

Some wealthy families choose to form family charities outside the US because of the stringent IRS rules and disclosure requirements, while some foreign charities fail to qualify for tax-exempt status in the US

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US TAXATION OF DOMESTIC AND FOREIGN FAMILY CHARITIES

Recent news headlines proclaimed that Ingvar Kampard, the founder of Ikea, had surpassed Bill Gates to become the world's richest man. How could a man from Sweden, a country with top income tax rates approaching 60%, become the world's richest man? It helps that Kampard is a Swiss tax resident. Moreover, in 1982, he gave away his Ikea shares to Stichting INGKA, a Dutch charitable foundation. Veckans Affarer, the Swedish business magazine that started the story about Kampard, estimated his wealth at \$53 billion by estimating the value of the foundation's Ikea shares.

The author of the story claims that the foundation makes only minor donations to charitable causes and is mainly an investment vehicle for Mr Kampard. The story estimates Bill Gates' Fortune at \$47 billion, but this does not include the \$27 billion in assets held by the Bill & Melinda Gates Foundation. This approach may be reasonable given the fact that the Bill & Melinda Gates Foundation is subject to stringent Internal Revenue Service (IRS) rules that would not allow the foundation to be used as an investment vehicle for its founders.

Domestic Section 501(c)(3) Private Foundations Exempt from US Income Tax

To obtain tax-exempt status pursuant to section 501(c)(3) of the Internal Revenue Code, a domestic entity must be organised and operated exclusively for charitable purposes and register with the IRS to obtain recognition of its tax-exempt status. A section 501(c)(3) organisation receives the same tax treatment regardless of whether it is formed as a trust or corporation. All section 501(c)(3) entities are classified as either public charities or private foundations.

Most family charities would be classified as private foundations because they

do not receive broad-based community financial support. A private foundation that primarily makes grants to other organisations rather than directly carrying on charitable activities is classified as a non-operating private foundation.

A multinational family might choose to form a domestic section 501(c)(3) private foundation because contributions can be deducted for income, gift and estate tax purposes. However, the ability to use an income tax deduction is limited annually to a percentage of a donor's income that can be as low as 20% in the case of appreciated securities. In some cases, the donor's cost basis in the property limits deductions of gifts of appreciated property. A nonresident can only use a charitable deduction to offset income effectively connected with a US trade or business. As a result, a tax deduction might not benefit a nonresident.

For gift and estate tax purposes, tax residents can deduct contributions to domestic section 501(c)(3) entities. Depending upon the situation, an estate or gift tax deduction may be necessary to fund a charity; otherwise contributions may be taxable at rates approaching 50%.

Different rules apply to determine the deductibility of contributions by nonresidents for gift and estate tax purposes, depending upon whether the charity is a corporation or a trust.

Nonresidents may fully deduct contributions to section 501(c)(3) corporations for gift and estate tax purposes regardless of where in the world the corporation uses the contribution. However, nonresidents may deduct contributions to section 501(c)(3) trusts only if the contribution is made for use inside the US. Gift and estate tax deductions may be of no use to nonresidents because many nonresidents are able to structure their gifts and estates so that they are not subject to US gift and estate tax. Nonresidents are

subject to gift tax only on tangible property in the US. They are subject to US estate tax only on US situs property.

IRS reporting and public disclosures deter some families from forming domestic section 501(c)(3) entities. A domestic section 501(c)(3) private foundation must file an application for recognition of its tax-exempt status with the IRS. It must also file annual private foundation tax returns. The filings disclose the details of the foundation's activities and finances to ensure compliance with the rules governing private foundations. Some states make this information available on-line (e.g. California's site: <http://caag.state.ca.us/charities/>).

The foundation must make its annual returns available for public inspection and publish an advertisement to that effect. Typically, state law requires filings with the state attorney general in the state in which a foundation is formed. Punitive excise taxes on private foundations also deter some families from founding domestic section 501(c)(3) entities:

- section 4941 taxes self-dealing between a foundation and its founders and managers;
- section 4942 taxes the failure to make annual distributions equal to greater than 5% of foundation assets;
- section 4943 taxes excess business holdings, including a 20% or greater interest in any company;
- section 4944 taxes jeopardising investments in an aggressive or concentrated portfolio;
- section 4945 taxes prohibited expenditures, including most grants to individuals, non-public charities, and non-operating foundations.

These taxes can punish a foundation and its founders and managers. The taxes escalate if the foundation does not correct violations upon notification by the IRS. For example, the self-dealing tax imposed on those receiving benefits from a self-dealing transaction escalates from 5 to 200% of the amount involved. In addition, the self-dealing tax would tax the responsible foundation managers on rates that escalate from 2.5% to 50%.

Section 6684 doubles these taxes if the violation is willful and flagrant or the person liable for the tax has previously been subject to a private foundation excise tax. Section 507 strengthens the enforcement of the private foundation excise taxes. It empowers the IRS to terminate a private foundation's status as a tax-exempt entity in the case of repeated or flagrant violations that are willful. Upon termination, the IRS may impose a tax to recapture all the income, estate, and gift tax benefits received by a foundation and its founders.

Section 4948(b) Foreign Charitable Organisations Exempt from US Income Tax

Section 4948(b) foreign charitable organisations create considerable planning opportunities for multinational families. Section 4948(b) confers special status for US tax purposes on any foreign charitable organisation that has received substantially all of its support (other than gross investment income) from sources outside the US. To qualify, Treas. Reg. section 53.4948-1 requires 85% of the support (which does not include capital gains and investment income) of the organisation to come from outside the US.

In applying the 85% rule, "gifts, grants, contributions or membership fees, directly or indirectly from a US person are from sources within the US". Section 7701(a)(30) defines US person as a US citizen or tax resident, including a domestic partnership, corporation, estate or trust. Gifts and contributions include any payment of money or transfer of property without adequate consideration.

Section 4948(b) foreign charitable organisations are exempt from:

- section 507 relating to termination of private foundation status;
- section 508 requiring charities to register with the IRS to obtain tax-exempt status and disallowing deductions for contributions to unregistered charities; and
- sections 4941-4945 codifying the private foundation excise taxes discussed above.



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Section 4948(c), however, allows the IRS to terminate the tax-exempt status of a section 4948(b) organisation if, in the same circumstances, a domestic organisation would be subject to termination under section 507, or penalties would be imposed under section 6684. Thus, a section 4948(b) organisation may lose its tax-exempt status for willful violations of the private foundation excise taxes that are repeated or flagrant. However, loss of tax-exempt status by a section 4948(b) charity does not result in the punitive taxes that apply to domestic private foundations.

The IRS may never even become aware of the existence of an unregistered foreign foundation. An unregistered foreign foundation is not required to file annual returns with the IRS, unless the foundation has US source investment income or significant activity in the US. Significant activity for this purpose does not include investment activity, but includes the operation of a trade or business and political activity. Section 4948(a) imposes a 4% excise tax on the gross investment income of a foreign foundation from US sources. However, investments in the US can be structured to avoid this tax through careful planning. In contrast, domestic private foundations are subject to 2% excise tax on their net investment income from all sources. The 2% excise tax cannot be eliminated through tax planning.

Section 4848(b) provides an excellent opportunity to minimise the effect of burdensome IRS regulation and reporting relating to registered charities. It should be considered for charitably inclined multinational families. If family members are considering becoming US tax residents, it should be discussed during pre-arrival tax planning.

Foreign charitable organisations not exempt from US income tax

The US tax status of a foreign charitable organisation that does not meet the 85% test is unclear unless the organisation registers with the IRS for recognition of its tax-exempt status. In most cases, a family charity that registers with the IRS will

subject itself to the private foundation rules discussed above relating to domestic section 501(c)(3) private foundations.

If a foreign charitable organisation neither registers with the IRS nor meets the 85% test, the organisation should be considered non-exempt for US tax purposes. IRS General Counsel Memorandum 38,840 (April 22, 1982) concludes that a non-exempt foreign charitable organisation should be classified as a nonresident alien individual for US tax purposes. It bases its conclusion on Senate Report 91-552, which provides legislative history regarding section 4948. Section 4948(b) confers tax-exempt status on foreign charitable organisations meeting the 85% test without requiring them to register with the IRS. The Senate Report seems to express that congressional intent to tax non-exempt foreign foundations as nonresident aliens. The General Counsel Memorandum is persuasive rather than binding legislative authority. Because it relies on congressional intent rather than black letter law, it is difficult to predict whether or not the courts would follow it.

Because of this uncertainty, multinational families with activities in the US should be cautious in the use of non-exempt foreign charitable organisations. The US has severe tax and reporting rules to prevent US tax residents from using foreign trusts and corporations to defer taxes. Arguments might be made that these rules do not apply to non-exempt foreign charities, but the law in this area is not well developed. Pursuant to section 508(d)(2), some transfers to exempt foreign charitable organisations are subject to US gift tax at a top rate approaching 50%. The problem is more likely with foreign charitable organisations that are organised as corporations because some foreign charitable trusts may qualify for an exception that would allow a deduction under sections 4947 and 508(d)(2)(A). US tax residents should be extremely cautious about contributions to non-exempt foreign charitable organisations, as should non-residents contributing US situs tangible property. ♦



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