The Universe of Charities

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U.S. Charities and the Tax Reform Act of 1969

English language dictionaries list the word "reform" twice. In the first listing, the definition is "to form again."

The second appearance of the word describes improvement - "changing what is wrong, corrupt, unsatisfactory, etc."

It is left to the reader to determine which definition of the word might apply in the context of the term 'Tax Reform Act of 1969.'

Before 1969

Before 1969, the universe of U.S. charities was fairly simple and quite easy to understand. For example, a charity could elect to be a corporation, a trust, or even a very loosely formed organization. And the rules were few.

Before 1969, there was but one general classification of charities. They were all governed by the same set of laws, rules, regulations and accounting practices. They were all identified by the IRS as tax-exempt organizations.

The Mellons, Rockefellers and Carnegies were giving away millions through their personal charities popularly called "private philanthropic foundations." They were different in name only and were also governed by the same simple tax code.

It was widely rumored that the impetus for the 1969 reforms was fraudulent practices among the foundations owned by wealthy families. But that was certainly not the case. Their charities were administered by their old prestigious law firms who, in most cases, were more meticulous about the tax code than were the churches, hospitals, service clubs and universities of the day.

After 1969 – Two Types of Charities

After 1969, all charities no longer fell under one rubric, a change that has led to endless confusion. Countless misunderstandings are caused by comments of government authorities, some of whom identify a dozen or so types of charities, while others claim to see the distinction of as many as a hundred different types.

The Internal Revenue Code further clouds public perceptions by presenting some 25 different sub paragraphs, all of which are "charities".

But, in the end, the Code establishes only two distinctly different categories, gives each its own name and requires of each a totally different reporting process under Section 501(c)(3).

Private foundations must file an IRS 990-PF (12 pages).

990-PF is an income tax return because private foundations must pay a tax on their net investment earnings.

Public charities (also known as major charities) are required to file either an IRS 990-EZ (2 pages) or IRS 990 (6 pages)
These forms are information returns.

Churches and other religious organizations are not required to file.

So, since 1969, there have been two types of charities. One is definitely inferior to the other because the public (major) charities lobbied successfully and exercised great influence on the new (1969) legislation. At the moment of the passing of the Tax Reform Act, the status of public charities was superior in every way to that of the new, intentionally inferior private foundations.

In theory, public charities invented what would appear to be their own competition for the donors' dollars. In practice, the private foundations became just another class of donor to the favored public charities.

It was as simple as it was devious. In the process of fund raising, doing their good works and redistributing their collected funds, the newly defined private foundations would be required to face onerous demands in the form of extremely complicated laws, rules, regulations and accounting practices.

To this day, the law still favors those who successfully lobbied for its final form. If a private foundation, in spite of its best efforts and intentions, is in technical violation and is found to be out of compliance and unable to comply, the penalty is Draconian. In fact, the foundation has committed a fatal error. It has no choice but to give 100% of its corpus, in the form of a grant, to a qualified public charity.

Granting 100% of its corpus is the act of giving away its entire 'self' - its total net worth, money in banks, assets of every description.

The original text of the Tax Reform Act of 1969 can be found on the Charitable Systems web site at:
http://www.charitablesystems.com/C/C2_HmPg.html

Private Foundations

Estate Planning

If the purpose of the Tax Reform Act of 1969 was to prevent the use of charities by wealthy individuals as an estate planning tool, the act was successful.

The founders of a private foundation lose virtually all control when, as required, a board of directors is appointed. The board, in turn, must comply with rigid mandate expectations that cannot be modified by the founder of the charity should his vision of charity change over the years.

The private foundation is clearly a flawed estate planning tool.

Common Problems

- Some 40,000 new U.S. tax-exempt organizations will be formed this year and will join the community of approximately one million existing charities. All 40,000 will automatically be given private foundation status.

  Of the people forming the new charities, few will have any idea of the odds against their success, or recognize that they are the natural prey of the large, powerful public charities.

- As critical as it is that private foundations follow the prescribed laws, rules, regulations and accounting practices, there is little consensus as to the actual meaning of many of the code sections.

  Lively debate continues as to the meaning and intent of several of the paragraphs of the code. With the stakes so high - the loss of the entire corpus of the charity - it is no wonder that directors of private foundations immediately see the wisdom in distributing their funds by simply making grants to public charities.

- The Internal Revenue Service provides an excellent commentary on the definition (and the very nature) of a private foundation:

  "Every organization that qualifies for tax exemption as an organization described in section 501(c)(3) is a private foundation unless it falls into one of the categories specifically excluded from the definition of that term (referred to in section 509(a))....

  "Even if an organization falls within one of the categories excluded from the definition of private foundation, it will be presumed to be a private foundation, with some exceptions, unless it gives timely notice, it must do so within 15 months from the end of the month in which it was organized.

  "There is an excise tax on the net investment income of most domestic private foundations. This tax must be reported on Form 990-PF, Return of Private Foundations, and must be paid annually at the time of the filing that return or in quarterly estimated tax payments if the total tax for the year is $500 or more.

  "In addition, there are several restrictions and requirements on private foundations, including:

  (1) restrictions on self-dealing between private foundations and their substantial contributors and other disqualified persons.

  (2) requirements that the foundation annually distribute income for charitable purposes.

(3) limits on their holdings in private businesses.

(4) provisions that investments must not jeopardize the carrying out of exempt purposes.

(5) provisions to assure that expenditures further exempt purposes.

"Violations of these provisions give rise to taxes and penalties against the private foundation and, in some cases, its managers, its substantial contributors, and certain related persons....

"A private foundation cannot be tax exempt nor will contributions to it be deductible as charitable contributions unless its governing instrument contains special provisions in addition to those that apply to all organizations described in 501(c)(3)."

Internal Revenue Service
The Digital Daily

- All private foundations are required by law to file a 990-PF income tax return each year, even if there is no taxable income. The reason is that the 990-PF is not just an income tax return.

  990-PF is also an information statement seeking to determine if the private foundation is in compliance with the law. In addition, the form is deceptively difficult to complete, especially if the person filling out the form doesn't understand the linguistic nuances in the questions.

  Few directors of private foundations are sophisticated enough to accurately accomplish the filing. Relatively few attorneys or accountants are sufficiently familiar with the intent of the form to provide the foundation with assurance of compliance 'with both the form and spirit of the law.'

Fund Raising

Private foundations are allowed to develop a number of fund raising programs. They include collection of charitable contributions from the public, developing elaborate portfolios to provide estate planning for donors and involvement in endowment investments. These are passive investment earnings and are not exempt from tax.

Of course there are rules and regulations, including who is disqualified from making a charitable contribution to the private foundation. The specter of being found out of compliance is ever present, even in fund raising.

Most private foundations find that the vast majority of the private foundation's activities are more associated with fund raising than with accomplishment of the stated mission, the thoughtful distribution of funds.

In the process of fund raising, should a private foundation engage in any commercial activity that is effectively connected with trade or business it is required to file a 990-T, Exempt Organization Business Income Tax Return.

990-T calls for the charity to be taxed exactly as if it were a corporation doing business on just the portion of the activity that is associated with the commercial enterprise. This is another form that is very difficult to complete, especially if the managers of the charity have not been aware of the need for substantial bookkeeping during the year. Without good records the deductibility of expenses is minimized which will throw off a greater taxed profit for the private foundation.

An Exception

Although it is true that all private foundations are governed by the same laws, rules, regulations and accounting practices, there is a seldom found distinction within the private foundation category.

The overwhelming majority are simply "granting private foundations." A very few manage to achieve the status of "operational private foundation".

Granting Private Foundations

All expenses are strictly regulated. In addition, managers must justify investments as to their 'appropriateness' and prove mission expenditures to be 'qualified.'

Managers may be held responsible for the failure of their charity and, in some cases, held personally responsible for assessed penalties. Widely perceived as threats, these rules make it easy for managers to decide they can accomplish their mission by making grants to public charities. Thus, private foundations simply become conduits for funding public charities.

In the process of this one-way traffic, grant writing has become a huge business, creating the documents that guide hundreds of millions of dollars from the hundreds of thousands of private foundations to the very few public charities. Some suggest that as much as 90% of the mission dollars of the community of private foundations are actually granted to public charities.

Operational Private Foundations

The Tax Reform Act of 1969 did not prohibit private foundations from conducting themselves as fully operational charities. However, the complexities of the act made it difficult and dangerous. An operational private foundation must be large enough and funded well enough to staff a full time legal team of experts. Its managers must be willing to continually devote a significant amount of the foundation's resources to assure ongoing compliance with the law.

Some large, well-endowed foundations strike a compromise. They elect to be partly operational, but hedge the security of their existence by granting significant sums to public charities. It is extremely rare to find a purely operational private foundation.

Public Charities

The several pages above reveal only the tip of the regulation iceberg for private foundations, while these five paragraphs will suffice to describe the totally different nature and infinitely superior status of public charities.

Although public charities are Internal Revenue Code Section 501(c)(3) tax-exempt organizations, they are NOT required to be in compliance with all of the laws, rules, regulations and accounting practices that have flowed from the Tax Reform Act of 1969.

Very few of those who aspire to form a new charity begin with vast amounts of donated assets. Even fewer are fully aware of and prepared for the inequities of the two-class structure of charities. And, of those who do have the required money and specific knowledge, virtually none are willing to assemble the strong team of tax and legal experts they would need to have in place for a year or two in order to gamble on direct entry into the charity arena at the public charity level.

The coveted public charity status is guarded by a particularly rigorous application process. The odds are virtually insurmountable for any applicants other than large, established, seasoned private foundations seeking reclassification.

The Tax Reform Act of 1969 has been a boon for public charities. Free of Draconian Code 501 (c)(3) governance, the environment is much the same as it was prior to 1969, with the glaring exception that now public charities have a powerful and forced system of funding - the private foundations.

Churches and Religious Organizations

Another odd result of the much heralded 1969 reform was that all public charities would not be created equal. Special freedoms had long since been guaranteed to churches and other religious organizations by the constitutional principle of separation of church and state.

The 1969 law allows religious entities to operate virtually unfettered by any form of government oversight or interference.

Churches, etc., are NOT required to apply for tax-exempt status. They are always awarded the much preferred public charity status.
So long as they are not effectively connected with any trade or business they are NOT required to file any form of tax return.

Churches seeking to avoid even the possibility of being viewed as a sham church apply voluntarily for tax-exempt status. The church will not be refused. It will receive public charity status. Its donors will be eligible for charitable contribution deductions for their tithes, offerings and other support.

Who will form U.S. private charities?

In a 1999 interview on National Public Radio, an IRS Commissioner was asked, "If private charities are so unfair to their founders, so awkward to manage and maintain, how do you explain the thousands of new ones that pop up every year."

The Commissioner answered, "I believe part of it is the fact that most charities are formed by well-meaning people whose minds are already made up. They announce their plans and start the process before they learn the requirements, or understand the restrictions.

"It's late in the first year of their formation by the time they come to us with their problems. They don't understand. They're getting legal and accounting advice from professionals they know, but they're generally people who specialize in areas far afield from the world of charities."

Statistically, U.S. citizens are the most charitable people in the world.

At one time or another nearly every American will contribute to one or more of the one million-plus U.S. charitable organizations representing every imaginable religious, political and sociological point of view.

Meanwhile, those who would choose to battle the odds and form their own U.S. charity must accede to certain immutable conditions. They:

1. must have access to considerable financial means,

2. must appoint a board of directors that, in turn, must continue to comply with the original mandate even though the founders' vision of charity may change over the years,

3. must employ legal and accounting advisors who deal on a regular basis with the unpredictable and erratic enforcement of 501(c)(3) requirements,

4. must find competent, hands-on managers who will stay current and who are not threatened by the chance that they might be held financially liable for certain actions of the charity, and

5. must be willing to risk charity related liabilities of their own.

Defining the Ideal Charity

By 1974, the Tax Reform Act of 1969 had been in effect long enough for thoughtful criticism to have begun surfacing at all levels of the U.S. charitable community.

The Amherst Joint Committee for the Study of Charitable Systems (AJCSCS), financed by several small colleges in the northeast, released the results of a three-year study of the then new law.

In an effort to be even-handed, the report was presented in two sections. Section I was a highly critical "exposure of the inequities and thinly disguised system of discrimination" that define the law.

Section II drew a composite picture of the committee's ideal, with recommendations for a fair and workable system of charities.

AJCSCS presented a comprehensive proposal for a virtual return to the days prior to the Tax Reform Act of 1969. Cited below are a few of the committee's nearly two hundred contributions to the concept of true tax reform:

1. There would be only one class of charity.

2. All charities would be tax exempt and would operate with a minimum of government interference.

3. An individual could create a private charity that would allow him to express his charitable intentions and, simultaneously, provide a safe harbor for his assets from generation to generation.

4. The individuals who formed a charity could opt to be its directors and managers and would not require a special education to do so.

5. So long as the charity was not "effectively connected" with any trade or business in the United States, the charity would need not file any form of tax or information return with the U. S. government.

6. The charity would be an excellent tool for estate planning.

7. Assets of the charity would not be available to satisfy legal liability issues of individual directors not related to the charity.

8. Members, managers and directors could not be held liable for legal, but ill-advised actions of the charity.

9. Directors would be able to change the charity's mission from time to time.

'Ideal Charity' Available Now

Contrary to popular opinion, U.S. citizens are free to form individual charities that include all nine of the above capabilities - and most of the additional recommended criteria in the AJCSCS proposal referred to above.

The concept pre-dates the Tax Reform Act of 1969. It goes back to the 1920's when the term 'independently wealthy' actually meant something. It appealed to robber barons and benevolent financial giants alike. It fit them perfectly.

The concept allowed them to practice their own brands of free-wheeling largess through their 'private philanthropic foundations' and, at the same time, maintain rigid, to-the-penny control of their assets without fear of government oversight or interference.

Those exact conditions and capabilities continue to be available to U.S. citizens in 2003, but not in the United States. From the earliest moment that informed citizens became aware of the dire effects of the Tax Reform Act of 1969, they have simply been taking their charities elsewhere.

It began with simple logic. Tax evasion is a crime. Tax avoidance is a right. If one were to consider forming a corporation in the United States, the most logical choice for legal tax avoidance would be Delaware or Nevada, possibly Wyoming, because the laws in those jurisdictions are the most favorable.

Similarly, given the complex and oppressive laws governing charities in the U.S., this would be the last place on the planet where one would logically form a charity.

Fortunately, U.S. citizens are able to form perfectly legal charities in certain foreign venues. Foreign charities are invited to freely operate within the United States. They can own properties and businesses in the U.S.; they can make investments in any and all financial instruments; they can make equity or debt financing investments.

The U.S. individual who forms a foreign charity enjoys total control of his charitable aspirations while comfortably protecting the assets of the charity from government intervention from one generation to the next.