CHARITABLE PLANNING FOR MULTINATIONAL FAMILIES

*The advantages and disadvantages of domestic section 501(c)(3) private foundations and section 4948(b) foreign charitable organisations are outlined by **Kent D Lawson**, together with some pitfalls for foreign charitable organisations that fail to qualify for tax-exempt status in the US*

A family charity can be more than a means of directing a family's charitable activities in a tax-efficient manner. A family charity can bring a family together, create a sense of family tradition, and pass philanthropic values from one generation to the next.

For a multinational family, the US tax rules regarding charitable activity can be complex and the pitfalls severe. In many instances, multinational families with investments or family members in the US choose to form foreign rather than domestic charities.

This article identifies planning opportunities that can be seized with the correct choice of charitable entity. Table 1 on page 16 summarises how various entity types fit within the statutory framework. All statutory references refer to the Internal Revenue Code of 1986, as amended.

Domestic section 501(c)(3) private foundations exempt from US income tax

To obtain tax-exempt status pursuant to section 501(c)(3), 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 are 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.

Tax deductions

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.

> *"Consider foregoing domestic section 501(c)(3) status because the US tax rules constrain the ability of many multinational families to benefit from income and gift tax deductions"*

A non-resident 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 non-resident.

For gift and estate tax purposes, tax residents can deduct contributions to 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 corporations and trusts to determine the deductibility of contributions by non-residents for gift and estate tax purposes.

Non-residents 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, they may deduct contributions to section 501(c)(3) trusts only if the contribution is made for use by the trust inside the US.

Gift and estate tax deductions may be of no use to non-residents because many can structure their gifts and estates so that they are not subject to US gift and estate tax.

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

IRS reporting

Internal Revenue Service (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, and annual private foundation tax returns.

The filings disclose the foundation's activities and finances to ensure compliance with the rules governing private foundations. Some states make this information available online – see California's site at http://caag.state.ca.us/charities/, for example

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.

> *"Consider foregoing domestic section 501(c)(3) status because the US tax rules impose annual government reporting and public disclosure"*

Table 1: Tax treatment of US and foreign charitable organisations

	Domestic section 501(c)(3) private foundations	Section 508(a) registered foreign foundations	Section 4948 foreign charitable organisations	Section 4947 non-exempt foreign charitable trusts	Non-exempt foreign foundation
US tax exempt status	Yes	Yes	Yes	No	No
Section 508 registration with IRS required	Yes	Yes	No	No	No
Subject to sections 4940 to 4945 private foundation tax rates	Yes	Yes	No	Yes	No
Sections 871, 4940 and 4948 tax rates	2%	4%	4%	30%	30%
Section 170 income tax deduction for residents	Yes	No	No	No	No
Section 873 income tax deduction for non-residents	Yes	No	No	No	No
Section 2055 estate tax deduction for citizens & residents	Yes	Yes	Yes	Yes	No
Section 2106(a)(2) estate tax deduction for non-residents	Yes	Yes/No	Yes/No	Yes/No	No
Section 2522(a) gift tax deduction for citizens & residents	Yes	Yes	Yes	Yes	No
Section 2522(b) gift tax deduction for non-residents	Yes	Yes/No	Yes/No	Yes/No	No

Excise taxes

Punitive excise taxes on private foundations 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 or 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 as well as its founders and managers.The taxes escalate if the foundation does not correct violations upon notification by the IRS.

"Consider foregoing domestic section 501(c)(3) status because the US tax rules impose punitive excise taxes on private foundations"

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 wilful 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 wilful. Upon termination, the IRS may impose a tax designed 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 for this special status, Treasury Regulation section 53.4948-1 requires that 85% of the support comes from outside the US. The definition of support does not include capital gains and investment income of the organisation.

For the 85% rule, "gifts, grants, contributions or membership fees membership fees, directly or indirectly from a United States person are from sources within the United States". Section 7701(a)(30) defines United States person to mean a US citizen or tax resident.

It also defines United States person to mean a domestic partnership, corporation, estate or trust.

Gifts and contributions include any payment of money or transfer of property without adequate consideration.

"Consider forming a domestic section 4948 foreign charitable organisation to minimise exposure to the onerous rules applying to a domestic 501(c)(3) organisation"

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.

Section 4948(c) 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.

A section 4948(b) organisation may lose its tax-exempt status for wilful 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. As a practical matter, 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 a 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 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 (22 April 1982) concludes that a non-exempt foreign charitable organisation should be classified as a non-resident alien individual for US tax purposes. The General Counsel Memorandum bases it conclusion on Senate Report 91-552, which provides legislative history regarding section 4948.

As explained above, 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 non-resident aliens. The General Counsel Memorandum is persuasive rather than binding legislative authority. Because it relies on congressional intent rather than the black letter law, it is difficult to predict whether or not the courts would follow it.

This uncertainty means that multinational families with activities in the US should be cautious in using 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 is not well developed.

Pursuant to section 508(d)(2), some transfers to non-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 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 regarding contributions to non-exempt foreign charitable organisations, as should nonresidents contributing US situs tangible property.

Some poorly advised US residents have transferred significant portions of their wealth to foreign charities in taxable transfers. In the event of an audit, they could be bankrupted by the potential tax, penalties, and interest. This pitfall highlights the need for competent cross-border charitable planning.

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