Scripps Heritage Planner

An Income, Estate and Gift Tax Newsletter for Professionals
from the Office of Gift Planning at Scripps Health Foundation

Winter 2013

WHAT ADVISORS SHOULD KNOW ABOUT CHARITABLE ORGANIZATIONS

IN THIS ISSUE:

www.scrippsheritage.org

Scripps Health Foundation

Our Services

The Office of Gift Planning at Scripps Health Foundation is available as a resource to estate planning professionals. Our office will provide these services at no cost or obligation:

• Immediate Telephone Consultations • Charitable Deduction Calculations
• Summary of Benefits • Flow Charts and Graphs • Private Client Meetings
• Presentations at Your Office • Seminars for Clients

Our Website: Resources for Estate Planning Professionals

Please visit us online at www.scrippsheritage.org to find many helpful tools, calculators and links to tax laws and articles. You may also sign up easily for our weekly eNewsletter on our web site.

Upcoming Gift Planning Seminars

Ups and Downs: The State of the San Diego Economy

Wednesday, April 3, 2013 Noon - 1:30 pm

Perspectives on Charitable Remainder Trusts and Charitable Gift Annuities

Wednesday, May 8, 2013 Noon - 1:30 pm

Surveying the 2013 Tax Landscape

Wednesday, June 5, 2013
Special Time: 8:00 - 9:30 am

All presentations will take place
at the Founder's Room, Schaetzel Center for Health Education

Scripps Memorial Hospital La Jolla
9888 Genesee Avenue
La Jolla, CA 92037

See back cover for further information about these educational opportunities.

Scripps Health Foundation

David E. Williams
Senior Director of Gift Planning
858-678-6359
williams.dave@scrippshealth.org

Natalie Ganz
Director of Gift Planning
858-678-6344
ganz.natalie@scrippshealth.org

What Advisors Should Know about Charitable Organizations

Most donors relate to the mission of a charity, not the way the charity is organized. A lengthy explanation of the difference between a tax-exempt organization and a qualified charity could cause a client to tune out. Nonetheless, how a charity is recognized under the Internal Revenue Code can be an important factor in how the donor realizes philanthropic goals.

In this issue of the ***Scripps Heritage Planner***, we compare different types of charitable entities and highlight key characteristics that make an entity a good choice for what the donor wants to accomplish. Specifically, for each type of organization we note significant attributes, how contributions are deducted, certain restrictions on giving, and the particular advantages of making a gift. This is where the professional advisor becomes the key link between the donor and the charity. The professional advisor's explanations and insights are a vital component in the process of the donor making the charitable gift in the way that best benefits both the charity and the donor.

Distinguishing Nonprofits, Tax-Exempt Organizations and Qualified Charities

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

A **nonprofit organization** is a group organized for purposes other than generating profit and in which no part of the organization's income is distributed to its members, directors, or officers. Nonprofit status is conferred under state rather than federal law and the requirements of and benefits to such organizations can vary from state to state.[1]

A **tax-exempt organization** is a nonprofit organization that is exempt from federal income taxation (a clear advantage indeed).[2] However, in order to qualify for tax-exempt status, a nonprofit must be organized and operated exclusively for one or more exempt purposes. IRC Sec. 501(c) lists the types of organizations that may claim tax-exempt status.

A donor can deduct a contribution made to a **qualified charity**. Note that a charity may be qualified for income tax purposes, but not necessarily qualified for gift and/or estate tax purposes; IRC Secs. 170(c), 2522, and 2055(a) individually list the categories of qualified charities for which contributions can be deducted for income, gift and estate tax (respectively).

501(c)(3) Organizations – The Tax-Exempt Exemplar

There are 29 categories of tax-exempt organizations under IRC Sec. 501(c). However, when most people talk about a tax-exempt organization or charity they usually mean an organization that qualifies under IRC Sec. 501(c)(3).

A 501(c)(3) organization includes any corporation, community chest, fund or foundation organized and operated for one of these purposes:

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

No net earnings generated by a 501(c)(3) organization can inure in whole or in part to the benefit of private shareholders or individuals. Furthermore, the organization cannot participate in political elections, nor devote a substantial part of its activities to influencing legislation by propaganda or otherwise.

Charities Considered Qualified for Income Tax Purposes

Though it is not the primary reason why donors give, the income tax charitable deduction is the nexus between philanthropic planning and tax planning.

Here are the categories of charities for which a contribution is deductible under IRC Sec. 170(c):

- A state, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes
- A corporation, trust, community chest, fund, or foundation created or organized in the United States or in any possession thereof, or under the law of the United States, any state, the District of Columbia, or any possession of the United States
- A corporation, trust, community chest, fund, or foundation organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals
- A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization organized in the United States or any of its possessions, where no part of the net earnings of which inures to the benefit of any private shareholder or individual
- In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association,

operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals

- A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incidental to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual

50% or 30%? That Is the Deductibility Question

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

What Is a 50% Organization?

A 50% organization is one of the qualified charities expressly described under IRC Sec. 170(b)(1)(A):

- Churches
- Hospitals and Medical Research Organizations
- Educational Organizations
- Governmental Units
- Publicly Supported Charities
- Certain Private Foundations
- Supporting Organizations

Concerning Publicly Supported Charities

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

1. A charity that normally receives a substantial part of its support from governmental units and/or direct or indirect contributions from the general public. This support does not include income received in the exercise or performance of its tax-exempt purpose.[4]
2. A charity that normally receives more than one-third of its support annually from any combination of gifts, grants, contributions or membership fees and gross receipts from admissions, sales of merchandise, performance of services, or the furnishing of facilities in an activity which is not an unrelated trade or business, and normally receives not more than one-third of its support from gross investment income and net unrelated business taxable income.[5]

What Is a 30% Organization?

Simply put, a 30% organization refers to all qualified charities not described under IRC Sec. 170(b)(1)(A)—generally speaking, this would be a private foundation as defined under IRC Sec. 509(a).

Deductibility Distinctions

Understanding the differences between a 50% organization and a 30% organization provides the basis for looking at how charitable contributions to each type of organization are deducted. For the sake of clarity, 50% organizations and 30% organizations will be referred to as public charities and private foundations, respectively.

The donor's *contribution base* is the donor's adjusted gross income without regard to any net operating loss carryback to the taxable year.[6]

Cash Gifts

- A cash contribution to a public charity is deductible up to 50% of the donor's tax contribution base[7]
- A cash contribution to a private foundation is deductible up to 30% of the donor's contribution base[8]

Appreciated Property Gifts

- A contribution of property to a public charity is deductible up to 30% of the donor's tax contribution base[9]
- The same contribution to a private foundation is deductible up to 20% of the donor's contribution base[10]

Valuation of Appreciated Property Gifts

- A contribution of appreciated property to a public charity is deductible at its full fair market value if the sale of the property would have resulted in long-term capital gain[11]
- Generally speaking, the same contribution to a private foundation is deductible only at its tax basis as ordinary income property,[12] with one significant exception—a gift of qualified appreciated stock (defined as publicly traded stock that would produce long-term capital gain if sold) can be deducted at its fair market value[13]

An Option When Giving to a Public Charity

A donor who gives appreciated property to a public charity may choose to value the property at its income tax basis rather than its fair market value. In doing so, the donor gains the advantage of deducting the contribution at 50% of the donor's tax contribution base as if it were a gift of cash.[14] This would be a sensible choice if there were little appreciation in the property (difference between the fair market value and the donor's tax basis) and/or the donor wanted to deduct a greater percentage of the contribution base in that particular tax year.

Gifts "for the use of" Charities

In most instances a gift is made directly to the charity, but occasionally a gift may be made "for the use of" the charity instead of "to" the charity. When gifts are made "for the use of" a charity, the applicable percentage limitations are the same as those for 30% organizations.[15]

For example, Joan owns a life insurance policy, which she gives to her favorite charity. There are a few more premium payments left to be made, and Joan wants to help out.

- If Joan sends a check in the amount of the premium to the charity, that is a gift "to" the charity, subject to the 50% limit
- If Joan pays the premium by sending money directly to the insurance company, that is a gift "for the use of" the charity, and therefore subject to the lower 30% limit

Supporting Organizations

Supporting organizations are 501(c)(3) organizations created to "support" a public charity (or charities).[16] Although a single donor or a family may establish one, supporting organizations are classified as public charities rather than private foundations. The close relationship between the supporting organization and a pubic charity (or charities) engenders a greater degree of supervision by the overseeing charity, which reduces improprieties.[17]

What Qualifies as a Supporting Organization?

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

1. Organizational and Operational Tests

A supporting organization must be organized and operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of the supported public charity or charities.[18]

2. Control Test

A supporting organization may not be controlled directly or indirectly by a disqualified person.[19] Under the IRC, a disqualified person is any one of the following:

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

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

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

- The power to veto actions of the organization[21]
- The right to designate who receives the income or principal from contributions[22]
- A larger than 50% voting power on the supporting organization's governing body[23]

3. Relationship Test

An organization must maintain one of three types of relationships with a public charity in order to be classified as a supporting organization:

- **"Operated, Supervised, or Controlled By"** This relationship compares to a parent company and its subsidiary, with the public charity holding a large degree of control over the policies and actions of its supporting organization. A majority of the governing body of the supporting organization is appointed or elected by the "supported" public charity.[24]
- **"Supervised or Controlled in Connection With"** This relationship requires the supporting organization to be "supervised or controlled in connection with" the public charity. There is common control and supervision since the same person (or persons) is in charge of both entities.[25]
- **"Operated in Connection With"** The third type of relationship is the most dynamic since it contains two subtests:
- The Responsiveness Test requires the supporting organization to be responsive to the needs and demands of the "supported" public charity or charities[26]
- The Integral Part Test requires the supporting organization to maintain "a significant involvement in the operations of one or more publicly supported organizations, and such publicly supported organizations in turn depend on the supporting organization for the type of support which it provides"[27]

Advantages of a Supporting Organization for a Donor

Creating a supporting organization provides advantages to the donor over creating a private foundation. A supporting organization:

- Is a 50% organization
- Is not burdened with the restrictions associated with private foundations
- Can achieve greater economic efficiencies by sharing staff and facilities with the "supported" public charity
- Can better maintain the donor's philanthropic wishes in perpetuity (with a private foundation, the donor's philanthropic goals may not be what surviving family members eventually pursue)

Donor Advised Funds

In recent years, donor advised funds (DAFs) have become one of the most popular charitable giving vehicles. This popularity is fueled largely by the growth of community foundations (which can offer these restricted accounts) and marketing from those commercial brokerage firms that have created a charitable arm to sponsor and maintain the DAF (e.g., Vanguard Charitable).

Definition

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

- Be solely owned and controlled by the sponsoring organization
- Be sequestered and separated from the sponsor's general fund and specifically identified by reference to a specific donor (or group of donors) in that all contributions must be attributable to the named donor (or group)
- Offer the donor advisory privileges with respect to distributions from the fund[28]

Restrictions

Although the donor may provide advice, the donor may not place any material restrictions on the fund's distribution. Material restrictions would cause the gift to be incomplete,[29] and therefore not deductible.

What constitutes a material restriction is a question that must be determined by looking at all the facts and circumstances. However, the following questions should be considered in determining whether a donor has placed a material restriction or condition on a contribution:

- Who owns the assets received from the donor?
- Are the assets held and administered by the donee charitable organization for the purposes of furthering the charitable organization's exempt purposes?
- Does the donee charitable organization's governing body have the ultimate control over the assets?
- Is the donee charitable organization's governing body organized and operated independently from the donor?[30]

Factors used to identify an independent governing body include the selection of the governing body, the terms of service for governing board members, and terms of renewal of service time for governing board members.[31]

Advantages of a DAF for a Donor

Donating to a DAF offers advantages to the donor:

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

Community Foundations

Community foundations have traditionally been the main providers of DAFs, but community foundations also offer a great deal more to the donor as a philanthropic partner. A community foundation provides help in grantmaking and has knowledge of both the potential grant-recipient charitable organizations and the community's charitable needs. Some community foundations place geographic restrictions on distributions from the funds, so donors will need to be aware of any such restrictions.

Types of Funds

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

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

Advantages of a Community Foundation for a Donor

Community foundations are attractive to donors because they offer many of the same benefits as private foundations, without some of the drawbacks.

- A gift to a community foundation generally provides a larger charitable tax deduction than a comparable gift to a private foundation
- Private foundation restrictions (and accompanying penalties for non-compliance) don't apply to community foundations
- A gift to a community foundation requires less in administrative and set-up costs than a comparable gift to a private foundation

Concerning Publicly Supported Charities

Generally, the term "private foundation" refers to a 30% organization. However, as noted above, there are certain private foundations that qualify as public charities for the purpose of deducting charitable contributions: private operating foundations,[32] pass-through foundations[33] and pooled fund foundations.[34]

Private Foundations

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

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

- Sales, exchanges or leases of property
- Loans
- Furnishing of goods, services or facilities
- Paying compensation
- Transferring income or assets from the foundation to the donor
- Payment to government officials[35]

2. Failure to Distribute at Least a Minimum Amount of the Foundation's Income for Exempt Purposes – The law requires a foundation to distribute annually the greater of:

- The foundation's adjusted net income for the tax year, or
- A minimum percentage of its investment assets (as valued for each tax year)[36]

3. Holding Business Enterprises in Excess of Specified Maximum Ceilings – Disqualified individuals are prohibited from:

- Owning more than 20% of the voting stock of any corporation, or
- Owning more than 35% of the voting stock of any corporation, if an unrelated party has effective control[37]

If disqualified persons do not own more than 20% of the voting stock, the private foundation may own the corporation's non-voting stock.

4. Investments that Jeopardize Tax-Exempt Status – A private foundation is prohibited from investing either principal or income in a way that would jeopardize its exempt purposes.[38] Although there is not a list of categories naming investments that violate the rules per se, the IRS will pay close scrutiny to the following activities:

- Trading securities on margin
- Trading in commodity futures
- Investment in working interests in oil and gas wells
- Buying warrants
- Selling short[39]

5. Expenditures for Lobbying – A private foundation must not engage in the following "taxable expenditures," including:

- Influencing legislation
- Influencing the outcome of a public election
- Making grants for non-charitable purposes
- Making grants to non-public charitable organizations (unless the foundation exercises "expenditure responsibility")
- Making grants to any individual for study or travel (unless the IRS approves in advance the grant-making procedures)[40]

Endnotes

1 For example, see the Revised Uniform Unincorporated Nonprofit Association Act—a law promulgated by the National Conference of Commissioners on Uniform State Laws—which governs all unincorporated nonprofit associations that are formed or operate in a state that adopts the act.

2 IRC Sec. 501(a).

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

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

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

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

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

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

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

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

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

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

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

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

15 IRC Sec. 1.170A-8(a)(2).

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

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

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

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

20 IRC Sec. 4946.

21 Reg. Sec. 1.509(a)-4(j)(1).

22 IRC Sec. 170(b)(1)(E)(iii).

23 Reg. Sec. 1.509(a)-4(j)(1).

24 Reg. Sec. 1.509(a)-4(g).

25 Reg. Sec. 1.509(a)-4(h).

26 Reg. Sec. 1.509(a)-4(i)(2)(i).

27 Reg. Sec. 1.509(a)-4(i)(3)(i).

28 IRC Sec. 4966(d)(2)(A).

29 IRC Sec. 170(f)(18)(B).

30 Reg. Sec. 1.507-2(a)(7)(i).

31 Reg. Sec. 1.507-2(a)(7)(ii).

32 Reg. Secs. 53.4942(b)-1 and 2

33 IRC Secs. 170(b)(1)(A)(vii) and (b)(1)(F)(ii)

34 IRC Secs. 170(b)(1)(A)(vii) and (b)(1)(F)(iii)

35 IRC Sec. 4941(d).

36 IRC Sec. 4942.

37 IRC Sec. 4943.

38 IRC Sec. 4944.

39 Reg. Sec. 53.4944-1(a)(2)(i).

40 IRC Sec. 4945.

Upcoming Gift Planning Seminars

Complimentary lunch/breakfast and self-parking are provided – MCLE credit is offered and available for those who qualify.

All presentations will take place at: Founder's Room, Schaetzel Center for Health Education

Scripps Memorial Hospital La Jolla • 9888 Genesee Avenue • La Jolla, CA 92037

To make a reservation: email giftplanning@scrippshealth.org or call 858-678-7120

Ups and Downs: The State of the San Diego Economy

Wednesday, April 3, 2013 Noon - 1:30 pm

Presented by:

Alan Nevin, Principal, The London Group

Issues related to the economy often are prominent in the headlines and of primary concern for individuals while planning their estates. Drawing on his experience as an economist and real estate expert, our speaker will provide an update on the status of the San Diego economy, both the highs and the lows, highlighting the role of the residential, commercial, and rental real estate markets

By Reservation Only – Deadline: Friday, March 29, 2013

Perspectives on Charitable Remainder Trusts and Charitable Gift Annuities

Wednesday, May 8, 2013 Noon - 1:30 pm

Presented by:

Frederick R. Vandeveer, Partner, McKenna, Long & Aldridge, LLP

David E. Williams, Senior Director of Gift Planning, Scripps Health

Charitable Remainder Trusts and Charitable Gift Annuities share many similar features such as providing income and to a donor, a charitable income tax deduction and other valuable tax benefits, and a gift to charity. Yet, they differ in important ways. Our speakers will provide a side-by-side comparison of the features and functioning of these two charitable gift vehicles. They will also compare and contrast the perspectives advisors and charities have with regard to Trustee selection, payout rates, and naming a charity as an irrevocable beneficiary.

By Reservation Only – Deadline: Friday, May 3, 2013

Surveying the 2013 Tax Landscape

Wednesday, June 5, 2013 Special Time: 8:00 - 9:30 am

Presented by:

Dorothy McLin, CPA, MGO Mensch

Natalie Ganz, Director of Gift Planning, Scripps Health

With the passage of the American Taxpayer Relief Act of 2012 and the implementation of certain tax provisions included in the "Affordable Care Act", advisors face many changes to the tax laws in 2013. Our speakers will review key new provisions that are in place this year and how they may impact your clients' plans. Included in the discussion will be an overview of how charitable giving will be treated under the new laws.

By Reservation Only – Deadline: Friday, May 31, 2013

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David E. Williams
Senior Director of Gift Planning
858-678-6359
williams.dave@scrippshealth.org

Natalie Ganz
Director of Gift Planning
858-678-6344
ganz.natalie@scrippshealth.org

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