii).

⁶ See Tyler, “Transparency in Philanthropy: An Analysis of Accountability, Fallacy, and Voluntarism,” *Philanthropy Roundtable*, 3/18/13.

⁷ See Reg. 1.501(c)(3)-1(d)(1)(ii). Private foundations operate under a different rubric for disqualified persons under Section 4941 pursuant to which certain transactions with disqualified persons are forbidden whether reasonable or not and even if the terms substantially favor the foundation and disfavor the disqualified person.

⁸ See *Better Business Bureau of Washington D.C., Inc.*, 326 U.S. 279, 34 AFTR 5 (1945).

⁹ Regs. 1.501(c)(3)-1(c)(1) and (2).

¹⁰ Reg. 1.501(c)(3)-1(d)(1)(ii).

¹¹ See *EST of Hawaii*, 71 TC 1067 (1979).

¹² See Section 4958.

cidental to the personnel performing services or fulfilling duties reasonably related to and necessary for pursuing the entities' exempt purposes.

Other purposes that might otherwise be nonexempt can be permissible and legitimately incurred, if they are not substantial; in other words, if they are incidental to pursuing the exempt purposes for which the entity was organized and is operated.¹³

Consider a Section 501(c)(3) organization that pays a contractor for providing services within a defined scope, deadlines, and prescribed quality. Such compensation that is at or below market rates likely is within permissible private benefit as long as the scope of work and its actual delivers are in pursuit of its exempt purposes. Additionally, the contractor's experiences and lessons subsequently acquired from fulfilling its contractual obligations may also be considered permissible private benefit because they are inseparably integrated with the engagement or activities. Those private benefits lose their incidental status if they are intended outcomes and substantive reasons for the underlying engagement, which thereby threatens to become or actually becomes substantial purposes.

Consider a company that designs, manufactures, and sells clothing that repels mosquitoes that spread malaria. Because malaria is generally a developing world concern, sales of such clothes in underdeveloped countries might be considered incidental to the charitable purposes of alleviating the effects of poverty and protecting health and welfare for those in poverty. At the same time, sales of those clothes in the U.S. would likely not be considered incidental to charitable purposes under those circumstances, even if revenues are used to subsidize serving needs in the developing world.

Suppose further that after the Zika virus began spreading in the U.S. in 2015, it was discovered that the same company's clothes also repel Zika-carrying mosquitoes, thus creating a different market in the U.S. based on an exempt, health care purpose. In the face of a pandemic, sales of that

clothing in the U.S. might then be recharacterized as incidental to those exempt purposes, under the right circumstances.¹⁴

Consider also that the IRS has frequently recognized that "networking" is not a permissible exempt purpose.¹⁵ However, if there is an in-person educational event organized by a 501(c)(3), there is no reasonable way to prevent people from meeting each other, getting caught up, exchanging contact information, or learning more about each other and their respective lives. Because such networking will happen as an integrated, unavoidable part of the underlying exempt activity, it can be incidental to the exempt purpose.

The example of networking makes a further point, which is that—unlike private inurement—private benefit does not necessarily need to be financial or even tangible. Examples might include driving traffic to a website; increasing awareness or notoriety of a person or entity; providing a discretely targeted or specifically trained workforce; encouraging customers for or investment in other than a tax-exempt entity; or allowing control over access to information.

How, then, does someone determine whether an activity is an "incidental," permissible benefit? Usually, it is a matter of assessing facts and circumstances such that what is incidental in one circumstance may be substantial—and thus impermissible—in a nearly identical, but still different other circumstance. The analysis is both quantitative and qualitative.

The quantitative analysis evaluates the relative money, people, time, or other resources dedicated to or served by the various underlying activities. With such weighting, however, the nonexempt amounts not only must be secondary, they must be insubstantial relative to the exempt amounts.

The qualitative analysis evaluates whether the respective benefits can be separated from each other or if they are inextricably integrated as a necessary byproduct such that pursuing exempt purpose(s) necessarily and unavoidably within reason involves pursuing the nonexempt but nonetheless permissible purpose(s).

For private foundations, there are circumstances in which incidental benefits are forbidden even if fair and reasonable, insubstantial, or inextricably integrated. The Code and accompanying regulations expressly forbid certain listed transactions¹⁶ between the foundation and its disqualified persons,¹⁷ which are a specifically defined list of deemed insiders even if not in decision-making or even influencing capacities. Such "self-dealing" transactions are a statutorily prescribed form of private inurement that

¹³ See *American Campaign Academy*, 92 TC 1053 (1989).

¹⁴ See Tyler, "Essential Policy and Practice Considerations for Facilitating Social Entrepreneurship: Commitment, Connections, Harm, and Accountability," in *CAMBRIDGE HANDBOOK OF SOCIAL ENTREPRENEURSHIP LAW* (Cambridge Univ. Press, forthcoming 2018).

¹⁵ See, e.g., Ltr. Rul. 201809011.

¹⁶ Section 4941(d), which defines "self-dealing" transactions.

¹⁷ Section 4946, which defines "disqualified persons."

¹⁸ See Department of Labor, Interpretive Bulletin 2015-01; IRS Notice 2015-62, 2015-39 IRB 411.

¹⁹ See Tyler, Note 14, *supra*; Tyler, Absher, Garman, and Luppino, "Purposes, Priorities and Accountability Under Social Business Structures: Resolving Ambiguities and Enhancing Adoption," *Advances in Entrepreneurship, Firm Emergence and Growth*, 19:39-60 (Emerald Publishing Limited, 2017).

would otherwise likely be permissible for 501(c)(3) organizations that are not private foundations, if reasonable and not the reason for the activity. They include transactions by which the foundation sells goods or products or leases space to disqualified persons even if such persons materially overpay for them at multiples far in excess of market value. Likewise are foundation purchases of goods or products or leases of space from such persons, even if at a discount of 99.9% off market prices.

With this grounding in private benefit/inurement and differences between substantial, insubstantial, and incidental, this article can now apply that grounding to more specific and unusual—albeit increasingly more common—circumstances.

Finance-oriented transactions and private benefit

The growth in attention among millennials and for-profit investors to impact investing; mission-related investing; environmental, social, and governance (ESG) investing; and other “social” endeavors has accelerated interest among 501(c)(3) organizations wanting to find ways to leverage that attention to attract new resources to their causes. Interest has also grown among consultants, investment managers, and others seeking to profit off these trends.

Action by regulators such as the Department of Labor and Treasury to clarify when/how pension funds and charitable endowments may or may not invest their assets has contributed to that attention.¹⁸ Policymaker interest in social impact bonds, other pay-for-success models, and newly designated opportunity zones seek to exploit similar leveraging opportunities. The still novel social purpose business structures like benefit corporations and low-profit limited liability companies (L3Cs) have been confusingly identified as attractive ways for 501(c)(3) enterprises to leverage innovative finance for social (“charitable”) purposes.

These opportunities present at least four traps for the unwary 501(c)(3) manager, board member, or legal counsel as it relates to potential for impermissible private benefit.

First, “social” purposes may or may not be synonymous with exempt purposes as required under Section 501(c)(3). While there certainly is overlap, permissible 501(c)(3) purposes are decidedly narrower. Thus, making concessionary investments in or committing charitable resources (e.g., personnel) or assets (e.g., intellectual property) to a “social” enterprise cannot be presumed to qualify as contemplated by Section 501(c)(3), even if it serves the public

and is generally agreed on as worthwhile or even desirable in service to public welfare.

Even without getting into the overlay of permissible financial returns to owners of a social enterprise, intended and actual “social” purposes and benefits may need to be evaluated within the framework provided above to determine if they are substantial or insubstantial and merely incidental to 501(c)(3) purposes and benefits. If they are more than insubstantial or other than incidental, the 501(c)(3) entities involved could risk being found to have engaged in private benefit transactions for which there could be consequences.

Second, discussions within “social” endeavors often emphasize that some of those involved “intend” both social and financial impact without further declaring the ordering of or relative priorities for those intentions or the permanence of that ordering or relationship. If there is a conflict and a choice must be made, what will be prioritized: social impact or financial returns? If decisions must be made about allocating resources, equipment, or staff in ways that contribute to social impact while simultaneously detracting from financial returns, how will each purpose weigh against the other in practice and not merely as a reflection of “best intentions”?¹⁹ What is the process for making these decisions and who is involved with it?

Laudatory yet ambiguous declarations of “intent” are probably not enough for a reasoned public benefit analysis. If private benefit can be found based on the actual activities and outcomes of an entity organized and operated exclusively for exempt purposes as are those under Section 501(c)(3), surely private benefit can be found in an entity grounded in good intentions. Consequently, 501(c)(3) board members, managers, and attorneys need to scrutinize their involvements with “social” endeavors to identify both quantitatively and qualitatively the extent to which their organization’s involvement risks facilitating or engaging in impermissible private benefit.

Given those possibilities, there are ways in which the board members, managers, and legal counsel can try to protect their organizations (and themselves) against impermissible private benefit in this regard by designing oversight and remedial controls through contract, veto rights, governance vehicles, mandatory exit strategies, and otherwise. Ultimately, others’ intentions are less relevant if the 501(c)(3) has control over the decision-making and, thus, can ensure the proper ordering and weighting of priorities. However, if that control or substantive involvement does not exist, knowing others’ intentions matters more.

Third, the still nascent social purpose business forms are too often lauded as prioritizing social or even charitable purposes or as ensuring accountability thereto. On closer examination of the structures, however, the benefit corporation and social purpose corporation structures by statute do not prioritize social or charitable purposes nor do they ensure accountability thereto. In fact, they eliminate legal accountability that might conceivably exist to such purposes.

The L3C is slightly different because it at least clearly prioritizes exempt purposes under Section 501(c)(3) over financial returns. Going further, L3C statutes explicitly deprioritize the latter such that it cannot be a substantial purpose.²⁰ Even so, 501(c)(3) board members, managers, and lawyers should not neglect additional means by which to protect against private benefit inuring from their organization's involvement.

There is no silver bullet protection against private benefit inherent in these forms. The reality may be quite the opposite in light of misrepresentations, misstatements, and misunderstandings about these forms that could be a danger for uninformed or under-informed 501(c)(3) board members, managers, or legal counsel.

Fourth is the potential for monetary, financial private benefit such as might happen if a "social" venture is described or structured so that financial returns are allocated differently among otherwise similarly situated investors based on priority of interest. That is, for-profit investors interested in financial returns may get preferred distributions either at a higher rate or earlier waterfall than 501(c)(3) investors who are presumed to be interested less in dollars and more in social returns. Alternatively, expenses and losses might be absorbed first to 501(c)(3) investors either directly or through guarantee vehicles; or losses might be ascribed to for-profit investors to offset gains from other ac-

tivities, thereby reducing their tax liability without corresponding value provided to 501(c)(3) investors.

Normally, the presumption should be that 501(c)(3) involvement is on at least the same terms and conditions as that of other comparably situated investors/participants. Stated differently, if an informed for-profit investor would not enter the deal on the terms proposed to the 501(c)(3), neither should the 501(c)(3). Otherwise the risk of impermissible private benefit is high. It will generally be the responsibility of the 501(c)(3)'s board members, managers, and legal counsel to operate with this presumption top of mind because others may mistakenly believe that greater prospects for charitable "returns" are enough for the 501(c)(3).

However, it may be that the endeavor's exempt purposes can only be pursued with involvement of the 501(c)(3) at concessionary levels—that is, on other than market terms—and that but for those concessions from the 501(c)(3), the exempt purposes could not or would not be pursued. As long as the 501(c)(3) can document those legitimate circumstances, it increases the likelihood that accompanying private benefit is incidental to pursuing the exempt purposes and, therefore, permissible.²¹

A fifth private benefit trap for the unwary in financial-oriented relationships, whether social or otherwise, is private benefit derived from the non-monetary, intangible but valuable reputation of the 501(c)(3), as discussed in the next section.

The 501(c)(3) entity's brand, reputation, credibility, and "goodwill"

Like other enterprises and people, 501(c)(3) organizations have reputations, brand recognition, and credibility that aggregate to "goodwill." Consider how these have value for the 501(c)(3) through how it attracts and grows donations, grants, volunteers, employees, collaborators, beneficiaries, and other relationships. It may not appear on a balance sheet as "goodwill," but it is there and valuable nonetheless.

When a 501(c)(3) enters into a relationship with other than 501(c)(3) organizations, part of its contribution to that relationship is its "goodwill." It may be that non-501(c)(3) collaborators are seeking to gain business or market advantages from associating with the 501(c)(3): access to new markets, customers, suppliers, or workforce. It may be that one of their objectives is to bask in the glowing halo of the 501(c)(3) and thereby gain economic or market advantage. The 501(c)(3) should protect its brand and goodwill, including by being intentional about the value its reputation brings to the

²⁰ See VT. STAT. ANN. section 4162. See generally Tyler III, "Negating the Legal Problem of Having 'Two Masters': A Framework for L3C Fiduciary Duties and Accountability," 35 VT. L. REV. 117, pp. 117-161 (2010); Brewer, *The Ongoing Evolution in Social Enterprise Legal Forms*, p. 53 in *THE SOCIAL ENTERPRISE ZOO: A GUIDE FOR PERPLEXED SCHOLARS, ENTREPRENEURS, PHILANTHROPISTS, LEADERS, INVESTORS, AND POLICYMAKERS* (Young, Searing, and Brewer, eds. (2016)).

²¹ Private foundations must undertake further analyses and documentation to protect against self-dealing under Section 4941. Disqualified persons co-investing alongside or in addition to the private foundation with which they are associated is not per se self-dealing; after all, the excess business holdings rules under Section 4943 presume some degree of permissible co-investment. However, even though permissible, the foundation and its disqualified persons should document their analysis that the disqualified person has not received special treatment that might be attributable to their connections to the foundation, such as exceptions to investor threshold requirements, favorable distribution rights, and fees. Other than to identify the issues, the details are beyond the scope of this article.

relationships. Otherwise, there is a risk that the non-501(c)(3) participants realize more than incidental benefit from that glow.

The non-501(c)(3) entities also contribute their own reputations and goodwill to the venture, including halos. It may even be that their glow is stronger and more valuable than that of the 501(c)(3), in which case reputational benefits may flow to the 501(c)(3) rather than the other direction. This should also be a part of the private benefit calculus as part of determining whether the private benefit is incidental or more substantial.

Unusual or complex operational contexts for private benefit

There are any number of daily activities of 501(c)(3) organizations that may give rise to impermissible private benefit, especially in contracting for goods or services. However, some of those relationships have increased the complexity for assessing private benefit given the nature of deliverables, especially in this electronic, digital, cloud-based age. Most formidable among these is likely data and all things related to it, for which most 501(c)(3) organizations contract with third parties.

The normal approach for analysis is the following: assess the monetary and non-monetary value of that which the 501(c)(3) is receiving (x) against the monetary and non-monetary value of that which it is providing to the other party to the arrangement (y) along with additional value that such party is receiving (z). As long as x is greater than or equal to $y + z$, y is at or below market rates, and z is integral to x, the potential for private benefit is lessened.

For instance, engaging a photographer or videographer involves the following considerations: Are they charging their normal fee for which they ordinarily get paid by clients or an inflated or reduced rate? Are their rates and terms typical for the industry and geography? Who will own the underlying work product, and is that their usual arrangement? What use rights does the organization have (e.g., cropping, editing, incorporating into other works, etc.) and are they restricted in some way? Who is responsible for obtaining/ensuring permissions from subjects of the photos or videos, especially if minors? Is that included in the fee or extra? Is the organization required or allowed to give the person credit publicly for their work? Can he include the organization in promotional materials, including lists of clients, testimonials, use of logo, etc., recognizing that his market presence relative to that of the organization may provide the vendor with more, less, or no value in these regards?

The organization should understand the vendor's market, terms, and practices and whether its arrangements deviate from those. Perhaps there has been a request for proposal (RFP) and formal bid process or efforts to get proposals from multiple vendors. Note that the organization's starting point should not necessarily be the amount it has budgeted for the service, although that amount should have been informed by an understanding of the market.

The private benefit analysis is often aided by the fact that the organization's own strategic mission or operational purposes will drive the above questions and getting to workable answers to them. Legal counsel is often helped by the ability to present issues in the opportunistic context of business or program needs, as opposed to esoteric but essential compliance-oriented complications like primacy of charitable purposes and prohibitions against impermissible private benefit.

Continuing from the preceding example, the communications, marketing, or public affairs team cares about their ability to use the photos or videos generated through the above relationship. They also care about protecting and advancing the organization's reputation, and they should care about their budget. Such caring facilitates managing against other than incidental private benefit.

More complex expectations are similar, even though the nature of the underlying good, service, or intangible may be different, as are the activities that are implicit in or corollary to the transaction. For example, a scope of services focused on developing and hosting an interactive website by which data is or might be collected is multi-layered. At a primary level is the data itself: What data and from what demographic or geographic area? Is it personally identifiable information, educational data, or health/medical information for which additional statutory mandates apply? Is it from minors or about the homeless? Is it from people in a different jurisdiction with different privacy laws and cultures? Is it being provided or scraped? Does the provider have legal authority to make it available or the scraper the legal right to access it? Those questions are just at the top level about the data itself.

Corollary to the data are similar questions about such things as the tools used to collect the data, algorithms designed to analyze or sort the data, platforms developed for making the data available, and protocols for evaluation and assessing impact. In some transactions, these may be primary considerations and not just corollary. Either way, they are important factors, and the failure to address them may give rise to private benefit problems, especially if the contracting party calls attention to the failure

by exploiting them in some way. In that regard and again repositioning private benefit into the realm of practical business or program objectives, there may be earned revenue opportunities that might be lost if the organization is not mindful of the above.

Data, tools, algorithms, platforms, or protocols are almost never isolated, especially if digital. For example, where and how will the data be stored? What levels of security and redundancy will be applied? How can the data be accessed and by whom? Are there service level expectations regarding that access? How can the data be used? Who gets to decide these matters? What protections exist in the event that the vendor closes its doors or something more nefarious happens?

All of these affect the private benefit analysis, especially when benchmarked against a growing body of industry standards. As services become more commoditized, pricing stabilizes as does the quality, but until that time pricing may be a la carte and quality may have wide variations. Price, however, is not the only valuable at issue, especially if the vendor can use the data for its purposes or allow others to access and use the data for their purposes with or without charging a fee. While the vendor charging a fee is a likely easy target for identifying private benefit, even free access can bring value in the forms of building relationships, raising awareness, generating leads, or creating competitive advantages.

In some ways the evolving and seemingly ubiquitous data commons and open source movements present opportunities to simplify certain of the above questions. However, the seemingly insatiable appetite many for-profit companies have for data as an integral part of their business and revenue models also complicates the questions and their answers, thereby potentially further complicating the private benefit analysis.

Conclusion; innovative structures for philanthropy

There is growing attention to the opportunities and challenges presented by approaches to philanthropy through other than private foundations. For instance, a given enterprise might have some subset of the following components: a private foundation; a Section 501(c)(3) public charity; an in-

vestment fund; a portfolio of invested companies; personal funds; a family office; a Section 501(c)(4) social welfare organization; the for-profit company from which the wealth was generated; and more. There may or may not be overlapping governance, legal control, effective control, employees, or otherwise. It may be that the private foundation or public charity has the fewest assets or that one or the other is the best endowed and most strategic for purposes of pursuing philanthropic outcomes.

In these situations, the enterprise and its structure are driven more by social impact than tax treatment. In fact, tax exemptions and charitable deductions may provide little value or incentive, especially when accompanying strings and handcuffs are perceived as impeding efforts to achieve social impact. These innovative enterprises can provide tremendous flexibility for choosing the means by which they pursue exempt purposes, including through commercial ventures.

Operating under these types of approaches other than honorably can create opportunities for misuse or even abuse. However, even operated honorably and with the purest of philanthropic intentions, they can present unique possibilities for impermissible private benefit if care is not taken and maintained to identify potential areas for mistakes and to ensure that adequate processes and knowledge are in place to prevent such mistakes.

Key opportunities for those types of mistakes are in transactions among related parties, whether in sharing facilities and equipment, overlapping employees, accessing data and tools, or otherwise. Sometimes what might seem like a common sense and efficient approach to transactions is actually problematic from a compliance perspective. Particularly concerning to the private foundation element of the enterprise should be awareness of which related parties are disqualified persons because, even though impermissible private benefit might be avoided, self-dealing under Section 4941 might not be. What might seem like unwelcome expense and processes on the front end ultimately might save money and time on the back end because impermissible private benefit and self-dealing are avoided, not to mention the potential reputational harms that can arise from perceptions of untended misuse or abuse. ■

TENANT IMPROVEMENT ALLOWANCES PAID TO EXEMPT ORGANIZATIONS

RICHARD A. NEWMAN

Landlords occasionally offer tenants build-out allowances that are greater than the cost the tenant will incur to build-out its space. Landlords do this in soft markets to fill buildings that might otherwise be empty. When landlords offer such inducements to exempt organizations, the exempt organization is confronted with the question of whether the amount of such allowance (a “tenant improvement allowance”) or the amount of such tenant improvement allowance that is in excess of the hard and soft costs incurred to build-out its space (an “excess allowance”) is unrelated trade or business income. There is no direct authority on this question.

The tax treatment of payments by landlords to tenants of tenant improvement allowances has been the source of much uncertainty over the years. The receipt of cash by a tenant can look like an accession of wealth by the tenant and therefore constitute gross income to the tenant. To the extent, however, that the amount paid by the landlord does not exceed the cost of the improvements and the landlord is considered to own those improvements, the traditional position has been that there was no accession of wealth by the tenant and, therefore, the payment does not constitute gross income to the tenant.¹

RICHARD A. NEWMAN is a partner in the Washington, DC office of Arent Fox, LLP.

Section 110

In the Taxpayer Relief Act of 1997,² Congress attempted to bring some clarity to this issue with respect to one class of leases by enacting Section 110. Section 110 provides that gross income of a tenant of retail space does not include tenant improvement allowances received from its landlord under a lease of 15 years or less to the extent such tenant improvement allowance is used by the tenant to pay for the hard and soft costs incurred by it to construct retail space pursuant to a lease under which the build-out constitutes real property and reverts to the landlord at the end of the lease term. To that extent, any such amount paid by the landlord to the tenant is excluded from the tenant’s gross income under Section 110, but the excess allowance would constitute gross income. By implication, amounts not excluded under Section 110 might be treated as income to tenants, but if Section 110 is viewed as merely a safe harbor for certain tenants, it would not preclude other tenants from following the traditional position outlined above that treats all tenant improvement allowances used to pay for landlord-owned improvements as excluded from income.

Where an exempt organization is considering a lease that would be for a term of more than 15 years, Section 110 does not apply to the tenant improvement allowance. Similarly, the Section 110

When a landlord offers an exempt organization tenant a tenant improvement allowance, the exempt organization should consider the question of whether the allowance is unrelated trade or business income.

Regulations define retail as "... selling tangible personal property or services to the general public,"³ and many exempt organizations are not involved in retail activities. Thus, even for short-term leases, the Section 110 safe harbor may not be available.

Interestingly, in October 1996, the IRS issued a Coordinated Issue Paper dealing with improvement of leased space and addressing the issue of when a tenant improvement allowance should be treated as gross income to the tenant or excluded from gross income. That Coordinated Issue Paper was referred to in the report by the House Ways & Means Committee,⁴ by the Senate Finance Committee,⁵ and by the Conference Committee⁶ on proposed Section 110. The Conference Committee indicated that, if an allowance did not fall within the scope of Section 110, the IRS Coordinated Issue Paper and then present law (including case law) would continue to apply.

As explained by the Joint Committee on Taxation in its "Blue Book" on the 1997 Act:

A coordinated issue paper issued by the Internal Revenue Service ("IRS") on October 7, 1996, states the IRS position that construction allowances generally should be included in income in the year received. However, the paper does recognize that amounts received by a lessee from a lessor and expended by the lessee on assets owned by the lessor were not includible in the lessee's income. The issue paper provides that tax ownership is determined by applying a "benefits and burdens of ownership" test that includes an examination of the following factors: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity interest was acquired in the property; (4) whether the contract creates present obligations on the seller to execute and deliver a deed and on the buyer to make payments; (5) whether the right of possession is vested; (6) who pays property taxes; (7) who bears the risk of loss or damage to the property; (8) who receives the profits from the operation and sale of the property; (9) who carries insurance with respect to the property; (10) who is responsible for replacing the property; and (11) who has the benefits of any remainder interests in the property. ...[T]he provisions of the IRS issue paper and present and prior law (including case law) will continue to apply where applicable.⁷

Thus, the IRS Coordinated Issue Paper largely ratified, with subsequent Congressional endorsement, the traditional position that a tenant improvement allowance allocable to landlord owned improvements is not income to the tenant. Nonetheless, in the discussion below, the assumption is that an *entire* tenant improvement allowance would be treated as gross income to an exempt organization since there is no direct authority supporting the traditional position that it is not. (To the extent

that a tenant improvement allowance would be attributable to an exempt organization's taxable unrelated business activities or to the extent an exempt organization is concerned about the lack of direct authority supporting the arguments made below, it might want to consider structuring its lease so that the portion of the tenant improvement allowance actually spent on the hard and soft costs of the tenant improvements can fall within the scope of those factors described in the excerpt from the Joint Committee report quoted above, in which the landlord is considered to be the owner of the improvements. In such circumstances, under the Consolidated Issue Paper/traditional position, only whether the excess allowance is unrelated trade or business income would need to be evaluated.)

Unrelated trade or business income

When treating the tenant improvement allowance as income to the exempt organization for this purpose, the question remains whether that income would be treated as unrelated, and therefore taxable, income to the exempt organization.

As noted, there is no direct guidance on this point. However, the two lines of reasoning outlined below support the position that tenant improvement allowance income should not be treated for federal income tax purposes as unrelated trade or business income by an exempt organization.

Unrelated trade or business definition—negotiating a lease

To be treated as an unrelated trade or business activity, an activity has to both be "regularly carried on"⁸ and "engaged in with the intent to earn a profit."⁹ While profit motive is a subjective test, the courts have traditionally looked at whether a nonprofit gained a competitive advantage vis-à-vis for-profit competitors as a marker of profit motive.¹⁰ Clearly, in a circumstance in which landlords are offering large tenant improvement allowances, it is not reasonable to expect that landlords are only offering such generous inducements to prospective tenants that happen to be exempt organizations, and thus the exempt organization being offered such an allowance should not be seen as getting a competitive advantage over a for-profit competitor if the exempt organization accepts any such lease proposal.

Moreover, if the exempt organization was seeking an unfair position vis-à-vis for-profits based on its exempt status, because an excess allowance might be taxable to a for-profit tenant and not to an exempt

organization, the exempt organization would demand *less* tenant improvement allowance (since it need not net out of the excess allowance amounts needed to pay the tax on such income). Thus, one could argue, an exempt organization has no profit motive in accepting any, including an excess, tenant improvement allowance.

Similarly, most exempt organizations in negotiating a new lease are not engaged in a business activity that is “regularly carried on” within the meaning of the Regulations or the *NCAA Case*. The Regulations describe an activity as regularly carried on only if it is carried on with frequency and continuity.¹¹ Negotiating a lease is neither a frequent activity nor a continuing activity, so it is not an activity that should be viewed as regularly carried on. Accordingly, if all or any part of a tenant improvement allowance income is treated as the exempt organization’s income, it would be reasonable to treat it as not being unrelated trade or business income.

Conclusion; tax policy consideration

Given the absence of guidance on the subject, an exempt organization may inquire whether tax policy considerations might suggest a basis on the IRS’s part to assert that tenant improvement allowance or excess allowance income should be taxable to an exempt organization. Clearly, the IRS always tilts towards taxing income, and exemptions from tax are narrowly construed.¹²

As noted above, however, to assert that an excess allowance is taxable income to an exempt organization would be a major change in the policy articulated in the *NCAA Case* (except insofar as the exempt organization has other unrelated trade or business activities). Moreover, since a rent reduction and increased tenant improvement allowances are

economically equivalent, including in income excess allowances given to taxable entities is a way to offset the greater deduction for rent such entities would otherwise be entitled to; this is a tax benefit analysis that does not apply to exempt organizations. To the contrary, in the case of an exempt organization, since it does not deduct rent expense (except to the extent allocable to unrelated trade or business activities), the economic equivalence between a rent deduction and a tenant allowance suggests that a tenant improvement allowance should *not* be treated as taxable income to an exempt organization, just as a reduction in rent would not cause its net taxable income to go up.

Accordingly, there is no tax policy basis to support the IRS taking the position that a tenant improvement allowance or excess allowance income attributable to an exempt organization should result in unrelated taxable income to the exempt organization (except to the extent attributable to the exempt organization’s other unrelated trade or business activities). ■

¹ *Frank Lyon Co.*, 435 U.S. 561, 41 AFTR2d 78-1142 (1978); Ltr. Rul. 8002042.

² P.L. No. 105-34, 8/5/97.

³ Reg. 1.110-1(b)(2)(iii).

⁴ H. Rep’t No. 105-148, 105th Cong., 1st Sess. 423 (1997).

⁵ S. Rep’t No. 105-33, 105th Cong., 1st Sess. 232 (1997).

⁶ H. Rep’t No. 220, 105th Cong., 1st Sess. 658-659 (1997) (Conference Report).

⁷ Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997* (Blue Book), pp. 347-349.

⁸ Reg. 1.513-1(b).

⁹ *Professional Ins. Agents of Michigan*, 78 TC 246, 262 (1982). See also *National Collegiate Athletic Association*, 92 TC 27 (1989) (the “*NCAA Case*”).

¹⁰ See, e.g., *Veterans of Foreign Wars of U.S.*, 601 F. Supp. 7, 54 AFTR2d 84-5743 (DC Mo., 1984).

¹¹ Reg. 1.513-1(c)(1); see also the *NCAA Case*, Note 9, *supra*.

¹² *Schleier*, 515 U.S. 323, 75 AFTR2d 95-2675, 388 (1995).

THE DISAPPEARING 60% DEDUCTION—NEW CHARITABLE GIVING LIMITS ARE NOT AS GENEROUS AS THEY APPEAR

BRAD BEDINGFIELD AND NANCY DEMPZE

A purported tax benefit in the Tax Cuts and Jobs Act to encourage charitable donations is illusory in many cases.

The Tax Cuts and Jobs Act (TCJA)¹ changed several rules affecting tax incentives for charitable giving. Many of these changes have been seen as negative for the charitable sector—in particular, the increased standard deduction eliminates the need for many taxpayers to itemize deductions, thereby reducing the incentive to make charitable gifts.

Congress did include one incentive to *encourage* more charitable giving, by increasing the annual “contribution base” (similar to adjusted gross income, or AGI) limits for cash gifts to public charities from 50% to 60%. Because of the way in which this increased limit was inserted into the existing Section 170, the 60% limit is unavailable in many cases, in particular when donors are making gifts to both public charities and private foundations, or gifts of both cash and noncash items, such as stock, land or art.

BRAD BEDINGFIELD is counsel at Hemenway & Barnes LLP in Boston. Brad works extensively with nonprofit organizations, navigating tax, regulatory, and governance matters, guiding charities and other nonprofits through formation, reorganizations, mergers, affiliations, and dissolution, and advising on innovative use of charitable assets, including social impact bonds and other forms of impact investing. NANCY E. DEMPZE is a partner at Hemenway & Barnes LLP. She represents nonprofits in connection with planned giving and development and serves as a trustee, executor, and estate planner. Nancy serves as a trustee and advisor to several foundations and is a member of several nonprofit boards, including chair of the board of trustees of Manomet (formerly Manomet Center for Conservation Sciences), and trustee of the Boston Museum of Science, where she chairs its planned giving committee.

Many people perceive this rule as simply allowing a taxpayer to make an incremental cash gift of 10% of AGI, on top of whatever deductions would have been allowed under the old rules. As demonstrated below, this is true *only* for years in which the donor has made gifts of up to 60% of AGI *entirely in cash*. With some limited exceptions (discussed below), to the extent that a donor is relying on anything other than cash gifts to public charities to make up the entirety of that 60%, the new higher deductibility limit is unavailable.

Section 170(b) is a complicated labyrinth of cross-references, and the new change in the law only makes things worse. The only way to really appreciate how the new limit operates is with examples, working through the various subparagraphs of Section 170(b) one by one to see how they interact. Before doing that, however, this article reviews some basic principles regarding charitable giving and income taxes, which will be important as the examples are discussed.

Basic principles

Gifts of cash and other property to U.S.-based charitable organizations are generally deductible for income tax purposes, as itemized deductions.² For gifts of capital gain property (i.e., capital assets with a cost basis that may differ from the asset’s fair

market value (FMV)), the amount of the charitable deduction depends in part on how long the property has been held, and in part on the type of charity receiving the property.

For gifts of short-term capital gain property (property held by a donor for less than one year) to any charity, a deduction is allowed only for the lesser of (1) FMV and (2) the donor's cost basis.³ For gifts of long-term capital gain property (property held by a donor for at least one year) to a public charity,⁴ a deduction is generally allowed for FMV.⁵ For gifts of long-term capital gain property to a private foundation, a deduction is generally allowed only for cost basis (or FMV, if less), unless the donor is giving publicly-traded stock.⁶

There are various special rules and restrictions for gifts of tangible property,⁷ intellectual property,⁸ inventory,⁹ scientific research property,¹⁰ gifts involving split interests,¹¹ and certain other specific categories.¹²

General limitations on deductions

The basic principles outlined above generally determine how much of an income tax charitable deduction a donor may receive *overall* with respect to a particular gift. The next question, then, is how much of that deduction may be taken *right away*, in the year of the gift.

The law generally does not allow taxpayers to completely wipe out their AGI through the charitable deduction,¹³ but rather limits the charitable deduction

to certain percentages of the donor's "contribution base" (AGI without regard to any net operating loss carryback) each year.¹⁴ Except in limited circumstances, the annual limitation is either 20%, 30%, 50%, or 60% of the donor's contribution base, with the percentage depending on what kind of property is being given and what kind of charity is receiving it.¹⁵

These limitations are found in different subparagraphs of Section 170(b)(1), and must be applied in a particular order. Prior to the TCJA, these caps were found in subparagraphs A through D. The TCJA adds a new subparagraph G, addressing cash gifts to public charities, and providing certain rules for how such gifts interact with the traditional caps in subparagraphs A through D. To show how these subparagraphs interact with one another, this article refers to gifts subject to the respective caps by reference to their subparagraphs. Each is summarized below.

Subparagraph G gifts

Although it is both the newest subparagraph and the last alphabetically, this is where the calculation begins. Under a new temporary rule enacted as part of the TCJA, for tax years after 2017 and prior to 2026, an individual donor may deduct up to 60% of the donor's contribution base for gifts of cash (and only cash—not short-term or long-term capital gain property) to a public charity.¹⁶ To qualify for the 60% threshold, such gifts must be "to" the public charity, not "for the use of" the public charity.¹⁷

¹ P.L. 115-97, 12/22/17.

² Section 63(d). Taxpayers who do not itemize deductions, but instead elect the standard deduction, do not receive any income tax benefit from making charitable contributions. Under the TCJA, the standard deduction has been temporarily increased (effective from 2018 through 2025), to \$12,000 for single filers (or married filing separately), \$18,000 for head of household, and \$24,000 for married filing jointly (in each case, to be adjusted for inflation in future years). Section 63(c)(2); Rev. Proc. 2018-18, 2018-10 IRB 392. Note that the "Pease" limitations, which reduced the effectiveness of itemized deductions in certain circumstances, have been suspended through 2025. Section 68(f).

³ Section 170(e)(1)(A).

⁴ Gifts to private operating foundations and other organizations listed in Section 170(e)(1)(A) are treated like gifts to public charities for purposes of these deduction rules. For simplicity, this article refers to all such organizations as "public charities."

⁵ Sections 170(a)(1), (e)(1).

⁶ Sections 170(e)(1)(B), (e)(5).

⁷ Sections 170(e)(1)(B)(i) and 170(o). If the public charity disposes of the related-use tangible personal property within the same year as the contribution, the deduction is limited to the donor's basis (Section 170(e)(1)(B)(i)(II)); and if the disposition by the charity takes place within three years of the donation, the donor will have recapture of a portion of the deduction relating to gain in the property (Section 170(e)(7)(A)). In both cases the result can be avoided if the charity certifies that the property's use was in fact related to the charity's exempt purposes. Section 170(e)(7)(B).

⁸ Sections 170(e)(1)(B)(iii) and 170(m).

⁹ Sections 170(e)(1)(A), (3), (6).

¹⁰ Section 170(e)(4).

¹¹ Section 170(f).

¹² See generally Sections 170(e) through (p).

¹³ In limited circumstances, gifts of conservation easements involving property used in agriculture or livestock production may be deducted against 100% of the contribution base in the year of the gift. Section 170(b)(1)(E)(iv). In addition, Congress occasionally passes disaster relief bills which suspend the annual limitations of Section 170(b) for qualifying cash gifts to support affected disaster areas. See, e.g., section 20104 of the Bipartisan Budget Act of 2018 (suspending adjusted gross income limitations for cash gifts made during a certain period for the purpose of relief efforts in the California wildfire disaster area).

¹⁴ Section 170(b) (because AGI is the same as "contribution base" for most individual taxpayers, and because AGI is the more commonly used term, this article uses them interchangeably for purposes of the illustrations below).

¹⁵ Section 170(b)(1).

¹⁶ Section 170(b)(1)(G) (increasing annual limitation to 60% for gifts of cash, enacted as part of the TCJA but expiring on 12/31/25).

¹⁷ Reg. 1.170A-8(a)(2). Many gifts in trust, including gifts to certain charitable lead trusts, are treated as contributions "for the use of" the recipient charity rather than "to" the charity, and therefore are subject to the lower 30% limitation for subparagraph B gifts. However, gifts to public charities of remainder interests in charitable remainder trusts are generally treated as gifts "to" the charity and therefore, to the extent that a charitable remainder trust (where the remainder interest will be distributed exclusively to public charities on termination of the annuity or unitrust interests) is funded with cash, should be eligible for the 60% limitation for subparagraph G gifts (pending further guidance from the Treasury Department on this question).

EXHIBIT 1
AGI Limitations for Each Category of Gift

	<i>Public Charity(PC)/ Private Foundation(PF)</i>	<i>Cash</i>	<i>Short-Term Capital Gain Property (Cost Basis Only)</i>	<i>Long Term Capital Gain Property</i>
Sub. G	PC	60%	See Sub. A	See Sub. A
Sub. A	PC	50% minus Sub. G gifts	50% minus Sub. G gifts	50% (if cost basis elected) minus Sub. G gifts
Sub. B	PF	Lesser of (i) 30% and (ii) 50% minus Sub. G gifts minus Sub. A gifts	Lesser of (i) 30% and (ii) 50% minus Sub. G gifts minus Sub. A gifts	See Sub D
Sub. C	PC	See Sub. G	See Sub. A	30%
Sub. D	PF	See Sub. B	See Sub. B	Lesser of (i) 20% and (ii) 30% minus Sub. C gifts

Subparagraph A gifts¹⁸

Traditionally, all gifts to (not “for the use of”) a public charity are subparagraph A gifts, provided that (as noted in the basic principles outlined above) deductibility of gifts of short-term capital gain property is limited to the donor’s cost basis, and deductibility of subparagraph C gifts (gifts of long-term capital gain property) is limited as described below. Under the TCJA, deductibility of cash gifts to public charities is now provided for primarily under subparagraph G. Other gifts (including gifts of short-term capital gain property) to public charities continue to fall under subparagraph A.

A donor may also make an election to deduct long-term capital gain property at the lesser of cost basis and fair market value (rather than at fair market value alone), in which case that gift will be treated as a subparagraph A gift.¹⁹ An individual donor may deduct up to 50% of her contribution base, reduced by the amount of any subparagraph G deduction allowed, for subparagraph A gifts.²⁰

Subparagraph B gifts²¹

For gifts of cash or short-term capital gain property to a private foundation, and for gifts that are “for the use of” rather than “to” a public charity, an individual donor may deduct up to the lesser of (1) 30% of the donor’s contribution base or (2) the excess of 50% (not 60%) of the donor’s contribution base for the year over the combined amount of subparagraph G gifts and subparagraph A gifts.²²

Subparagraph C gifts²³

Subparagraph C of Section 170(b)(1) operates as a limitation on deductibility of subparagraph A gifts involving long-term capital gain property. Except for gifts of qualified conservation easements,²⁴ an individual donor may deduct up to 30% of his contribution base for gifts of long-term capital gain property to a public charity.

Subparagraph D gifts²⁵

For gifts of long-term capital gain property to a private foundation, an individual donor may deduct up to the lesser of (1) 20% of her contribution base and (2) the excess of 30% of the donor’s contribution base for the year over the amount of subparagraph C gifts.

Excess contributions from each category generally may be carried forward for up to five tax years, but may only be used within the same category in those future years.²⁶

Exhibit 1 shows the AGI limitations (as percentages of the donor’s contribution base) for each category of gift:

Examples

When a donor gives one type of gift in one year, the rules are fairly simple. A donor giving nothing but cash to public charities absolutely may deduct up to 60% of the donor’s contribution base. Things become much more complicated, however, when a donor makes gifts of different kinds of assets to

different kinds of charities. In that case, it is necessary to determine the order in which these different limitations apply. The following are two examples of how this would work under the TCJA.

Example 1 (cash and short-term capital gain property).

Maya has AGI of \$100,000, and contributes \$35,000 cash to a public charity (a subparagraph G gift), \$20,000 of short-term capital gain property to a public charity (a subparagraph A gift), and \$10,000 cash to a private foundation (a subparagraph B gift), for a total of \$65,000 of charitable contributions.

- The \$35,000 cash contribution to the public charity is deductible in full during the year of the gift under subparagraph G, as it is less than 60% of Maya's contribution base.
- The \$20,000 contribution of short-term capital gain property to a public charity is only deductible in the year of the gift up to \$15,000, as the subparagraph A maximum (\$50,000, or 50% of Maya's contribution base) is reduced under the subparagraph G rules by the \$35,000 subparagraph G deduction, leaving only \$15,000 of subparagraph A deduction left to be used.
- The \$10,000 cash contribution to the private foundation is not deductible *at all* in the year of the gift under subparagraph B, even though the public charity donation is \$5,000 below the 60% threshold. This is because the rule for mixed gifts to public charities and private foundations in subparagraph B limits deductibility of the private foundation gift to the lesser of \$30,000 (30% of Maya's contribution base) and \$0 (the difference between (1) Maya's combined subparagraph G and subparagraph A gifts and (2) 50%, not 60%, of Maya's contribution base).
- In all, only \$50,000 of the \$65,000 contributed (or 50% of the donor's contribution base) is allowed as a deduction in the tax year of the contribution. The unused subparagraph A and subparagraph B contributions may be rolled over and used as subparagraph A and subparagraph B deductions, respectively, for up to five subsequent years.

Example 2 (cash and long-term capital gain property).

Maya has AGI of \$100,000, and contributes \$20,000 cash to a public charity (a subparagraph G gift), \$35,000 of long-term capital gain property to a public charity (a subparagraph C gift), \$5,000 cash to a private foundation (a subparagraph B gift), and \$5,000 of long-term capital gain property in the form of publicly traded stock to a private foundation (a subparagraph D gift).

- The \$20,000 in cash contributions to the public charity is deductible in full under subparagraph

G, as it is well below \$60,000 (60% of Maya's contribution base).

- The \$35,000 of long-term capital gain property is deductible only up to \$30,000 in the year of the gift. Subparagraph A only allows up to \$30,000 of additional deductibility for gifts to a public charity, as the 50% limitation of subparagraph A (\$50,000) must be reduced by the amount of any subparagraph G deduction (\$20,000). Separately, the subparagraph C limitation (30% of Maya's contribution base) would also limit this deduction to \$30,000.
- The \$5,000 cash contribution to the private foundation is not deductible *at all* in the year of the gift, as subparagraph B limits that deduction to the lesser of \$30,000 (30% of Maya's contribution base) and \$0 (the excess of 50% of Maya's contribution base, or \$50,000, over the combined subparagraph G and subparagraph A gifts, or \$55,000).
- Similarly, the \$5,000 contribution of long-term capital gain property to the private foundation is not deductible in the year of the gift, as subparagraph D limits that deduction to the lesser of \$20,000 (20% of Maya's contribution base) and \$0 (the excess of \$30,000, or 30% of Maya's contribution base, over \$30,000, the amount of allowed subparagraph C deductions).
- In all, only \$50,000 of the \$65,000 contributed (or 50% of the donor's contribution base) is allowed as a deduction in the tax year of the contribution. As with Example 1, the unused contribution amounts may be rolled over and used as deductions for up to five subsequent years, subject to the same contribution limits for such gifts in those future years.

¹⁸ Section 170(b)(1)(A).

¹⁹ Section 170(b)(1)(C)(iii) and (e)(1). Notably, electing to take a deduction at cost basis does not convert a gift into a subparagraph G gift (with the potentially higher AGI limitation), as subparagraph G only applies to cash gifts. This election merely removes the lower AGI limitation of subparagraph C as it applies to subparagraph A gifts.

²⁰ Section 170(b)(1)(C)(iii)(I) (providing that contributions taken into account under subparagraph G will not be taken into account under subparagraph A) and (II) (providing that subparagraph A will be applied by reducing the contribution limitation allowed under subparagraph A by the aggregate amount of subparagraph G contributions).

²¹ Section 170(b)(1)(B).

²² Section 170(b)(1)(C)(iii)(II) (providing that subparagraph B shall be applied by treating any reference to subparagraph A as a reference to both subparagraph A and subparagraph G).

²³ Section 170(b)(1)(C).

²⁴ Donors of qualified conservation easements may deduct up to 50% or, in certain circumstances, up to 100% of their contribution base. Unused deductions of qualified conservation easements may be carried forward for up to 15 years. Section 170(b)(1)(E).

²⁵ Section 170(b)(1)(D).

²⁶ Sections 170(d) and 170(b); Reg. 1.170A-10.

²⁷ See Note 13, *supra* (regarding gifts of certain qualified conservation contributions and certain cash gifts for disaster relief under special legislation).

Because the 50% limitations embedded in subparagraphs A and B were not increased to 60%, and because application of these subparagraphs requires first reducing the amount subject to them by the amount of any subparagraph G gifts, the higher 60% limitation disappears to the extent that a taxpayer is relying on anything other than subparagraph G to get all the way up to 60%.

It would be going too far to say that *any* mixing of gifts (in terms of type, or foundation classification of recipient) destroys the higher 60% limitation. For example, Maya could give \$60,000 in cash to a public charity, and then a mix of other gifts (cash and other property to public charities and private foundations) in addition to that, and she would still be able to deduct the full \$60,000 of cash (60% of her contribution base) in the year of the gift. This is because she is not relying on any of the other paragraphs to get her to 60% in the year of the gift. The other donations, however, would be carried forward to the extent permitted. Similarly, Maya could give \$55,000 cash to a public charity, and the same mix of other gifts, and she would get the full \$55,000 (55% of her contribution base) in the year of the gift, as she is relying only on subparagraph G for the cash gift. Again, Maya would have to carry forward the deduction for all of the other gifts, as she could not use any of them to make up that additional 5%.

In addition, as noted above, there are a couple of situations in which a donor may make gifts deductible up to 100% of the donor's contribution base, which may be taken effectively "on top" of the donor's aggregate subparagraph A through D

and subparagraph G deductions.²⁷ While contributions of qualified conservation easements are generally limited to the excess of 50% of the donor's contribution base over other charitable contributions (which would allow for no additional immediate deduction in the examples above), contributions of certain qualified conservation easements by farmers or ranchers may be deductible up to the excess of 100% of the donor's contribution base over other charitable contributions, which would allow a taxpayer to "stack" this deduction on top of any others made during the year.²⁸

Qualified disaster relief payments under special legislation (such as section 20104 of the Bipartisan Budget Act of 2018, regarding qualifying cash gifts made between 10/8/17 and 12/31/18 to certain public charities²⁹ for relief efforts in the California wildlife disaster) work similarly, providing the ability to "stack" qualified deductions on top of any Subparagraph A, B, C, D or G deductions.³⁰ Example 3 shows how this "stacking" works:

Example 3 (regular cash donations, short-term capital gain property, and qualified disaster relief cash donations). Maya has AGI of \$100,000, and contributes \$55,000 cash to a public charity (a subparagraph G gift), \$10,000 of short-term capital gain property to a public charity (a subparagraph A gift), and \$35,000 in qualified disaster relief cash gifts.

- The \$55,000 in regular cash contributions to public charities (not qualified disaster relief gifts) is deductible in full under subparagraph G, as it is below \$60,000 (60% of Maya's contribution base).

¹⁸ Section 170(b)(1)(A).

¹⁹ Section 170(b)(1)(C)(iii) and (e)(1). Notably, electing to take a deduction at cost basis does not convert a gift into a subparagraph G gift (with the potentially higher AGI limitation), as subparagraph G only applies to cash gifts. This election merely removes the lower AGI limitation of subparagraph C as it applies to subparagraph A gifts.

²⁰ Section 170(b)(1)(C)(iii)(I) (providing that contributions taken into account under subparagraph G will not be taken into account under subparagraph A) and (II) (providing that subparagraph A will be applied by reducing the contribution limitation allowed under subparagraph A by the aggregate amount of subparagraph G contributions).

²¹ Section 170(b)(1)(B).

²² Section 170(b)(1)(G)(iii)(II) (providing that subparagraph B shall be applied by treating any reference to subparagraph A as a reference to both subparagraph A and subparagraph C).

²³ Section 170(b)(1)(C).

²⁴ Donors of qualified conservation easements may deduct up to 50% or, in certain circumstances, up to 100% of their contribution base. Unused deductions of qualified conservation easements may be carried forward for up to 15 years. Section 170(b)(1)(E).

²⁵ Section 170(b)(1)(D).

²⁶ Sections 170(d) and 170(b); Reg. 1.170A-10.

²⁷ See Note 13, *supra* (regarding gifts of certain qualified conservation contributions and certain cash gifts for disaster relief under special legislation).

²⁸ Section 170(b)(1)(E)(iv).

²⁹ Contributions to supporting organizations or donor-advised funds do not qualify. See section 20104(a)(4)(B) of the Bipartisan Budget Act of 2018.

³⁰ See section 20104 of the Bipartisan Budget Act of 2018. Qualified disaster relief payments do not have their own subparagraph of the Code. They instead constitute special legislation that allows certain deductions outside the confines of Section 170(b)(1) on a discrete and temporary basis. Such deductions are applied last, after any deductions that are subject to Section 170(b)(1) (including qualified conservation easement deductions).

³¹ Note that while the subparagraph G cash gifts reduce the available subparagraph A deduction, qualified disaster relief cash gifts do not have any effect on the subparagraph A deduction. Accordingly, had Maya made all \$90,000 of her cash gifts that year as qualified disaster relief payments, the \$10,000 of short-term capital gain property would have been deductible in full under subparagraph A.

³² Interestingly, if Maya had given more than her contribution base in the aggregate, any unused deductions for qualified disaster relief payments would have carried forward as subparagraph A contributions (not subparagraph G contributions), subject to the aggregate 50% threshold in future years. See section 20104(a)(2)(A)(ii) of the Bipartisan Budget Act of 2018. Accordingly, if Maya wanted to give more than her contribution base as qualified disaster relief payments in a given year, she would actually be better off giving that excess amount as regular subparagraph G cash gifts (not qualified disaster relief payments), which may be eligible for the higher 60% limitation in future years.

- The \$10,000 of short-term capital gain property to the public charity is not deductible at all in the year of the gift, as subparagraph A limits that deduction to \$0 (50% of Maya's contribution base, or \$50,000, reduced by the amount of any subparagraph G deduction, in this case \$55,000).³¹ This deduction may be carried forward for up to five years as a subparagraph A deduction (subject to the same 50% limitation in each future year).
- The \$35,000 in qualified disaster relief cash gifts is allowed in full in the year of the gift. Under section 20104 of the Bipartisan Budget Act of 2018, those payments are not subject to Section 170(b)(1), but under special rules are allowed in the year of the gift to the extent of the excess of Maya's contribution base (\$100,000) over the amount of all other charitable contributions allowed under Section 170(b)(1) (in this case, \$55,000).
- In all, \$90,000 of the \$100,000 contributed is allowed as a deduction in the tax year of the contribution. If Maya had given \$10,000 more in cash for qualified disaster relief, she could have deducted the entire \$100,000 of her contribution base.³²

Opportunities to make gifts of qualified disaster relief payments are not widely advertised, as these special provisions tend to be nestled in other legislation and are not made part of Section 170. However, where available, this option can provide powerful additional tax incentives for a taxpayer who wants to make charitable gifts of a large portion of her contribution base.

However, setting those less common sorts of gifts aside, a donor must rely *solely* on cash gifts to public charities to reach that higher 60% limitation

afforded by subparagraph G. This need to rely solely on cash gifts to public charities significantly undermines the usefulness of the higher 60% threshold. It is common for donors who are gifting that much of their income in a given year to give property other than cash, for a variety of reasons (including avoidance of capital gains tax on sale of the property). Accordingly, in many situations, the higher 60% threshold may be of limited use to most taxpayers.

Conclusion

A donor may deduct more than 50% of her contribution base only when:

- Making cash gifts to public charities of more than 50% of her contribution base (all qualifying under subparagraph G, without relying on any subparagraph A through D contributions, up to a maximum limit of 60% of her contribution base).
- Making a gift of a qualified rancher or farmer conservation easement, which allows for "stacking" of the deductible amount on top of other contributions (up to an aggregate of 100% of her contribution base);
- Making a qualified disaster relief cash gift, which likewise allows for "stacking" of the deductible amount on top of other contributions (up to an aggregate of 100% of her contribution base).

Many have urged Congress to change subparagraph G to allow this new 60% threshold to "stack" on top of other contributions the way that qualified disaster relief cash gifts do. In the meantime, however, donors should understand that in many cases this purported new tax benefit is illusory. ■

THE “SIMPLE” PRIVATE FOUNDATION— CHANGING ONE LIFE AT A TIME

JOHN DEDON

Private foundations are not only for the ultra-affluent, as a recent increase in the standard deduction broadens their appeal.

On 12/22/2017, Christmas came early for many taxpayers, when President Donald Trump signed the Tax Cuts and Jobs Act of 2017 (TCJA), effective for most tax returns filed in 2018. But many in the charitable world are concerned that the TCJA will reduce charitable giving. As the Washington Post reported, “Many U.S. charities are worried the tax overhaul bill ... could spur a landmark shift in philanthropy, speeding along the decline of middle-class donors and transforming charitable gift-making into a pursuit largely left to the wealthy.”¹ The concern is based on the following TCJA changes:

1. The increased amount taxpayers can pass to their families estate tax free.
2. The reduced income tax rates, which increase the after-tax cost of charitable contributions.
3. The increased standard deduction, which reduces the number of taxpayers who will itemize deductions and in turn claim charitable income tax deductions.

Taxpayers are most familiar with public charities, such as churches, schools, hospitals, museums and health organizations. Despite the TCJA, public charities may continue to receive their share of donations.² Where the projected reduction in charitable giving will likely be felt the most, is with the poor and distressed and at the grass roots level. According to the *New York Times*, less than 10% of charitable donations

address basic human needs, like sheltering homeless, feeding the hungry or caring for other basic human needs.³ As Dan Cardinali, president of Independent Sector, a national organization dedicated to advancing philanthropy notes, it is deeply disturbing that the TCJA “is now poised to de-incentivize the heart of civic action in America.”⁴

Particularly alarming to those in the charitable world, is that the expected drop in donations to the poor is occurring at the same time that there is a widening gap between the “haves and the have nots.”⁵ According to Benjamin Soskis of the Urban Institute’s Center on Nonprofits and Philanthropy: “That’s a trend that has mirrored wealth inequality—the skewing of giving toward fewer but large donations.”⁶

As explained below, current law already exists not only to compensate for the expected decrease in donations, particularly to the poor, but also to motivate donors who desire to have a more intimate and immediate effect on their charitable giving. The answer is a private foundation, but not the “private foundation” of the super wealthy, or even the very wealthy—instead, a private foundation designed for donors who typically give \$3,000 to \$10,000 per year and want their donations to go directly to individuals for charitable purposes. Indeed, according to the IRS and the data collected from Forms 1040, the average donation to charities is \$4,400.⁷ This article also debunks the accepted notion that the expense, complexity, and compliance of creating a private foundation makes it a tool for only the very wealthy.

JOHN DEDON is of counsel to the law firm of Cameron McEvoy PLLC in Fairfax, Virginia. He practices in the estate planning, asset protection, and business areas and is also the author of the blog, Dedon on Estate Planning. Copyright ©2018, John Dedon.

EXHIBIT 1

Sample Drafting Language for Private Foundation

DONNY AND DEBBIE DONOR FOUNDATION

On this _____ day of _____, 2018, this Trust Agreement is made by and among DONNY DONOR (“Trustor”), and DONNY DONOR and DEBBIE DONOR (collectively, “Trustees”).

ARTICLE 1. ESTABLISHMENT

Trustor hereby establishes the DONNY AND DEBBIE DONOR FOUNDATION (the “Foundation”).

ARTICLE 2. TRUST ESTATE; TRUSTEES

1. Trust Estate. Trustees acknowledge receipt of the property of Trustor described in the attached Schedule A which, together with any other property hereafter transferred to and accepted by Trustees, shall constitute the “trust estate” and shall be administered by Trustees as provided in this agreement.
2. Trustees. The Foundation shall have no fewer than two and no more than seven Trustees. The number of Trustees may be increased or decreased from time to time by agreement of all Trustees.

ARTICLE 3. PURPOSE

The Foundation is organized exclusively for charitable, religious, educational, and/or scientific purposes under section 501(c)(3) of the Internal Revenue Code.

The Foundation will promote charitable purposes, including to make funds available to a broad range of charitable organizations and individuals whose needs correspond to the philanthropic goals of its Trustees and come within the charitable purposes outlined in Section 501(c)(3) of the Internal Revenue Code, provided, however, that:

- (a) no part of the Foundation’s net earnings or assets will, either directly or indirectly, inure to the benefit of the Foundation’s Trustor, Trustees, or any of its employees or their families, or any private individual (except that reasonable compensation may be paid for services rendered to or on behalf of the Foundation, and payments and distributions may be made in furtherance of the purposes set forth in this Article 3);
- (b) no substantial part of the activities of the Foundation shall consist of carrying on propaganda or otherwise attempting to influence legislation (except as may be permitted by Section 501(h) of the Internal Revenue Code, as amended), and the Foundation shall not participate in or intervene in (including the publication or distribution of statements) any political campaign on behalf of any candidate for public office, nor shall the Foundation engage in any activities that are unlawful under applicable federal, state, or local law;
- (c) the Foundation shall not be operated for profit, and it shall not carry on any other activities not permitted to be carried on by a trust exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code, or by a trust to which contributions are deductible under Section 170(c)(2) of the Internal Revenue Code; and
- (d) during such time that the Foundation is deemed to be a private foundation, as defined in Section 509 of the Internal Revenue Code, as amended, the Foundation shall distribute its income and principal, if necessary, in such manner as not to subject the Foundation to tax liability under Section 4942(a) of the Internal Revenue Code, as amended, and the Foundation shall not engage in any act of self-dealing (as defined in Section 4941(d) of the Internal Revenue Code, as amended), retain any excess business holdings (as defined in Section 4943(c) of the Internal Revenue Code, as amended), make any investment which would jeopardize the carrying out of any of its exempt purposes under Section 4944 of the Internal Revenue Code, as amended, or make any taxable expenditures (as defined in Section 4945(d) of the Internal Revenue Code, as amended).

ARTICLE 4. OPERATIONS

The Foundation shall engage in activities that benefit or support the charitable purposes set forth in ARTICLE 3 above.

ARTICLE 5. CONSTRUCTION: RESTRICTIONS

The Foundation is constituted as a tax-exempt trust under Virginia law. Trustees intend that the Foundation qualify as an organization exempt from federal income taxation as a private foundation under Code Section 501(c)(3), meaning such organization is organized exclusively for charitable, religious, educational, and scientific purposes, including, for such purposes, the making of distributions to organizations that qualify as exempt organizations under Code Section 501(c)(3), or corresponding section of any future tax code. This agreement shall be construed accordingly, and all powers and authority of Trustees shall be limited accordingly. Trustees shall have the power to amend this instrument in order to comply with the requirements of Code Sections 501(c)(3), and 509, and the Regulations thereunder, and any such amendment shall be deemed effective as of the date of creation of the trust.

Notwithstanding any other provision of this document, the Foundation shall not carry on any other activities not permitted to be carried on (a) by an organization exempt from federal income tax under Code Section 501(c)(3), or corresponding section of any future federal tax code, or (b) by an organization, contributions to which are deductible under Code Section 170(c)(2), or corresponding section of any future federal tax code.

ARTICLE 6. FISCAL YEAR

The fiscal year of the Foundation shall end on the last day of December, or such other date as may be fixed from time to time by Trustees.

EXHIBIT 1, cont'd
Sample Drafting Language for Private Foundation

ARTICLE 7. DISSOLUTION

Upon the dissolution and final liquidation of the Foundation, and after paying or making provision for the payment of all debts and liabilities of the Foundation, Trustees shall distribute all remaining assets of the trust estate to one or more organizations designated by the Trustees of the Foundation. All organization designated by the Trustees must be duly qualified, organized and operated exclusively for exempt purposes, within the meaning of Section 501(c)(3) of the Internal Revenue Code. Any assets not so distributed shall be distributed by a court of competent jurisdiction in the county or city in which the trust is located, exclusively for such purposes or to such organizations as such court shall determine, which are organized and operated exclusively for such exempt purposes, or to the federal government or a state or local government to be used for a public purpose.

ARTICLE 8. CREATION OF CORPORATION

Trustees are authorized and empowered to form and organize a nonprofit corporation for the uses and purposes of the Foundation, and qualifying as a public charity or a private foundation under Code Sections 501(c)(3) and 509. Such corporation, if organized, shall be named the DONNY AND DEBBIE DONOR FOUNDATION, INC. Upon the creation and organization of such corporation, Trustees are authorized and empowered to convey, transfer and deliver to such corporation all the property and assets to which the Foundation may be or become entitled. It is the purpose of this ARTICLE 8 that the board of directors of such corporation, if incorporated and organized as provided by this ARTICLE 8, shall take the place of Trustees, who shall be the incorporators of such corporation.

ARTICLE 9. GENERAL ADMINISTRATIVE PROVISIONS

Duties of Trustees—

1. Annual Accounting. After the end of each fiscal year for the trust, Trustees shall prepare a statement or statements showing: (a) how the property of the trust is invested; and (b) all transactions relating to the trust for the preceding fiscal year. Trustees shall maintain the accounting statement or statements with the permanent records of the trust.
2. Investments. In acquiring, investing, reinvesting, exchanging, self-dealing, and managing the property of the trust, Trustees shall exercise the judgment and care, under the circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds. In determining the prudence of a particular investment, Trustees shall consider the proposed investment or investment course of action in relation to all property of the trust. Trustees may delegate to others such duties, powers (including discretionary powers), and authority as Trustees think necessary or proper. Trustees may incorporate, or join with others in the incorporation of, any unincorporated farm, business, or business property. If any asset donated to this Trust does not meet the requirements of the prudent man standard, the Trustee may nevertheless retain the asset for so long as the Trustee may deem appropriate.
3. Income. If all the income of the property of the trust is not distributed or applied during a fiscal year, Trustees shall add the undistributed portion to principal.
4. Capital Gains and Losses. Trustees shall allocate long-term capital gains and losses to principal.
5. Common Trust Funds. If a corporation is serving as a Trustee, Trustees may invest all or any portion of the property of the trust in a common trust fund maintained by the corporate Trustee, to which Code Section 584 applies. Trustees shall maintain separate accounts and records which will sufficiently identify the portion of the total common trust fund which constitutes the property of the trust, and the income earned by, or attributable to, such portion.
6. Powers of Trustees. Trustor grants to Trustees the continuing, absolute, discretionary power to deal with any property, real or personal, held in the trust estate as freely as Trustor might in the handling of Trustor's own affairs. In addition, Trustees shall have all of the power, authority and discretion given a trustee under the laws of the Commonwealth of Virginia on this date, including those set forth in Sections 64.2-105 and 64.2-778 of the Code of Virginia (or any successor provisions thereto), which powers are incorporated in this Agreement by this reference. Such powers may be exercised independently and without the approval of any court in Virginia or any other jurisdiction. Such powers shall be exercised by a majority vote of the Trustees, however, Trustees may delegate to a single Trustee the ability to do any acts that the Trustees could vote on collectively.
7. Fees and Expenses of Trustees; Bond. Trustees shall be entitled to reasonable compensation for the acceptance and administration of the trust and for the payments and distributions made by Trustees. Trustees are entitled to extra compensation for unusual or extraordinary services. Trustees shall be reimbursed for all expenses reasonably incurred in the administration of the trust. No bond or other security shall be required of Trustees or any of them in any jurisdiction.
8. Resignation of Trustee; Appointment of Successor Trustee, Officers. Any Trustee shall have the right to resign as a Trustee without court proceedings. The remaining Trustees shall have the right, without court proceedings, to appoint a successor Trustee by a majority vote. No successor Trustee shall be liable for the acts or omissions of any prior Trustee. Trustees may be removed by a majority vote of the Trustees and the remaining Trustees shall have the right, without court proceedings, to appoint a successor Trustee. Trustees may be added as Trustees by the majority vote of the then serving Trustees. DONNY DONOR shall serve as the Foundation's Chairman; DEBBIE DONOR shall serve as the Foundation's President and Secretary. If DONNY DONOR or DEBBIE DONOR shall be unable or unwilling to serve, then the DONORS' children shall serve as successor Co-Trustees of the Foundation.

EXHIBIT 1, cont'd
Sample Drafting Language for Private Foundation

9. Extent of Liability. Trustees shall have the duty to act in good faith and with reasonable care and, in the absence of affirmative evidence to the contrary, shall be deemed to have so acted.
10. Liability of Trustee and Former Trustees.
- A. No Trustee or former Trustee (collectively referred to in this Agreement as the "Indemnified Group") shall be personally liable for:
- (1) any liability or obligation of the Trust under any agreement;
 - (2) errors in judgment (including acting in reliance on the opinion of legal counsel or public accountants or believing in good faith that he or she is acting within the authority granted in this Agreement);
 - (3) any acts or omissions that do not constitute fraud, gross negligence or willful misconduct; or
 - (4) the negligence, whether of omission or commission, dishonesty or bad faith of any employee or agent selected and supervised by a member of the Indemnified Group with reasonable care or of any other member of the Indemnified Group; but each member of the Indemnified Group shall be liable only for his or her respective fraud, gross negligence or willful misconduct.
- B. In any threatened, pending, or completed action, suit, or proceeding (civil or criminal) to which a member of the Indemnified Group was or is a party or is threatened to be made a party by reason of the fact that he or she is or was a Trustee of a Trust, or because he or she executed an agreement for the benefit of a Trust, that Trust shall indemnify and hold harmless that member of the Indemnified Group against all expenses (including reasonable attorneys' and accountants' fees, court costs and expenses), judgments and amounts paid in settlement actually and reasonably incurred by him or her in connection with that action, suit or proceeding if the conduct of that member of the Indemnified Group did not constitute fraud, gross negligence, or willful misconduct.
- C. To the extent that a member of the Indemnified Group has been successful on the merits in seeking indemnification in accordance with this ARTICLE 9, Section 10, the Trust shall indemnify him or her and hold him or her harmless against the expenses (including reasonable attorneys' and accountants' fees, court costs and expenses) actually and reasonably incurred by him or her in seeking that indemnification.
- D. For purposes of ARTICLE 9, Sections 10(B) and 10(C), the termination of any action, suit or proceeding by judgment, order, settlement or otherwise shall not create a presumption that the conduct of a member of the Indemnified Group constituted fraud, gross negligence or willful misconduct.
- E. Expenses (including reasonable attorneys' and accountants' fees, court costs and expenses) incurred in defending any claim, action, suit or proceeding (civil or criminal) shall be paid by the Trust in advance of final disposition of the matter upon receipt of an undertaking by or on behalf of that member of the Indemnified Group to repay that amount if that member of the Indemnified Group is ultimately determined not to be entitled to be indemnified.

ARTICLE 10. LAW GOVERNING; SAVINGS CLAUSE

This instrument shall be governed by the laws of the Commonwealth of Virginia. Any provision prohibited by law or unenforceable shall not affect the remaining provisions of this instrument. However, in any conflict with Code Sections 501(c)(3) or 509 of the Code and the Regulations thereunder, those Code sections and the Regulations shall govern.

EXECUTED by Trustor and Trustees on the day and year first above written. This Agreement may be signed in counterparts, each of which will constitute an original.

TRUSTOR:

DONNY DONOR

TRUSTEES:

DONNY DONOR

DEBBIE DONOR

I, the undersigned, a Notary Public in and for the jurisdiction aforesaid do hereby certify that DONNY DONOR and DEBBIE DONOR personally known to me to be (or satisfactorily proven to be) the persons whose names are signed to the foregoing Trust Agreement, has acknowledged the same before me in my jurisdiction aforesaid.

GIVEN under my hand and seal this ____ day of _____, 2018.

NOTARY PUBLIC

This article also provides a summary of the TCJA provisions affecting charitable donations. Then it discusses the legal basis allowing private foundations to donate directly to individuals for charitable purposes; discusses the cost, creation, and compliance issues pertaining to the “simple” private foundation recommended in this article; and concludes that donors, through their private foundations, can make tax-deductible charitable contributions directly to individuals within a charitable class—and thus help those individuals most likely to suffer the greatest under TCJA. And the private foundation can be created and operated without excessive cost or complication.

TCJA revisions affecting charity

The TCJA’s impact on estate and income tax planning is significant. Turning first to estate tax, the TCJA doubles the taxable threshold per individual to approximately \$11.2 million per person. Thus, for single individuals there is no estate tax unless net assets exceed \$11.2 million upon death. For married couples, there is no estate tax unless the couple’s taxable estates exceed \$22.4 million. Prior to the TCJA, the Tax Policy Center estimated that only about 11,300 estate tax returns will be filed for 2017, of which 5,500 will be taxable.⁸ So even before the passage of the TCJA, estate tax affected only the wealthy; now estate tax affects only the very wealthy. The obvious implication for charitable planning is that couples with assets under \$22.4 million no longer have an estate tax incentive to leave assets to charities to reduce their taxable estates.

Turning to the TCJA and income tax, income tax rates have been reduced to a maximum of 37%, instead of 39.6%. More importantly from a charitable

perspective, the new law almost doubles the standard deduction—the amount everyone is allowed to subtract from their taxable income to lower their tax bill in lieu of itemizing deductions—to \$12,000 for singles (up from \$6,350 for 2017) and \$24,000 for married couples who file jointly (up from \$12,700). With a higher standard deduction, fewer people will itemize their deductions. The Tax Policy Center estimates the number of itemizers will drop from around one-third of income tax filers to only 5%.

And charitable donations are allowed only when a donor itemizes deductions by listing them separately on the donor’s Form 1040. So taxpayers donating tens of thousands of dollars will still itemize, but taxpayers giving \$4,000 or \$5,000 are less motivated to do so.⁹ According to one report, charitable giving could decrease by \$13 billion.¹⁰

The TCJA provisions affecting individuals are scheduled to sunset in 2026, not to mention any federal law can be changed at any time Congress and the President choose. However, for at least the next three to eight years, the TCJA applies.

Alternative route to desired tax result

Charitable donations are expected to decrease in 2018 and future years. If the commentators are correct, the reduction will affect all charities, but the poor and distressed will suffer more than the larger public charities. What can be done about it? One answer is a private foundation to give directly to charitable beneficiaries who are individuals.

What is a 501(c)(3) charity—public vs. private. To distinguish between the churches, schools, hospitals,

¹ Frankel, “Charities Fear Tax Bill Could Turn Philanthropy Into a Pursuit Only for the Rich,” *Washington Post*, 12/23/2017.

² *Id.* “Nonprofits have long noticed that the wealthy are more likely to cut big checks to support museums and universities, while smaller donors tend to give to social service agencies....”

³ Strom, “Big Gifts, Tax Breaks and a Debate on Charity,” *N.Y. Times*, 9/6/2007.

⁴ Frankel, *supra* note 1.

⁵ Nadasen, “Extreme Poverty Returns to America,” *Washington Post*, 12/21/2017, citing a U.N. Report on poverty in America.

⁶ *Id.*

⁷ Frankel, *supra* note 1. The article also reports that the United Way has around 30,000 donors who give \$10,000 a year.

⁸ As stated on its website, The Tax Policy Center is a joint venture of the Urban Institute and Brookings Institution that provides timely, accessible analysis and facts about tax policy to policymakers, journalists, citizens, and researchers.

⁹ Now married taxpayers will add the maximum \$10,000 allowed for state income and property taxes, allowable mortgage interest and medical expenses, and charitable contributions, and if less than \$24,000 they will not itemize.

¹⁰ Tax Policy and Charitable Giving Results, Indiana University Lilly Family School of Philanthropy, 5/17.

¹¹ Charitable purposes are varied, but they include, religious, health, educational, and scientific purposes, and more general “charitable” purposes.

¹² For example, under Section 170(b)(1), contributions to public charities are deductible to the extent they do not exceed 60% of the donor’s adjusted gross income (AGI) in years 2018 through 2025 (50% in other years) versus 30% of AGI for contributions to a private foundation. (The 60% figure was increased from 50% by the TCJA). Further, the general rule for contributions of stock to a public charity is that deductions are at fair market value and limited to 30% of AGI, versus the stock basis and 20% of AGI for private foundations.

¹³ See Sections 4940 through 4945, which except as noted, are not directly relevant to the gist of this article.

¹⁴ As stated earlier, the perception that private foundations are only for wealthy donors is not correct, as posited below.

¹⁵ Ltr. Rul. 8126092.

¹⁶ Ltr. Rul. 200634016. Section 170(c)(2)(B) defines “charitable contribution” as a contribution to any charitable organization for charitable purposes; Reg. 1.501(c)(3)-1(d)(2) defines “charitable” as including “relief of the poor and distressed or of the underprivileged.”

¹⁷ *Id.*

¹⁸ Rev. Rul. 79-19, 1979-1 CB 195.

¹⁹ Rev. Rul. 68-73, 1968-1 CB 251.

²⁰ Armas and Pagnillo, “Best Practices for Charitable Gifts to Individuals,” *Wealth Management.com*, 10/5/2016.

and museums mentioned above, that already do and will continue to receive the bulk of charitable donations, and the private foundation recommended herein to help charitable individuals, some background is helpful.

Charities (often referred to as “501(c)(3) organizations”) differ from other tax-exempt organizations in two significant ways:

1. They satisfy a charitable purpose under Section 501(c)(3).¹¹
2. Contributions to charities are tax-deductible. However, not all charities are treated the same. Generally public charities are the more desirable 501(c)(3) organization, while private foundations have greater restrictions.

What distinguishes a public charity from a private foundation? Typically, the key is the amount of public support (some charities such as churches are “public charities” by class, regardless of support). Public charities generally receive a substantial part of their support from the general public. Therefore, the perception is that the general public serves as a watchdog, and thus less government regulation is required. On the other hand, private foundations typically are created and funded solely by wealthy donors. With limited donors involved in the organization, Congress believes there is a greater opportunity for a private foundation’s donors to take advantage of the tax laws for their personal benefit. As a result, there are advantages to being a public charity,¹² while private foundations are subject to additional restrictions and certain excise taxes.¹³

For purposes of this article, the entity created will be a private foundation because support will likely come solely from one family. Moreover, despite income tax advantages enjoyed by public charities compared to private foundations, those advantages are not consequential for purposes of this article. And finally, as set forth below, a private foundation is necessary to allow charitable donations directly to individuals within a charitable class.¹⁴

Private foundations and legal support for distributions directly to individuals. The law is clear that tax-deductible contributions can be made to private foundations, and private foundations can make “grants” to individuals. Section 4945, which imposes a tax on private foundations and their managers if a private foundation makes a nonqualifying grant to an individual, is the governing provision. Section 4945(g) provides that allowable individual grants include those awarded on an objective and nondiscriminatory basis, pursuant to a procedure approved in advance by the IRS, and are for a scholarship or fellowship and used for study at an educational organization. In addition, grants include prizes and awards, and

grants to achieve a literary, artistic, musical, scientific, teaching, or other similar capacity, skill, or talent of the grantee.

The bulk of the IRS guidance and commentary pertaining to grants covers the Section 4945(g) grants described above. But separate from Section 4945(g) grants, private foundations can also make grants to individuals who are within a charitable class. For example, Reg. 53.4945-4(a)(3) provides that grants include funds distributed to indigent individuals to enable them to purchase furniture.

In later private letter rulings, the IRS approved grants to “indigent individuals and groups to promote the betterment of the general public.” Specifically, the grants were for necessary items such as food, clothing, furniture, and other items of basic sustenance.¹⁵ The IRS has also approved grants to individuals who are impoverished and have desperate financial needs due to being (1) victims (or families of victims) of a natural disaster, violence, terrorist act or act of war; (2) impoverished; or (3) victims of discrimination, social injustice, or persecution. The IRS stated the grants are permissible because they further a charitable purpose under Section 170(c)(2)(B) and are deductible in their own right, separate from the Section 4945(g) grants for education, travel, and the like.¹⁶

The cornerstone is that the grant must satisfy a charitable purpose.¹⁷ And significantly, the IRS includes within a charitable class those who are “distressed” in a broader sense than solely a financial sense. The IRS has issued a number of rulings listing classes of people qualifying for charitable distributions regardless of whether they are financially distressed. For example, within the class of charitable beneficiaries are the elderly. In Rev. Rul. 75-198, 1975-1 CB 157, the IRS stated “the aged, apart from considerations of financial distress alone, are also, as a class, highly susceptible to other forms of distress in the sense that they have special needs.” Other charitable classes include the handicapped¹⁸ and hospital patients¹⁹.

One of the most well-known and generous private foundations making charitable grants directly to or for the benefit of individuals is The Sunshine Lady Foundation, Inc., created and funded by Doris Buffett, the sister of Warren Buffett. According to the Sunshine Lady Foundation’s annual tax returns, each year the foundation makes significant distributions to individuals for charitable purposes. Total distributions to date have been reported to be around \$100 million.²⁰

But what about the limits for charitable deductions? As noted above, under the TCJA, most married taxpayers will claim the \$24,000 standard

deduction because they will not have more than \$24,000 in itemized deductions. Historically, the largest itemized deductions are state and local income and property taxes, mortgage interest deductions, medical expenses, and charitable contributions. But now, with the \$10,000 cap on deducting state and local income and property taxes, and limits on interest and medical expenses, most donors' charitable contributions will not exceed the \$24,000 floor. But what if the "average" donation of \$4,400 was bundled into a single year donation of \$44,000 to be distributed to beneficiaries over ten years? Granted, that is a significant amount for those typically giving \$4,400 annually, but contributions could also be bundled into, for example, a five-year donation of \$22,000. In either event, the charitable donation, coupled with other itemized deductions, again make itemizing worthwhile and contributions income-tax advantaged, in at least that year.

Once inside the private foundation, the funds could be used to distribute the \$4,400 per year or more to charitable individuals.²¹ The donor could use funds inside his or her private foundation (or funds outside of the private foundation) to also give to public charities. But the point is this hypothetical donor accomplished two objectives: charitable contributions were again deductible, and the donor had a direct impact in his or her community, helping those most in need.

Why not a donor advised fund? Donors can establish a donor advised fund (DAF) easily and at low cost. Although they are not without controversy,²² they are a terrific solution for many interested in charitable giving with little compliance or monitoring. However, DAFs do not satisfy the charitable purposes discussed above for one controlling reason: DAFs are prohibited from making

grants to individuals,²³ with narrow exceptions not relevant here.

The "simple" private foundation: cost, creation, and compliance

The premise of this article is that a private foundation is the necessary charitable tool to compensate for the decline in giving that will be felt among the poor and distressed—the very recipients most in need of help. Only through a private foundation can contributions be bundled to again allow donors in selected years to itemize and claim deductions for their contributions. Those contributions can then be distributed to beneficiaries in need.

A common view, however, is that private foundations are only appropriate for the very wealthy who have the time to run them, or if not the time, the resources to retain whatever help they need to do so.

But is this true? Or more accurately, is it true for the "simple private foundation" that is the subject of this article?

Creating the foundation. The creation of a private foundation is a two-step process:

1. An entity needs to be formed under state law.
2. IRS Form 1023 or Form 1023-EZ needs to be filed, seeking IRS approval with the IRS user fee.

The state law entity is typically a trust or a corporation—each is equally acceptable to the IRS. Although corporations are more familiar, primarily because of tradition and a perception that there is greater liability protection, in this instance a trust is recommended. With a trust, there is no state filing or fees. Also, most states limit liability against trustees of tax-exempt entities to the amount of trustee compensation.²⁴ Here, there will not be compensation paid to anyone. The author has received IRS approval for private foundations using the sample trust language in Exhibit 1.

What about the claim that it can take months to create a private foundation? Actually, it is well settled that, upon signing of the trust document, the private foundation is created and, with a tax identification number, is eligible to receive tax-deductible contributions. What takes months is receipt of the IRS Determination Letter approving the foundation. But IRS approval is retroactive to the date the trust was signed. In this instance, where the charitable purpose is clear, and donors will not be engaging in any danger areas, approval is virtually guaranteed.²⁵ ■

²¹ Section 4942 requires private foundations to distribute 5% of the fair market value of their non-charitable-use assets for the current year by the end of the next year. So if the 2018 contribution is \$44,000, then \$2,200 needs to be distributed in 2019, less than the projected payout of \$4,400.

²² Criticisms include the fees the DAFs charge for the money under management and the amount held in accounts without any current gifting requirements.

²³ Section 4966 (c)(1)(A). See the exceptions in Section 4966(d)(2)(B)(ii).
²⁴ E.g., VA Code § 8.01-220.1:1.

²⁵ It is the author's experience that, if the IRS has questions regarding an application, the questions are answered and approval ultimately granted, rather than a rejection.

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