TAXING CHARITY: LINKING INCOME TAX RETURNS TO SAMPLES OF NONEXEMPT CHARITABLE AND CHARITABLE REMAINDER TRUST RETURNS

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Introduction

The charitable sector strives to improve the economic and social climates in the United States and abroad in numerous ways. Each year, billions of dollars in contributions to charitable entities provide support for such areas as education, the arts, and health and human services, making a notable impact on the quality of life worldwide. Because charitable organizations help to provide many vital services, determining the degree to which they should be taxed in relation to their various sources of income and differing organizational structures is an intricate process. The U.S. government has long faced the unique task of providing incentives to encourage philanthropy, while at the same time ensuring that these incentives are not abused by individuals or charitable organizations. Various charitable organizations collect and disburse income differently, and are in turn taxed in different ways, further complicating the relationship between public service and Federal obligation. Examining the types of charitable organizations that generate taxable income is important to understanding how these entities are formed, operated, and regulated.

This paper examines the Federal income tax liability that is incurred by two specific types of charitable organizations -- nonexempt charitable trusts and charitable remainder trusts. They differ from most other charitable entities in that they are generally controlled and operated by individuals or families and are consequently subject to more stringent tax regulations and, in some cases, must pay income tax. First, the legal and tax issues related to nonexempt charitable and charitable remainder trusts will be examined to better understand the framework in which these entities conduct charitable activities. Next, there is a brief description of the filing requirements for each of these organizations and of the information that they must provide to the Internal Revenue Service (IRS). This is followed by a discussion of the methodology used to link sample data from information returns filed by these two types of trusts with information provided on their income tax returns. By doing this, the Federal income tax liability reported by nonexempt charitable and charitable remainder trusts is identified. Subjects such as taxation of charitable income, sources of income and deductions, and tax burden are also investigated. Finally, there is a discussion of the results and conclusions drawn, as well as some future plans for additional research.

Nonexempt Charitable and Charitable Remainder Trusts: Legal and Tax Issues

In essence, a trust is a three-party arrangement among the creator of a trust, the manager of a trust, and a trust's beneficiary, which may include more than one person or organization. A trust's creator, also known as a grantor or donor, may form a trust during his or her lifetime or upon death. A trust is a legal entity that can incur Federal income tax liability that is separate from that of the grantor. Trusts may be organized in different ways and serve a variety of grantor motives. Funds placed in trust can provide advantages for estate, financial, personal, or business purposes such as decreasing tax burden and controlling disbursements to beneficiaries. Often, the amounts in trust are directed completely or in part to charitable interests, which serve as the trust's beneficiaries. When trusts receive income and distribute that income to charitable interests, a charitable deduction may be employed to reduce trust income tax liability for a given year. While this environment provides a valuable tool for charitable giving, the combination of reduced tax liability and little or no public accountability has necessitated the adoption of stricter tax regulation and oversight for trusts with charitable beneficiaries.

Nonexempt charitable and charitable remainder trusts are two common trust vehicles used to make distributions to the charitable sector. A nonexempt charitable trust is one that designates all of its interests, or beneficiaries, as charitable. With few exceptions, all of its financial outlays are distributed for charitable purposes. Charitable contributions are made annually until all of the trust's assets and income have been expended. A charitable remainder trust is a type of "split-interest trust" -- so-called because its interests are both charitable and noncharitable. Charitable remainder trusts are complex trusts that pay a lifetime interest to noncharitable beneficiaries and a remainder interest to a designated charitable organization [1].

There are two types of charitable remainder trusts -- annuity trusts and unitrusts. Both annuity trusts and unitrusts pay a fixed percentage that is between 5 and 50 percent of the fair market value of trust assets. Payments must be made annually to one or more noncharitable beneficiaries. For annuity trusts, the amount to be paid is based on the fair market value of the assets initially placed in trust, while for unitrusts the payment is based on the net fair market value of assets as valued annually. When a specified triggering event occurs, such as the death of the donor or non-charitable beneficiary, the trust ceases to exist and its remaining assets are transferred to a specific charity. While the precise amount that the charity receives cannot be determined until the expiration of the trust, the Internal Revenue Code states that the amount transferred to the charity must be at least 10 percent of the fair market value of the assets initially placed in the trust. The donor receives a tax deduction when the trust is created based on the estimated amount that will be donated to charity in the future.

Nonexempt charitable and split-interest trusts are distinguished under regulation from certain types of organizations deemed tax-exempt by virtue of their charitable activities under Internal Revenue Code section 501(c)(3). The majority of section 501(c)(3) organizations are defined, for tax purposes, as public charities, meaning that they are largely controlled and supported by a variety of sources within the general public. Another type of 501(c)(3) organization is the private foundation, which resembles a public charity in that its mission is exclusively charitable, but differs in that it is narrowly supported and controlled by an individual, corporation, or family. Since private foundations have less inherent accountability to the general public than charities, they were thought to provide more opportunities for individuals wishing to engage in tax-avoidance schemes and thus required additional oversight. Prior to 1969, however, little legislation had been enacted to deter charitable organizations from engaging in abusive practices.

With the Tax Reform Act of 1969 (TRA69), Congress addressed problems within the charitable sector by developing a new set of rules and definitions for charitable giving. Specifically, the legislation created stricter tax requirements for private foundations to meet in exchange for their tax-exempt status. TRA69 introduced some noteworthy tax legislation, including an annual excise tax on the income that private foundations receive solely from investment assets, known as net investment income, and a requirement to distribute a minimum amount each year or face tax penalty. Section 4947 was added to ensure that private foundations could not intentionally avoid the new requirements by organizing as nonexempt (or taxable) "charitable trusts" and taking advantage of the unlimited charitable deduction made available to charitable trusts in order to avoid all tax liability. Section 4947(a)(1) required that nonexempt charitable trusts be subject to the same rules as those private foundations or, in fewer cases, public charities, described under section 501(c)(3). Additionally, split-interest trusts were defined for the first time in section 4947(a)(2). Although some of these trusts were made subject to the private foundation requirements, those organized as charitable remainder trusts were excluded from section 4947 requirements and granted tax exemption under section 664.

Nonexempt charitable and charitable remainder trusts may be subject to certain income tax requirements. Because not all of the income reported by nonexempt charitable and charitable remainder trusts is collected and distributed for charitable purposes, certain income is reported and taxed each year. Since a nonexempt charitable trust is not, by definition, tax-exempt, any income it receives and does not subsequently distribute for charitable purposes is taxable under Subtitle A, regardless of the source. In contrast, a tax-exempt charitable remainder trust incurs tax liability only on unrelated business income (UBI) -- income received from an activity that constitutes a trade or business that is regularly carried on and is not substantially related to the organization's exempt purpose [2].

Filing Requirements

Each year, nonexempt charitable and charitable remainder trusts must provide information regarding their charitable activities to the IRS on an information return, using Form 990-PF and Form 5227, respectively. While these returns are not used to determine or pay income tax, they must be filed annually to provide financial data, information on charitable contributions, and various other items. Some nonexempt charitable and charitable remainder trusts may be required to file an income tax return, Form 1041, in addition to the required information return.

Form 990-PF

While some charitable trusts receive a large degree of public support and operate much like public charities, most are treated as private foundations and are, therefore, subject to the private foundation filing requirements. Most nonexempt charitable trusts are required to file Form 990-PF, *Return of Private Foundation (or Section 4947(a)(1) Nonexempt Charitable Trust Treated as a Private Foundation).* This information return is used by nonexempt charitable trusts and private foundations to provide information regarding their charitable operations, determine their taxable participation in political or lobbying activities, and calculate the excise tax on net investment income. Additionally, private foundations and charitable trusts report their charitable outlays on this form in order to determine whether or not they have met the annual "payout" requirement. Nonexempt charitable trusts that distribute all of their income for charitable purposes and, therefore, have no taxable income for a given year are required to file this form only [3].

Form 5227

Form 5227, *Split-Interest Trust Information Return*, is filed annually by all split-interest trusts classified under section 4947(a)(2) of the Code. The return is used to report financial activity within a given calendar year and to determine if a trust is treated as a private foundation and, therefore, subject to the excise tax. Three main types of trusts file Form 5227: charitable lead trusts, charitable remainder trusts, and pooled income funds classified in section 642(c)(5). Only those organizations for which an amount was transferred to trust after the enactment of TRA69 are required to file. Charitable remainder trusts are the only type of split-interest trust that is required to indicate if any unrelated business income was earned during the tax year. Trusts indicate having had UBI by answering "Yes" to a question on the return [4].

Form 1041

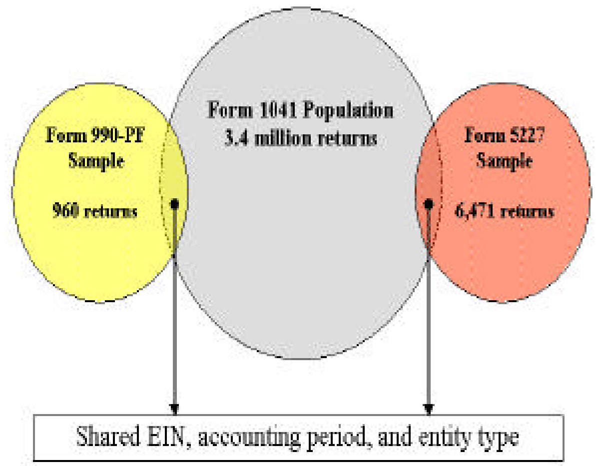
In order to report income and determine tax liability for estates and trusts, their managers, also known as fiduciaries, file Form 1041, *U.S. Income Tax Return for Estates and Trusts* [5]. This form is used to report income and deductions of an estate or trust, including any income that is distributed to beneficiaries, charitable or noncharitable. Income, deductions, and tax liability, as well as any applicable payments or credits are reported on the return. A fiduciary must file Form 1041 for a domestic estate or trust that meets specific income or beneficiary requirements. The form is filed by nonexempt charitable and split-interest trusts and five additional types of entities. Nonexempt charitable trusts with taxable income and charitable remainder trusts with UBI for a given year are required to file this form to report all income and pay any income tax due [6].

Methodology for Return Linkage

Sample data were collected from 1998 Forms 990-PF and 5227 in order to determine the population of filers, verify entity types, and collect certain financial information for those filers. To determine income tax liability for these charitable entities, the data collected in the samples were then linked to 1998 Forms 1041. Figure A provides a visual representation of the linking process.

The data from Forms 990-PF and 5227 that are presented in this paper are based on information from separately collected and weighted samples of pre-audit returns filed with IRS. Returns were selected based on a stratified, random Bernoulli sample. Samples were stratified based on both the size of fair market value of total assets and the type of organization. Nonexempt

Figure A. -- Representation of Forms 990-PF, 1041, and 5227 Linkage



charitable trusts were selected at rates ranging from 1.2 percent to 100.0 percent; charitable remainder trusts were selected at rates from 1.9 percent to 100.0 percent. For 1998, the Form 990-PF sample included 960 returns for nonexempt charitable trusts out of a population of 2,667. Out of a population of 85,060 charitable remainder trusts, 6,471 were selected for the Form 5227 sample [7].

Returns included in the samples were computer-selected from the IRS Business Master File (BMF) based on the employer identification number, or EIN. A transform, defined as a fixed, random number, was associated with each EIN. If the transform fell within the specified range of numbers associated with each sample strata, the return was then selected for the sample [8]. If the return was not selected for the sample, it was counted nonetheless to obtain an accurate population count. To ensure data accuracy and improve statistical reliability, the data drawn from the sample were subject to comprehensive testing and correction procedures. In most cases, changes made to a return based on administrative processing, audit procedures, or taxpayer amendment were not incorporated.

The data from Form 1041 presented in this paper were collected from returns filed for 1998, prior to any audit examination or taxpayer correction. Return data came from the IRS Returns Transaction File (RTF). These data were collected during the course of regular IRS processing for revenue purposes, and, thus, only data necessary for tax administration purposes were collected. Unlike data from Forms 990-PF and 5227, which were collected by SOI based on statistical samples of filed returns, data from Form 1041 were drawn from the entire population of 1998 returns processed by IRS. Tests were run on the Form 1041 data to check for and correct such significant inaccuracies as keying errors and incorrect math calculations. For 1998, approximately 3.4 million Form 1041 returns were filed for trusts and estates.

Nonexempt charitable trusts having accounting periods beginning in 1998, and therefore ending between December 1998 and November 1999, were required by IRS to file a 1998 Form 990-PF and were included in the Form 990-PF sample. All data from Form 5227 were collected from returns filed with accounting periods beginning in January 1998 and ending in December of the same year. In cases where organizations changed their accounting period or filed initial or final returns, part-year returns may have been included.

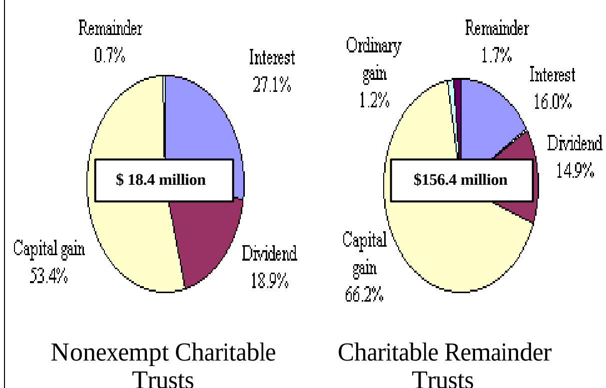
Sample data from Forms 990-PF and 5227 were linked with Form 1041 population data to seek possible matches. For a match to occur, an EIN from the Form 1041 data set had to match exactly to an EIN from the Form 5227 or Form 990-PF data set. In order for a match to be valid, the records for which a match occurred must have covered the same accounting period and reported the same entity type. While approximately 92.6 percent of the Form 1041 returns that were linked to Forms 990-PF and 5227 reported their tax years as the 12-month period of 1998, some returns were for prior years and for noncalendar years ending in 1999. While matches to prior-year returns were disregarded, matches between noncalendar years during 1999 were included in the final data set.

Data items from both Forms 990-PF and 5227 were compared with similar data items from Form 1041 to ensure that all returns had been linked correctly. Despite differences between the information returns and tax returns, many corresponding items were found. Nonexempt charitable trusts report revenue and expenses on Form 990-PF, which differ somewhat from the income and deduction items reported on Form 1041. However, amounts reported for income items such as interest and ordinary dividends closely mirrored data reported on the income tax return. Expenses reported on Form 990-PF were also similar to deductions taken on Form 1041. Charitable remainder trusts are required to report income and deduction items on Form 5227 that are almost identical to those collected on Form 1041. For both nonexempt charitable and charitable remainder trusts, the largest discrepancies between the information and tax returns involved amounts reported for capital gains, which could be attributed to differences in reporting requirements between forms. Because organizations file Form 990-PF and Form 5227 for information purposes, but file Form 1041 to determine their annual Federal income tax liability, values from Form 1041 were used in these analyses when such discrepancies occurred.

Results and Conclusions

As stated, Form 1041 data were linked to the weighted samples of return data based on EIN, entity type, and tax period. The linkage resulted in 176 and 1,437 weighted matches to Forms 990-PF and 5227, respectively [9]. The total net income, or the sum of all income line items, reported on Form 1041 for those organizations matched to nonexempt charitable trust returns (Form 990-PF) was $18.4 million; for matches to charitable reminder trust returns (Form 5227), aggregate net income was $156.4 million. Of the eight types of income specifically reported on Form 1041 -- interest, dividend, business, capital gain, farm, ordinary gain, and other income, as well as income from rents, royalties, partnerships, and other estates and trusts -- capital gain income was the largest income category reported by charitable remainder and nonexempt

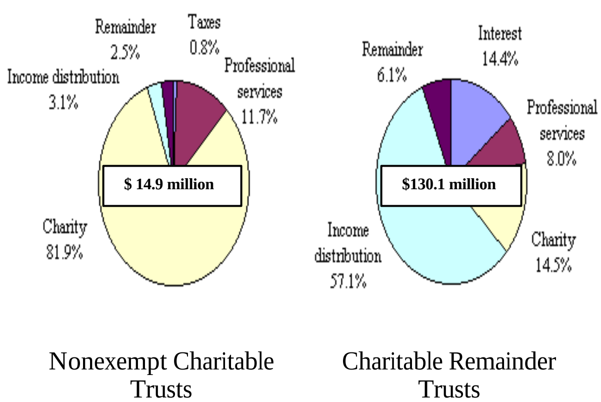
Figure B. -- Form 1041: Sources of Reported Net Income, by Entity Type, Tax Year 1998



charitable trusts that filed Form 1041, as shown in Figure B. Capital gain income reported on Form 1041 accounted for 53.4 percent, or $9.8 million, of the total net income reported by nonexempt charitable trusts, while this income category composed 66.2 percent, or $103.5 million, of the total net income reported by charitable remainder trusts. For both groups of filers, interest and dividend income were the second and third largest components, respectively, of total net income reported on Form 1041.

To a greater degree than reported income, the deductions that were reported by nonexempt charitable and charitable remainder trusts were reflective of each entity's function. Deduction categories included interest, taxes, professional services, disbursements to charity, income distribution, standard exemption, and other miscellaneous deductions. Figure C presents a breakout of deduction percentages. Nonexempt charitable trusts collectively reported $14.9 million in total deductions, which was 81.3 percent of total net income. Charitable contributions were the largest component of total deductions for these filers at 81.9 percent. Charitable remainder trusts collectively reported $130.1 million in total deductions on Form 1041, which was 83.2 percent of reported total net income. For these organizations, the income distribution deduction reported on Form 1041 accounted for the largest share of total deductions, 57.1 percent [10].

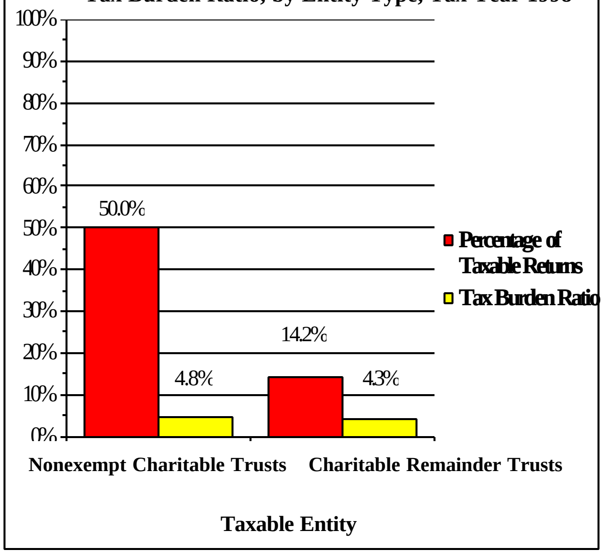
Figure C. -- Form 1041: Sources of Reported Deductions, by Entity Type, Tax Year 1998



Total tax liability, as reported on Form 1041, is based on taxable income (total net income less total deductions) [11]. Figure D shows the percentage of taxable returns and tax burden ratio for both nonexempt charitable and charitable remainder trusts. Half of nonexempt charitable trusts that filed Form 1041 incurred some tax liability, which totaled $0.9 million for these organizations [12]. The tax burden ratio, calculated by dividing total tax liability by total net income reported by these filers, was 4.8 percent. In contrast, for charitable remainder trusts that filed Form 1041, only 14.2 percent, 204 filers, reported any tax liability. Total tax liability for these returns was $6.8 million, 4.3 percent of total net income, roughly the same percentage as the ratio for nonexempt charitable trusts that filed Form 1041.

In conclusion, because trusts that file Forms 990-PF and 5227 are formed and operated differently, the income, deductions, and tax liability that they report on Form 1041 can vary. Although both types of filers included in this research had similar patterns of income, deductions taken were less similar, but were consistent

Figure D. -- Percentage of Taxable Returns and Tax Burden Ratio, by Entity Type, Tax Year 1998



with each entity's mission. In addition, nonexempt charitable trusts filed fewer returns and reported smaller amounts of total net income, deductions, and tax liability than charitable remainder trusts, but incurred tax liability far more frequently. However, both types of entities shared similar calculated tax burden ratios, with total tax liability accounting for less than 5 percent of their total net incomes. Thus, while the types of function-specific deductions taken by each group of filers differed, the employment of these deductions resulted in a minimal tax burden in both cases.

In the future, the authors hope to perform a more in-depth examination of these types of trusts. Issues such as discrepancies between information-return and taxation-return figures will be explored. In addition, discovering under-, over-, or lack of reporting is key to understanding trends in filing and reporting data. Compiling data from several filing years, unlike the use of a single year of data in this research, may help to expand knowledge regarding nonexempt charitable and charitable remainder trusts and their taxable activities.

Notes and References

[1] A complex trust is a trust that performs at least one of the following activities in a tax year: (a) retains some current income; (b) provides amounts to be paid, permanently set aside, or used for charitable purposes; or (c) distributes amounts allocated to the corpus, or principal, of the trust.

[2] For a detailed explanation of nonexempt charitable and split-interest trusts, see *Exempt Organizations Technical Instructions Program*

for FY 2001, (2000), Washington, DC: U.S. Government Printing Office, pp.79-105.

[3] For more information on organizations that file Form 990-PF, see Whitten, Melissa "Domestic Private Foundations and Charitable Trusts, 1996-1997," *Statistics of Income Bulletin*, Fall 2000, Volume 20, Number 2, pp. 150-190.

[4] For more information on organizations that file Form 5227, see Belvedere, Melissa J., "Charitable Remainder Trusts, 1998," *Statistics of Income Bulletin*, Winter 2000-2001, Volume 20, Number 3, pp. 58-76.

[5] Fiduciaries are gatekeepers for estates and trusts who ensure that assets in their custody are managed with due diligence. In addition, assets are distributed by fiduciaries in compliance with trust and estate documents and applicable law. A fiduciary may be other than a person, i.e., a bank.

[6] For more information on organizations that file Form 1041, see Mikow, Jacob M., "Fiduciary Income Tax Returns, 1997," *Statistics of Income Bulletin*, Winter 2000-2001, Volume 20, Number 3, pp.77-99.

[7] Nonexempt charitable trusts were sampled at a rate of 1.2 percent for trusts with assets under $100,000; 10.9 percent for trusts with assets of at least $100,000 but less than $1,000,000; and 100.0 percent for trusts with assets of $1,000,000 or more. Charitable reminder trusts are composed of charitable remainder annuity trusts and charitable remainder unitrusts. Charitable remainder annuity trusts were sampled at a rate of 3.1 percent for trusts with assets under $500,000; 6.9 percent for trusts with assets of at least $500,000 but less than $1,500,000; and 100.0 percent for trusts with assets of $1,500,000 or more. Charitable remainder unitrusts were sampled at a rate of 1.9 percent for trusts with assets under $1,000,000; 4.2 percent for trusts with assets of at least $1,000,000 but less than $3,000,000; and 100.0 percent for trusts with assets of $3,000,000 or more.

[8] For additional information on the transform and sample selection methods, see Harte, J.M. (1986), "Some Mathematical and Statistical Aspects of the Transformed Taxpayer Identification Number: A Sample Selection Tool Used at IRS," *1986 Proceedings of the Section on Survey Research Methods*, American Statistical Association, pp. 603-608.

[9] Linking between Forms 990-PF and 1041 resulted in 75 matches (176 weighted records). Weights for these records ranged from 1 to 9.3. The coefficient of variation for these records equaled 16.7 percent. For Forms 5227 and 1041, linking produced 146 matches (1,437 weighted records). Weights for these records ranged from 1 to 55.2. The coefficient of variation for these records equaled 17.0 percent.

[10] Unlike other deductions, the deduction for income distribution shifts tax liability for the income distributed to receiving beneficiaries (noncharitable). The trust, in this case, is a "pass-through" entity for income tax purposes. Generally, beneficiaries pay income tax on the part of income that is distributed to them, while trusts pay income tax on the portion that is accumulated but not distributed.

[11] Total tax liability was the amount of calculated tax obligation that was incurred by the trust based on taxable income, less tax credits, plus recapture taxes, the alternative minimum tax, and household employment taxes.

[12] "Taxable returns" were those with reported income tax liability.

SOURCE: Statistics of Income Division, Internal Revenue Service, as presented at the 2001 Joint Statistical Meeting of the American Statistical Association, Atlanta, Ga. 2001.