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FEDERAL TAX ASPECTS OF NON-PROFIT ORGANIZATIONS

By MARCUS SCHOENFELD†

THE EXEMPTION FROM Federal income tax is of major importance to potentially eligible non-profit associations, trusts, and corporations. Possibly it is the single most important factor in many decisions to create or maintain non-profit organizations.

If an organization meets the tests set forth in the Internal Revenue Code, it is "exempt from taxation."¹ Note that the categorization under state law of a corporation or association as "charitable" or "non-profit" does not determine its Federal tax status. An organization is exempted from Federal income tax *only* if it meets the tests of the Internal Revenue Code. Most classes which may qualify for tax-exemption are listed in section 501(c); however, a few classes are exempted by sections 401, 501(d), 521, and 526.

For purposes of this paper, it will be assumed that the organization in question is clearly within one or another of the statutory classifications of exemption.²

PART 1: EXEMPTION FROM FEDERAL INCOME TAX

However, even if the organization is so qualified, to be fully exempt certain pitfalls must be avoided. For example, it must comply with certain filing requirements. It may lose exemption in whole or in part if it is a "feeder organization," if it engages in a "prohibited transaction," or if it has "unrelated business income." Each of these will be discussed in turn.

Filing requirement. Even if an organization is squarely within an exempt category, it is fact not exempt until it files the appropriate form with the District Director of Internal Revenue for the district within which its principal office or place of business is located.³

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1. I.R.C. § 501(a) (1954), 26 U.S.C. § 501(a). Unless otherwise stated, all citations hereinafter are to the INTERNAL REVENUE CODE OF 1954, as amended. The corresponding citation to Title 26 of the U.S. Code will be omitted.

2. For a discussion of problems which may arise with respect to classification, see the author's contribution to Oleck, Non-Profit Corporations and Associations (2d ed., Prentice-Hall, to be published 1965) Chapter 28.

3. Reg. § 1.501(a)-1(a) (2) (1959). A § 401 employees trust need not so file. *Ibid.*

The proper form for each type of organization is:⁴

Form 1024: Section 501(c)(4), (5), (6), or (8) organizations.

Form 1025: Section 501(c)(7) organizations.

Form 1026: Section 501(c)(2), (12), (13), or (15) organizations.

Form 1027: Section 501(c)(9) or (17) organizations.

Form 1028: Section 521 farmers' organizations.

Credit unions under section 501(c)(14) must show compliance with state law.⁵ All other types of exempt organization must file an application for exemption showing all facts relating to exemption.⁶

In addition, mutual insurance companies must file a copy of their policies,⁷ and title-holding companies (described in section 501(c)(2)) must show that the organizations for which they hold titles are exempt.⁸

A charitable organization (under section 501(c)(3)) must give a detailed statement of its proposed activities.⁹

Whatever form or application is filed, a copy of the articles of incorporation, declaration of trust, or similar document, must be attached, along with copies of all bylaws or regulations; finally, the latest financial statements of the organization must be attached.¹⁰

Once the organization is determined to be exempt, it may rely on such determination unless there is a change of law or regulations.¹¹ However, the mere fact that the 1954 Code renumbered and reenacted provisions of the 1939 Code would not require a reapplication for exemption;¹² this reapplication would be required only if there were a substantive change in law.¹³ If the organization has undergone a "substantial" change of character or purpose it may not rely on an exemption ruling issued with respect to its previous status.¹⁴ Of course, if the application for exemption does not fully disclose the facts, an exemption ruling based upon these incomplete facts is not valid.¹⁵

At one time the application could not be filed until the organization

4. Reg. § 1.501(a)-1(a)(3)(i) (1959); § 1.521-1(e) (1963).

5. Reg. § 1.501(a)-1(a)(3)(i) (1959).

6. *Ibid.*

7. Reg. § 1.501(a)-1(b)(i) (1959).

8. Reg. § 1.501(a)-1(b)(ii) (1959).

9. Reg. § 1.501(a)-1(b)(iii) (1959).

10. Reg. § 1.501(a)-1(a)(3)(i) (1959).

11. Reg. § 1.501(a)-1(a)(2) (1959).

12. *Ibid.*

13. *Ibid.*

14. *Ibid.*

15. Southern Maryland Agricultural Fair Ass'n, 40 B.T.A. 549 (1939).

had been in *active operation* for twelve months; but such ruling will be issued even in advance of any operation if the proposed operations can be described in such detail that the organization will be clearly exempt.¹⁶ Until the Revenue Service determines the organization to be tax-exempt, it must either file a regular corporate return and pay the indicated tax, or it must ask for an extension of time to file a return.¹⁷

Even if exemption has been granted, the organization still must file an annual information return.¹⁸

"Feeder" Organizations. A "feeder" is an organization which carries on a trade or business for profit, and pays this profit to a tax-exempt organization.¹⁹ For example, a spaghetti company which pays its profits over to a university would be a "feeder."²⁰ A "feeder" is not exempt from tax.²¹ Thus it is taxable on its entire income, not on just its unrelated business income.²²

It is important to distinguish a "feeder" from a mere "title holder," which is exempt under section 501(c)(2). The latter is a mere passive holder of property; the "feeder" actively carries on a trade or business. For this purpose only, rental of real estate is not deemed to be a trade or business.²³

Unrelated Business Income. Certain exempt organizations — those qualifying for exemption under section 501(c)(2), (3), (5), (6), and (17), or under section 401 — must pay tax on their "unrelated business income."²⁴ Such tax also applies to colleges and universities owned or operated by any state or political subdivision thereof.²⁵

The organization neither loses its exemption, nor is it taxable on all of its income. Rather it is taxable only on its gross income from any "unrelated trade or business," less the allowable deductions directly connected with such trade or business.²⁶

Certain exceptions to this general rule exist;²⁷ for example: dividends, interest, rents from realty (except "business leases" as defined in section 514), and sales of capital assets, are generally not included in "unrelated business income."²⁸ The details of these exceptions are often complicated and are beyond the scope of this work.

16. Rev. Proc. 63-30, 1963-2 C.B. 769, *modifying* Rev. Proc. 62-30, 1962-2 C.B. 512.

17. Rev. Rul. 60-144, 1960-1 C.B. 636.

18. I.R.C. § 6033 (1954).

19. I.R.C. § 502 (1954); Reg. § 1.502-1 (1963).

20. See *C. F. Mueller Co. v. Comm.*, 190 F.2d 120 (3d Cir. 1951).

21. I.R.C. § 502 (1954).

22. *Sico Foundation, v. U.S.*, 295 F.2d 924 (Ct. Cl. 1961), *rehearing denied*, 297 F.2d 557 (Ct. Cl. 1962).

23. I.R.C. § 502 (1954); Reg. § 1.502-1(a) (1963).

24. I.R.C. § 511(a) (1954).

25. I.R.C. § 511(a)(2)(B) (1954).

26. I.R.C. § 512(a) (1954).

27. I.R.C. § 512(b) (1954); Reg. § 1.512(b)-1 (1958).

28. *Ibid.*

An "unrelated trade or business" is one which meets two conditions:²⁹

First it must be a "trade or business" "regularly carried on" by the organization.³⁰ "Trade or business" has been well defined under section 162, and this definition applies here.³¹ "Regularly" means that the activity is conducted with sufficient consistency to indicate a continuing purpose to derive income from such activity, even if performance is infrequent or seasonal.³²

The second condition is that the trade or business must be one which is not substantially related to the purpose or function which is the basis for the organization's exemption (aside from the production of income).³³ Thus an agricultural college may operate a wheat farm, and this will be related to the purpose of its exemption.³⁴

It should be noted that a church, convention, or association of churches is exempted from the tax on unrelated business income.³⁵ Only the church (or association of churches) itself is exempt; other religious organizations (*e.g.*, religious orders) are not so exempt.³⁶ The Regulations define "church" or "association of churches" in great detail.³⁷

Denial of Certain Losses, Expenses, and Interest. Certain losses sustained on sales or exchanges between charitable organizations and persons controlling said organizations are not allowable.³⁸ Similarly, certain expense deductions and interest deductions may be lost between these parties if not actually paid.³⁹

Prohibited Transactions. If a charitable organization exempt under section 501(c)(3), or any trust exempt under section 401 or section 501(c)(17) engages in certain transactions with certain persons it loses its exemption.⁴⁰ This is true even if it would be fully qualified for exemption but for section 503.

The organizations potentially subject to this loss of exemption are any:⁴¹

. . . organization described in section 501(c)(3) or (17) or section 401(a) except—

29. I.R.C. § 513 (1954); Reg. § 1.513-1(a) (1961).

30. Reg. § 1.513-1(a)(1) and (2) (1961).

31. Reg. § 1.513-1(a)(1) (1961).

32. Reg. § 1.513-1(a)(3) (1961).

33. Reg. § 1.513-1(a)(4) (1961).

34. *Ibid.*

35. I.R.C. § 511(a)(2)(A) (1954).

36. Reg. § 1.511-2(a)(3)(i) (1958).

37. Reg. § 1.511-2(a)(3)(ii) (1958).

38. I.R.C. § 267(a)(1), (b)(9) (1954).

39. I.R.C. § 267(a)(2), (b)(9) (1954).

40. I.R.C. § 503(a)(1) (1954).

41. I.R.C. § 503(b) (1954).

- (1) a religious organization (other than a trust);
- (2) an educational organization which normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on;
- (3) an organization which normally receives a substantial part of its support (exclusive of income received in the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501(a)) from the United States or any State or political subdivision thereof or from direct or indirect contributions from the general public;
- (4) an organization which is operated, supervised, controlled, or principally supported by a religious organization (other than a trust) which is itself not subject to the provisions of this section; and
- (5) an organization the principal purposes or functions of which are the providing of medical or hospital care or medical education or medical research or agricultural research.

Thus, if any 501(c)(17) or 401(a) organization or any 501(c)(3) organization except those listed above, engages in certain transactions with the following persons, the exemption is lost. These persons are:⁴²

. . . the creator of such organization (if a trust); a person who has made a substantial contribution to such organization; a member of the family (as defined in section 267(c)(4)) of an individual who is the creator of such trust or who has made a substantial contribution to such organization; or a corporation controlled by such creator or person through the ownership directly or indirectly, of 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of the corporation.

The transactions which involve the loss of exemption are those in which the organization:⁴³

- (1) lends any part of its income or corpus, without the receipt of adequate security and a reasonable rate of interest to;
- (2) pays any compensation, in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered, to;
- (3) makes any part of its services available on a preferential basis to;

42. I.R.C. § 503(c) (1954).

43. *Ibid.*

(4) makes any substantial purchase of securities or any other property, for more than adequate consideration in money or money's worth, from;

(5) sells any substantial part of its securities or other property, for less than an adequate consideration in money or money's worth, to; or

(6) engages in any other transaction which results in a substantial diversion of its income or corpus to;

any of the persons listed above.

"Adequate security" with respect to prohibited loans means something more than a mere promise to pay, or stock in the borrowing company; in general, it must be something that may be sold or disposed of on default, of such a nature that it may reasonably be anticipated that no loss of principal or interest will result from the loan.⁴⁴

Certain highly technical provisions modify these rules for loans made by section 401(a) and section 501(c)(17) trusts to the employer involved.⁴⁵

Certain trusts which may benefit owner-employees are subject to even more stringent rules concerning what transactions are "prohibited."⁴⁶

The prohibited transaction does not of itself cause loss of exemption. Such denial of exemption occurs only for the first taxable year after the taxable year in which the Commissioner sends notice of the prohibited transaction (by registered or certified mail) to the organization.⁴⁷ However, if the organization entered into the transaction with the purpose of diverting a substantial part of corpus or income from the exempt purposes, no such notice is required.⁴⁸

An organization which loses its exemption because of section 503 may regain its exemption in the following taxable year by filing a new application for exemption together with an affidavit by the principal officer that the organization will not knowingly engage in another prohibited transaction.⁴⁹ Such reexemption will be granted only for the year following the application; thus the organization must be denied exemption from taxation for at least one year.⁵⁰

In any year in which the organization actually loses its exemption under section 503, any donor to the corporation loses any charitable

44. Reg. § 1.503(c)-1(b) (1960).

45. I.R.C. § 503(h), (i) (1954); Reg. § 1.503(h), 1.503(i) (1960).

46. I.R.C. § 503(j) (1954) (added in 1962).

47. I.R.C. § 503(a)(2) (1954); Reg. § 1.503(a)-1(b) (1964).

48. *Ibid.*

49. I.R.C. § 503(d) (1954); Reg. § 1.503(d)-1(a) (1958).

50. Reg. § 1.503(d)-1(b) (1958).

deduction under the income tax, the estate tax, and the gift tax.⁵¹ In addition, in any case where notice is not required because of an actual purpose to divert substantial corpus or income, the donor also loses the charitable deduction for the taxable year of the prohibited transaction and all subsequent years, if the donor or any member of his family was a party to the prohibited transaction.⁵²

Note that a non-exempt trust normally enjoys an unlimited charitable contribution deduction.⁵³ By analogy with section 503, however, such trust will have its charitable deduction limited to 20 percent of its taxable income should it engage in a "prohibited transaction."⁵⁴

Unreasonable accumulation of income. Any charitable organization which would be subject to section 503 ("prohibited transactions") is also subject to a loss of exemption:

... for the taxable year if the amounts accumulated out of income during the taxable year or any prior taxable year and not actually paid out by the end of the taxable year—

(1) are unreasonable in amount or duration in order to carry out the charitable, educational, or other purpose or function constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3); or

(2) are used to a substantial degree for purposes or functions other than those constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3); or

(3) are invested in such a manner as to jeopardize the carrying out of the charitable, educational, or other purpose or function constituting the basis for exemption under section 501(a) of an organization described in section 501(c)(3).⁵⁵

"Income" for purposes of this test is determined under the principles applicable to a section 316 calculation of "earnings and profits."⁵⁶

There is no need for annual distributions of income; income may be accumulated to permit accomplishing a concrete charitable purpose, if the program as a whole is reasonable.⁵⁷ The amount accumulated becomes unreasonable when more income is accumulated than is needed, or if the duration of accumulation is longer than needed.⁵⁸

Loss of exemption under section 504 does *not* affect deductibility of contributions for the year of disallowance or for prior years.⁵⁹ The

51. I.R.C. § 503(e) (1954).

52. *Ibid.*

53. I.R.C. § 642(c) (1954).

54. I.R.C. § 681(b) (1954).

55. I.R.C. § 504(a) (1954). Note there are special rules for certain testamentary trusts.

56. Reg. § 1.504-1(c) (1958).

57. *Samuel Friedland Foundation v. U.S.*, 144 F. Supp. 74 (D.C. N.J. 1956).

58. Reg. § 1.504-1(b)(1) (1958).

59. Reg. § 1.504-1(f) (1958).

procedure for regaining a lost exemption is much the same as under section 503.⁶⁰

Note that a non-exempt trust normally has an unlimited charitable contribution deduction.⁶¹ However, by analogy with section 504, should a non-exempt trust unreasonably accumulate income, its charitable deduction is limited to 20 percent of its taxable income.⁶²

PART 2: DEDUCTIBILITY OF CONTRIBUTIONS TO CHARITABLE ORGANIZATIONS

Charity is twice blest by the Internal Revenue Code. Not only is it exempt from tax itself, but those who contribute to charitable organizations are potentially entitled to a deduction for the contribution on their own tax returns. Such deduction is allowable not only for the income tax,⁶³ but also for the estate tax,⁶⁴ and the gift tax,⁶⁵ this discussion will be concerned only with the possible income tax deduction. In general, however, the considerations involved in estate or gift tax deductibility are similar.

To be deductible, the contribution must be made to a certain type of organization. In general, the deduction is allowable only in the year it is actually paid (not just pledged). If the gift is of property other than money, certain valuation problems appear. Generally, the amount of the deduction is limited to a specified percentage of the donor's income; certain contributions in excess of these limitations may be deductible in a future year. Each of these will be discussed in turn.

What donees are "charitable." Section 170(c) defines "charitable contribution" as:

a contribution or gift to or for the use of—

(1) A State, a Territory, 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.

(2) A corporation, trust, or community chest, fund, or foundation—

(A) created or organized, in the United States or in any possession thereof, or under the law of the United States, any State or Territory, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes or for the prevention of cruelty to children or animals;

60. Reg. § 1.504-1(e) (1958).

61. I.R.C. § 642(c) (1954).

62. I.R.C. § 681(c) (1954).

63. I.R.C. § 170 (1954).

64. I.R.C. § 2055 (1954).

65. I.R.C. § 2522 (1954).

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B).

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization—

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) 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.

(5) 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 incident 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.

Note that the gift may be "to" a qualifying organization or "for the use of" such organization. Note also that the requirements of section 170(c)(2) are almost identical to those of section 501(c)(3) (relating to exemption from tax).⁶⁶

In practice, the taxpayer claiming the charitable deduction usually does not need to show that the donee is qualified under section 170(c). This is so because a contribution to any organization listed in a currently-supplemented Treasury publication⁶⁷ is deemed to have been made to a qualified charity. If the donee is not currently listed therein, the donor must show qualification of the donee under section 170(c).

66. Section 170(c)(2) specifically lists "trusts" and 170(c)(2)(A) requires the organization to be domestic; section 501(c)(3) does neither. Section 501(c)(3) lists "testing for public safety" as a charitable purpose, and 170(c)(2)(B) does not; 501(c)(3) prohibits political campaigning and 170(c)(2) does not — but most cases are likely to be covered by the propaganda or legislation test. Otherwise the subsections are identical.

67. Cumulative List of Organizations Described in § 170(c) of the INT. REV. CODE OF 1954, I.R.S. Publication No. 78 (Rev. 12-62). Supplemented bi-monthly.

While the courts generally tend to favor charity, in each instance the statutory requirements for qualification must be complied with exactly. For example, a contribution to a section 170(c)(1) organization must be "for exclusively public purposes." Similarly only an "individual" (*i.e.*, not a trust or corporation) may claim a deduction under section 170(c)(4), and then only if the charitable purpose test is met. And a corporation giving to a section 170(c)(2) organization is entitled to a deduction only if either the gift will be used within the United States, or the recipient also is a corporation. In general, however, "charitable" is broadly construed under section 170(c)(2). For example, a dominant purpose ". . . free of all personal, private, or selfish considerations" is charitable.⁶⁸

Since the recipient must be an organization listed in section 170(c) in order to qualify for the deduction, gifts to individuals — however worthy — can never qualify for a charitable deduction.

Maintenance of certain students. A taxpayer who takes a primary or secondary school student into his household may claim a charitable deduction for the costs of maintaining the student, if it is done pursuant to a plan of a sponsoring charity.⁶⁹

Timing of the deduction. Any charitable contribution is deductible if actually paid during the taxable year, regardless of the taxpayer's method of accounting (*i.e.*, cash method or accrual method).⁷⁰ An accrual basis corporation may also elect to deduct the contribution in the year the directors authorize payment, but only if payment is actually made within two and one half months of the end of that year. All other taxpayers are limited to a deduction in the year of payment. However, there is a "carryover,"⁷¹ which may create a deduction in a later year. In general, the time of delivery or of mailing is the time of the contribution.⁷²

Valuation of the contribution. The amount potentially deductible when property other than money is contributed to charity is the fair market value of the property at the time the contribution is made.⁷³

However, if the property consists of assets which are inventory in the hands of the donor, the potential deduction is the lowest price the donor would have received if he had sold the property in his usual markets.⁷⁴ In any case, amounts expended in producing or acquiring the contributed property (and which are reflected in cost of goods sold for the year of contribution) are not allowable in computing cost of

68. Isabel Peters, 18 T.C. 55, 59 (1953).

69. I.R.C. § 170(d) (1954); Reg. § 1.170-2(f) (1963).

70. I.R.C. § 170(a) (1954); Reg. § 1.170-1(a) (1963).

71. See *infra* text at note 109 ff.

72. Reg. § 1.170-1(b) (1962).

73. Reg. § 1.170-1(c) (1963).

74. *Ibid.*

goods sold for the year of contribution;⁷⁵ this prevents a double deduction for the same expenditure.

No deduction is allowed for a contribution of services.⁷⁶ However, unreimbursed expenses incurred as an incident to performing the donated services may be deductible contributions.⁷⁷

The rental value of property which a charity is permitted to use and occupy rent-free is not deductible, since no *payment* has been made to or for the use of the charitable organization.⁷⁸

The Regulations recognize that a transfer of property may be in part a gift and in part a sale.⁷⁹ When such "bargain sale" is made to a charity the portion which is a gift is deductible, even if the motive for the "bargain sale" is to avoid a realization of the appreciated value of the asset by the donor.⁸⁰ However, the donor must be able to show that the fair market value of the asset in fact exceeded the sale price.⁸¹

A donation of property subject to a mortgage or a debt is deductible to the extent of the donor's equity.⁸² However, the contribution of such encumbered property presents additional problems.

First, the amount of the contribution deduction must be reduced by the amount of any interest paid by the donor which is attributable to such liability and to any period after the date of the contribution.⁸³ This is done to prevent a double deduction — once for interest and once for a charitable contribution.

Second, a contribution of encumbered property may lead to a realization of income by the donor. Suppose a taxpayer borrows money using appreciated property as security, and then donates the property to a charity (subject to the liability). When the charity satisfies the debt to remove the encumbrance, the donor has a windfall profit: the money he borrowed is now his to keep. In effect this is the same as a sale of the property at a price equal to the amount of the "loan," and a contribution of an amount equal to the difference between the fair market value of the property and the "loan"; and this is how the courts treat such transactions.⁸⁴ Thus a realization in fact is treated as a taxable event.

75. *Ibid.*

76. Reg. § 1.170-2(a) (2) (1956); O.D. 712, 3 C.B. 188 (1920).

77. Reg. § 1.170-2(a) (2) (1956).

78. I.T. 3918, 1948-2 C.B. 33.

79. Reg. § 1.1001(e) (1957).

80. William Waller, 39 T.C. 665 (1963).

81. John M. Coulter, P-H Tax Ct. Mem. 1950-77, 9 TCM 248 (1950).

82. See Magnolia Development Corp., P-H Tax Ct. Mem. 1960-177, 19 TCM 248 (1960).

83. I.R.C. § 170(b) (4) (1954) (added in 1958); Reg. § 1.170-1(c) (2) (1962).

84. Magnolia Development Corp., *supra* note 82.

Realization of income on contribution. In addition to a donation of encumbered appreciated property, discussed above, certain other contributions may result in a realization of income by the donor.

For example, a donation of installment obligations is a disposition within section 453(d), so the donor must realize income to the extent the fair market value exceeds the basis.⁸⁵

Similarly, a partner's contribution of his partnership interest may produce a realizable gain to the partner-donor to the extent the partnership interest includes his share of any unrealized accounts receivable.⁸⁶

The so-called "Pomona Plan"⁸⁷ provides another instance of realization of income on a contribution to charity. At one time a taxpayer could make a gift in trust to a charitable organization, retaining a life interest, with remainder to the charity; the charity agreed to exchange the property for tax-exempt securities. The donor received a charitable deduction for the present value of the remainder, realized no income on any accretion in value of the donated property, and received tax-free income for life. Since December 2, 1960, however, the donor must realize gain to the extent the proceeds of the sale (by the charity) exceed his (the donor's) basis.⁸⁸ In effect the donor is deemed to have exchanged his property for tax-exempt securities, then donated them to the charity subject to his life estate.

Although a disposition of "section 306 stock"⁸⁹ usually produces ordinary income to the taxpayer, a charitable gift of such stock will not cause a realization of income.⁹⁰

Reduction of the amount of the deduction. As mentioned above,⁹¹ the amount of certain prepaid interest must be subtracted from the charitable deduction.

If certain depreciable property⁹² is contributed to a charity, the amount of the allowable deduction must be reduced by the depreciation which would have been "recaptured"⁹³ if the property had been sold instead.⁹⁴

Similarly, if the property was eligible for the investment credit, an early disposition by gift to charity will result in additional tax.⁹⁵

85. Rev. Rul. 55-157, 1955-1 C.B. 293.

86. Rev. Rul. 60-352, 1960-2 C.B. 208.

87. The plan was originally designed to benefit Pomona College (California).

88. Rev. Rul. 60-370, 1960-2 C.B. 203.

89. As defined in I.R.C. § 306(c) (1954).

90. Rev. Rul., 57-328, 1957-2 C.B. 229.

91. See *supra* text at note 83.

92. As defined in I.R.C. § 1245(a)(3) (1954) (added in 1962) and § 1250(c) (1954) (added in 1964).

93. Under I.R.C. § 1245 (1954) (added in 1962) and § 1250 (1954) (added in 1964).

94. I.R.C. § 170(e) (1954) (added in 1962 and amended in 1964).

95. I.R.C. § 47(a) (1954) (added in 1962).

Limitation on amount of the deduction. In general, the amount of the charitable deduction is limited to a specified percentage of the donor's income. However, for certain rare individuals, and for estates and trusts, there is no limitation. But even if the deduction is limited in the year of the contribution, the excess may often be "carried forward" and deducted in a future year.

If the donor is an estate or a trust there is no limitation on the amount of its charitable contribution deduction.⁹⁶ However, these organizations are subject to the rules relating to "unrelated business income" and "prohibited transactions."⁹⁷

The rare individual who habitually spends more than 90 percent of his income on charity plus Federal income taxes, may enjoy an unlimited charitable deduction. More specifically, if the sum of one's charitable contributions plus one's income tax paid exceeds 90 percent of one's taxable income⁹⁸ for the year of the contribution *and* for any eight of the preceding ten taxable years, the taxpayer may elect this unlimited "limitation."

The "carryforward" cannot be used to meet the 90 percent test for any year.⁹⁹ However, for taxable years beginning after 1963, only contributions made to certain publicly supported organizations, or to certain active operating private organizations which do not engage in certain prohibited transactions, will qualify.¹⁰⁰

A corporation's charitable deduction is limited to five percent of its taxable income for the year.¹⁰¹ If there is a contribution in excess of this limitation, it may be deductible in some future year because of a "carryforward" as explained below.

An individual (not entitled to the unlimited deduction mentioned above) is generally limited to a deduction of 20 percent of his "adjusted gross income."¹⁰² However, if his contributions exceed this 20 percent limitation, up to 10 percent more of his adjusted gross income may be deductible if the additional contribution is made to certain designated classes of charities.¹⁰³

96. I.R.C. § 642(c) (1954).

97. I.R.C. § 681(b) and (c) (1954).

98. I.R.C. § 170(b)(1)(C) (1954). For this purpose, "taxable income" as defined in § 63(a) does not include the deduction for charitable contributions itself, the personal exemption (§ 151), or any net operating loss carryback (§ 172).

99. I.R.C. § 170(g) (1954) (added in 1964).

100. I.R.C. § 170(g)(2), (3), and (4) (1954) (added in 1964).

101. I.R.C. § 170(b)(2) (1954). For this purpose, "taxable income" as defined in § 63(a) does not include the deduction for charitable contributions itself, the special corporate deductions for tax-exempt interest or for dividends received (§§ 242-247), any net operating loss carryback (§ 172), and the Western Hemisphere Trade Corporation deduction (§ 922).

102. I.R.C. § 170(b)(1)(B) (1954). For this purpose, "adjusted gross income" as defined in § 62 does not include the deduction for a net operating loss carryback (§ 172).

103. I.R.C. § 170(b)(1)(A) (1954). For this purpose, "adjusted gross income" as defined in § 62 does not include the deduction for a net operating loss carryback (§ 172).

Thus up to 30 percent of adjusted gross income may be deducted by an individual. Prior to 1964, the types of donee organizations which entitled the donor to the additional 10 percent of limitations were churches, schools, hospitals (and associated medical research organizations), and endowment foundations of state colleges or universities.¹⁰⁴ To these, the Revenue Act of 1964¹⁰⁵ has added as preferred donees (for taxable years beginning after 1963): governmental units,¹⁰⁶ and any section 170(c)(2) charity ". . . which normally receives a substantial part of its support . . . from a governmental unit . . . or from direct or indirect contributions from the general public."¹⁰⁷

Note that a contribution must be made "to" one of these organizations; a contribution "for the use of" such organizations will not qualify for the additional 10 percent.¹⁰⁸

Of course failure to qualify for the extra 10 percent in no way disqualifies the deduction for the 20 percent limitation.

Carryforward of excess contributions. A corporation which makes charitable contributions in excess of the 5 percent limitation need not lose the excess contribution as a deduction. Such excess may be "carried over" to each of the following five years (until exhausted) and be deductible in that year.¹⁰⁹ The 5 percent limitation still applies for these future years; thus only if the actual contributions in a given year are less than 5 percent of taxable income can a portion of the excess carried forward be used in that year.¹¹⁰

An individual may similarly carry forward certain excess charitable contributions for five years (until exhausted). However, for individuals, only contributions to organizations which entitle him to the additional 10 percent limitation may be carried forward.¹¹¹ In computing the carryforward, all contributions which do not meet the additional 10 percent test are ignored.¹¹² Thus the amount of the carryforward from any year is the total amount of gifts that qualify for the additional 10 percent, minus 30 percent of adjusted gross income (ignoring any net operating loss carryback).¹¹³ In the year of a carryforward the order of potential deductibility is: first, actual contributions made to organizations which qualify for the additional 10 percent; second, the carryover of prior excess contributions to organizations not qualifying for the additional 10 percent.¹¹⁴ In that year, the 30 percent

104. I.R.C. § 170(b)(1)(A), (i, ii, iii, and iv) (1954).

105. P.L. 88-272, 88th Cong., 2d Sess., § 209 (1964).

106. I.R.C. § 170(b)(1)(A)(v) (1954) (added in 1964).

107. I.R.C. § 170(b)(1)(A)(vi) (1954) (added in 1964).

108. I.R.C. § 170(b)(1)(A) (1954); Reg. § 1.170-2(b) (1963).

109. I.R.C. § 170(b)(2) (1954) (as amended in 1964).

110. *Ibid.*

111. I.R.C. § 170(b)(5)(A) (1954) (added in 1964).

112. S. REP. No. 830, 88th Cong., 2d Sess. 61-62 (1964).

113. I.R.C. § 170(b)(5)(A) (1954) (added in 1964).

114. S. REP. No. 830, 88th Cong., 2d Sess. 62 (1964).

of adjusted gross income limitation applies, but since this 30 percent is allocable as described in the preceding sentence, a carryforward is absorbed before any non-qualifying (*i.e.* for the additional 10 percent) contributions.¹¹⁵ Thus, some or all of the non-qualifying contributions may not be deductible at all.¹¹⁶

To prevent a double tax benefit (because of the possible interaction of the net operating loss carryover provisions and the charitable carryover provisions) the charitable carryover must be reduced to the extent it increases a net operating loss carryover.¹¹⁷

Contribution of a future interest. A contribution of a future interest in tangible personal property will not give rise to a charitable deduction until all intervening interests (or rights of possession or enjoyment) of the donor (or certain of his relatives) have expired.¹¹⁸

Contributions vs. business expenses. Contributions which are in excess of the 5 percent corporate limitation may not be deducted as a business expense.¹¹⁹ However, if the transfer to the charitable organization is made with a reasonable expectation of commensurate return, the amount transferred might be deductible as a business expense.¹²⁰

Potential loss of deduction. If the donee organization loses its exempt status because it engages in a "prohibited transaction," the donor may be denied a charitable contribution.¹²¹

Transfers in trust. A transfer to a trust, which is not itself exempt, may be deductible as a charitable contribution if the beneficiary of the trust is a charitable organization.¹²² It is deductible as a contribution "for the use of" the charity.¹²³ Remember, only the 20 percent limitation applies for such transfers. However, no deduction is permitted if, at the time of transfer, the grantor has a reversionary interest in the income or corpus greater than 5 percent of the value of property in the trust upon which the potential charitable contribution would be computed.¹²⁴ For this purpose "reversionary interest" means any possible reversion in the donor (or his estate) after a possession or enjoyment of income or corpus in the charity; such reversion includes a power of appointment exercisable in favor of the grantor (or his estate) by the grantor or a nonadverse party.¹²⁵

115. *Ibid.*

116. *Ibid.* Other examples of the mechanics of the computation may be found *id.* at 213.

117. I.R.C. § 170(b)(5)(B) (1954) (added in 1964) (for individuals); I.R.C. § 170(b)(3) (1954) (for corporations).

118. I.R.C. § 170(f) (1954) (added in 1964).

119. I.R.C. § 162(b) (1954).

120. Reg. § 170-1(c)(1) (1962).

121. See discussion *supra* text at note 51 ff.

122. Emerson R. Miller, P-H Tax Ct. Mem. 1960-267, 19 TCM 1487 (1960).

123. Rev. Rul. 57-562, 1957-2 C.B. 159. See Muzaffer Er Selcuk, 30 T.C. 962 (1958).

124. I.R.C. § 170(b)(1)(D) (1954); Reg. § 1.170-2(d)(1) (1964).

125. Reg. § 1.170-2(d)(1) (1964).

In addition to a possible contribution deduction, a transfer to a trust may relieve the donor of liability for the income tax on the income of the trust corpus. The so-called "*Clifford* sections" (sections 671-678) determine whether or not the grantor is taxable as the owner of the corpus or income.

While a full discussion of the "*Clifford* sections" is beyond the scope of this paper, mention should be made of one possible disposition thereunder. If the income (or a specific portion thereof) of the trust is irrevocably payable to a designated beneficiary of the type described in section 170(b)(1)(A)(i) (ii) or (iii)¹²⁶ for at least two years, and no other violation of provisions of the "*Clifford* sections" occurs, the donor is not taxable on the income of the trust *res.*¹²⁷ If the charitable beneficiary or beneficiaries would not qualify as just stated, or if the specific designation requirement is not met, then the minimum term of the trust must be 10 years, to avoid taxability of the grantor on the income.¹²⁸

Note that the price of such income tax exemption will be a loss of the charitable contribution deductions, unless the reversionary interest of the donor somehow is less than the 5 percent limit discussed above.

The use of a transfer in trust, with the income payable to a charity, was a device for circumventing the 20 percent or 30 percent limitation on the contribution deduction, since the trust has no charitable contribution limitation. The advent of the five year carryforward of excess contributions in the Revenue Act of 1964 will minimize the use of this trust device, since large contributions will rarely be partly "wasted" now.

Method of deduction. An individual may claim the charitable contributions deduction only if he itemizes his deductions; it cannot be claimed by one who elects the standard deduction.¹²⁹

CONCLUSIONS

Many non-profit organizations would exist even if there were no Federal income tax benefits for that form. However, the exemption from tax and the deductibility of charitable contributions have certainly affected the number of such organizations and their behavior. This brief survey of the tax law as it applies to non-profit organizations can not pretend to completeness. However, it is hoped that it may provide guidance to those entering the field for the first time.

126. Note that this refers to charities which entitled a donor to the additional 10% of limitation even before 1964. The organizations added to the additional 10% list by the Revenue Act of 1964 do not qualify for the two year trust of § 673 (b).

127. I.R.C. § 673(b) (1954) (as amended in 1964); Reg. § 1.673(b)-1 (1962).

128. I.R.C. § 673(a) (1954); Reg. § 1.673(a)-1 (1956).

129. I.R.C. §§ 62, 63(b), 141 (1954).